AUDITING AND ASSURANCE SERVICES

STUDY TEXT

C2

Final Level

THE NATIONAL BOARD OF ACCOUNTANTS AND AUDITORS TANZANIA (NBAA)

C2 AUDITING AND ASSURANCE SERVICES

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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

C2 - Auditing and Assurance

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. The examination will consist of two sections.

Section A	One compulsory question (covering a range of syllabus content)	40 marks
Section B	Three questions out of Five	60 marks

SECTION A

LEGAL, REGULATORY AND ETHICAL ISSUES

A1

STUDY GUIDE A1: ETHICAL ISSUES

Get Through Intro

The old expression "say what you mean and mean what you say" applies particularly to accountants today. This is because the code of professional ethics that accountants are expected to abide by is better documented and more stringently enforced than at any time in the past.

As part of their code of conduct, accountants are always expected to apply the fundamental principles of professional ethics namely integrity, objectivity, professional competence, due care, confidentiality and professional behaviour.

For example, Tom Jones is the auditor of a public listed company. While auditing the organisation's financial statements, he realises that the business will realise better than expected results. This will invariably cause the price of the stock to rise. However Tom cannot pass this information on to any other third party at any time until the financial statements are published.

To ensure that auditors abide by these fundamental principles, safeguards and control mechanisms should be implemented. This Study Guide discusses the fundamental principles and the effectiveness of available safeguards. You must understand and remember this Study Guide because as professional accountants you will have to abide by this code of conduct.

Learning Outcomes

a) Assess and advise on technical, professional and ethical issues that may arise during assurance engagements including evaluation and communication with any party to the engagement.
b) Identify and select measures and safeguards to deal with ethical threats in relation to an engagement.
c) Identify and make judgements upon when it may be appropriate to refer a matter to a more senior colleague or for third party advice or consultation.

1. Assess and advise on technical, professional and ethical issues that may arise during assurance engagements including evaluation and communication with any party to the engagement.
Identify and select measures and safeguards to deal with ethical threats in relation to an engagement.

[Learning Outcomes a and b]

1.1 Technical, professional and ethical issues that may arise during assurance engagements

The accounting profession requires moral underpinnings since much of our work is 'regulated' work in the fields of insolvency, company financial statements, acting as a reporting accountant, auditing or related assurance work.

Regulated work, we can argue, requires 'independence' either technically by having no self-interest or pragmatically by having an 'attitude of mind characterised by integrity and objectivity, i.e. being and being seen to be free of influence'.

Without independence there can be no credibility and without credibility there can be no confidence in the information or reports we produce or the work we undertake.

An audit improves the reliability of financial statements i.e. it makes them more credible and increases shareholders' confidence in them. **Hence auditor independence is an important factor in establishing the credibility of the audit opinion.**

Definition

Independence comprises:

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 objectivity and professional scepticism.

b) **Independence in 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 any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional scepticism had been compromised.

IFAC, Glossary of terms

Independence from the audit client is required both during the engagement period and the period covered by the financial statements. The engagement period starts when the audit team begins to perform audit services.

The engagement period ends when the audit report is issued. For a recurring audit, independence ceases when the contract between the two parties is terminated.

Codes of Professional Ethics for accountants (i.e. IESBA Code issued by IFAC) have developed largely as a response to events where individuals or firms have done what is seen as the wrong thing and where changing circumstances have demanded review of the scope and circumstances.

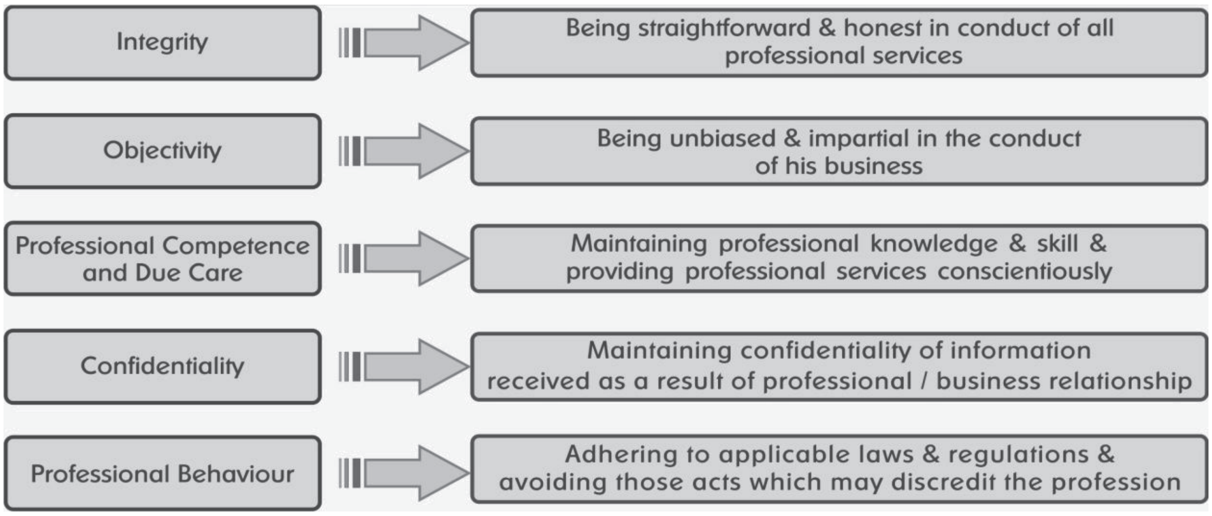
The codes begin with fundamental principles that are to be adhered to by all professional accountants (both in business and in public practice), followed by a conceptual framework of guidance to determine responses.

They are drafted in such a way that does not compromise compliance with the mandatory fundamental principles.

1. Fundamental principles of the professional code of ethics

(a) A professional accountant is required to adhere to the following fundamental principles:

Diagram 1: Fundamental principles of professional code of ethics



(b) Additional Guidance

Exceptions to the rule of confidentiality

Circumstances where members are or may be required to disclose confidential information:

(i) Disclosure is permitted by law and is authorised by the client or the employer

(ii) Disclosure is required by law

For example:

Production of documents or other provision of evidence in the course of legal proceedings; or disclosure to the appropriate public authorities of infringements of the law that come to light

(iii) There is a professional duty or right to disclose, when not prohibited by law:

- ❖ to comply with the quality reviews of NBAA or other professional body;
- ❖ to respond to an inquiry or investigation by NBAA or other regulatory body;
- ❖ to protect the professional interests of a professional accountant in legal proceedings; or
- ❖ to comply with technical standards and ethical requirements.

(c) Matters to be considered before disclosure of confidential information is made

Members should consider:

(i) Whether the interests of any parties, including third parties whose interests may be affected, could be harmed if the client or employer consents to the disclosure of information by members.

(ii) Whether all the relevant information is known and substantiated, to the extent it is practicable.

(iii) When the situation involves unsubstantiated facts, incomplete information or unsubstantiated conclusions, professional judgement should be used in determining the type of disclosure to be made, if any.

(iv) The type of communication that is expected and to whom it is addressed. In particular, the professional accountant should be satisfied that the parties to whom the communication is addressed are appropriate recipients.

A professional accountant can disclose confidential information to regulatory authorities like tax authorities or the police only after satisfying himself about the statutory authority under which the information is required. If the member is not convinced on the matter, he is advised to give confidential information after seeking legal advice on the matter.

Test Yourself 1

Mzawa LLP is an audit firm.

The firm was the auditor of Seka, a company operating seven footwear stores. During the audit of the entity's financial statements, the auditors identified sales invoices valued at TZS2, 000 million, which were not recorded in the books of accounts. This would materially affect the reported revenue and profits. The firm decided not to take any action against their largest, most successful client.

Required:

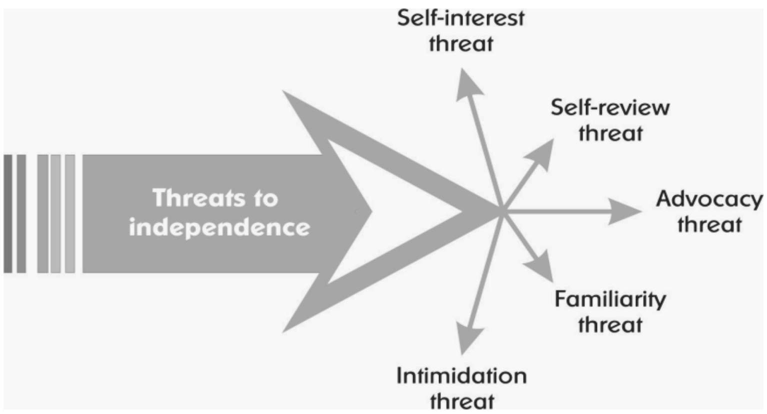
Has the firm acted in accordance with the fundamental principles?

---

2. Threats to independence

By not acting in accordance with the fundamental principles, the professional accountant faces threats to his independence. These threats can be mitigated by applying safeguards. The threats faced by professional accountants and the safeguards to overcome them are discussed below:
The threats faced by professional accountants are as follows:

Diagram 2: Threats to independence



(a) Self-interest threat

This occurs when the accountant may be biased on account of a financial, personal or any other interest in the client.

Self-interest threat caused due to financial, personal and other interest (like probable employment with client, excessive dependence on client fees). These threats can be overcome by avoiding the financial, personal and other interests.

The firm cannot avoid the threat caused due to apprehension of losing the client, as the auditor is practically appointed by the management (although technically appointed by the shareholders). This naturally leads to the danger that the accountant may not be completely independent and objective in his work and may be influenced to deliver a more favourable picture of the organisation's financial performance and position than is justified.

(b) Self-review threat

Self-review refers to a situation whereby an auditor is assigned the task of auditing his own work or the work of a colleague.

Such an assignment would make it difficult for the auditor to maintain objectivity. A self-review threat occurs when an accountant has to review and regulate his previous judgments. The risk that exists here is the temptation for an accountant to "cover up" any mistakes he may have made.

The following are examples of situations where a self-review threat would arise:

(i) The auditor is involved in **reporting on financial systems** which he had previously **designed or implemented**.
(ii) The auditor audits accounts prepared by a member of his assurance team.
(iii) A member of the assurance team has been a director in the client's organisation. (iv) The auditor has ownership of an assurance client's assets.
(v) The auditor assists or supervises employees of the assurance client as they perform their normal activities.
(vi) The auditor of financial statements performs a valuation service and the valuation is incorporated in the financial statements.
(vii) The auditor of financial statements is involved in providing internal audit services for the same client.
(viii) 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).
(ix) The auditor provides corporate financial services, advice or assistance to assurance clients e.g. underwriting or promoting client's shares.

(c) Advocacy threat

This arises when an auditor acts as an advocate for or against a client's position or opinion.

The following are examples of advocacy threats:

(i) 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**.

(ii) The position of the **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.

(d) 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 following are examples of familiarity threats:

(i) An assurance team member has a longstanding business relationship with the client.

(ii) An assurance team member is a close friend of the assurance client / director.

(iii) 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.

(iv) An assurance team member accepts material gifts from the client.

(v) A **former partner / senior employee** of the **audit firm are now a director for the assurance client**.

(vi) An assurance team member is a **relative of a person in a position of power** in the assurance client's organisation.

(e) Intimidation threat

This threat arises from the possibility that the auditor may be threatened by the dominating personality of, or by other pressures from, the client's senior management.

It can also occur if an auditor believes he is being, forced by the assurance client or by another interested party to give an untrue opinion.

The following are examples of intimidation threats:

i. threat of removal of auditor from services, due to disagreement regarding the application of accounting standards.

ii. Threat of reduction in fees if scope of audit is not reduced.

iii. Threat of intimidation by litigation authorities in situations involving litigation between the auditor or audit firm and the assurance client.

iv. The recruitment of senior management of assurance client into the audit team.

v. The appointment of an assurance team member into the client company.

vi. Physical intimidation.

vii. Threat by auditors seeking a second opinion from other audit firms on any matter in which they require clarification.

3. 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:

i. Safeguards created by the profession, legislation or regulation
ii. firm-wide safeguards in the work environment
iii. engagement-specific safeguards in the work environment

Each of these is explained below:

(a) 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.

(b) 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:

i. 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.

ii. assuming a management responsibility when providing internal audit services to an audit client

iii. preparation of accounting records and financial statements

iv. providing valuation services, if the valuation requires a significant level of subjectivity and includes items which are material to financial statements

v. providing corporate finance services involving promoting, dealing in, or underwriting an audit client's shares, providing litigation support

vi. preparing or changing journal entries (without client approval), authorising or approving transactions or preparing source documents

(c) 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

(d) 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).

(e) Instances of firm-wide safeguards in the work environment include:

i. Leadership of the firm establishing the expectation that members of an assurance team will act in public interest

ii. Firms designating a member of its senior management to be responsible for overseeing the adequate functioning of the firm's quality control system

iii. Firms setting up a disciplinary mechanism to promote compliance with policies and procedures

iv. Firms setting policies and procedures that will enable the identification of interests or relationships between the firm or members of engagement teams and clients

v. Firms documenting its internal policies and procedures relating to compliance with the fundamental principles

vi. Firms designing policies and procedures to implement and monitor quality control of engagements

(f) Instances of engagement-specific safeguards in the work environment include:

i. 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
ii. Audit firms discussing ethical issues with those charged with governance of the client
iii. Audit firms disclosing to those charged with governance (of the client) the nature of services provided and extent of fees charged
iv. Auditors involving another firm to perform or re-perform part of the engagement
v. Firms rotating senior assurance team personnel

Tip

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.

(g) Examples of safeguards which need to be in place to reduce the threat to an acceptable level in various situations where assurance firm faces conflict of interest

(i) Valuation services

Where the auditors provide valuation services which are **not significantly relevant to the financial statements**, the audit firm can incorporate the following safeguards:

- 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.
- Having different team members (and partners) for the assurance and valuation services.

(ii) Internal audit services

An audit firm faces a **threat of self-review** if the firm provides internal auditing services.

Where the auditors provide internal audit, the audit firm can incorporate the following safeguards:

i. Obtaining approval of the scope and risk and frequency of the internal audit work from the audit committee, supervisory board or audit client.
ii. Obtaining an acknowledgement from the client that they are responsible for setting up, maintaining and monitoring the company's internal controls.
iii. Designating responsibility for the internal audit activities to a competent team member (preferably from senior management).
iv. Making the client responsible for assessing the adequacy of the internal audit procedures and the firm's
v. Recommendations to improve the existing internal controls.
vi. Reporting internal auditing work to the audit committee or supervisory board.
vii. Having different team members (and partners) for the assurance and internal audit services.

For firms based in the US, the auditor / audit firm is not permitted to provide internal auditing services. This is a provision of the Sarbanes-Oxley Act.

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.

(iii) 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

(iv) 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.

A fee is not regarded as being contingent, if established by a court or other public authority!

Example

Kibo Banks has agreed to underwrite the shares of Rongai 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 are 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
- ❖ 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

(v) 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.

(vi) 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.

(vii) 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

(viii) 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.

(ix) 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.

(x) Corporate Financial 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.

(xi) 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 Mawenzi 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 Mawenzi'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 Mawenzi Developers to offer an opinion after obtaining all the relevant information from the company. She should communicate the matter directly to Martha only if Mawenzi Developers gives her permission.

Safeguards

In the absence of permission to communicate, second auditors should not offer a second opinion.

Audit firms which provide a second opinion must:

- 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.

(xii) 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.

(xiii) 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.

(xiv) 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.

(xv) 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

4. Communication with any party to the engagement

From the above, it is clear that non-adherence to the ethical requirements of IFAC is quite likely to cause material misstatements in the financial statements.

Therefore, regular communication is encouraged between the firm and those charged with governance of the audit client regarding relationships and other matters (discussed above) that might, in the firm's opinion, reasonably bear on independence.

Such communication enables those charged with governance to:

- ❖ Consider the firm's judgments in identifying and evaluating threats to independence,
- ❖ Consider the appropriateness of safeguards applied to eliminate them or reduce them to an acceptable level, and
- ❖ Take appropriate action.

Such an approach can be particularly helpful with respect to intimidation and familiarity threats.

Example

Joseph Daudi is auditing the books of Mkomilo Inc, an organisation that owns a large chain of retail stores. Mkomilo is a very important client for the firm Joseph works. The accountant at Mkomilo who is senior in age and knows Joseph well (as Joseph is auditing Sentron since two years) wants the provision for bad debts to stand at 1%, a figure Joseph is uncomfortable with.

Joseph points out that the provision should stand at 5% because the industry average is 5% and also the provisions for the previous years at Senetron were 5%, therefore he cannot allow the organisation to use the 1% figure.

Joseph is then informed by the accountant, that the organisation could "always find an auditor or firm that would allow it."

Joseph faces an intimidation threat and a familiarity threat as Joseph has audited this entity for the two previous years. Furthermore, the accountant is senior and has also threatened the audit firm.

Joseph discusses the matter with the engagement partner. The partner recalculates the amount of provision for bad debts and confirms the correctness of Joseph's decision.

Furthermore, he immediately communicates this matter to the audit committee of Mawenzi.

The communication points out the intimidation by the accountant and the auditor's workings to support the provision of 5%. This communication convinces the audit committee of the appropriateness of the firm's decision on the matter. The audit committee advises the board to take disciplinary action against the accountant.

Tip

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 threat

Test Yourself 2

Tusonge is an accountancy firm.

(a) Tutonge Plc is a client of the firm. Pauline as not paid the firm for the last 6 months.

(b) Geofrey, the partner of the firm has recently taken a loan from Uchumi Bank in order to buy a car. The terms of the loan were in line with the banking rules. Hawa another partner, has been offered a free world tour by West Bank as a Christmas gift.

Required:

Discuss the professional and ethical issues involved in the above scenario.

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2. Identify and make judgements upon when it may be appropriate to refer a matter to a more senior colleague or for third party advice or consultation.
[Learning Outcome c]

Situations requiring advice	Persons referred to
Partners, staff or client staff moving between the audit firm and its audit client	Partners and any other members of the audit team intending to join a client must inform the firm of their intentions.
Auditor suspecting that management or those charged with governance are involved in non-compliance with laws and regulation	The auditor shall communicate the matter to the next higher level of authority at the entity (e.g. audit committee) Where no higher authority exists, auditor shall consider the need to obtain legal advice
If integrity/honesty of management or those charged with governance is in doubt	The auditor shall seek legal advice
When the auditors become aware of suspected or actual frauds or instances of non-compliance which should be reported to the relevant authority, they should: Report to management Report to those charged with governance Report to regulatory and enforcement authorities where appropriate	If management refuses to correct the misstatement, the auditor should consider taking further action, such as notifying those charged with governance of the entity in writing, or obtaining legal advice.
As part of client and engagement acceptance procedures for services that may involve the holding of client assets, if the assets were derived from illegal activities, such as money laundering, a threat to compliance with the fundamental principles would be created	The professional accountant may seek legal advice.
A professional accountant in business may face pressure (caused due to intimidation threats) to: Act contrary to law or regulation / technical or professional standards Facilitate unethical or illegal earnings management strategies Intentionally mislead (including misleading by remaining silent) others, in particular: the auditors of the employing organization regulators Issue, or otherwise be associated with, a financial or non-financial report that materially misrepresents the facts	The safeguards to mitigate the threats to an acceptable level include: Obtaining advice, where appropriate, from within the employing organization, an independent professional advisor or a relevant professional body. Seeking legal advice.
Circumstances that create a threat to a professional accountant in business performing duties with the appropriate degree of professional competence and due care include having: Insufficient time for properly performing or completing the relevant duties Incomplete, restricted or otherwise inadequate information for performing the duties properly Insufficient experience, training and/or education 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: Obtaining additional advice or training. Obtaining assistance from someone with the necessary expertise. Consulting, where appropriate, with: Superiors within the employing organization; Independent experts; or A relevant professional body.

Continued on the next page

Situations requiring advice	Persons referred to
Offers of inducements may create threats to compliance with the fundamental principles. When a professional accountant in business or an immediate or close family member is offered an inducement, the situation shall be evaluated.	The professional accountant shall determine whether to take one or more of the following actions: Informing higher levels of management or those charged with governance of the employing organization immediately when such offers have been made Informing third parties (like a professional body or the employer of the individual who made the offer) of the offer; after seeking legal advice Advising immediate or close family members of relevant threats and safeguards where they are potentially in positions that might result in offers of inducements, for example, as a result of their employment situation Informing higher levels of management or those charged with governance of the employing organization where immediate or close family members are employed by competitors or potential suppliers of that organization

Test Yourself 3

Dede is the auditor of Transnational Communications (TC), a mobile manufacturing company. During the audit of the company, Dede came across many occurrences of fraud caused due to certain department heads using their corporate credit cards to pay their personal bills. The value of this management impropriety amounted to TZS 85 million, which was material to the financial statements.

Required:

Explain how Dede should tackle this matter.

Answers to Test Yourself

Answer to TY 1

The auditor has been influenced by his client and has ultimately lacked integrity, objectivity and professional competence and due care since, in effect; he has allowed fraud to take place and has failed in his duty as auditor to require amendment or to modify his opinion. Each of the fundamental principles which are violated is explained below:

Integrity

This principle requires members to be “straightforward and honest in all professional and business relationships”. In addition members must 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:

- ❖ are carefully prepared
- ❖ do not contain information which is false or deceptive
- ❖ contain information which is relevant
- ❖ exclude information which is vague i.e. they must not misguide the users

The firm has not acted with integrity as the financial statements include material misstatements, which the auditor is aware of.

Objectivity

A professional accountant should be objective and unbiased. For all professional decisions which are to be taken, accountants must ensure that there is no conflict of interest. Therefore, all their findings and judgments should be based solely upon sound rationale and research. The scenario clearly indicates that the firm is biased as it is the firm’s largest client.

Professional Competence and Due Care

A professional accountant must ensure that he has the necessary professional skill and knowledge to handle the tasks that are assigned to him by his client. He must continuously update himself with the latest developments with respect to knowledge and practices in the profession. The accountant must work meticulously and ensure that the services he provides are in accordance with the professional standards set by the relevant professional body. The firm has not acted with professional competence and due care as they have not provided professional services by acting conscientiously and in accordance with applicable technical and professional standards.

Answer to TY 2

(a) In case of Polly Plc

1. Non-receipt of fees from client will affect the integrity, objectivity and independence of the firm for the following reasons

The firm may not be interested in the work but is forced to carry out the assignment since the fees are overdue. This will affect the auditor's integrity because:

- ❖ The auditor may not carry out the assurance engagement carefully.
- ❖ The information which is provided may be false or deceptive.
- ❖ The auditor may not include information which is relevant.

2. Threats faced

The firm would face the following threats:

Self-interest: this threat occurs because of an apprehension of not getting the fees from the client.
Intimidation: this threat occurs when the auditor wants to give a qualified audit report but the firm is pressured by the client into giving an unqualified opinion so that the overdue fees will be paid by the client.

3. Safeguards

The following safeguards can be applied:

- ❖ Employing the services of another accountant / partner (who is not a part of the assurance team) to review the work which is performed and also give additional guidance.
- ❖ Discussing the issue of the outstanding fees with the audit committee.

The firm shall determine whether the overdue fees might be regarded as being equivalent to a loan to the client. Furthermore, the firm needs to reconsider whether it is suitable to accept reappointment, in view of the overdue fees.

(b) In case of Grant

1. Objectivity

Professional accountants must also uphold objectivity as a principle so that all financial statements give a true and fair view whatever the pressures and circumstances. In order to ensure objectivity a professional accountant who provides assurance services must not accept or offer gifts or hospitality which will affect professional judgement.

For the loan taken by Grant, the loan is taken at the normal lending rates given to all customers of the bank. Hence by accepting such a loan the firm will not lose its objectivity. Therefore it does not face a threat to its independence.

2. Threats

However, the Christmas gift given by the bank to Hugh would affect the objectivity of the firm since Hugh may be tempted to give an unbiased report. This will give rise to the following threats to the firm:

Self-interest: this threat occurs when the auditor feels that the audit report which is to be certified must not be qualified so that the client is kept happy.
Familiarity threat: this threat occurs when the auditor becomes well-acquainted with the client due to which the auditor will not want to give a qualified opinion.

3. Safeguards

Whenever a firm accepts a gift which is significant, there are no safeguards which can mitigate the threats. Hence the firm must not accept the gift.

Answer to TY 3

Firstly, Mzawa's work should be reviewed by the audit senior and if Mzawa's observation is correct, the matter should be discussed with the engagement partner.

Then this matter should be reported to the management of TC. If management refuses to correct the misstatement, the auditor should consider taking further action, such as notifying those charged with governance of the entity (or audit committee) in writing or obtaining legal advice. Furthermore, based on legal advice, the matter should be reported to the regulatory authorities like the NBAA (The National board of accountants and auditors).

Quick Quiz

1. Fill in the blanks.

(a) The IFAC Code of Ethics focuses on serving the _________________. (b) A principles-based approach is

also known as a__________________.

(c) According to the principle of objectivity, a professional accountant should be _______ and ________.

(d) The threat of _____________ arises if an auditor believes that he is being forced by the clients or another relevant party to give an untrue opinion.

(e) Fees which depend upon the outcome of the auditing work are called ________________.

(f) ________________ can occur when an entity seeks a second opinion from a professional accountant.

2. Answer in brief.

(a) Confidentiality specifies that the accountant must continuously update himself with developments regarding professional knowledge and practices. Is this true or false?

(b) The self-review threat can arise when the fees received from a particular client form an important part of his overall earnings. Is this true or false?

(c) While conducting internal audit work, an audit firm can face the threat of self-review. Is this true or false?

(d) The firm should assign the same team members to each audit as a safeguard when it has competitors as clients. Is this true or false?

(e) Discuss the safeguards that can be taken into consideration by an audit firm while providing legal services. (f)

In the case of changes in a professional appointment, what are the issues that should be taken into account by an accountant?

Answers to Quick Quiz

1.

(a) Public interest
(b) Conceptual framework approach
(c) Unbiased, impartial
(d) Intimidation
(e) Contingent fees
(f) Conflicts of interest

2.

(a) False, professional competence and due care specifies that the accountant must continuously update himself with developments regarding professional knowledge and practices.

(b) False, the threat that arises when the fees received from a particular client forms an important part of the auditor's overall earnings, is a self-interest threat.

(c) True, because the auditor may review his own work while carrying out external audit.

(d) False, because when a firm has competitors as clients the risk of not adhering to the fundamental principle of confidentiality occurs. Hence the firm should assign different team members to each audit.

(e) The safeguards to be considered while providing legal services are as follows:

The members of the assurance team should be different from the members of the legal service team.
A firm's employee or partner must not be appointed as the counsel for legal affairs.
The decision on legal services should be made by management.
The audit committee of the assurance client must be informed about the legal services provided by the firm.

(f) The accountant is required to:

identify the reasons for the earlier accountant being replaced
know 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

Self-Examination Question

Question 1

You are an audit manager of Makini a firm of Chartered Certified Accountants. You are assigning staff to the final audit of Namanga Bites, a company listed on a stock exchange, for the year to 31 December 20X2. The following professional and ethical issues have come to light:

(a) Bertha, the assistant manager who was a team member of the interim audit of Namanga Bites, has since inherited 15,000 TZS 1,000 shares in Namanga Bites. Recently, the shares took a beating at the stock exchange and are now quoting at TZS 5,200. Bertha has told you that she has no intention of selling the shares until the share price recovers from the fall to TZS 7,200.

(b) You have just received an email from Jackson, the finance director of Namanga Bites, informing you Elisamia, an audit senior carrying out the interim audit of Namanga Bites, has been short-listed for the position of finance director with Namanga Bites. This piece of information came as a surprise to you, as you were not aware that Makini had applied for the position.

Required:

Comment on the ethical and other professional issues raised by the above matters and their implications, if any, for staffing the final audit of Namanga bites for the year to 31 December 20X2.

Question 2

Fimbo and Co. Certified Accountants, recently held a staff training session on quality control. The session concluded with staff being invited to raise matters from their experience relating to the ethical rules on independence. Some of these matters are given below:

(i) Shortly before commencing the final audit of a large listed company, a junior staff member on the audit team inherited a substantial number of shares in that company. No action was taken because, although representing a large investment for the staff member concerned, the number of shares was totally immaterial with respect to the company. Moreover the partner knew that, when the company's results were announced, the share price would rise and he did not think it was fair to require the staff member to sell them now.

(ii) The Management accountant of another listed company client had an accident and was away from work for three months. At the time of accident the audit senior was winding up the prior year's audit and, because of his familiarity with the company's management system, it was agreed that he would take over as management accountant for the three months.

(iii) In its management letter to another audit client, Fimbo and Co. warned the company that their computer system lacked essential controls. The company decided to install a totally new computer system and Fimbo and Co.'s management consultancy department was appointed to design the new system.

(iv) Fimbo and Co. was recently approached, by a large company that was not, then an audit client, for a second opinion the company was in dispute with its existing auditors who were proposing to issue a modified auditor's report because of disagreement over inventory valuation. Fimbo and Co's technical partner reviewed the evidence provided by the company and advised the company that its accounting treatment was in order. Shortly afterwards, Fimbo and Co. was invited to accept nomination as new auditors. The reply to the letter of enquiry to the existing auditors made it clear that the company inventory valuation dispute was not as straight forward as the company had made it out to be.

Required:

Discuss the possibility that Fimbo and Co. had impaired their independence or otherwise acted unprofessionally in each of the situations (i) to (iv) described above.

Answer to Self-Examination Question

Answer to SEQ 1

Bertha has inherited shares in the client's business.

Bertha has reported the inheritance to Namanga Bites. This indicates that Namanga Bites has a policy which includes reporting any financial interest of audit staff (in the assurance client) to the firm. This is a good sign.

Furthermore, Bertha has no intention of selling the shares until their value in the capital market recovers from the fall TZS 7,200. It is quite improbable that Namanga Bites will offer her the difference of 5,000 x TZS7,200 – TZS5,200) = TZS15 million.

This means that Bertha has a financial interest in the business. This will affect her **integrity, objectivity and independence** because while carrying out the audit work:

- ❖ If there are irregularities noticed which need to be reported (and which will affect the share prices) she may be biased and not report the facts
- ❖ Even if no irregularities are noticed, the audit committee or the supervisory board of Quick Bites may not be convinced of the reliability of the findings, i.e. even if Bertha acts with integrity and objectivity, it may not appear this way to the audit committee or the supervisory board of Namanga bites

Threats faced

1. Self-interest

Bertha has inherited shares in Quick bites. This is a direct financial interest since she controls the shares. The scenario states that Bertha has an interest in selling the shares inherited only if they recover from the fall in value to Tshs 5,200. This means that Bertha stands to benefit from not reporting any irregularities which she observes while undertaking the audit work and which would affect the price of the shares in the capital market. Therefore, the threat of self-interest exists.

Safeguards

In view of the threat to its independence, Namanga Bites is advised to ensure that the following safeguards are in place so that the threat can be mitigated:

Namanga Bites should instruct Bertha to sell the shares as soon as possible. However, Bertha has expressed her intention to dispose of the shares only after the value recovers in the capital market. Hence, it is unlikely that Bertha will sell the shares as suggested by Namanga Bites.

If any audit work has been undertaken by Bertha (after inheriting the shares), then the work must be carefully reviewed by another professional accountant.
Bertha must not be included in the audit team, as recommended by the IFAC Code of Ethics.
However, as a stricter safeguardNamanga Bites' Code of Ethics could prohibit staff from holding a financial interest in an assurance client. This would mean that Bertha would have to either sell off her inherited shares or resign from the services of Namanga Bites. Namanga must keep its audit committee informed about the matter relating to Bertha.

Conclusion

In view of the threat to independence, if Bertha does not dispose of the shares immediately, she must be removed from the audit team.

(a)

The impending appointment of Makini at Namanga Bites indicates non-adherence to the fundamental principle of integrity by both Makini and Jackson on account of the following reasons:

Makini not informed B F Slater about his application for the post of finance director at Namanga Bites. By not informing B F Slater, he has **not acted with integrity** because he is the auditor of the same company where he has applied for the position of finance director.

Threats faced

Makini is simultaneously acting as an audit senior and as a prospective employee of Namanga Bites. This indicates the **threat of self-interest in Namanga Bites**. The reason for this is that Makini may be tempted to act in such a way that the management of Namanga Bites will be happy with him and therefore more likely to employ him.

For example, if irregularities are noticed in the course of the audit, Makinimay not report the matter so that the management of Namanga Bites is happy with him.

Safeguards

There exists no safeguard to mitigate the risk. Hence Makini should be removed from the audit team.
The audit work and the working papers used in auditing / supervising the audit work undertaken by Makini todate need to be carefully reviewed by another professional accountant. This must be undertaken to ensure that Makini has adhered to all the fundamental principles while discharging his function as an audit senior.

The planning work, if any, undertaken by Makini for the final audit of Namanga Bites needs to be reviewed carefully by B F Slater, and another employee of Slater should be taken in the team.

According to the IFAC guidance, a partner or an employee of an assurance firm can join a key management position in an assurance client only after a period of two years since the conclusion of the audit in which he was employed**.** Mac Enroe must be aware of this matter and act accordingly.

Answer to SEQ 2

(i) Shareholding by staff member

While partners are not allowed to hold shares in client companies there is no specific prohibition in the Professional Conduct on the holding of shares in audit clients by audit staff provide the staff members concerned are not personally involved in the audit of such clients. However some audit firms have adopted a prohibition on the holding of shares in audit clients by audit staff as an in house rule.

The argument that independence is not impaired because the holding is insignificant. If the holding is of such a size as is likely to influence the behavior of the audit staff member then it is material. If the staff member was allowed to retain the shares then he or she should not have been included in the audit team.

If the partner advised the staff member not to sell the shares until after the audit was completed then this would have been unethical and possibly illegal in that it constitutes insider dealing the use of privileged information to secure a personal advantage in the trading of shares.

(ii) Management accounting services

Preparation of accounting records on behalf of a listed or public company is prohibited.

An exception to this Rule allows such work to be performed in an emergency situation which does not extend beyond the minimum period necessary and where every care was taken that management accepted full responsibility for the work of the audit firm's staff members.

It is more reasonable, however to argue that assignment of a staff member to the position of management accountant is likely to breach the rules on independence. It amounts to staff member of the firm being engaged in making management decisions of behalf of the client. The firm will thus be reporting on a statement of financial performance in which one of its own employees had played an active part. A user of the financial statements might conclude that the audit firm might have an incentive to conspire with management in concealing poor performance attributable in part, to the actions of its own staff member.

(iii) Advice on controls

This raises a controversial area in auditor independence. While the reporting of control weaknesses discovered during the audit is a required procedure, advising on the development of new systems to overcome that weakness is seen by some critics as a possible threat to independence.

There is both general and a specific issue. The general issues are that audit firms generate revenues from clients for both audit and non-audit work. However contracts for non-audit work are given by management in performing the audit, the auditors may be reluctant to disagree with management for fear of losing non-audit contracts.

The specific issue is that known as self-review. Since the firm designed the new internal control system, there is a presumption, when evaluating control effectiveness at the next audit, that there will be no weakness in the system.

Rules of Professional Conduct in Tanzania do not prevent auditors from providing non-audit services within the overall fee limit of 30% per NBAA Code of Ethics Bylaws of 2013 (Note IFAC Code is 15%) from any one client. However, they do stress that, in advising the client the audit firm must not make executive decisions. The implementation of advice is the responsibility of management over which the auditor has no control. At the next audit the auditor must check that the system has been properly put into operation and that it is being operated effectively.

(iv) Advice to no-audit clients

Although Fimbo and Co. are not threatening their own independence their action is in breach of professional rules on second opinions.

By offering advice they are prejudicing the independence of the auditors of the company they are advising. This practice is sometimes referred to as opinion shopping and is carried out by companies in order to exert pressure on their existing auditors. When invited to provide such advice, professional rules require Fimbo and Co. to communicate directly with the company's auditors to ensure that their advice is based on all available facts relevant to the judgment.

Fimbo and Co. are under an ethical responsibility to decline to be nominated as auditors and to write to the company retracting the advice previously given in the light to further information.

SECTION A

LEGAL, REGULATORY AND ETHICAL ISSUES

A2

STUDY GUIDE A2: REGULATORY ISSUES

Get Through Intro

The objective of an assurance engagement is to provide reasonable assurance on whether the financial statements which are audited are free from material misstatements and to express an opinion on whether the financial statements are prepared in accordance with the applicable financial reporting framework.

In the process of meeting these objectives, the auditor is required to comply with the code of ethics and perform the audit in accordance with auditing standards. However, the auditor is required to abide by the national laws, auditing standards, code of ethics, etc. which may be different from the international standards of auditing and code of ethics. In addition, the auditor also has to comply with international laws and regulations.

As an accountant, you will probably be involved in an audit at some point in your career. Either you will have your work checked by an auditor or be on the "other side of the fence" and be auditing the work of others. Therefore, it is important that you understand the various national as well as international approaches to various facets of audit.

This Study Guide discusses the standard setting process, the interaction between national laws and regulations and the requirements of an assurance engagement as well as the various approaches to audit like the Sarbanes-Oxley Act, The Turnbull guidelines etc.

Learning Outcomes

a) Explain, evaluate and communicate the process and issues in the standard setting process at national and international level.
b) Evaluate and communicate the interaction between national laws and regulations and the requirements of an assurance engagement.
c) Evaluate and communicate the differences between different jurisdictions and how the deal with audit issues including national approaches, international approaches and approaches such as the US Sarbanes-Oxley and related requirements for audit.

1. Explain, evaluate and communicate the process and issues in the standard setting process at national and international level.
Evaluate and communicate the interaction between national laws and regulations and the requirements of an assurance engagement.
[Learning Outcomes a and b]

1.1 Development and status of International Standards on Auditing

The accounting profession believes in and practices both self-regulation and self-promotion. The profession established and maintains the **International Federation of Accountants ("IFAC")**. IFAC is a global organisation comprising of 173 members and associates (mostly national professional institutes) spread across129 countries. Membership stands at more than 2.5 million accountants from public practice, industry and commerce, the public sector as well as educational backgrounds.

IFAC describes its mission or aim as being "to serve the public interest, strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards and speaking out on public issues where the profession's expertise is most relevant."

One of IFAC's main activities is publishing a uniform set of auditing standards to serve as a benchmark for professional accountants around the world when they are conducting their audits. IFAC heavily promotes these standards as it believes that their adoption will lead to a uniform quality of auditing across the globe.

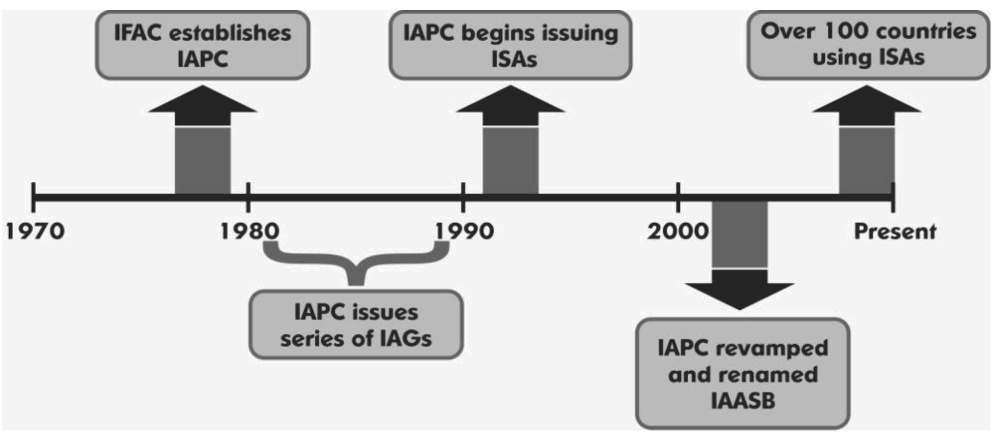
This push for a "globally harmonised framework" began in the late 1970s when IFAC created an International Auditing Practices Committee ("IAPC") **to develop this uniform set of auditing standards. Throughout the 1980s and 1991 IAPC issued a series of** International Auditing Guidelines ("IAG") **which were the predecessors to** International Standards on Auditing ("ISA").

Since 1991 the IAPC has been issuing ISAs that are basic principles and procedures regarding auditing, coupled with guidance on how they should be applied. ISAs are developed because "national standards on auditing and related services published in many countries differ in form and content. The International Auditing Practices Committee (IAPC) takes note of such documents and differences and, in the light of such knowledge, issues ISAs, which are intended for international acceptance."

In 2002 after a task force review the IAPC was renamed the International Auditing and Assurance Standards Board (IAASB). **Other incorporated changes were to make the work and procedures of the board more transparent and to widen its membership to include non-auditors.**

According to Preface to the international standards on quality control, auditing, review, other assurance and related services, the ISAs are not intended to override or supersede local laws and regulations. However they are heavily promoted with the aim that they will lead to audits being conducted in accordance with international standards on a global scale. **Today over 70 countries have either adopted or are in the process of adopting / incorporating ISAs into their national auditing framework.**

Diagram 1: The development and status of International Standards on Auditing



The objective of IAASB is to develop a set of standards that is accepted worldwide. The pronouncements made by IAASB are related to audit, other assurance and related services that are conducted according to these standards.

The practices of auditing financial or any other type of information in a particular country are governed by the local laws and regulations of that country. These regulations are in the form of:

Statutory laws e.g. the Companies Act 2002.
Statements issued by the regulatory / professional bodies in that particular country e.g. In UK, ISAs are issued by the Auditing Practice Board (APB), in Tanzania auditing standards are issued by The NBAA.

The ISAs contain basic principles and essential procedures together with related guidance in the form of explanatory material and appendices. It is necessary to consider and understand the entire text of an ISA to understand and apply the basic principles and essential procedures.

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

Authority of ISAs and other pronouncements

Standard	Applicable for
International Standards on Auditing (ISAs)	An audit of historical financial information
International Standards on Review Engagement (ISREs)	Applied in the review of historical financial information
International Standards on Assurance Engagements (ISAEs)	Applied in assurance engagements dealing with subject matters other than historical financial information.
International Standards on Related Services (ISRSs)	Applied to compilation engagements, engagements to apply agreed upon procedures to information and other related services engagement as specified by the IAASB.
International Standards on Quality Control (ISQCs)	Applied for all services falling under the ISAS, ISAES and ISRSs.
International Auditing Practice Statements (IAPSs)	Provide interpretive guidance and practical assistance to accountants for implementing ISAS and to promote good practices.

1.2 Standard setting process at national and international level

The IAASB describes its goal as being “to serve the public interest by setting high quality auditing, assurance, quality control and related services standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.”

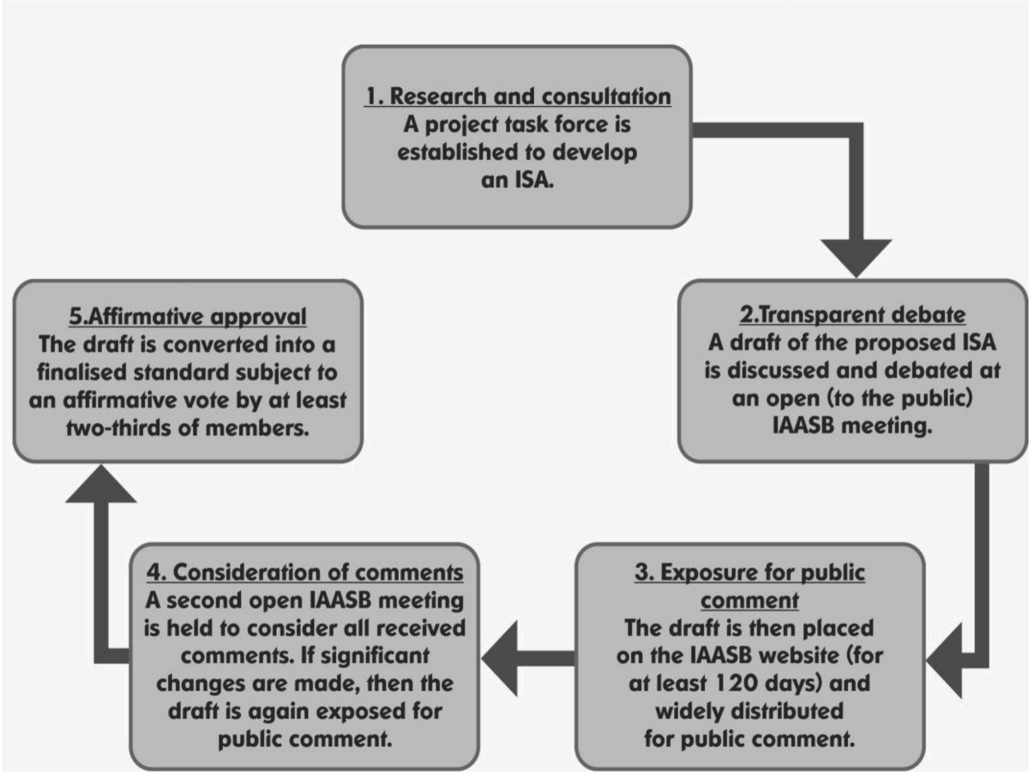
As mentioned earlier, the ISAs issued by the IAASB are not meant to override or supersede local auditing regulations. The reason for their wide adoption is because the IAASB has worked closely with many national standard setters.

By following the process shown in the diagram below the IAASB has managed to:

- ❖ cooperate with national standard setters,
- ❖ help minimise duplication of efforts and
- ❖ gain support and acceptance of their standards during the early stages of their development

In addition, the IAASB also hosts an annual meeting with various national auditing standard setters to discuss and debate proposed ISAs and drafts. In this way the board can reach a consensus with local standard setters at an early stage of development for the ISAs.

Diagram 2: Development process for an International Standard on Auditing



Test Yourself 1

Do International Standards on Auditing override local standards?

The National Board of Accountants and Auditors (NBAA) has a legal mandate to set accounting and auditing standards in Tanzania.

Effective from 1 July, 2004, the National Board of Accountants and Auditors (NBAA) has wholly adopted the following standards:

International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB)
International Accounting Standards (IASs) and International Standards of Auditing (ISAs) issued by the International Federation of Accountants (IFAC)

In view of the above, the standard setting process at the national level is not relevant.

1.3 Interaction between national laws and regulations and the requirements of an assurance engagement

From the above discussion, it is clear that auditing practices are guided by the ISAs. However, local laws and regulations supersede the requirements of ISAs. Each country generally publishes its own national standards on auditing and related services, which may vary in form and content. The ISAs are meant to be used in various countries.

Therefore, while issuing ISAs, the IAASB tries to ensure that the ISAs take into account as many national issues as possible.

2. Evaluate and communicate the differences between different jurisdictions and how the deal with audit issues including national approaches, international approaches and approaches such as the US Sarbanes-Oxley and related requirements for audit.

[Learning Outcome c]

The failures of big **entities** such as **Enron** have **highlighted** the **need for a regulatory framework**. As a backlash against the multitude of recent high profile financial scandals such as that of Enron, where the auditor, Arthur Andersen was also found guilty for destroying the important papers and for gross negligence, regulation of audit and related services is now being demanded by the stakeholders of organisations such as shareholders, investors, account payables and even the society at large.

The **regulatory environment in which auditors function require auditors to:**

- ❖ Comply with accounting standards (national as well as international)
- ❖ Comply with auditing and quality standards (national as well as international)
- ❖ Comply with the code of ethics of the professional body of which the auditor is a member

Let us look at how each of the above is tackled in different jurisdictions.

2.1 Accounting standards

Accounting standards are the basic guidelines on which an entity prepares its financial statements. Different sets of accounting standards are followed by different economies throughout the globe; however, the basic objective of all these sets of standards is to derive high quality financial statements that provide its varied stakeholders with required information that is essential for proper economic decisions. But due to differences between national accounting standards, the same financial transaction may be accounted for in different ways in different countries.

The above scenario continued till many years, but now, due to globalisation, all the economies are under pressure to harmonise financial reporting standards and move towards a single set of global accounting standards. The pressures are felt on account of the need to reduce inconsistencies, promote comparability, reduce compliance cost and minimise barriers for global trade and cross border investments.

International Financial Reporting Standards (IFRS) has evolved as a solution to this harmonisation problem, and countries throughout the globe have adopted IFRS, or converged their national accounting standards to IFRS, or are in the process of adopting or converging.

There are more than eighty countries which made it mandatory for some or all of the domestic companies to use IFRS for the preparation of financial statements. There are various other countries which had not made it mandatory but still permit the use of IFRS for domestic companies. Apart from these countries, there are other important countries which do not intend to scrap their national standards, and are working towards convergence i.e. amending their national accounting standards so that they are brought in line with IFRS.

IFRS adoption in major economies (landmarks in the process of international harmonisation)

1. The European Union

On 19 July 2002, a regulation was passed by the European Parliament. This was the first major landmark in the process of harmonisation as a result of this Regulation, and all EU listed companies were required to prepare their financial statements following IFRS from 2005.

2. The United States

The United States, which is the most influential world economy, is yet to adopt IFRS. However, as a result of the Norwalk agreement, it is working with the IASB to develop high quality standards and thus, even the US is set to converge to IFRS in the coming years. The Norwalk Agreement refers to a Memorandum of Understanding signed in October 2002 between the Financial Accounting Standards Board, the US accounting standard setting body, and the International Accounting Standards Board (IASB). This move initiated in October 2002 a significant step towards the convergence of US GAAP and International Financial Reporting Standards.

3. **The table below provides the IFRS adoption\convergence status for various countries as on April 2010.**

Country	Status for listed companies as of December 2011
Argentina	Required for fiscal years beginning on or after 1 January 2012
Australia	Required for all private sector reporting entities and as the basis for public sector reporting since 2005
Brazil	Required for consolidated financial statements of banks and listed companies from 31 December 2010 and for individual company accounts progressively since January 2008
Canada	Required from 1 January 2011 for all listed entities and permitted for private sector entities including not-for-profit organisations
China	Substantially converged national standards
European Union	All member states of the EU are required to use IFRSs as adopted by the EU for listed companies since 2005
France	Required via EU adoption and implementation process since 2005
Germany	Required via EU adoption and implementation process since 2005
India	India is converging with IFRSs at a date to be confirmed.
Indonesia	Convergence process ongoing; a decision about a target date for full compliance with IFRSs is expected to be made in 2012
Italy	Required via EU adoption and implementation process since 2005
Japan	Permitted from 2010 for a number of international companies; decision about mandatory adoption by 2016 expected around 2012
Mexico	Required from 2012
Republic of Korea	Required from 2011
Russia	Required from 2012
Saudi Arabia	Required for banking and insurance companies; full convergence with IFRS currently under consideration
South Africa	Required for listed entities since 2005
Turkey	Required for listed entities since 2005
United Kingdom	Required via EU adoption and implementation process since 2005
United States	Allowed for foreign issuers in the US since 2007; US SEC committed to global accounting standards and IFRS best placed to meet that need in the US (see **SEC February 2010 statement on global accounting standards**), awaiting decision regarding use of IFRSs for domestic companies

Note: The list refers to listed companies only. The table is not an authoritative assessment of the use of IFRS in those countries. In the majority of cases, the information has been provided by the relevant national authorities or is based on information that is publicly available. For definitive information on the use of IFRSs in any particular country or countries contact the relevant national authority or authorities directly.

(**Source:** http://www.ifrs.org/Use+around+the+world/Use+around+the+world.htm)

2.2 Auditing and Quality Standards

This is discussed in Learning Outcome 1

The IAASB (set up by IFAC) has issued various auditing and quality control standards which apply to audit and review of historical financial statements as well as non-assurance engagements.

However, most countries have their own local standards which take care of national issues.

1. Clarity Centre Project Overview

With a view to enhance the quality and uniformity of audit practises worldwide, in 2004, the IAASB embarked on a clarity project which involved ensuring that the existing international auditing standards are understandable, clear and capable of consistent application.

Diagram 3: Scope of clarity project

On February 27, 2009, the Clarity Project reached its completion when the Public Interest Oversight Board approved the due process for the last several clarified ISAs. Auditors worldwide now have access to 36 newly updated and clarified ISAs and a clarified International Standard on Quality Control (ISQC).

Just as accounting standards are being adopted world-wide, International Standards on Auditing (ISAs) - as issued by the International Auditing and Assurance Standards Board (IAASB) - are being adopted around the world. The adoption of international standards is an on-going process.

2. Summary of the Basis of ISA Adoption by Jurisdiction

Names of countries and jurisdictions	No of countries	Status of ISA adoption	Details of ISA adoption
Bulgaria, Costa Rica, Cyprus, Estonia, Honduras, Latvia, Malta, Mauritius, Romania, Slovakia, Slovenia	11	Y	Required by Law or Regulation i.e. country law or regulation requires the use of ISAs
Bahamas, Barbados, Bosnia and Herzegovina, Botswana, Canada, Czech Republic, Dominican Republic, Georgia, Guatemala, Guyana, Germany, United Kingdom, Tanzania, etc.	32	Y	ISAs are adopted
Albania, Australia, Bangladesh, Chile, China,Denmark, Finland, France, Germany, Hong Kong , India, etc.	29	Y	National Standards are the ISAs
USA, Ghana, etc.	54	N	Others
TOTAL (countries and jurisdictions	**126**		

From the above, it is clear that most of the countries have adopted the ISAs. Most of the 54 countries which have not adopted the ISAs are in the process of doing so.

The status of adoption in some of these countries is as follows:

(a) Unites States of America

The Auditing Standards Board (ASB), which is a technical body of the AICPA, issues various Statements on Auditing Standards (SASs), which provide guidance on various audit matters. All AICPAs who perform audit engagements are required to comply with SASs.

As part of the harmonization process, the ASB standards will be developed concurrently with new ISAs. The approach is to use the ISAs as a base with modifications where it better serves the needs of U.S. users or for legal and regulatory reasons. It is intended that there will be very few or no differences between the requirements of the ISAs and the Statements on Auditing Standards (SASs).

(b) Ghana

Ghana Auditing Standards are established by the Ghana National Auditing Standards Board, which is a part of the Institute of Chartered Accountants (Ghana). Laws / regulations contain the basic principles and essential procedures of the IAASB pronouncements; however, it is not certain whether the principles and essential procedures of the current ISAs have been incorporated.

(c) Iran

Existing professional standards in Iran are based on the IAASB pronouncements with local adaptation as necessary and are legally binding. The Audit Organization (official standard setter) started translating ISAs in the early 1990s. Localized versions of these translations were issued as exposure drafts (EDs) and after due process of standard setting, were published in early 2000.

(d) Russian Federation

Over the past decade, various steps were taken to incorporate ISAs into Russian Audit Standards including translation of the 2005 IFAC Handbook. To strengthen its commitment to ongoing convergence with ISAs, a Federal Law approved in December 31, 2008 will require Russian standards to be established in accordance with ISAs (Article 7 of the Federal Law on Auditing Activity). This Federal Law provides for the establishment of an Audit Council to set the standards and will require Federal Standards on Auditing Activity to be established in accordance with ISAs from January 1, 2010 onwards.

2.3 Internal controls and auditor independence

1. United States of America

Poor corporate governance was one of the reasons for the collapse of companies such as Enron and WorldCom.

The Sarbanes-Oxley Act was enacted by Congress in response to the fraud perpetrated by several large U.S. companies hence corporate scandals like Enron and WorldCom were the main catalysts for the swift regulatory response. The Sarbanes-Oxley Act (SOA) was named after its two main contributors. Although the primary impetus of Sarbanes-Oxley was to deter corruption domestically, its impact has had multinational reach.

The SOA **applies to all listed companies in the USA and subsidiaries of US-based companies**. In addition to the specific rules stated by the SOA, it also required the Securities Exchange Council (SEC), which is the financial market regulator, to issue rules to enable the implementation of the rules stated by the SOA.

Main contents of SOA

(a) Public Company Accounting Oversight Board (PCOB)

The Public Company Accounting Oversight Board was set up by the SOA. All registered firms are required to register with it. It was set up to protect the interests of investors. Its main functions were to supervise the audit of public companies (that are subject to securities law) by ensuring that the audit reports were accurate and independent.

According to section 103, the **board** could **establish auditing, quality control, ethics, independence and other standards** relating to the preparation of audit reports.

The **board** is **required to perform functions** so as **to ensure that registered public accounting firms maintain high professional standards** so as **to improve the quality of audit services** offered.

In reality the board took over functions undertaken (inadequately) by the accounting profession itself.

(b) Auditing standards

The **auditing standards established by the board** include:

(i) **Retention of audit working papers for a minimum period of seven years**.
(ii) Provision of a **second partner review which is approved by a qualified person** (e.g. the board) other than the person in charge of the audit. For example, the audit of a public limited company will be certified by the partner, after the audit is reviewed by another partner of the firm (who is qualified).
(iii) **Description of the scope and procedure of the tests of internal controls performed by the auditor**. For example, scope would include the area of procurement of non-current assets and the procedure would be the test of control.

(c) Internal control reporting

The CFO and CEO are responsible for maintaining internal and financial controls.
External auditors are required to report on managements' reports on internal controls in addition to the FS.
Public companies are required to submit an annual assessment of the effectiveness of their internal financial auditing controls to the SEC.

The audit report must include an evaluation of the internal controls which need to include the following:

(i) Maintenance of sufficient records that accurately and fairly reflect the transactions. For example, the records for receipt of non-current assets are; the copy of the vendor's delivery advice, the entry stamp for receipt of material at the security gate, the preparation of a goods received note and the entry of receipt of materials in the stores ledger.

(ii) Provision of reasonable assurance that transactions are recorded in such a way as to enable:
The preparation of the financial statements in accordance with generally accepted accounting principles.
the authorisation of receipts and expenditures by the management and directors of the company.

(iii) Disclosure of all material weaknesses of / material non-compliance with internal controls found in the company.

(d) Quality control standards

The quality control standards of the board shall include:

(i) Compulsory rotation of lead / reviewing partners every five years.
(ii) Prohibiting auditors from providing services such as consultation on accounting and auditing, supervision of audit work, inspection etc.

(e) Auditor independence

Auditors are prohibited from undertaking services such as internal audit, bookkeeping of audit client, investment adviser, financial information systems design and implementation, actuarial services, management functions or human resources, appraisal or valuation services broker or dealer, investment services, legal services and expert services unrelated to the audit and any other service that the board determines, by regulation. In this way auditor independence can be ensured.

(f) Audit committee

(i) The following are the provisions relating to the audit committee:

All listed companies are required to have audit committees.
All **members of the audit committee are required to be members of the board and also independent** i.e. not accept any consultation fees or any other fee from the company.
The audit committee must have **at least one financial expert**.

(ii) According to the SOA a **''financial expert''**, is a person who, through education and experience as a public accountant or auditor:

- ❖ Understands generally accepted accounting principles and financial statements;
- ❖ Is experienced in the preparation or auditing of financial statements;
- ❖ Is experienced with internal accounting controls; and
- ❖ Understands the functions of the audit committee.

(iii) The responsibility of the audit committee includes appointment, fixing of compensation and supervision of the work of a public accounting firm employed by the committee for the purpose of either preparing or issuing an audit report. Auditors are required to report matters to audit committees.

The matters to be reported include:

- ❖ Significant accounting policies and practices to be followed (for example accounting policies relating to foreign currency transaction).
- ❖ Financial information within GAAP, which has been recorded differently, after discussion with the management of the company. (The audit committee must be informed of the consequences of such a treatment and the treatment which is favoured by the auditor)
- ❖ Other communications (in the form of management letter) issued to the auditor by the company.
- ❖ CEO and CFO must report any deficiencies in controls or any fraud involving management to the audit committee.

(g) Corporate responsibility for financial reports

The **CEO and CFO** are required to **review all financial reports, report all changes in controls** and certify that the **financial statements fairly present** the **financial condition of the company.** The financial statements are required to be drawn up after taking into account all **material** issues which would affect the **financial condition** of the entity.

If the financial statements which are certified by the CFO and CEO are required to be restated due to a non-compliance which is material, the CFO and CEO are required to forfeit their bonuses.

The **CEO and CFO** are **required to report** all **deficiencies in controls or any frauds** involving management to the **audit committee**.

(h) Whistle-blowing protection to employees and auditors

The Act gives **protection to employees and auditors of listed companies who give information regarding or assist in the investigation into fraud to shareholders**. The protection is in the form of not permitting such companies to harass, threaten, suspend etc. such employees or auditors who have enabled the investigation.

(i) Sarbanes-Oxley compliance

All applicable companies must set up a financial accounting framework. The financial reports generated by the framework must be easily traceable to the source data. The source data cannot undergo any changes unless they are documented. Furthermore, all changes made to financial data and accounting software should contain a proper audit trail i.e. changes need to be documented with respect to the nature of the changes, who made the changes and why were the changes made.

Example

Bright Ltd has accounting software which links all items of income, expenses, assets and liability appearing in the financial statements of the entity with the voucher number, voucher date, name of party, amount etc.

In this way all the financial reports generated are easily traceable to source data.

The accounting software has a control whereby all vouchers which are prepared and recorded in the system cannot be deleted. If, on a future date, a voucher recorded is found to be incorrect, the entryy can be rectified only with the help of a journal entry.

Continued on the next page

In this way the source data remains intact.

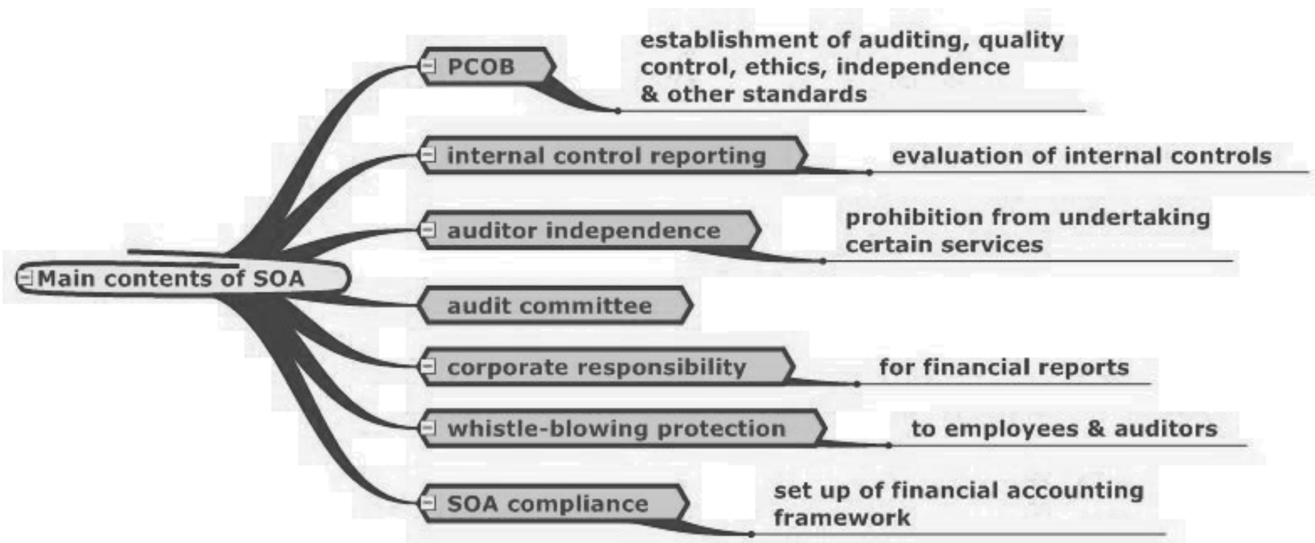
The accounting package has an inbuilt control whereby all alterations to programs are made only after authorisation by the system analyst and are properly documented to show who has made the changes and when the changes were made. The documentation will also mention the reason for the alteration, the results of the test run of the altered program and the authorisation of the system analyst for putting the altered program into program into the operation.

In this way the accounting software is fully documented with information regarding what was changed, why, by whom and when.

(j) Others

The threat of being charged with a criminal offence encourages managers to comply with the Sarbanes-Oxley Act.

SUMMARY



Test Yourself 2

Tresses Ltd is a US-based private company manufacturing and marketing various shampoos and hair dyes including permanent, semi-permanent and temporary hair dyes. The company's growing market and increased product popularity has prompted the owners' decision to execute an initial public offering for additional investment to take their company global.

Required:

Discuss the provisions of the SOA that the company would require to comply with so as to ensure that it: (a)

protects the interests of the new / existing investors of the company
(b) Protects whistle-blowers
(c) Ensures auditor independence
(d) Has a good audit committee

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2. According to the UK Corporate Governance Code, the board is required to maintain a sound system of internal control.

In this connection, the board is required to review the effectiveness of the internal controls which include financial, operational, compliance controls and risk management systems on an annual basis and report to shareholders. Disclosures tend to be rather bland and standard giving little real understanding of how risks are managed. Underlying this, the Combined Code and the Turnbull guidelines that followed it do encourage listed companies to build the right environment and embed risk management and control into the culture and processes of the business.

The disclosures made must also include an acknowledgment by the board that it is responsible for the company's system of internal control and for reviewing its effectiveness. It should also explain that such a system is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss.

The UK model is a model of enterprise risk management that sees risk management and internal controls as components in supporting the achievement of strategic objectives in addition to supporting financial reporting and legal compliance.

Main provisions of The Turnbull Report

In 1999, the Turnbull committee was established to provide guidance to companies, on the implementations of the internal control requirements of the Combined Code.

The **important recommendations** of the report were as follows: The **board of directors is responsible for**:

(a) Establishing a sound system of internal controls, e.g. by setting out policies and procedures for all major areas of business.
(b) Ensuring that the controls are functioning effectively, e.g. by assigning the task to internal auditors. (c) Assessing the effectiveness of internal controls, e.g. by reviewing the internal audit reports.
(d) Reporting the effectiveness of internal controls in the annual report of the company.
(e) Assessing the risks faced as a result of decisions on corporate strategy and objectives. For example, if a company decides to acquire a new business, the risks faced due to the decision include the new business not being profitable to the company.

2.4 Code of Ethics

The IESBA code of ethics (discussed in detail in Study Guide A1), which is a principles-based approach, recognises that accountants face different threats under different circumstances. However, it is impossible to predict all possible threats and set up the safeguards necessary to remove them. The code, therefore, acts as a guide for some conflicts of interest.

Auditors functioning in the USA are required to abide by the provisions of the AICPA codes. The areas which are

common to both the codes include:

The principles of independence, confidentiality, due care and truthful reporting of information
The ethics which accountants in business are required to adhere to

Some of the areas where the provisions differ include:

1. The IESBA Code is principles based, whereas the AICPA Code is rules-based. When an accountant (who operates in a region where the IESBA Code is to be adhered to) faces an ethical dilemma, they are required to use the conceptual framework approach to mitigate the threat to an acceptable level. However, AICPA members are required to comply with this approach only when the AICPA Code does not explicitly provide guidance on the situation of ethical dilemma.

2. The IESBA Code addresses issues like Long Association of Senior Personnel with a Client, Fees—Relative Size etc. However, the AICPA does not address this issue, and so AICPA members should also apply the conceptual framework on this matter.

3. The AICPA addresses the 'discreditable acts' that violate the Code. This is not addressed by the IESBA Code.

Answers to Test Yourself

Answer to TY 1

International Standards on Auditing are not meant to and do not override local standards and regulations. The relationship they share is one of co-existence. However by working closely with various national standard setters, the IAASB has helped to make adoption / integration of ISAs an almost seamless process in many countries.

Answer to TY 2

The Sarbanes-Oxley Act of 2002 (SOX) was designed mainly to boost pubic confidence in corporate governance and financial reporting of public companies by restoring public trust in corporations and capital markets. **SOX was intended to apply only to public companies**, but reforming the law imposed on public companies dramatically affected the way in which private companies tackle internal control and governance issues.

Private companies tend to implement most of the easier changes such as adopting a code of ethics for the officers, appointing independent directors and audit committees etc, but in the case of Tresses, due to its public issue, the company would have to strictly adhere to the provisions of the SOA. The requirements to be met are as follows:

(a) Protecting the interests of all investors: in order to protect the interests of investors, the public company has to register with the PCAOB (Public Company Accounting Oversight Board). According to the SOA, the board has established auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports. The board ensures that registered public accounting firms maintain high professional standards so as to improve the quality of audit services offered.

(b) Protection for whistleblowers: Sarbanes-Oxley provides protection for **whistleblowers** and imposes criminal penalties and fines on a company and its board, for actions taken against whistleblowers in retaliation.

Such protection will ensure that fraud does not occur. Tresses will have to develop methods to investigate reports by whistleblowers and the accuracy of the claims. It should also avoid taking any action in the form of harassment, threats etc. against the whistleblower.

The provisions of the SOA relating to whistleblower protection will force the company to obtain expertise from sources other than external auditors, as its books and records will be scrutinised more than ever.

(c) Auditor independence can be ensured by:

prohibiting auditors from undertaking services such as internal audit, bookkeeping of audit client, investment adviser, financial information systems design and implementation, actuarial services, management functions or human resources, appraisal or valuation services broker or dealer, investment services, legal services and expert services unrelated to the audit and any other service that the board determines, by regulation.

Rotating review partners every five years.

Obtaining a second review of the audit work by another partner of the auditor's firm.

(d) Provisions related to audit committees

All listed companies are required to have audit committees.

All members of the audit committee are required to be members of the board and also independent i.e. not accept any consultation fees or any other fee from the company.

The audit committee must have at least one financial expert.

Quick Quiz

1. _______________ has a legal mandate to set accounting and auditing standards in Tanzania.

   A NBAA
   B IFAC
   C IAS
   D IFRS

2. According to the SOA, a **''financial expert''**, is a person who, through education and experience as a public accountant or auditor:

   A understands generally accepted accounting principles and financial statements
   B is experienced in the preparation or auditing of financial statements
   C is experienced with internal accounting controls and understands the functions of the audit committee
   D All of the above

3. Which of the following is incorrect according to Sarbanes-Oxley compliance?

   A CEO and CFO must review all financial reports
   B CEO and CFO must report any deficiencies in controls or any fraud involving management to the audit committee
   C Financial accounting framework must be in place that can generate financial reports that are readily verifiable with traceable source data
   D Auditors should not report on matters relating to significant policies to audit committees

4. Which of the following is not an effect of Sarbanes-Oxley compliance?

   A The implementation of SOA leads to an increased cost of compliance
   B Avoidance of auditor conflict of interest by barring auditors from undertaking non-audit work
   C Improved risk assessment and control processes
   D Every manager in charge is responsible for the operational consequences; board responsibility ends with the delegation of the authority

5. The standard setting process at the Tanzanian level is not relevant. State whether this statement is:

   A True
   B False

6. Which of the following countries have not fully adopted ISAs by jurisdiction?

   A Tanzania
   B Romania
   C India
   D Ghana

Answers to Quick Quiz

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

   The National Board of Accountants and Auditors (NBAA)

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

3. The correct option is **D.**

   According to the SOA, auditors are required to report matters relating to significant policies, to audit committees.

4. The correct option is **D.**

   The SOA is underpinned by the rules-based approach. It holds the BOD responsible and accountable to the stakeholders. Therefore the board's responsibility does not end with the delegation of authority.

5. The correct option is **A.**

   This is because effective from 1 July, 2004, the National Board of Accountants and Auditors (NBAA) has wholly adopted the IFRS issued by IASB, and IASs and ISAs issued by the International Federation of Accountants (IFAC).

6. The correct option is **D.**

   Ghana has not fully adopted ISAs by jurisdiction. It's auditing standards and laws / regulations contain the basic principles and essential procedures of the IAASB pronouncements; however, it is not certain whether the principles and essential procedures of the current ISAs have been incorporated.

Self-Examination Question

Question 1

Joanne Taylor is the executive director of Healthline, a charitable not-for-profit hospital located in the US. Being a not-for-profit organisation, there are no specific rules or regulations on the best practices of corporate governance. Recently, it was proposed by the Senate and House of Representatives of the United States of America to broaden the scope of the SOA to not-for-profit organisations.

Required:

(a) Explain the Sarbanes-Oxley Act in brief.
(b) Explain to Joanne why it is essential for Healthline to start following the SOA voluntarily in order to be a responsible entity.

Answer to Self-Examination Question

Answer to SEQ 1

(a) The SOA in brief

The Sarbanes-Oxley Act refers to "The American Competitiveness and Corporate Accountability Act of 2002." It was created in response to corporate accounting scandals that occurred in the US. The Act came into existence to protect investors by improving the accuracy and reliability of corporate disclosures. It was enacted by the Senate and the House of Representatives of the United States of America.

The SOA is enforced by law and applies to publicly-traded companies. It requires them to adhere to standards of governance as laid down by the Act and makes them legally accountable to those who are in control.

(b) NFP and SOA

Although the law applies to publicly-traded corporations, it has served as a wake-up call to the non-profit community as well. In the corporate sector, publicly-traded companies are guided by the regulations spelt out in the SOA so as to ensure good governance. However, for non-governmental organisations / not-for-profit organisations, there are no specific rules or regulations and their effectiveness is based on achievement of core objectives of corporate governance. In short there is no obligation for NFPs to follow the SOA.

(c) Benefits of applying SOA

Use of best practices by compliance with the SOA can:

- ❖ Improve the internal controls of the hospital
- ❖ Provide transparency about its operations to all its stakeholders
- ❖ Improve the confidence of its donors and trustees who sponsor the activities of the hospital

Therefore, Healthline being a responsible NFP will have to follow the Sarbanes-Oxley Act as a standard for good governance practices.

Relating aspects of SOA to Health line

(i) **Setting up an audit committee**: the audit committee reviews the effectiveness of the internal controls of the company and also ensures that financial reporting communicates the true and fair financial status of the organisation.

Therefore the hospital can set up an audit committee comprising the independent, non-executive directors with at least one 'financial expert' who supervises those who control the finance function for the organisation as whole.

(ii) **Balance and composition of the board:** in most non-profit organisations one or more board committees are formed to deal with financial issues. Hence it is good practice for non-profits to have independent, non-executive directors on the committee with sufficient expertise to ensure the balance and effectiveness of the board

(iii) **Conflict of interest and auditors' independence:** according to the SOA (the rules-based approach) policing can be more effective as auditors can be made more **independent** through legal restrictions and through criminal penalties. Effective policing makes financial reporting easier and helps the organisation to portray a true and fair financial picture of the organisation.

The SOA governs the responsibilities of auditors. It requires rotation of audit partners every 5 years and prohibits auditors from providing nine other services (e.g. Internal audit, bookkeeping of audit client, investment adviser, financial information systems design and implementation etc.)

Therefore the board of a non-profit organisation should change reviewing auditors every five years and prohibit auditors from providing any non-audit services to prevent any conflict of interest.

(iv) **Accountability:** the SOA requires the signing officer (CEO / CFO) to review the reports. The CEO / CFO of a publicly-held company is required to certify the company's financial statements and attest their appropriateness and the accurate presentation of the financial condition of the company.

To encourage accountability in non-profits, the executer (the CEO of the non-profit organisation) should ultimately be held responsible for the financial reporting of the organisation. This practice will also increase transparency in operations and disclosures.

SECTION A

LEGAL, REGULATORY AND ETHICAL ISSUES

A3

STUDY GUIDE A3: LEGAL ISSUES I

Get Through Intro

A strong regulatory environment is vital in today's business world as it provides assurance to the various stakeholders of companies, who have become highly sceptical about the intentions of management because of the multitude of recent high-profile financial scandals.

Organisations today are expected to be well regulated and ethically run in terms of both their operations and their financial reporting.

Towards this end, there has been a push for the adoption of a uniform set of auditing across the globe. The growth of multinational companies has also contributed to the growing demand for international standards. International Standards of Auditing are now fast emerging as globally accepted standards which provide recognised benchmarks for all nations.

When we compare the responsibilities of the management and the auditor under different situations, we will observe that in most cases, the management is held responsible for all consequences of defaults / mistakes / non-compliance (if any) and the auditor is responsible only for possible misstatements in the financial statements.

This makes one wonder whether a negligent auditor is always protected by law. Has he nothing to fear and no professional responsibilities?

This Study Guide discusses these issues and the responsibilities of the auditor towards his audit client and towards third parties. It also provides an understanding of the need for a regulatory framework and its effectiveness. Therefore, it is a significant Study Guide for you to understand and remember, because you will be regulated by these standards when you become an auditor!

Learning Outcomes

a) Identify and explain the nature and purpose of laws, regulations standards and codes in the context of assurance engagements.
b) Identify, evaluate and explain how audits may fail to meet expectations of users.
c) Identify, evaluate and explain the extent of legal liability including criminal and civil law liability including professional negligence issues and how they can be mitigated.

1. Identify and explain the nature and purpose of laws, regulations standards and codes in the context of assurance engagements.

[Learning Outcome a]

1.1 Assurance engagements

Before the objectives and general principles (laws, regulations standards and codes) of external audit engagements are explained, the definition of an assurance engagement should be examined.

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

First of all, what is an assurance and why is it needed? Ann assurance is an assertion that the statements presented are correct. However, the need for assurance arises in every field, not just accounting.

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.

Diagram 1: Assurance engagement

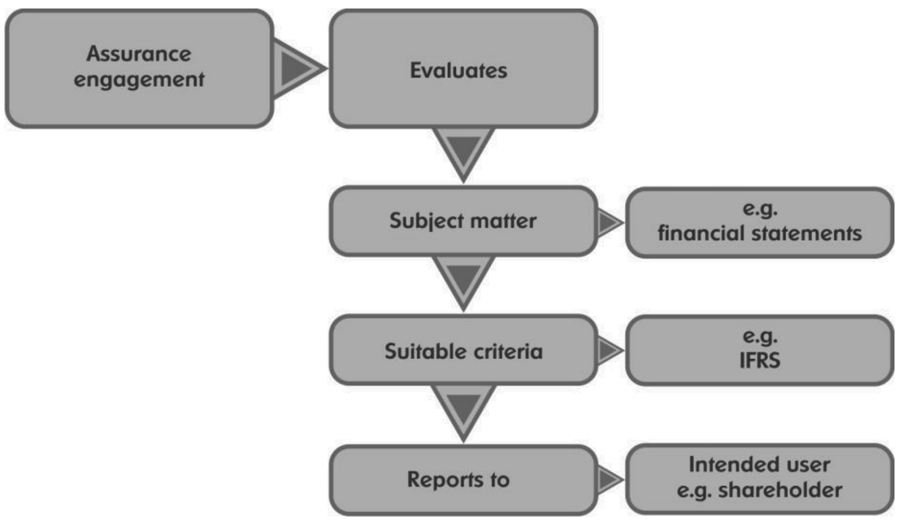
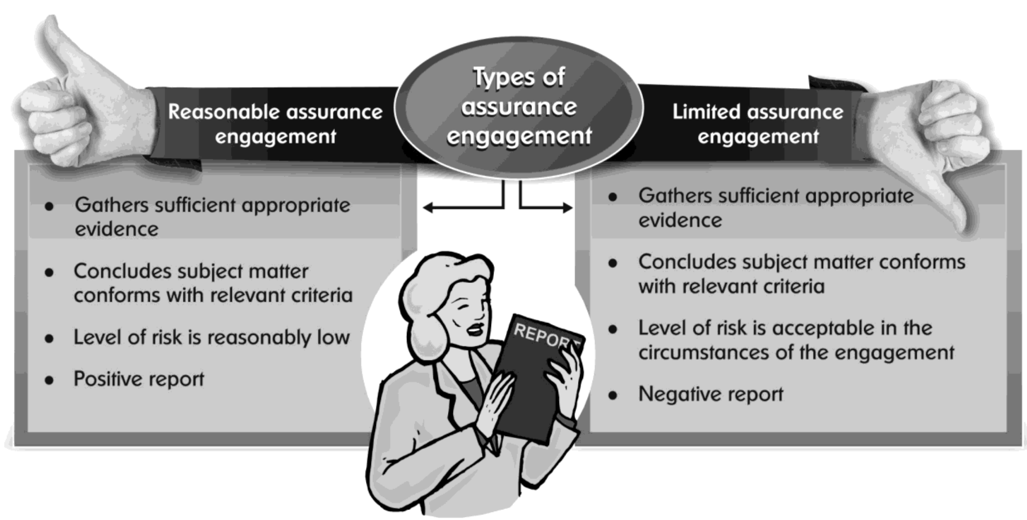


Diagram 2: Types of assurance engagement



1.2 Nature of laws, regulation, standards and codes in the context of assurance engagements

The **regulatory environment in which auditors function requires auditors to:**

Comply with the **code of ethics** of the professional body of which the auditor is a member e.g. the NBAA, ICAEW
Comply with national laws and regulations
Comply with accounting and auditing standards (national as well as international standards)

Each of the above mentioned points are explained in turn below.

1. Compliance with Code of Ethics

The auditor should comply with the Code of Ethics for professional accountants, issued by the International Federation of Accountants. A Code of Ethics is a set of rules obligatory on the member of the professional body. (Study Guide A1 explains the IFC code of ethics in detail.) Therefore accounting bodies 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).**

Example

One of the requirements of the IFAC Code of Ethics is that the auditor should not accept / continue engagements in which the member has a conflict of interest with the entity. This is because, when there is conflict of interest between the auditor and the entity to be audited, it is quite difficult for an auditor to maintain objectivity in his work. This is how the Code of Ethics regulates the statutory audit and the auditor.

Generally, cases of alleged non-compliance with the code of ethics are referred to a disciplinary committee for investigation. Those failing to comply with the rules are required to answer a complaint before the disciplinary committee.

2. Compliance with national laws and regulations

(a) Compliance with The Companies Act

A statutory audit is an audit **required by statute**. For example, The Companies Act of each country, requires all companies (above a certain size) registered under the Act to have their financial statements audited by an independent auditor. The Act contains the provisions related to the audit e.g. appointment, removal etc. of an auditor.

From the above, it is clear that compliance with the provisions of the Companies Act is obligatory for an entity as well as the auditor. **This statute may have provisions regarding the appointment, removal etc. of the auditor and also regarding reporting requirements**.

(i) The auditor of a company in UK should comply with the provisions of The Companies Act 2002. This requires the auditor to:

- ❖ Provide an opinion of whether the financial statements audited, are true and fair;
- ❖ Confirm that the annual financial statements are in accordance with the requirements laid down in The Company's Act; and
- ❖ State whether the information provided in the directors' report conforms to the annual accounts.

Other than the law requiring a statutory audit there are certain other laws and regulations that the auditor should comply with.

(ii) Rights of an auditor

The rights of an auditor are governed by the regulatory framework within which an auditor functions. They have been discussed in detail in Paper B3.

The rights can be summarised as follows:

- ❖ Right of access to records
- ❖ Right to information and explanations
- ❖ Right to receive resolutions
- ❖ Right to attend and receive notice of meeting
- ❖ Right to speak and to be heard at general meetings of the company

(iii) Duties of an auditor

The duties of an auditor are governed by the regulatory framework within which an auditor functions. They have already been discussed in detail in Paper B3. The duties can be summarised as follows:

- ❖ maintenance of adequate accounting records
- ❖ Compliance with legislation while preparing the financial statements.
- ❖ examination, comparison and verification of accounting records and returns with financial statements of the entity
- ❖ truth and fairness of financial statements
- ❖ compliance of material disclosures in financial statements with the applicable statute

(iv) Appointment of auditors

The provisions relating to the appointment of auditors (governed by the regulatory framework) have already been discussed in detail in Paper B3. They can be summarised as follows:

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 (AGM) 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 share is owned by the state, the auditor is appointed by the CAG/NAOT (National Audit Office of Tanzania)

(v) Removal and resignation of auditors

The removal and resignation of auditors (governed by the regulatory framework) have already been discussed in detail in Paper B3. They can be summarised as follows:

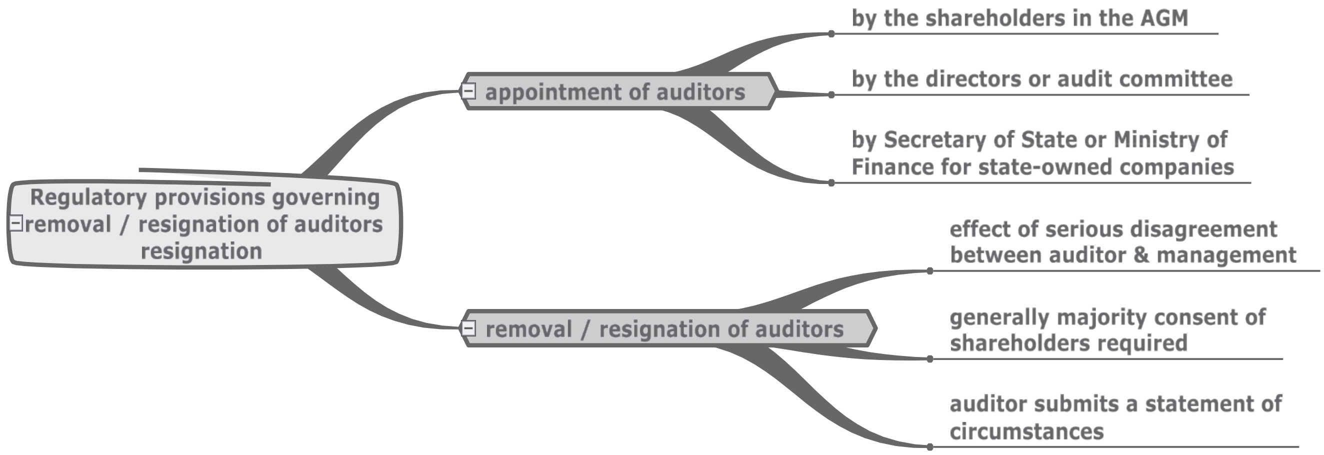
In order to protect the interests of auditors as well as shareholders, in many countries, the law requires the consent of a majority for the removal of the auditor and provides an opportunity to the auditor to make a representation before all the shareholders.

The auditor has to give a statement to all the shareholders in the Annual General Meeting about the reason for the disagreement (or the fact that removal or resignation was innocent). This is because the auditor should not be removed by management just to protect their interests. The facts should be communicated to the shareholders. The letter communicating the circumstances is usually called a statement of circumstances.

The auditor should communicate his resignation to the entity. The communication should be made in writing and a statement of circumstances as required in the case of removal should also be made along with the resignation letter. If there is no reason the shareholders should know about, then this should be made clear in the statement of circumstances.

The appointment of the auditor, his removal or his resignation should be communicated to the regulatory authorities.

SUMMARY



(b) Compliance with Income tax Act

In many countries a statutory audit is required under the Income Tax Act. The auditor performing tax audit has to comply the provisions of the Income Tax Act as well as of the Companies Act.

(c) Compliance with industry specific norms

Statutory audit should also comply with the **laws and regulations** related to a particular industry like the audit of a bank must comply with the provisions of Banking and Financial Institutions Act 2006 and BOT Act 2006..

(d) Compliance with provisions of professional bodies regulating audits

The regulatory environment for audit differs from country to country. Each country has a number of different professional bodies to regulate the audit and auditors in their country. Examples of regulatory bodies for auditors in some of the countries are as follows:

UK	Chartered Institute of Management Accountants (CIMA)
USA	The Financial Accounting Standards Board (FASB) to establish accounting standards The American Institute of Certified Public Accountants (AICPA) of accountants
Tanzania	National board of Accountants and Auditors

Therefore auditors operating in each country discussed above should comply with the requirements of the registration or regulation under which the engagement is conducted

3. Compliance with accounting and auditing standards (national as well as international)

Apart from the laws and regulations, the auditor should also conduct an audit in accordance with International Standard on Auditing (ISAs). ISAs contain basic principles and essential procedures together with related guidance. Auditing standards provide guidance on various issues relating to the audit. These are the generally accepted procedures of audit, which an auditor should follow.

The auditor should also consider the International Auditing Practice Statements (IAPSs) applicable to the audit engagement. IAPSs provide guidance and practical assistance to auditors for implementing ISAs. If there are certain standards relating to a specific country, the auditor should consider both the international standards and the standards of that particular country. **The auditor should not represent compliance with International Standards on Auditing unless the International Standards on Auditing relevant to the audit have been fully compiled with.**

The auditor should be familiar with all the applicable accounting standards because they are expected to report on any non-compliance with these and the reason for this non-compliance.

Example

The International Accounting Standard on valuation of inventory (IAS 2) requires that the inventory should be valued at the lower of the cost or net realisable value. If this is not followed, the auditor should report this, together with the reasons for non-compliance with the standard.

If the auditor does not follow these guidelines, they may be held liable for professional negligence.

Auditors operating under the regulatory framework of NBAA are required to comply with the **International Standard on Auditing** (ISAs). However, the ISAs are not intended to override or supersede local laws and regulations. The list of auditing standards which is released by IAASB is as follows:

ISA No.	Title
200	Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing
210	Agreeing the Terms of Audit Engagements
220	Quality Control for an Audit of Financial Statements
230	Audit documentation
240	The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements
250	Consideration of Laws and Regulations in an Audit of Financial Statements
260	Communication with Those Charged with Governance
265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
300	Planning an Audit of Financial Statements
315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
320	Materiality in Planning and Performing an Audit
330	The auditor’s responses to assessed risks
402	Audit Considerations Relating to an Entity Using a Third Party Service Organization
450	Evaluation of Misstatements Identified during the Audit
500	Audit Evidence
501	Audit Evidence: Specific Consideration for Selected Items
505	External confirmations
510	Initial audit engagements: Opening Balances
520	Analytical procedures
530	Audit sampling
540	Auditing Accounting estimates, Including Fair value Accounting Estimates and Related Disclosures
550	Related parties
560	Subsequent events
570	Going concern
580	Written representations
600	Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)
610	Using the Work of Internal Auditors
620	Using the Work of an Auditor’s Expert
700	Forming an Opinion and Reporting on Financial Statements
705	Modifications to the Opinion in the Independent Auditor’s Report
706	Emphasis of Matter Paragraphs and Other Matter(s) Paragraphs in the Independent Auditor’s Report
710	Comparative Information—Corresponding Figures and Comparative Financial Statements
720	The Auditor’s Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements
800	Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
805	Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
810	Engagements to Report on Summary Financial Statements

1.3 Purpose of laws, regulations standards and codes in the context of assurance engagements

Regulation of the audit and the auditor is necessary for the following reasons:

1. To protect public interest

An auditor is a person who ensures the integrity of financial statements by providing a high level of assurance about the truth and fairness of the financial statements. People trust the audited financial statements when taking major decisions such as sale or purchase of the shares of the entity. Hence, an auditor owes a duty to protect the general public from being deceived.

Therefore it is necessary to regulate an auditor so as to assure the client and the users of financial statements that the auditor's work meets high professional standards.

Example

Most national laws governing audit and the Code of Ethics of different professional bodies stress the independence and objectivity of the statutory auditor. Many require that the statutory auditor should not provide consultancy services to the audit client so as to maintain his independence. This is because a person who is not independent might not give an unbiased opinion on the financial statements.

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2. To maintain dignity of the profession

A professional body is a body which regulates the functioning of all aspects of any profession, right from the entry level of a student, to the highest level of its members.

The professional body to which the auditor belongs is held in high esteem by society. The members of the body should not damage its image. They should act in a manner which upholds the dignity and integrity of the profession. Therefore these bodies use certain regulations such as a Code of Ethics and make it obligatory for its members to follow them so that the dignity of the profession can be maintained.

Example

The Code of Ethics of The NBAA, sets out fundamental principles which are obligatory for all the members of the ACCA. Disciplinary action is taken against a member (or student) who does not follow these principles.

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3. To ensure independence and professional competence of the auditors

We know that the opinion expressed by an auditor should be independent. In order to try to ensure the independence of auditors, national legislation (such as the Companies Act), the code of ethics etc. contain certain provisions. Although these regulations do not ensure absolutely that the auditor is independent, they act as a check on the auditor.

Example

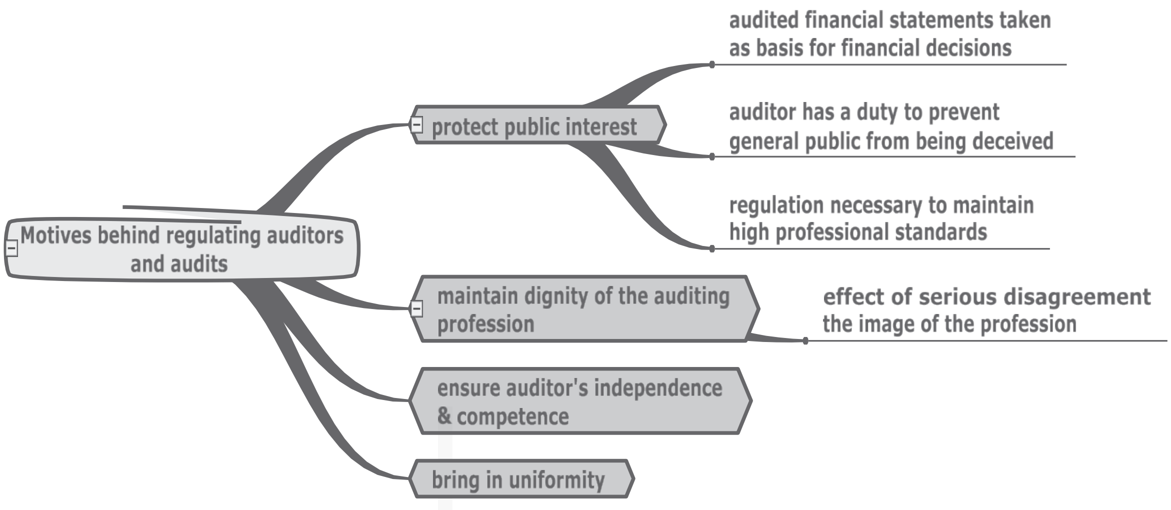
The Companies Act of most nations requires that a person who is a relative of a director or related to the entity in any other manner, including having a financial interest in the entity, should not perform a statutory audit of the entity.

Most of the statutes require that a person performing an audit should be professionally qualified and possess the requisite skills and competence to perform the audit work.

4. To bring uniformity to the audit procedures

Auditing standards provide guidelines for an auditor to follow in performing an audit. This brings uniformity to the work of the auditor.

SUMMARY



Example

ISA 570 (Revised) deals with going concern. This provides guidance on the auditor's responsibility in the audit of financial statements for the going concern status of an entity. This includes the auditor's responsibility when the entity's going concern status is in danger.

Test Yourself 1

Your firm of five CPA- qualified auditors is appointed to conduct the audit of Prestige Corporation. Ethan is one of your audit staff. He has just joined your firm and is pursuing the CPA qualification. This is his first audit. You are the senior auditor, and in that capacity, explain to Ethan that auditors should comply with all the relevant laws and regulations. Ethan is surprised since he doesn't understand why it is necessary to regulate auditors and who regulates them.

Required:

Explain to Ethan the reasons and mechanisms for the regulation of auditors.

1.4 Money Laundering, Predicated Offences and Financing of Terrorism Under Anti-Money Laundering Act, 2006

Meaning of Money Laundering

Money laundering can be defined as any act or attempted act to disguise the source of money or assets derived from criminal activity. That is transforming ***"dirty money"*** into ***"clean money".***

Anti-Money Laundering Act, 2006 provides a more technical definition "Money Laundering means engagement of a person or persons, direct or indirectly in conversion, transfer, concealment, disguising, use or acquisition of money or property known to be of illicit origin and in which such engagement intends to avoid the legal consequence of such action and includes offences referred in section 12 of AMLA, 2006).

Predicate Offences under AMLA, 2006

The AMLA illustrates predicate offence to mean:

(a) Any dealing which amounts to illicit drug trafficking under the law for the time being relating to narcotic drugs and psychotropic substances.

(b) Terrorism, including terrorist financing;

(c) Illicit arms trafficking;

(d) Participating in an organized criminal group and racketeering;

(e) Trafficking in human beings and smuggling immigrants;

(f) Sexual exploitation, including sexual exploitation of children;

(g) Illicit trafficking in stolen or other goods;

(h) Corrupt practice;

(i) Counterfeiting;

(j) Armed robbery;

(k) Theft;

(l) Kidnapping, illegal restraint and hostage taking;

(m) Smuggling;

(n) Extortion;

(o) Forgery;

(p) Piracy;

(q) Hijacking;

(r) Insider dealing and market manipulation;

(s) Illicit trafficking or dealing in human organs and tissues;

(t) Poaching;

(u) Tax evasion;

(v) Illegal fishing;

(w) Illegal mining;

(x) Environmental crimes; or

(y)any other offence which the Minister responsible for Finance may, by notice publish in the Gazette, declare, whether committed within the national boundaries of the United Republic of Tanzania or outside the country.

Financing of Terrorism

As provided in the AMLA 2006, terrorist financing means –

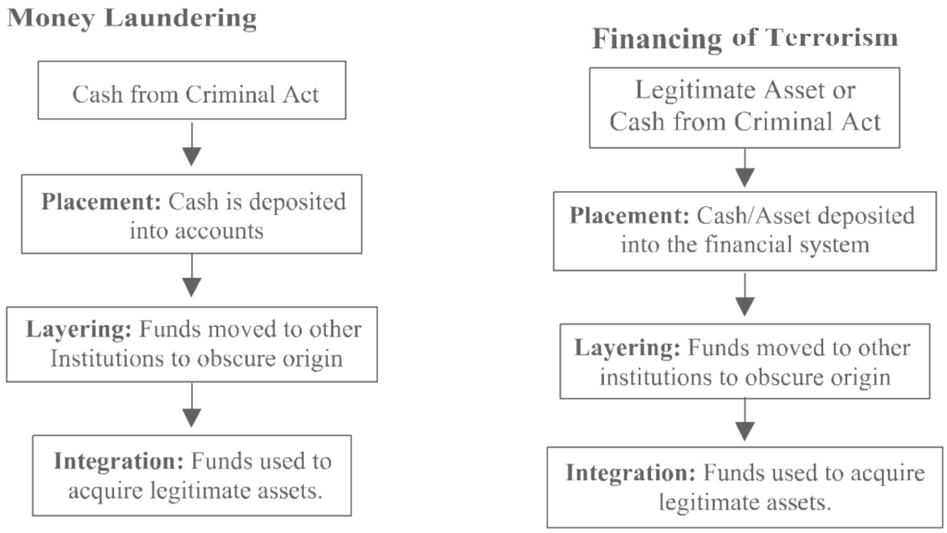
(a) The provision of, or making available such financial or other related services to a terrorist, group or entity which is concerned with terrorist act; or

(b) Entering into or facilitating, directly or indirectly, any financial transaction related to dealing in property owned or controlled by or on behalf of any terrorist or any entity owned or controlled by a terrorist.

Money Laundering and Financing of Terrorism

The linkage between money laundering and financing of terrorism, is that the techniques used to launder money are essentially the same as those used to conceal the sources of and uses for terrorist financing. The diagram below summarises the relationship and also explains the stages for both

STAGES OF MONEY LAUNDERING AND FINANCING OF TERRORISM



To complete the process, there are three recognized stages in the money laundering cycle:

Placement Stage

This stage involves the placing of the proceeds of crime (***'dirty money'***) into the system. This can include:

i. Depositing money into bank accounts or purchasing money orders or bank drafts, which can be converted into ***'clean money'*** once negotiated.
ii. Money being put into a business and mixed with other ***'clean money'*** before it is deposited into the business' bank account or perhaps used by the business to acquire supplies or products that are then sold.

Layering Stage
This may happen on a continuous basis even after the third stage has been completed. Involves executing a variety of transactions intended to disguise the audit trail and the source of ownership of the funds or property. The money launderer also does this so that it will be more difficult to trace funds back to the original criminal activity that gave rise to the proceeds.

Integration Stage
The third stage of the cycle is the placing of the laundered proceeds back into the economy so as to create a perception of legitimacy, the investing of these proceeds into otherwise legitimate business activities earns additional so-called ***"legitimate"*** business profits on top of the criminal proceeds being earned by the owner of the funds.
By their nature, the layering and integration stages are the most likely stages in which an accountant may be involved in the money laundering process because here is where transactions involve real businesses that file their taxes and have financial statements prepared.

How To Manage The Risk Of Money Laundering
Know Your Client
Appropriate identification procedures, as required by the AMLR 2007, are mandatory when accepting appointment as auditor. The extent of information collected about the client and verification of identity undertaken will depend on the client risk assessment. Auditing standards on quality control for audits state that acceptance of client relationships and specific audit engagements includes considering the integrity of the principal owners, key management and those charged with governance of the entity is of paramount. This involves the auditor making appropriate enquiries and may involve discussions with third party, the obtaining of written reference and searches of relevant databases. The procedure may provide some of the relevant client identification information but may need to be extended to comply with the AMLR, 2007.

Accountants and auditors may use various sources of information to enhance business knowledge of their client, including direct discussion with the client. Information sources (*e.g.* websites, brochures, reports etc) prepared by the client may help to judge the type of the client. Accountants and auditors need to consider whether there are any particular steps they wish to specify for use in higher risk cases to increase the depth of customer due diligence. Accountants and auditors might, as appropriate to their risk assessment, wish to check the names of new clients against lists of known terrorists and other sanctions information elsewhere if they deem appropriate. Full details of name and address as well as the details of the identity document provided should also be keenly observed.

If a transaction is being undertaken on behalf of another person, identification evidence of all the persons concerned should be obtained and copies of all documents called for verification should be kept on record. Auditors should make sure that they also adhere to the requirements of International Standards on Auditing (ISA 315) – *Obtaining an understanding the entity and its environment and assessing the risk of material misstatements.*

On-Going Monitoring of Business Relationships

For accountants and auditors, ongoing monitoring of the business relationship is very important. This comprises scrutiny of activity during the relationship, including enquiry into source of funds if needed, to ensure all is consistent with expected behaviour based on accumulated customer due diligence information. Accountants and auditors may wish to consider updating customer information on a more routine basis as appropriate opportunities arise. Examples of such opportunities may include:

(a) At the start of new engagements and when planning for recurring engagements.
(b) When a previously delayed engagement restarts.
(c) Whenever there is a change of control and/or ownership of the client.
(d) When there is a material change in the level, type or conduct of business; and
(e) Where any cause for concern, or suspicion, has arisen (in such cases, care must be taken to avoid making any disclosure which could constitute *tipping off)*.

It may be helpful for the auditor to explain to the client the reason for requiring evidence of identity and this can be achieved by including an additional paragraph in the audit engagement letter. Where client identification procedures start before the engagement letter is drafted it might be helpful for the auditor to address this in pre-engagement letter communications with the potential client.

Client Identification

As with other professional services, firms, accountants and auditors are required to identify their clients for the purposes of the anti-money laundering legislation. They are likely to request from their client, and retain some information and documentation and/or to make searches of appropriate information of their clients. If the accountant or auditor is not able to obtain satisfactory evidence of identifying the client within a reasonable time, there may be circumstances in which an accountant or auditor is not able to proceed with the assignment. It may also be helpful to inform the client of the accountant or auditor's responsibilities under AMLA, 2006 to report knowledge or suspicion, or reasonable grounds to know or suspect, that a money laundering offence has been committed and the restrictions created by the 'tipping' off (section 20 of the AMLA, 2006) on the auditor's ability to discuss such matters with their clients.

Partners, audit managers and staff in audit firms have to comply with the AMLA which includes provisions that may require auditors to make a money laundering disclosure in relation to information they obtain as part of their normal audit work. It is not the practice to inform client when such a disclosure is made or the reason for it because of the restrictions imposed by the 'tipping off' provisions of the legislation. Whether or not to include these illustrative paragraphs in the audit engagement letter is a policy decision to be taken by auditing firms.

Further Client Identification

Once the accountant or auditor suspects a possible breach of AMLA or its regulations, the accountant or auditor will need to make further enquiries to assess the implications of the breach in the financial statements. Auditing standards require that when the auditor becomes aware of information concerning a possible instance of non-compliance of laws and regulations, the auditor should obtain an understanding of the nature of the act and the circumstances in which it has occurred, and sufficient other information to evaluate the possible effect on the financial statements.

Where the accountant or auditor knows or suspects, or has reasonable grounds to know or suspect, that another person is engaged in money laundering, a disclosure must be made to the firm's AMLRO or for sole practitioners to FIU. The anti-money laundering legislation does not require the accountant or auditor to undertake any additional enquiries to determine further details of the predicate criminal offence. If the accountant or auditor is genuinely uncertain as to whether or not there are grounds to make a disclosure, the accountant or auditor should bring the matter to the attention of the senior accountant or audit engagement partner who may seek advice from the AMLRO.

Reporting to FIU does not relieve the auditor from other statutory duties.
Examples of statutory reporting responsibilities include:

(a) Auditors of entities in the banking sector have statutory duty to report matters of 'material significance' to the Bank of Tanzania which come to the auditor's attention in the course of the audit work.

(b) Auditors of entities in the public sector have statutory duty to report matters of material significance' according to the Public Audit Act, 2008 which come to the auditor's attention in the course of the audit work.

(c) Auditors of other types of entities are also required to report matters of 'material significance' to their respective regulatory authorities.

IDENTIFYING SUSPICIOUS TRANSACTIONS

The number of different activities, customer types and individual transaction circumstances, makes it impossible to produce an exhaustive list of indicators of suspicious or unusual transactions. When other indicators are taken together they may point to the potential of a transaction or series of transactions as being suspicious or unusual, which would require the accountant or auditor to play safe and take a closer look at other factors prior to making a decision as whether to report or not.

Client General Indicators

There are several indicators that an accountant or auditor can use to identify transactions that may be related to money laundering and terrorism financing. Examples include;

(a) Client is known to be involved in, or indicates his involvement in criminal activities
(b) Client does not want correspondence sent to home address
(c) Client has accounts with several banks in a particular jurisdiction for no obvious reason, or has recently established relationships with different financial institutions.
(d) Client uses same address but frequently changes the names involved.
(e) Client appears to have only a vague knowledge of the amount of the transaction and the client goes to unnecessary lengths to justify the transaction
(f) Client presents information or details which are confusing
(g) Client is secretive, nervous or reluctant to meet in person.
(h) A transaction is suspicious but the client seems to be blind to the fact that he might be involved in money laundering
(i) Client provides a telephone contact which either does not exist or has been disconnected.
(j) Client is involved in an activity unusual for that client or business
(k) Client insists that a transaction be done quickly.
(l) Client attempts to develop a close relationship with staff
(m) Client uses different names and addresses
(n) Client attempts to bribe or offer unusual favours to provide services which are suspicious or unusual

Client Specific Indicators

In addition to the client general indicators mentioned above, there may be other more specific indicators relating to each particular industry, which either alone, or when taken together with other general indicators, will lead also to the conclusion that a particular transaction is suspicious.
These specific indicators may include the following;

(a) Client appears to be living well beyond his/her means in the light of his/her employment, profession or business.
(b) Client conducting business transactions inconsistent with the nature of their employment, profession or business or where business activity is inconsistent with industry average or financial ratios.
(c) Client requests anonymity.
(d) Client wants accountant or auditor to coordinate international transactions, including currency exchanges, or to coordinate cross-border movement of funds, when this type of transaction is inconsistent with the ordinary business practice of the client.

(e) Client is unconcerned about fees to be paid in respect to an aborted transaction.

(f) Client requests accountant or auditor to establish a nominee company or trust for deposit of funds, when this type of transaction is inconsistent with the ordinary business practice of the client.

(g) Client makes unusual requests for placement of funds into trust accounts for safekeeping.

(h) Client refuses to discuss the business purpose of the transaction.

(i) Client seeks to obtain trust account information and is prepared to pay unusually high fees to use this information and account.

(j) Client offers to pay a much higher fee than is usually charged or than accountant or auditor quotes for similar assignments.

(k) Client has cheques inconsistent with sales

(l) Client has a history of changing accountants or auditors

(m) Client is uncertain as to the location of the company or business records

(n) Client has no employees, which is unusual for the type of business

(o) Client is paying unusual consulting or similar fees to offshore companies

(p) Client records consistently reflect sales at less than cost, but entity continues in business without reasonable explanation of the continued loss.

(q) Client makes large payments or transfers to subsidiaries or other controlled entities that are not within the normal course of business.

(r) Examination of source documents shows misstatements of business activity that cannot be readily traced through the company books.

(s) Client is undertaking activities inconsistent with its commercial registration license and Memorandum and Articles of Association

(t) Client acquires large consumer assets (i.e. luxury automobiles, personal residences etc.) when this is inconsistent with the ordinary practice of the company or industry.

(u) Client is invoiced by organizations located in territories that do not have adequate anti-money laundering systems, or are known to be highly secretive banking and tax havens.

Detecting Suspicious Transaction

There may be numerous reasons why a particular transactions, or group of transactions, are considered suspicious or unusual, reasons which may be unrelated to the value of such transaction. The bottom line is that all transactions suspicious or unusual for any reason are to be reported. Under AMLA, 2006 there is no value threshold under which suspicious or unusual transactions need not be reported. The implication being that all suspicious transactions, no matter what their value are subject to the reporting requirement. A transaction may be considered as suspicious or unusual as the result of a combination of different indicators, which individually are relatively insignificant, but when taken together raise an alert that the transaction may be connected with money laundering or terrorist financing.

The context in which the transaction occurs may also be significant, and this will vary depending on the type of business and the nature of the client.

Accountants and auditors must evaluate transactions in terms of what seems appropriate and is within the normal practices in a particular business or industry. In the event that transactions do not appear normal, then there may be reasonable grounds for considering such transactions as suspicious or unusual in the context of money laundering or terrorist financing. When considering whether a transaction or group of transactions is suspicious or unusual, accountants or auditors need to consider all aspects of the entity's business, financial history, background and also his behaviour. Any or all of these and other factors, may lead to consider that the transactions should be reported.

Accountants and auditors should be always vigilant against money laundering transactions at all times. A transaction may be of suspicious nature irrespective of the amount involved. If in any doubt, or if there is any element of a transaction or group of transactions, which makes accountant or auditor feel uncomfortable with the transaction(s), then take initiative to report.

APPOINTMENT OF ANTI-MONEY LAUNDERING REPORTING OFFICER (AMLRO)

All accounting and auditing firms should appoint Anti-Money Laundering Reporting Officer (AMLRO). An AMLRO is appointed by the accounting or auditing firm for monitoring transactions and ensuring compliance with the Anti-Money Laundering Law. The role of the AMLRO carries significant responsibility and should be undertaken by an appropriately experienced individual with sufficient authority to enable decisions to be taken independently. The AMLRO is required to:

(b) Decide if there are sufficient grounds for suspicion to pass those reports on to FIU.
(c) Act as the key liaison point with FIU and law enforcement agencies including dealing with consent and disclosure issues.
(d) Advice on how to proceed with work once an internal report has been issued to guard against risks of tipping off or prejudicing an investigation; and
(e) The design and implementation of internal anti-money laundering systems and procedures.

The functions of an AMLRO can be delegated, although this does not relieve that AMLRO of his responsibility, and accounting or auditing firm should have contingency arrangements for discharging the duties of an AMLRO during periods of absence or unavailability. It is recommended that businesses appoint an alternate or deputy AMLRO for these situations and ensure that the reporting channels are well known to all relevant employees.

The AMLRO will also be responsible for reporting of suspicious transactions to the Financial Intelligence Unit (FIU). Any suspicious transaction(s), if undertaken, should have prior approval of AMLRO. The AMLRO shall have reasonable access to all the necessary information/documents, which would help him in effective discharge of his responsibilities. The responsibility of the AMLRO may include:

(a) Putting in place necessary controls for detection of suspicious transactions.
(b) Receiving disclosures related to suspicious transactions from the staff or otherwise.
(c) Deciding whether a transaction should be reported to the appropriate authorities
(d) Training of staff and preparing detailed guidelines or handbook for detection of suspicious transactions.

All accountants, auditors and other staff of the accounting or auditing firm should first report money laundering/ terrorist financing issues that come to their knowledge to the AMLRO.

REPORTING OF SUSPICIOUS TRANSACTION

Reporting of Suspicious Transactions

To the extent possible, all suspicious transactions should be reported to the AMLRO before they are undertaken. Full details of all suspicious transactions whether put through or not should be reported in writing to the AMLRO. Any transaction which seems suspicious may be undertaken only with prior approval of AMLRO. If the AMLRO is reasonably satisfied that the suspicious transaction may have resulted in money laundering, he should make a report to the Financial Intelligence Unit (FIU)

Reporting Procedures

For individual accountants and auditors (internal auditors) while reporting suspicious transactions should follow procedures developed by their respective employers and if no such procedures exist they should advise their employers to put in place reporting procedures and appointment of AMLRO for reporting suspicious transactions and any other money laundering activities. For accounting and auditing firms they should put in place internal reporting procedures for their accountants and auditors. Those internal procedures should clearly set out what is expected of individual accountants and auditors who discover suspicions or obtain knowledge of possible money laundering.

The internal reporting procedures can take any form specified by the firm, e.g. phone calls, emails, handwritten, etc, supplemented by copies of third party documents and working papers but firms should ensure that, whatever forms the reporting takes, relevant personnel are aware of the procedures to be used. Consideration should be given to how to minimize the number of copies of reporting information held within firms. Accounting and auditing firms may wish to consider whether it is advisable to specify telephone or face to face contact with the AMLRO as the preferred initial reporting step, with the reporting records being created by the AMLRO pursuance to section 17 of the Act.

It is recommended under this guideline that all details of internal reports are held by the AMLRO and excluded from client files. Exclusion of information from client files assists in avoiding inappropriate disclosure of information and provides some protection against the threat of tipping off. Client files should retain only that information relevant to, and required for the professional work being undertaken.

The AMLRO Reporting Procedures to FIU

The AMLRO is responsible for making decisions on whether the information contained in the suspicious transactions need to be relayed to FIU. The role of the AMLRO carries significant responsibility and should be undertaken by a senior person within the accounting and auditing firm who has sufficient authority to take independent decisions, and who is properly equipped with sufficient knowledge, and resources, to undertake the role. The key role is that of receiving information on suspicious transactions and reporting to FIU as applicable. It is for accounting and auditing firms to determine the format of their internal reports but reports to FIU must be made in pursuance to section 17 of the Act and Regulation 21.

Feedback from FIU

When AMLRO, accountant or auditor reports suspicious transactions or any matter related to money laundering he may want to know the feedback of whatever he has reported to the FIU. As stipulated in Regulation 31, the FIU is responsible for providing the accountant or auditor with feedback which includes;

(a) Acknowledgement of the receipt of the suspicious and unusual transactions reports and results of investigation;
(b) Whether a matter is closed because of prosecution;
(c) Whether a report was found to relate to a legitimate transaction;
(d) Information on the decision or result;
(e) Information on current techniques, methods and trends of money laundering and terrorism financing ;
(f) Examples of actual money laundering and terrorism financing cases, if any.

TIPPING OFF

Tipping off offence may be committed if a person knowing or suspecting that a report has been made either to an AMLRO or to FIU, and• making any disclosure which he knows or suspects is likely to prejudice any investigation that might follow that report. Section 20 of the Anti-Money Laundering Act,
2006 prohibits accountants and auditors from disclosing to an authorized third party the fact that a suspicious transaction report or related information is being reported to the FIU.

RECORD KEEPING AND RETENTION

For all accounting and auditing firms, records must be kept of clients' identity, the supporting evidence of verification of identity (in each case including the original and any updated records), the firm's business relationships with them (i.e. including any non-engagement related documents relating to the client relationship) and details of any occasional transactions and details of monitoring of the relationship. These records must be kept for at least five years after the end of the relevant business relationships or completion of the transactions. Care is needed to ensure retention of historic, as well as current records. Retention of any record (s) related to money laundering and terrorist financing should be in pursuance to Regulation 29.

THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS

Where it is suspected that money laundering has occurred the auditor will need to apply the concept of materiality when considering whether the auditor's report on the financial statements needs to be qualified or modified, taking into account whether:

(a) The crime itself has a material effect on the financial statements;
(b) The consequences of the crime have a material effect on the financial statements; or
(c) The outcome of any subsequent investigation by the police or other investigatory body may have a material effect on the financial statements.

If it is known that money laundering has occurred and that directors or senior employees of the firm were knowingly involved, the auditor will need to consider whether the auditor's report is likely to include a qualified opinion on the financial statements. In such circumstances, the auditor considers whether disclosure in the report on the financial statements, either through qualifying the opinion or referring to fundamental uncertainty, could alert a money launderer.

Timing may be the crucial factor. Any delay in issuing the audit report pending the outcome of an investigation is likely to be impracticable and could in itself alert a money launderer. The auditor seeks advice from the AMLRO who acts as the main source of guidance and if necessary is the liaison point for communication with FIU and other relevant law enforcement agency.

RESIGNATION AND COMMUNICATION WITH SUCCESSOR AUDITORS

The auditor may wish to resign from the position as auditor if he believes that the client or an employee is engaged in money laundering or any other illegal act, particularly, where a normal relationship of trust can no longer be maintained. Where the auditor intends to cease to hold office there may be a conflict between the requirements under section 177, 178 and 179 of the Companies Act 2002 for the auditor to deposit a statement at a company's registered office of any circumstances that the auditor believes need to be brought to the attention of members or creditors and the risk of 'tipping off'. This may arise if, for example, the circumstances connected with the resignation of the auditor include knowledge or suspicion of money laundering and an internal or external disclosure being made.

Where such disclosure of circumstance may amount to 'tipping off', he should seek advice from the AMLRO who acts as the main source of guidance and if necessary is the liaison point for communication with lawyers, FIU and the relevant law enforcement agency. The auditor may as a last resort need to seek legal advice.

Where the only information which needs to be disclosed is the underlying circumstances which gave rise to the disclosure, there are two scenarios to consider:

(a) Where the auditor only wishes to disclose the suspicions about the underlying criminal conduct and the basis for those suspicions, the auditor will not commit an offence under AMLA if that information only is disclosed. For example, if audit files are made available to the incoming auditor containing working papers that detail circumstances which have lead the audit team to suspect the management of a fraud and this suspicion is noted on the file, this will not constitute a 'tipping off' offence.

(b) If the auditor wishes to disclose any suspicions specifically about money laundering (for example, if the working papers in the example above indicated that the suspected fraud also constituted a suspicion of money laundering), then as a matter of prudence, reporting should follow procedure indicated in the AMLA and AMLR.

The offence of 'tipping off' may also cause a conflict with the need to communicate with the prospective successor auditor in accordance with legal and ethical requirements relating to changes in professional appointment. For example, the existing auditor might feel obliged to mention knowledge or suspicion regarding suspected money laundering and any external disclosure made to FIU. Although the AMLA and its regulations are silent on this, but best practice would not constitute 'tipping off' if it was done to prevent the incoming auditor from committing a money laundering offence.

STAFF TRAINING AND TRAINING PROGRAMS

All employees of the accounting and auditing firms must be trained to be aware of the policies and procedures relating to prevention of money laundering, provisions of the AMLA and the need to monitor all transactions to ensure that no suspicious activity is being undertaken under the guise of money laundering. This requirement is placed by section 19 of the AMLA, 2006.

INTERNAL CONTROLS OF AUDIT FIRMS

Controls should be in place to ensure that detection and reporting procedures are being followed. There should be;

(a) Clear lines of authority and responsibility
(b) Segregation of duties
(c) Rotation
(d) Establishment of limits
(e) Monitoring of activities
(f) Identification and monitoring of key risks
(g) New and ongoing client acceptance process

NBAA CONTROLS OF ACCOUNTING AND AUDITING FIRMS

NBAA as regulator of accountancy profession in Tanzania has put in place a mechanism for reviews to be undertaken for audit firms, which will ensure among other things that requirements under the Anti-Money Laundering Act 2006, Cap. 423 are implemented. These reviews are conducted through Audit Quality Review (AQR) which is designed to include the independent testing of money laundering and terrorist financing prevention and detection procedures used by audit firms.

For accounting firms, regulatory visit is the control that will be used to test compliance with the requirements under the Anti-Money Laundering Act, its regulations and the procedures provided in this guideline.

Tests, among other things, will be conducted in order to assess:

(a) Compliance with identification and record keeping procedures
(b) Maintenance of all AML/CFT specific documents
(c) Compliance with monitoring orders

COMPLIANCE WITH GUIDELINE

In relation to forming business relationships or carrying out one-off transactions, there should be established and documented procedures which require the maintenance of:

(a) Identification procedures
(b) Record-keeping procedures
(c) Procedures for internal controls and reporting to FIU

Accounting and auditing firm should also prohibit a person with whom it forms a business relationship from conducting any transaction by means of an anonymous or a numbered account only.

PROFESSIONAL CONFIDENTIALITY

The accountant or auditor's professional duty to maintain the confidentiality of client information may preclude reporting suspicious transaction to party outside the client entity. However, section 21 of the Anti-Money Laundering Act 2006, overrides professional confidentiality of accountants and auditors to make communications to law enforcement authorities.

Section 22 of the AMLA 2006, provides protection from any liability arising from the disclosures to the designated authority, whether the information was provided as a result of a monitoring order, production order, suspicious transaction, or routine transaction reporting.

OFFENCES

1 A money laundering offence involves concealing or converting property or the proceeds of property, knowing or believing that the property or proceeds were derived from the commission of another offence (known as a *predicate* offence). An offence is committed by an accountant or auditor if he/she fails to report where he has knowledge, suspicion or reasonable grounds for suspecting money laundering and terrorism financing activity.

2. Non reporting of suspicion to FIU

Accountants and auditors have a statutory duty to report to the to FIU when they have knowledge or suspicion, or reasonable grounds for knowledge or suspicion, of involvement of the entity's directors in money laundering, or of a failure to comply with the AMLA, 2006 and its regulations would normally be regarded. In determining whether such a duty arises, the auditor should follow the requirements of International Standards on Auditing and Customer Due Diligence intimated in the NBAA guideline.

3. A tipping off offence is not committed when a report is made to that person's supervisory authority or in any other circumstances where a disclosure is not likely to prejudice an investigation.

2. Identify, evaluate and explain how audits may fail to meet expectations of users. [Learning Outcome b]

2.1 The expectation gap

The expectation gap is the gap between an auditor's actual standards of performance and what the public expects of his performance i.e. it occurs when the audits fail to meet the expectations of users of audited financial statements..

Example

Peoplesoft Ltd was engaged in the supply of manpower to the hotel industry in China. It appointed Lee as an auditor for its China division. Lee gave an unmodified report for the year 20W8.

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 $10,000.

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 that therefore their accuracy was assured. This gap between Lee's performance according to the auditing standards and Peoplesoft's belief is known as the expectation gap.

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.

Typical illustrations of the expectation gap are as follows:

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 (REVISED) 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 (REVISED) 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.

According to the UK Corporate Governance Code:

The board is required to maintain a sound system of internal control.
The external auditor must review whether the Corporate Governance statement complies with the Code.

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.

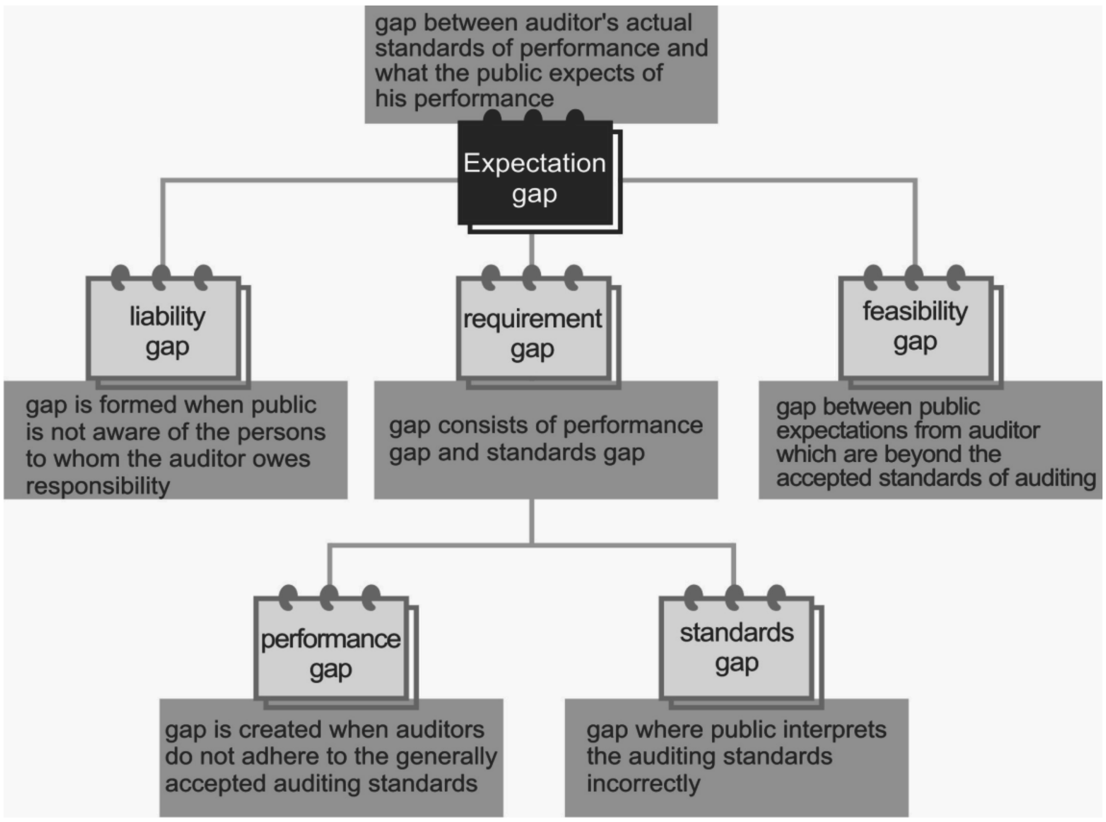
Effective internal control can only help an entity to achieve these objectives; it can provide management information about the entity's progress, or lack of it, toward its objectives. However, internal control cannot change an inherently poor manager into a good one. What's more, changes in government 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.

Diagram 3: Classification of expectation gap



1. Requirement gap

A requirement gap consists of a performance gap and a standards gap.

(a) Performance gap

When auditors do not adhere to generally accepted auditing standards, a performance gap is created.

Example

Nelson, the auditor of Jerry Publications, accepted the statement of accounts receivable duly authorised by the marketing director as audit evidence. Later it came to light that at least 25% of the customers were not genuine.

According to generally accepted audit standards, auditors are required to show professional scepticism and verify the customer's statement of accounts. Therefore Nelson has not adhered to ISA 500 Audit Evidence. This is a performance gap.

(b) Standards gap

A standards gap arises when the public does not interpret the auditing standards correctly. For example, the public believes that auditors are responsible for the detection of fraud. However, according to ISA 240, the prime responsibility for the prevention and detection of fraud vests with the management.

A standards gap is a gap between:

- ❖ The public's interpretation of statutes and accounting standards; and
- ❖ The interpretation of the standards through cases held in courts of law.

Example

It is the duty of auditors to verify the existence of an entity's assets.

However, in the Kingston Cotton Mills case it was held that auditors cannot be held for negligence when, in the absence of any circumstances which indicate the possibility of fraud, the auditors accepted the certificate of inventory which was certified by a responsible official of the company, as sufficient audit evidence.

(c) Feasibility gap

This is the gap between the public's expectations of the auditor which are beyond the accepted standards of auditing i.e. society's unrealistic demands of auditors. The demands are not feasible. The example of Peoplesoft Ltd given earlier illustrates the feasibility gap.

2. Liability Gap

This gap is formed when the public is not aware of the persons to whom the auditor owes responsibility. For example, in the Caparo Industries Plc case, (explained in Learning Outcome 3) it was held that auditors owed no duty of care towards individual shareholders. The auditors owe a responsibility to the shareholders as a whole or the company.

2.2 Narrowing the gap

According to DTI reports, high profile audit failures like BCCI, Maxell, Coloroll, Queens Moat House, and Polly Peck have led to loss of investments, pension, jobs and taxation. However there is little sign of introspection by the auditing industry upon the institutional failures of professional education, audit technologies and the ideologies and values of auditing firms.

The audit industry has shunned the 'consumer rights' revolution (where producers are expected to withdraw their products and compensate injured parties to meet public expectations) which has touched so many other industries.

Diagram 4: Methods to bridge the expectation gap

The expectation gap can be bridged in the following ways:

(i) **Making the public aware of the auditing practices and the reasons why they cannot meet public expectation.** For example, the practical difficulties which auditors would face in taking responsibility for the prevention and detection of fraud, since fraud is normally organised and involves intentional concealment or misrepresentation. In addition, the Long Form audit reports which clearly describe the auditor's responsibility.

(ii) Auditors must ensure that the **engagement letter includes the nature, scope and purpose of the audit** and **significant areas which will not be covered**.

(iii) Auditors must take steps to **ensure that the quality of audit is maintained** at the highest level.

(iv) **Professional bodies** like the NBAA and ICAEW must consider **the possibility of increasing auditors' responsibilities towards third parties**.

(v) Audit reports should **explicitly state that audit does not guarantee the going concern status of the entity.**

(vi) Audit reports must **include a disclaimer of the auditor's responsibility towards detection of fraud**.

Test Yourself 2

(a) Smith was the auditor of Bright Bankers for the year 20W0. The audited financial statements contained a note that the cash balance as at 31 December 20W0 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.

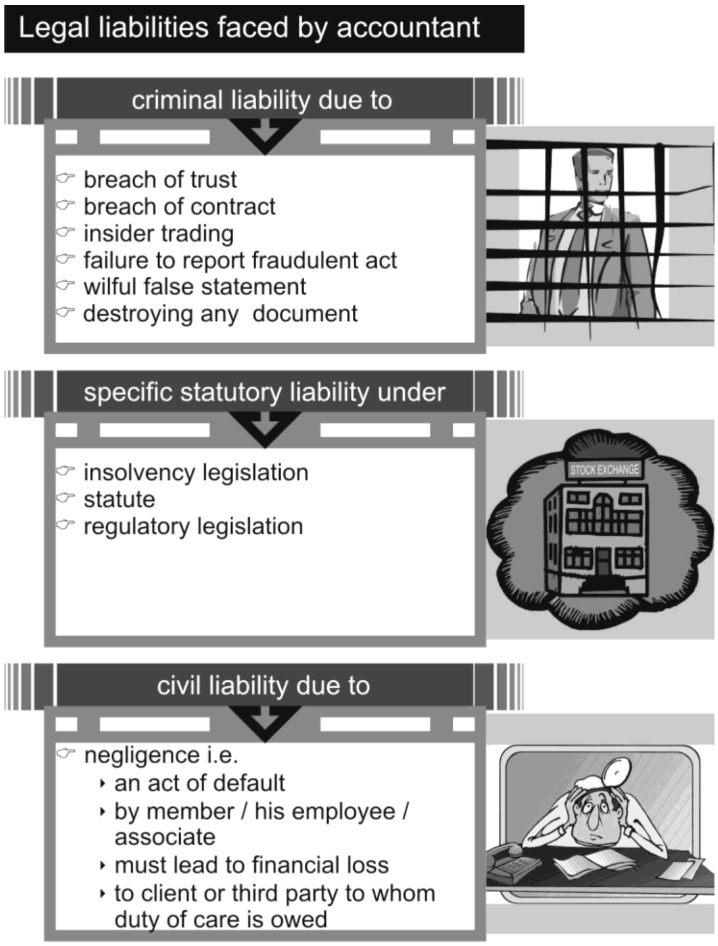
Required:

Identify the expectation gap and justify your answer.

3. Identify, evaluate and explain the extent of legal liability including criminal and civil law liability including professional negligence issues and how they can be mitigated.
[Learning Outcome c]

It is a general perception that negligent auditors are protected by the law. However this is a misconception. In a number of member countries of the European Union and in the US, audit firms have been held responsible for negligence. In several cases, the liability was also higher than the auditor's direct responsibility for financial failure and the amount of audit fees.

Diagram 5: Liabilities faced by accountant



The services provided by accountants include:
- ❖ accounting,
- ❖ assurance services,
- ❖ taxation consultancy services,
- ❖ management accountancy services and
- ❖ valuation of shares and bonds.

A professional accountant is expected to be held responsible for the quality of work performed by him.

Tip

Accountants who **do not discharge their services responsibly** face the following **legal liabilities**:
- ❖ **Criminal liability for negligence**
- ❖ **Specific statutory liability**
- ❖ **Civil liability for negligence**

The identification, evaluation and the extent of each of these is discussed in the following paragraphs:

3.1 Criminal liability

1. The following case study is an instance of a criminal liability against auditors.

Case Study

Rex v Lord Kylsant and another

The annual accounts of Royal Mail Stream Packet contained an intentional false representation of a trading profit, whereas in reality the company had made a trading loss. This occurred when the earnings of the fleet were not sufficient to show a trading profit. The chairman and the auditor were criminally prosecuted for intentionally deceiving the shareholders about the financial status of the entity.

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2. **Breach of trust**: the auditor not maintaining the confidentiality of information or not using client information for the benefit of the client.

Example

Right Accountants are the auditors of Dvyne Plc. Dvyne Plc has recently tendered for a catering contract with Cat Airlines. The partner of Right informed his brother-in-law (who was a caterer) about the value of the tender. This is a criminal liability involving a breach of trust since:

Confidentiality is not maintained i.e. information about the client was passed to the auditor's brother-in-law client information was not used for the benefit of the client i.e. it was used for the benefit of the auditor's brother-in-law.

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3. **Breach of contract**: continuation of an audit engagement after the term of appointment is completed.

4. **Insider trading:** the auditor makes use of unpublished price sensitive information (like acquisitions or change in profits) to obtain personal benefit. Auditors generally avoid purchasing shares in the client company so that the probability of insider trading will not occur.

Example

Tanya is the auditor of Tiptoes Plc, a shoe company. Tanya accesses confidential information during the course of audit. The information is that the company will be issuing bonus shares next month. Tanya wants to purchase shares in Tiptoes so that she will be allotted the bonus. However Tanya cannot purchase shares in her own name as this will hamper her independence. Therefore she decides to purchase the shares in the name of her mother. This is insider trading since Tanya is using price sensitive market information for her personal benefit. This is a criminal offence.

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5. **Failure to report suspected fraud or money laundering**

6. **Wilful false statement**

Example

The Companies Act in India would hold an auditor guilty of a criminal offence, if any misstatement is made in an entity's prospectus. The auditor would have to prove that either the misstatement was not material or that he had reasonable grounds to believe the misstatement was true. Only then can he be relieved of the criminal liability.

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7. **Destroying or damaging any document** etc.

3.2 Specific statutory liability

A professional accountant may also be held liable for not adhering to the provisions of various Acts like the Companies Act, the Insolvency Act and the Income Tax Act.

1. Liability arising from insolvency legislation

Example

Rex is a professional accountant. On 25 April 20W8, he was appointed the liquidator of Minerex Plc, a mining company located in the UK.

The tasks which were performed for the winding up of the company included selling off all free assets and obtaining as much dividend as possible.

The priority chain was as follows:

- secured claims
- claims with first priority (tax claims and settlement with regulators)
- claims with second priority (wage claims or settlement with employees)
- claims without priority (unsecured payables)

The list of secured claims included Jasmine Plc (whose director is a cousin of Rex) who is actually a supplier of the company. Lisa, an employee of the company, was aware of the matter and sued Rex for negligence in the administration of his duties in the capacity of liquidator.

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2. Liability arising from statute such as tax legislation. For example, when the auditor does not disclose creative accounting practices made by the client with the intention of paying lower taxes

Example

Lily Plc is a soap manufacturer. The tax auditor is aware that the company delayed the recognition of income by reporting the sale of two consignments (for significant amounts) which took place on 28 December 20W7 as a sale for the year 20W8. This was done intentionally so that lower revenue would be reported and the company could pay lower taxes. The tax auditor had documentary evidence of the fraud, but signed the tax audit report with the incorrect sales amount. This will give rise to a professional liability arising from statute.

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3. Liability arising under regulatory legislation e.g. non-compliance with stock exchange regulations, Sarbanes-Oxley Act provisions

Example

Under S-802 of the Sarbanes-Oxley Act, accountants are required to retain audit working papers for a minimum of five years. An accountant who intentionally violates this provision could face a maximum sentence of 10 years in prison.

Criminal offences, if proved, are punishable by payment of a penalty and / or imprisonment.

3.3 Civil liability

A professional accountant can face civil liabilities for negligence, when he conducts his duties negligently.

Case Study

Arthur E Green and Co v The Central Advance and Discount Co Ltd

The auditors gave an unmodified audit report even though the financial statements contained a schedule of bad debts which was provided by the managing director. The auditors were aware that the list of bad debts was inaccurate and they were not satisfied with the audit evidence.

Judgment

The auditor was charged with negligence.

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1. Liability for negligence

The liability on account of professional negligence occurs due to:

an act of default; by a member or his or her employee / associate; which must lead to financial loss; to a client or third party to whom duty of care is owed. Each of these points is explained below.

(a) **An act of default** means either **an act** or **omission** which occurs **due to non-application of the professional care and skills** which are normally applied by accountants and auditors.

Professional competence and due care

An accountant acts with professional competence and due care when he **works meticulously and ensures that the services he provides are in accordance with the professional standards set by the professional body.**

Accountants can be charged with non-application of professional care and skills if they:

(i) **Do not ensure that clients or employers** are **provided** with professional services based on the **latest developments in the profession**, both legislative and technical.

Example

Relaxo Plc has non-current assets valued at Tshs 35,000 million. While conducting the audit of Relaxo Plc, the auditors, Becker, finalised the audit without reviewing whether the assets were impaired according to the provisions of IAS 36, Impairment of Assets.

Non-compliance with the terms of the IAS 36 would amount to an act of omission due to non-application of professional care and skills.

This would indicate an act of default. The auditor could be charged with a liability for negligence.

Case Study

Kingston Cotton Mill

The profits of the company were deliberately inflated by manipulation of the quantities and values of inventory. The auditors had depended on a certificate from the manager relating to the correctness of inventory in detail. Also no circumstances existed which indicated the probability of fraud.

According to the judge, an auditor is a watchdog and not a bloodhound. He is not bound to be a detective or to perform his audit work with the suspicion that there is something wrong. 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 his suspicion.

Judgment

The **auditor was not charged with negligence** for using the certificate of the correctness of inventories from a responsible official of the company, on the grounds **that there were no circumstances which indicated a possibility of fraud.**

(ii) Do not apply the code of ethics which are laid down by the profession

We have already discussed the importance for accountants to adhere to fundamental principles in Study Guide A1. Accountants can be charged with liability due to negligence, if they do not maintain independence.

Example

An auditor, who reports on the financial systems which he has designed, would face a threat to his objectivity. This would affect his independence and the client could charge the auditor with **liability for negligence** due to **Non-application of professional care and skills**.

(iii) do not **ensure that either they or their employees and professional associates are suitably trained and supervised**

Example

A tax accountant, who specialises in preparing and filing VAT returns for corporate clients, must ensure the following:

He and his staff are suitably qualified and skilled.
He and his staff are kept informed of any changes to tax law.
He devotes sufficient time and attention to each client's tax return.

If the team does not possess the qualities mentioned above, the auditor can be charged with **liability for negligence** due to **non-application of the professional care and skills**.

(iv) do not act in accordance with the requirements of the assignment, carefully, thoroughly and promptly

Example

Das & Co are appointed as the internal auditor of CNC Plc The scope of work to be carried out for the quarter ended 31 March 20X3 includes the verification of internal controls in the ERP systems of the company. This will require Das & Co to:

Possess the skills to carry out the audit (for which the audit team must include qualified systems auditors);
And complete the audit within the timeframe specified.

In the absence of these qualities, Das can be held liable for negligence.

(v) do not carry out further audit procedures, on occasions when auditors suspect that there are material misstatements in the financial statements. The auditors are expected to carry out further audit procedures until the suspicions are either confirmed or dispelled.

(b) by member / his or her employee / associate

A **professional accountant** is **expected to take responsibility for his work**. In short, the work of the accountant, if performed by his employee or his associate, needs to be carried out under the supervision of the accountant. Therefore, even if the accountant takes the assistance of either his employees or his associates, the accountant cannot be absolved of his responsibility.

Continuing the example of Das & Co

Das & Co assigned the task of carrying out audit procedures on petty cash to Samuel, an audit assistant. The petty cash balance according to the books of account was TZS 975,000, whereas the petty cash which was available with the cashier was TZS 75,000. Samuel failed to carry out a physical verification of the petty cash balance. Later it came to light that petty cash had been misappropriated.

Das & Co were charged with negligence since the auditors:

- ❖ Failed to verify the cash in hand; and
- ❖ The large petty cash balance did not make them suspicious of the probability of a misappropriation.

Hence the acts of negligence by Samuel, the audit assistant of Das & Co, resulted in the firm being charged with liability for negligence.

The example of Das & Co is similar to the case of **London Oil Storage Co v Seear Hasulk & Co,** where the **auditors were charged with negligence for failure to conduct the audit with professional scepticism and thereby not detecting the misappropriation of the petty cash balance**.

The above point is also supported by the case of **Henry Squire (Cash Chemists Ltd) v Ball Baker** in which **it was held** that **the principal is responsible for his clerk's negligent work.**

(c) Must lead to financial loss

Professional accountants can be charged with liabilities for negligence, **only if either their clients or third parties suffer from financial loss on account of acts of negligence by auditor**. The financial loss suffered by a client must be a direct financial loss, i.e. not an indirect or remote loss.

Example

Gamma is a professional accountant in the US. He is the tax consultant of West Coast Miners.

During 20X4, the company filed its income tax returns and paid the income tax as calculated by Gamma. During a tax audit, it came to light that the company had made significant errors in the computation of tax on account of applying incorrect rates of depreciation under the tax code. Due to the incorrect computation of tax, Gamma was asked to pay penalties amounting to TZS38 million.

Gamma's incorrect calculation of the tax is **act of default** which occurred **due to non-application of the professional care and skills which** are normally applied by accountants and auditors. Furthermore, the amount of penalty imposed by the IRS is a direct financial loss suffered by West Coast Miners.

(d) To client or third party to whom duty of care is owed

An act of **negligence arises when a duty of care exists**.

For a duty of care to exist, the following factors need to be satisfied:

(i) The accountant must be in a position to reasonably foresee that the statements (or the work carried out by the accountant) **would be relied upon by the client or the third party**.

(ii) The accountant is sometimes informed before carrying out the work that a third party would rely on the statements (or work) carried out by the accountant. For example, an accountant who is asked to prepare a project report for the purpose of getting a bank loan will be in a position to know, in advance, that the project report will be used by the bank for the purpose of vetting the loan application.

However, even **when the accountant is not explicitly informed** by the client that a third party would rely upon the results of his work, **the accountant is expected to understand the likely parties who would rely on his work.** For example, an accountant who prepares a transfer pricing report should be aware that the report will be used by the tax authorities.

The following cases support this point:

Case Study

Royal Bank of Scotland v Bannerman Johnstone Maclay

APC Limited was a plant hirer to the construction industry. Their main financers were the Royal Bank of Scotland (RBS). As part of the terms of finance, APC was required to provide the audited financial statements within six months of the end of its financial year.

APC provided RBS with the unmodified audit reports for the periods ended 30 November 1995 and 31 March 1997, which were certified by APC's auditors: Bannerman Johnstone Maclay (BJM).

RBS provided additional loans and also acquired equity shares in the company. The company failed to repay its loans. On failure to recover its loans and investments, RBS charged BJM with negligence in the preparation of the financial statements for 1995 and 1997.

Continued on the next page

It contended that they had relied on the financial statements certified by BJM, while providing additional loans to APC. In their opinion, BJM owed them a duty of care since:

BJM was well aware that APC's cash hungry business was financed by RBS.

BJM had evidence (in the form of RBS's loan papers, which was part of the working papers to support the going concern status) of the bank's requirement for audited accounts, which were to be provided to the bank along with the monthly management accounts of APC.

Hence, BJM was well aware (or was expected to be aware) that as part of the bank's monthly process of assessing the continuation of the financial support to APC, RBS would rely on the audited financial statements of APC.

BJM defended the proceedings on the grounds that duty of care towards RBS did not arise from the prevailing circumstances, unless BJM wanted the bankers to rely on their work.

Judgment

Although the **bank had never made direct enquiries about APC's financial position from Bannerman,** the judge held that the **auditors had a duty of care since they had sufficient knowledge that the bank would rely on the financial statements.**

Caparo Industries Pls v Dickman

Fidelity Plc (Fidelity), a company listed on the LSE, was manufacturers and vendors of electrical equipment. The financial results of Fidelity for the year ended 1984, were declared by the directors in May 1984. The financial statements of Fidelity for the year ended 31 March 1984 were audited by Touche Ross and approved by the board, one day prior to the announcement of the financial results.

The financial results indicated significantly lower profits as compared to the expected profits. The declaration of the financial results led to a sharp fall in the price of the company's shares in the stock market. The audited financial statements were made available to the shareholders, along with the notice to the AGM, on 12 June 1984.

On 8 June 1984, Caparo purchased 10,000 shares of the company. On 12 June 1984, they purchased an additional 50,000 shares in the company. Later, in September 1984, they made a bid and purchased the remaining shares of the company. In this way they acquired a controlling interest in the company.

Later it came to light that the audited financial statements included creative accounting practices in the areas of inventory and revenue which resulted in a falsely projected profit of £1.3m, which was actually a loss of more than £40,000. Caparo alleged that it had relied on the audited financial statements as the basis for acquiring a controlling interest in the company.

Judgment

The above transactions indicated that **Caparo had two relationships with Fidelity**:

❖ **as shareholders** - when the shares were purchased

❖ **as prospective investors** - when Caparo purchased a controlling interest, based on the audited financial statements

The House of Lords delivered a judgment that the **auditors owed no duty of care towards individual shareholders or to prospective investors of the company who rely on the audited financial statements as the basis for making investment decisions.** The auditors owe a responsibility to the shareholders as a whole or the company. Also Caparo's position as an investor did not indicate the existence of proximity.

Continued on the next page

The judge contended that a duty of care will exist only if:

(a) **The auditor is in a position to reasonably foresee that the financial statements** audited by them **would be relied upon by the client or the third party:** Touche Ross knew in advance that that the audited financial statements would be made available to Caparo.

(b) **There is a "relevant degree of proximity" between the parties:** i.e. proximity between the auditors and individual shareholders or prospective investors. There was no proximity between Touche and Caparo, since Caparo was either a minority shareholder or a prospective investor in the company.

(c) **The auditor is justly and fairly entrusted a duty of care by the client / third party:** in the absence of proximity between Caparo and Touche Ross, Touche Ross is not justly entrusted with the duty of care by Caparo.

The absence of the above conditions indicated that Touche Ross **did not owe any professional liability towards Caparo.**

(iii) There has to be a "relevant degree of proximity" between the parties.

Proximity means closeness. **It does not mean physical nearness but rather closeness in terms of relationship or because the parties are likely to rely on the work of the accountant.**

Example

Jay, the auditor of Sea Shells Resorts, certifies a report **solely** for Prego Hotels, which has requested and commissioned this report. In this case, Jay will only have a duty of care towards Prego Hotels since he has 'Proximity' with them.

However, if the auditor's report is used by other prospective investors who suffer economic losses, the prospective investors have no proximity with the auditors. Therefore the auditors do not have a duty of care.

However there are situations where the accountant can foresee that his work will be used. In **Candler v Crane Christmas**, it was held that **for proximity to exist** the accountant or **auditor preparing the accounts must be aware of:**

the particular person who would use his work; and
the purpose for which the accounts / audited statements being prepared would be used.

Case Study

ADT Ltd v BDO Binder Hamlyn

The controlling interest over Britannia Security Systems Group was taken by ADT Ltd Binder Hamlyn (BH) were the auditors of the group. While deciding to acquire the group, the ADT officials met the auditors and asked them whether there were any matters which would affect the true and fair status of the company's financial statements as reported in the audit report for the year 1989. The partner affirmed that the firm stood by the audited financial statements and there were no significant matters which they needed to be told about.

ADT acquired the group for £105m. However, later it came to light that the group was only worth £40m.
ADT sued BH for £65m plus interest on account of the losses incurred by them due to negligence in the audit work.

Court's decision

The courts held that **BH owed a duty of care towards ADT on account of the proximity which was created after the meeting between representatives of ADT and BH**. The judge ordered that BH pay £65m plus interest due to negligence caused by the firm.

(iv)The accountant is justly and fairly entrusted a duty of care by the client / third party.

Case Study

Possfund v Diamond

It was held that auditors owe a duty of care towards investors who make investments based on the contents of the prospectus.

Case Study

Hedley Byrne v Heller & Partners

Hedley Byrne was an advertising firm. Hedley proposed to undertake a significant advertising contract for Easipower Ltd In order to be assured of the financial health of the company, Hedley contacted the Bank of Heller & Partners. The bankers informed Heller that Easipower had a clean record with the bank. However they also gave a disclaimer that the bank and its officials would not take responsibility for the information disclosed.

In spite of the disclaimer, Byrne entered into the advertising contract with Easipower. Later Easipower, who owed £20,000, became bankrupt. Hedley sued Heller on grounds of negligence, for giving information which was misleading.

Judgment

The bank was justly and evenly assigned the duty of care by Hedley. The relationship was "sufficiently proximate" since the bank was aware that Hedley would rely on the information made available by them. This relationship demanded that the bank was not negligent in its 'duty of care'.

However, **the disclaimer absolved the bank of its duty of care**. Therefore, because a disclaimer had been given, the bank did not have to pay any damages.

Test Yourself 3

Blue Clouds Finance Ltd (BFL) was a member of Blue Clouds Group and a subsidiary of Blue Clouds holdings, a publicly listed company. Captureclue LLP was the auditor of the company for the year 20X3.

During the course of the audit, the auditors came across the following:

Sales returns of approximately TZS 31,000 million were not recorded.
Fictitious invoices of approximately TZS 5,000 million were created and recorded.
Profits of approximately TZS 3,000 million were inflated by falsely lowering the cost of goods sold.

The auditors started the audit during December 20X3. The auditors submitted an adverse report during June 20X4. They also reported that the fraud was carried out by the company's sales manager and the accounts manager. This was because the company followed the policy of making bonus payments as a percentage of profits to the senior managers of the company. Hence the fraud was carried out by the sales manager and the accounts manager since they wanted to get high bonus amounts.

Within 25 days of submitting the audit report, the auditors were sued for negligence. By 30 June 20X4, the company had inflated profits due to creative accounting practices in the area of sales amounting to Tshs700 million.

Required:

Can Captureclue be held liable to the company? If so, under which provision?

3.4 How liabilities can be mitigated?

Various instances where auditors and accountants were held liable for negligence, to audit clients as well as to third parties have already been explained. Furthermore, accountants are often required to rely on the work of their employees and/or associates even though they are personally responsible.

Diagram 6: Ways to restrict auditor's liability

1. Issue a Disclaimer

Example

"This report has been marked 'CONFIDENTIAL'. It has been prepared solely for the members of Cosby Company in accordance with the Companies Act 2006. The audit report consists of those matters that are required to be undertaken for an audit and to be stated in an audit report and not for any other purpose.

In the circumstances, with the full support of law, I am not held responsible for any other party other than the company and the company members for the audit report or for the audit opinion."

In the **Royal Bank of Scotland v Bannerman Johnstone Maclay case** discussed earlier (in para 3.3)**,** in which the judge held that **the auditors had a duty of care since they had sufficient knowledge that the bank would rely on the financial statements**.
In view of the above judgment, what safeguard could the auditor have used so as to avoid the liability?

The auditor could have issued a disclaimer to the audit report saying that it accepts no responsibility towards the lenders of APC and third parties, unless it is specifically accepted in writing.

Response to Bannerman judgment

However, the ICAEW permits its members to take appropriate steps to reduce their exposure to liability to claims of third parties.

The viewpoints of the ICAEW are as follows:

When disclaimers indicate a lack of confidence in the professional work of an accountant, disclaimers would not be appropriate. For example disclaimers endorsed by auditors owing no liability towards stakeholders (other than shareholders) on the endorse copies of financial statements which are filed with Companies House (UK Registrar of companies) in accordance with s 226 of the Companies Act 2006.

However, if a member of the ICAEW prepares financial statements on behalf of a client, he may mention in his report that the financial statements prepared by him do not provide assurance about the true and fair nature of the financial statements. The accountant also did not verify the information provided by the client for compiling the financial statements.

2. Use of an Engagement Letter

Engagement letters are discussed in detail in Study Guide B2

Accountants and clients have a contractual relationship. Such a relationship requires the accountant to apply professional care and skill. However the degree of skill and care to be exercised would depend upon the nature of the work, the accountant's experience in carrying out similar functions, etc. This is why the duty of care is subjective.

As a safeguard, it is recommended that members **prepare letters of engagement which contain the details of the work to be carried out, the time frame for completion of the assignment, the fees to be charged** etc. The letter of engagement must be accepted by the client. It will minimise the risk of disputes relating to the work carried out by the auditors.

It is advised that **significant matters which are excluded from the professional work undertaken must be mentioned in the engagement letter.**

Example

Sam & Co is the internal auditor of Delta Group of companies. The scope of work for the first quarter includes review of the existence and effectiveness of internal controls in the area of purchases. The company is a certified ISO 9001 organisation. The engagement letter issued by Sam & Co specifically mentions that the review of the effectiveness of the internal controls would not include verification of adherence to ISO 9001 standards. For example, whether purchases made adhere to the quality regulations set out in the ISO documentation.

However, there are no circumstances under which the auditor can be exempted from liability due to negligence, breach of duty or breach of trust. S 310 of the Companies Act 1985 (which applies to companies in the UK) makes void any arrangement by which the auditor's liability is reduced.

The engagement letter must also include any exclusion or restriction of liability which is agreed between the accountant and the client / employer.

Example

Jasmine Perfumeries urgently needs finance so it has approached National Bank. National Bank has asked for the unaudited financial statements since the audit of Jasmine is underway. Therefore Jasmine has appointed Steven who is a professional accountant to prepare the financial statements for the year 20X7. Steven has been asked to compile the financial statements from Jasmine's books of account.

By accepting this assignment, Steven will face considerable risk. This is because Jasmine or the business community (which may rely on the financial statements) may not understand the implications of "unaudited" financial statements. They (the client or the business community) may rely on the financial statements since they have been compiled by Steven, who is a professional accountant.

Hence Steven issues an engagement letter to Jasmine which clearly lies down his duties and also the fact that the financial statements are compiled from the books of account and he (Steven) will not be liable for misstatements which arise out of misstatements in the financial statements.

Advice on limited information

Accountants may be asked to carry out investigations, offer advice on taxation matters or offer management consultancy or book-keeping services to their clients. The nature of each engagement will be different. Therefore the **engagement letter issued by the accountant must clearly specify the extent of the responsibility he agrees to undertake, making particular reference to the information supplied to him as a basis for his work and to those areas** (if any) to be excluded from his examination.

Example

Vista Labs is a pathology laboratory. Four years ago, the company invested in an expensive piece of equipment which was used for carrying out its investigations. Recently the internal auditors noticed that significant cash receipts were not recorded. The internal auditors pointed out their observations to the management.

The management appointed Janet, who is a professional accountant, to investigate the matter. Janet was informed that all pathology tests carried out in the lab were recorded in the lab reports and machine log books. The cash receipts could be cross-checked with the lab reports and machine log records. Janet was asked to investigate the matter for the period from 20X2 to 20X3.

Continued on the next page

Janet issued an engagement letter which stated that:

(i) She would undertake the investigation for all the receipts made during 20X2 to 20X3
(ii) The records used for the investigation would be the counterfoils of the receipt books, cash book, lab reports and machine log books
(iii) She would rely on the accuracy of the lab reports and machine log books

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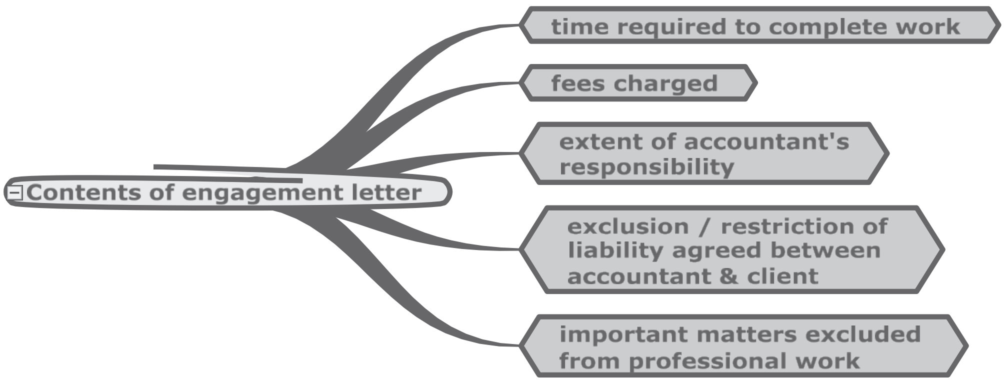
SUMMARY



3. Avoiding liability to third parties

Exposure to claims by third parties arises due to access (to documents prepared by public accountants) given to third parties. Access to public documents (like the audit reports of listed companies) issued by accountants cannot be denied to the general public. Hence the auditor is exposed to claims from the general public on matters contained in public documents.

However, for other work (other than audit of listed companies), the auditor can mitigate the exposure to claims from third parties by carrying out the following steps:

Use of disclaimers – as explained earlier

Work done for special purposes

When accountants prepare work or give assurance on a matter which is meant for a particular purpose, they must **clearly state in the document, the purpose for which the document is used**.

Confidential reports

Sometimes auditors are asked to prepare confidential reports, e.g. investigation reports, which are circulated only to specific persons. The auditor expects that the persons, for whom the reports are prepared, will alone rely on the reports. In this case, the **auditor must mention that the report is prepared for the private use of the client and the report must not be issued to any other person without the consent of the accountant**.

4. Capping

The auditor's liability can be restricted by capping or setting a limit on the amount of liability which can be imposed on any specific party. This amount can be determined as a multiple of audit fees for a particular engagement, i.e. there will be a direct relationship between the audit fees and the amount of liability or the liability will be a proportion of the turnover of the company.

Germany, Austria, Greece and Portugal are examples of countries which have fixed statutory caps.

The capping method has recently been introduced in the Companies Act 2006 ("Act"). Some of the methods of capping which can be used are as follows:

- ❖ **By setting a fixed cap** (explained above)
- ❖ **Solely by referring to the 'fair and reasonable' test**

The parameters 'fair and reasonable' have not been explained either by the Act or by the Financial Reporting Council (FRC). According to the FRC, the parameters will be decided on a case by case basis and the decision will lie with the court.

This method of capping will not be acceptable to auditors because the court can fix a higher amount of liability than the amount set in the contract, if the amount set in the contract is not 'fair and reasonable'.

A **combination of a fixed cap and proportionate liability**

Any capping proposal is prone to criticism since it is inherently arbitrary. Such a mechanism also hampers the court's discretion and also leads to significant costs of litigation.

5. Incorporation

In many jurisdictions, auditors are allowed to operate only as sole traders or partners i.e. firms have joint and several liabilities. This means that a partner can face liability on account of negligence by other partners of the firm as well as the directors of the client company.

Example

Stiletoes is a shoe manufacturer. The company's executive's recently uncovered fraud in the area of inventory. The fraud was carried out by the staff in the stores and the purchase departments. The bankers, who relied on the audited financial statements of the organisation in choosing to finance the working capital of the company, sued the company and its auditors for providing fraudulent financial statements.

The court ordered the directors of the company as well as the auditors to pay a total of TZS 750 million to the bank, out of which the auditors were asked to pay 30% (i.e. Tshs225 million) and the directors were asked to pay the remaining TZS 525 million. The directors could pay only TZS 500 million since they became bankrupt. This meant that the partners of the audit firm had to pay TZS 250 million (TZS750 million – TZS500 million) instead of TZS 225 million, as stated above. This is because the partners of the firm were jointly and severally responsible (along with the directors) for paying the liability.

KPMG in the UK is an example of where auditors have chosen to become incorporated. This means that the **liability of the partners is restricted to the assets of the incorporation.**

Audit firms may form incorporations to address their liability problems. However, forming incorporation does not overcome the problems described above.
This is because:

- It makes the audit company fully liable for the total amount of any judgment which exceeds the professional indemnity insurance
- It makes the audit partners and the company liable for negligent acts by any partner of the company
- It protects the private assets of the 'innocent' audit partners
- Partners who are 'guilty' of negligence owe joint and several responsibilities the firm can be forced into liquidation
- The firm would need to publish its financial statements and also be subjected to audit

6. Limited Liability Partnership (LLP)

LLP was introduced in the UK in 1997. Under an LLP, 'innocent' members are not personally liable for the acts of negligence by other members. Their liability is restricted to their share in the assets of the business. In short there is no difference between the liabilities of members of incorporation and an LLP.

The only difference between the two entities is the taxation implications, i.e. incorporation has to pay taxes like any other 'company'. However an LLP does not pay tax. Only its members pay taxes for the income earned through the LLP.
Ernst & Young in the UK is an example of an LLP.

7. Professional Indemnity Insurance (PII)

Accountants who do not discharge their services responsibly face several legal liabilities**. Accountants face legal claims from clients and third parties due to negligent services provided to clients.**

Many countries have instituted insurance policies which cover risks associated with professional negligence.

Advantages of PII

PII protects accountants against damages which arise due to mistakes such as errors of judgement, or damage to clients' documents which result in damage to the client's business / reputation.

It enables innocent members to be compensated for losses incurred on account of negligent work carried out by other members / employees / associates.

PII is very useful for audit firms which operate as partnership firms since members are personally liable for negligence of partners. PII provides compensation to take care of this liability.

Audit firms and directors of client companies are jointly and severally responsible for negligent work being carried out. The firm may even face bankruptcy as a result of the liability. On such occasions, PII is useful.

Disadvantages of PII

PII excludes claims which exceed the policy amount, claims made after the policy has expired and activities which are specifically mentioned in the policy as excluded e.g. overseas work. Hence when a firm faces liabilities which are excluded from the PII, the firm will have to finance the claim.

The availability of PII to settle claims of negligence can make accountants act negligently in their work.

The cost of insurance premium is a direct cost to the firm. PII is either expensive or unavailable for certain high risk work.

Test Yourself 4

Benny and his friend Bill started a financial advisory business (called Access Financers) in 19W8. The company was a medium-sized enterprise. Vincent Vaz, their friend, is a practicing accountant. Considering the nature of the business and the fact that the company did not have any experienced qualified accountants, Benny and Bill decided to appoint Vaz as a consultant.

He was expected to advise the company on matters related to finance and taxation including any new developments in these areas. He was also expected to make instant decisions on important matters. Vaz informed Access that he would offer advice and prepare the Income Tax Returns, but he would not be in a position to represent the company before the tax officials.

Required:

What safeguards should Vaz take to ensure that he is not held liable for negligence?

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8. Liability Limitation Agreements (LLA)

Companies have expanded geographically and financially, and the society also has become more litigious. So, auditors are faced with increasing number of claims, including many that, if successful, would be beyond the company's financial resources.

Therefore new provisions were introduced by the Companies Act 2006 by which the auditors can, for the rst time, agree contractually with their audit client the limitation of their liability in respect of an audit. This is done by way of a **Liability Limitation Agreement (LLA).**

Definition

"An agreement that purports to limit the amount of a liability owed to a company by its auditor in respect of any negligence, default, breach of duty or breach of trust occurring in the course of an audit of accounts, of which the auditor may be guilty in relation to the company."

Features of an LLA

There is no defined format of an LLA; however, it should contain the following features:

(a) An LLA should be approved by a resolution of the company's shareholders. For public companies, this must be done at a General Meeting, while private companies have the option of using a written resolution.

(b) For group companies, the resolution needs to be passed for each UK company in the group and not just the holding company.

(c) LLAs are valid only for one financial year.

(d) The Companies Act also states that arrangements to limit the liability will not be effective except to the extent that they are "fair and reasonable" in the particular circumstances. Although the question of what is a "fair and reasonable" limit on the auditor's liability will ultimately be for the Court to decide in each individual case, the Act sets out a number of factors that should be taken into consideration, such as:

- ❖ The auditor's responsibilities which include provisions relating to the statutory audit and the duties and rights of auditors;
- ❖ The nature and purpose of the auditor's contractual obligations to the company; and
- ❖ The professional standards expected of the auditor.

(e) In assessing the limitation of liability, the court must not consider circumstances arising after the loss or damages are incurred or the possibility of recovering compensation exists, from other persons liable in respect of the same loss or damage.

(f) A company which has entered into an LLA must disclose the principal terms of the agreement in a note to the company's annual accounts for the financial year to which the agreement relates.

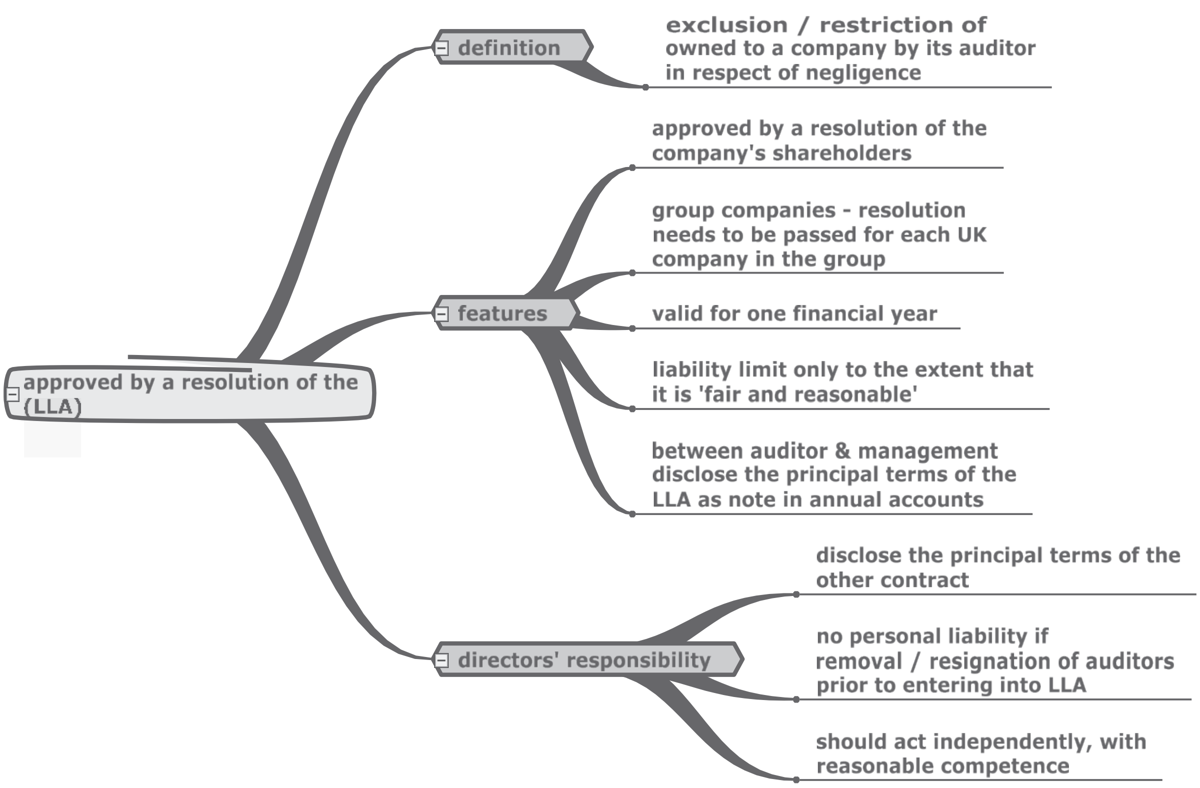
Responsibility of the directors

The directors of a company which enters into an LLA with the auditors owe the same duties as they would when entering into any other contract on behalf of the company.

The directors will not incur personal liability in relation to the decision to enter into an LLA provided they have obtained shareholders' approval prior to entering into the LLA.

While entering into the LLA, the directors need to ensure that they act independently, with reasonable competence and in a way that they honestly believe to be most likely to promote the success of the company for the benefit of shareholders.

SUMMARY



Answers to Test Yourself

Answer to TY 1

1. Reasons for regulation of auditors

(a) To protect Public Interest

The auditors are intermediaries between the owners and management. The owners of Prestige Corporation are spread all over the world and they cannot look into the day-to-day work of the company, therefore they appoint independent auditors to determine the financial position of the company. In order to assure the owners that the auditors are working with due care and meet professional standards, it is necessary to regulate auditors.

(b) To Maintain Dignity of the Profession

Generally, auditors are members of a professional body, say, Chartered Accountants or ACCA-qualified. The auditor's attitude has a direct bearing on the reputation of the professional body. Therefore, to maintain their reputation, these bodies regulate auditors by framing regulations for them e.g. a Code of Ethics.

(c) To Ensure Independence and Professional Competence of the Auditors

Auditors should be qualified and should maintain their independence in their work. In order to ensure that the auditors' independence is maintained, they are regulated. For example, by not accepting the internal audit role at Prestige.

(d) To Bring Uniformity in the Audit Procedure

These regulations, such as auditing standards, provide guidelines to auditors on how to tackle a particular situation. As a result, these regulations bring uniformity to the work of auditors.

2. Mechanisms for regulation of the auditors

(a) Code of Ethics

A Code of Ethics is a set of rules obligatory to the members of the professional body. The members should follow the rules otherwise they will have to give an explanation to their professional body for their non-compliance.

(b) Auditing standards

Auditing standards provide guidelines to auditors on how to tackle a particular situation.

(c) Various Laws and Regulations

A statutory auditor should comply with the provisions of the law governing audit and also other applicable laws.

Answer to TY 2

(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 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 a performance 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 a feasibility gap because the audit committee's expectations from the auditor are beyond the accepted standards of auditing.

Answer to TY 3

Captureclue **can face the following liabilities:**

(a) Criminal liability due to failure to report suspected fraud

According to ISA 240, when the auditor determines that fraud exists, the matter needs to be reported promptly to the appropriate level of management and those charged with governance. Captureclue was aware that the fraud existed and then investigated the circumstances which led to the fraud, however reported the matter to the audit committee only when the audit was finalised. Therefore Captureclue can face a criminal liability **due to failure to report suspected fraud.**

(b) Civil liability for negligence, since the auditors conducted their duties negligently

This is because they did not apply professional care and skills, which are normally applied by auditors, i.e. they did not report the suspected fraud to the audit committee promptly (as explained in the earlier paragraph). Prompt reporting to the audit committee would have avoided further financial loss to the entity.

For Capture to be held liable for negligence, it will also have to be proved that the client faced a financial loss due to the negligence. The scenario indicates that the same creative accounting practices were followed by the company during the current accounting year; hence the company has incurred a financial loss due to the negligence.

Answer to TY 4

Vaz can be held liable for negligence if there is a breach of contract**. A breach of contract can occur if Vaz does not carry out his responsibilities as any other accountant would have done.**

(a) For this he has to ensure that:

He promptly updates Access with the latest developments in the field of finance and accounts.
He makes decisions promptly and correctly.
He follows the fundamental principles of integrity, objectivity, etc. at all times.
He shows professional due care.

(b) Before carrying out any work for Access, Vaz must issue an engagement letter to Access promptly, which must be accepted by Access.

The engagement letter must clearly mention:

The duties which he will perform e.g. keeping Access up-to-date with the latest developments in the fields of finance and taxation, giving instant decisions, preparing the Income Tax Returns
any significant matters to be excluded which have been agreed with Access e.g. not representing Access before tax officials

(c) As a policy, if Vaz is given additional responsibilities on a future date, after issuing the engagement letter, he should only accept these responsibilities after they have been clearly defined in writing.

(d) Whenever he gives instant advice at the request of Access, Vaz should clearly mention that the advice given may be revised after the matter is considered in depth.

(e) Vaz must take out professional indemnity insurance from a reputed insurance company so that he can be compensated against any damages and penalties that he may face.

Quick Quiz

1. **Fill in the blanks.**

   (a) An accountant who does not maintain the confidentiality of a client's information or does not use the information provided for the benefit of his client gives rise to ________________________ liability.

   (b) An accountant of a listed company is said to be liable under ______________________ where he has not followed the rules and regulations of the stock exchange.

2. It is advised that important matters which are not mentioned in the professional work undertaken must be mentioned in the engagement letter. Is this true or false?

3. What is insider trading in relation to an auditor?

4. State two advantages of PII.

Answers to Quick Quiz

1.
   (a) Criminal

   (b) 'Specific statute'

2. True

3. Insider trading in relation to an auditor means that the auditor makes use of unpublished price sensitive information of his client company to obtain personal benefit.

4. The advantages of using Professional Indemnity Insurance (PII) are mentioned below:

   PII protects accountants against damages which arise due to mistakes such as errors of judgement, or damage to clients' documents which result in damage to the client's business / reputation.
   It enables innocent members to be compensated for losses incurred on account of negligent work carried out by other members / employees / associates.

Self-Examination Questions

Question 1

Swift & Flow (S&F) is an accountancy firm which carries out various assurance and accountancy related services.

The firm was appointed by Dvyne Confectionery to carry out a special investigation into the payroll systems of the company. The management had decided to carry out an investigation since the audit committee had received an anonymous letter which stated that there were many irregularities in the area of payroll including dummy employees, excessive increments paid to employees and failure to deduct loan installments from employees' monthly payroll.

S&F accepted the appointment by signing the appointment letter issued by the board. The appointment letter wanted the firm to investigate all the aspects of the payroll including the methods of adding a new employee to the payroll, removing an employee from the payroll, processing annual increments, processing the payroll, monitoring attendance, recording of payroll and payment of salary.

S&F completed the assignment within the agreed time frame. It was later paid its fees. Two months later, the external auditors noticed that the increment list which was recorded in the system contained many errors for employees who received increment of less than Tshs750,000. The audit committee was shocked since S&F had not reported this matter as part of their assignment.

Dvyne immediately took up the issue with S&F. S&F informed Dvyne that the number of officials who were paid less than Tshs750,000 was not significant to the payroll. Hence they did not carry out the verification. The audit committee was not convinced and decided to sue S&F.

Required:

Will Dvyne succeed in its suit against S&F?

Question 2

Greengarden Plc manufactures a variety of plastic furniture for both home and office use. It has been engaged in this business for the last 6 years. Unick LLP is the company's auditor and a reputed firm. Its partners are practising ACCA members. During 20X6, Sharp Plc, a new supplier of the company, agreed to supply raw materials to the company on credit, after relying on the audited financial statements of Greengarden. These financial statements had been audited by Unick.

Within six months, Greengarden had become bankrupt. This was due to its use of creative accounting practices in the area of revenue recognition and misappropriation of cash. This could have been detected by the auditors if they had maintained professional scepticism during the course of audit. On not receiving the payments from Greengarden, Sharp Plc has filed a suit against Unick for negligence in audit work.

Required:

Explain with reasons, whether Sharp is likely to win the case.

Question 3

Precious Ltd is a newly established company. Your firm has been appointed to carry out a statutory audit of Precious Ltd under the Companies Act. Aaron, a consultant of Precious Ltd, told the management of Precious Ltd that the company needed to be audited under the Income Tax Act.

One of the directors asks why, if Precious has already appointed a statutory auditor to carry out the company audit (as required by the Companies Act), it is necessary to appoint another auditor. The director also suggests that, if the audit under the Income Tax Act is a requirement, Precious should appoint the same firm to perform this audit as well as the statutory audit.

Required:

Discuss the implications of appointing the same auditor to perform an audit under the Companies Act as well as under the Income Tax Act.

Answers to Self-Examination Questions

Answer to SEQ 1

A professional accountant can face civil liabilities for negligence, when he conducts his duties negligently.

Liability for negligence would occur:

(a) if S&F has not applied professional care and skills

Since it conducted its duties negligently. From the scenario it is evident that S&F has not applied the professional care and skills which are normally expected of an accountant conducting such an assignment. This is because S&F was expected to verify all aspects of the payroll which included increments to employees. This was especially important in the type of assignment which the firm was assigned. This is supported by the decision in Armitage v Brewer & Knott.

(b) If it Leads to Financial Loss

Professional accountants can be charged with liabilities for negligence, **only if either their clients or third parties suffer from financial loss on account of acts of negligence by the auditor**.

It is clear from the scenario that Dvyne has suffered a financial loss.

(c) To client or third party to whom duty of care is owed

An act of **negligence arises when a duty of care exists**.

To determine whether a duty of care exists, the following factors need to be satisfied:

S&F must be in a position to reasonably foresee that its work would be relied upon by the client.
There has to be a "relevant degree of proximity" between the parties.
S&F is justly and fairly entrusted a duty of care by the client / third party.

Dvyne was appointed by S&F, so it was aware that its work would be relied upon by the client. There was a contract between S&F and Dvyne so there was a relevant degree of proximity between them. The appointment letter clearly specified the scope of work, so the firm was justly entrusted the duty of care.

Considering the above points, it appears that Dvyne will succeed in its suit against S&F.

Answer to SEQ 2

The court will decide whether Unick LLP has been negligent while carrying out the audit work. If Sharp can prove that Unick's negligence led to the financial loss, then Sharp will win the case.

A professional accountant like Sharp can face civil liabilities for negligence, if it conducts its duties negligently.

The **circumstances which can give rise to the liability** are as follows:

(a) **Act of default** i.e. an act or omission which occurs due to **failure to apply the professional care and skills** which are normally applied by auditors.

Unick can be charged with not applying professional care and skills since the firm has not acted in accordance with the requirements of the assignment, carefully, thoroughly and promptly. The scenario clearly mentions that the auditors i.e. Unick did not maintain professional scepticism during the course of the audit. This means that they did not adhere to the generally accepted auditing standards.

(b) By member or his employee / associate

The scenario mentions that Unick is a firm made up of ACCA practitioners.

(c) Must lead to financial loss

The scenario mentions that Sharp Plc suffered a financial loss in the form of non-payment of the amount due from Greengarden, after Greengarden became bankrupt.

(d) To client or third party to whom duty of care is owed

To determine whether a duty of care exists, the following factors need to be satisfied: Unick must be in a position to reasonably foresee that the statements (or the work carried out by the accountant) would be relied upon by the client or the third party.

There has to be a **"relevant degree of proximity**" between the parties. Proximity means closeness. **It does not mean physical nearness but rather closeness in terms of relationship or because the parties are likely to rely on the work of the accountant.**

The accountant is justly and fairly entrusted a duty of care by the client / third party.
For proximity to exist, while preparing the accounts Unick must have been aware of:
The particular person who would use the work; and
The purpose for which the accounts / audited statements being prepared would be used.

In the case of Sharp Plc, the point of debate is whether there was a relevant degree of proximity between Sharp and Unick. Applying the precedents set in the Caparo case, M Naughton (James) Paper Group v Hick Anderson (1991) and Berg Sons and Co Ltd and others v Adams and others (1992), the court did not award damages against third parties, even though the auditors were negligent, on the grounds that they did not owe a duty of care to third parties.

Therefore, the general legal position is that in the absence of exceptional circumstances, the auditor **does not owe a duty of care to individual shareholders, payables or other stakeholders**. However, in spite of the above judgment, if Sharp is able to prove that there was a relevant degree of proximity, between Sharp and Unick, then Sharp will win the suit.

Answer to SEQ 3

Implications of appointing the same person as an auditor under the Companies Act as well as under the Income Tax Act

It can be useful if the same auditor is appointed to perform different audits, as he can use the work done under one audit and reduce his work for another audit. However, often regulations prohibit the same person from performing other services. This is because, if an auditor receives a large fee from one client, he may not able to maintain independence in his work. For example, if a firm is appointed as the statutory auditor for the Income Tax Act as well as for the Companies Act, there is the possibility that it might ignore any unusual transactions or any unusual accounting policy adopted by Precious Ltd so as to protect the valuable fee income received from that client overall. There might also be the hope of getting more work e.g. an internal audit, other consultancy work etc. In this way, the independence of the auditor may be affected.

SECTION A

LEGAL, REGULATORY AND ETHICAL ISSUES

A4

STUDY GUIDE A4: LEGAL ISSUES II

Get Through Intro

The various stakeholders of an organisation are always concerned about its compliance with laws and regulations. The layman often believes that auditors check this compliance and if financial statements are audited it means that the organisation has complied with all laws and regulations for the relevant period.

How correct is this belief? In light of recent financial scams, there is growing criticism of the accounting profession. Questions like “Where were the auditors? What were they doing?” are often heard. The accounting profession has to pull its socks up to regain public confidence. However, blaming the auditor for all violations of laws and regulations committed by an organisation is like giving a dog a bad name and hanging him!

This Study Guide compares and contrasts the responsibilities of management and auditors concerning compliance with laws and regulations. As an auditor you must be aware of your responsibilities and remember that when you practise you will face many situations where you will discover non-compliance. This Study Guide will enlighten you about how to deal with such situations!

Learning Outcomes

a) Compare and contrast the responsibilities of management and auditors in relation to compliance with laws and regulations in an audit of financial statements.
b) Describe the auditor’s considerations of compliance with laws and regulations and plan audit procedures when possible non-compliance is discovered.
c) Discuss how and to whom non-compliance should be reported.

1. Compare and contrast the responsibilities of management and auditors in relation to compliance with laws and regulations in an audit of financial statements.
[Learning Outcome a]

Although the auditor is not responsible for ensuring that the entity has complied with applicable laws and regulations, he has certain responsibilities regarding such compliance.

ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements, stipulates the responsibilities of an auditor while performing the audit of financial statements.

1.1 Responsibilities of management

It is the responsibility of the management to **ensure that all the applicable laws and regulations are complied with**. It is also responsible for establishing an effective system to ensure such compliance.

The responsibility for having an effective system to ensure compliance can be discharged by the following:

1. **Identifying legal requirements**, monitoring them and ensuring that appropriate procedure is in place to ensure that these requirements are met.

Example

In order to ensure that all the amendments in the Finance Act are complied with, management may implement the following procedure. When the new tax budget is released, the finance executive shall prepare a checklist for new tax provisions and check that these provisions are complied with.

In addition, the entity may have an automatic reminder system which will give a reminder (say 7 days before the due date) of all the due dates i.e. due date for paying taxes, filing returns etc.

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2. **Instituting and operating appropriate internal control:** management may conduct regular reviews of the internal control system in order to ensure the efficiency and effectiveness of the system. In large organisations, an internal auditor may be appointed to ensure that the internal control system is efficient and effective enough to ensure compliance with laws and regulations.

3. **Engaging legal advisors to assist in monitoring legal requirements:** in some countries, a large entity is required by law to appoint a legal advisor and should make him responsible for ensuring that all the applicable laws and regulations are complied with.

4. **Developing and following a code of conduct**, communicating it to the staff and monitoring compliance.

Example

Do-well is a bank. According to the local laws of the country, every bank should report a transaction above $10,000 and suspicion of money laundering to the Regularity Authority. In order to comply with the money laundering law, the management of Do-well bank has developed an anti-money laundering programme for the bank and communicated it to all the employees.

Accordingly, Williams, the senior manager of the bank, is appointed as a compliance officer and he is made responsible for ensuring that the requirements of money laundering legislation are communicated to all the employees. In order to ensure that the employees are aware of the requirements, Williams has conducted a workshop.

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5. **Maintaining a register of applicable laws and regulations**, updating it regularly and checking compliance regularly.

In addition, management may assign appropriate responsibilities to an internal auditor or an audit committee to ensure such compliance.

1.2 Responsibility of the auditor

An auditor is **not responsible for preventing non-compliance**. The auditor is not expected to detect non-compliance with all laws and regulations.

Definition

According to ISA 250, **non-compliance** refers to acts of omission or commission by the entity being audited, either intentional or unintentional, which are contrary to the prevailing laws and regulations. Such acts include transactions entered into by, or in the name of, the entity or on its behalf by its management or employees. However, it does not include personal misconduct (unrelated to the business activities of the entity).

However, in the following circumstances, the auditor should test for compliance with applicable laws and regulations:

1. According to **ISA 200**, the **auditor should plan and perform the audit** with an **attitude of professional scepticism** recognising that the audit may reveal conditions or events that would bring into question whether an entity is complying with laws and regulations.

Example

Donna is the auditor of Manufax, a manufacturing company. While planning an audit, she should plan how she is going to audit the legal expenses. This is because penalties and penal interests are usually included in the legal expenses.

Sometimes expenses are recorded inclusive of penalties and penal interests. For example, if the licence is renewed after the due date, penal interest as a result of the late renewal is included in the licence fees. In such cases, Donna should also apply her professional knowledge and experience to identify the non-compliance (especially when it has a material impact on the financial statements and business) and should check such items of expenditure in detail.

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2. When designing and performing audit procedures and evaluating and reporting the results of such procedures, the auditor should recognise that non-compliance by the entity with laws and regulations may materially affect the financial statements.

Example

NJoy is a company which manufactures plastic toys. According to the Environmental Protection Act of the country, companies such as NJoy should treat the emissions from their factories. If NJoy has not complied with the laws and regulations related to the environmental laws, a penalty may be imposed on it which may materially affect the financial statements.

In addition, as a result of the pollution caused by NJoy, the entity's production process may be stopped which will then affect the financial position of the entity.

Therefore, the auditor of NJoy should be aware of NJoy's compliance with the applicable laws and regulations. The auditors should ensure that emission records are examined and legal correspondence is checked to make sure that no fines need to be recorded.

The auditor should check the laws and regulations which have an impact on the form and content of financial statements, including industry specific requirements such as those for insurance companies and banking companies.

3. When an auditor is conducting an audit in accordance with specific statutory requirements and is specifically required to report on the compliance with certain provisions of the law, then the auditor will plan to test for compliance with these provisions.

Example

In India, a statutory auditor (performing an audit under the Companies Act) needs to submit a CARO report which is a report required under the Companies Act. Accordingly, the auditor has to give details about whether the company is regularly depositing undisputed statutory amounts including retirement funds, investor education and protection funds, employees' state insurance, income tax, sales tax, wealth tax, service tax, customs duty, excise duty and any other statutory amounts that are payable.

In these cases, the statutory auditor has to check that the company has complied with the related provisions of the abovementioned laws. In order to discharge this duty, the auditor should have knowledge of the provisions of the laws which are applicable to the entity the auditor is auditing.

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4. An auditor should also plan his audit to test the compliance with laws and regulations which are so important that they have a fundamental impact on the operations of the organisation and non-compliance could cause the entity to cease operations.

Example

Continuing the example of NJoy

According to the provisions of the local laws on environmental protection, if the pollution caused by a company is above a certain limit, the regulators have the authority to cease the operations of the company responsible for the pollution.

Therefore the auditor of NJoy should plan the audit to test whether the emissions created by NJoy are within the limit. To do this, the auditor may perform the following procedures:

- ❖ Check the internal controls in place to ensure the emissions remain within the limit
- ❖ Check any correspondence from the regulators in this regard
- ❖ Check with the legal advisor whether the company has received any such notice from the regulators

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The auditor should understand the legal and regulatory framework within which the entity conducts its business.

Example

An auditor conducting an audit of a bank should be aware of the fact that the applicable laws and regulations for a bank include the regulations of the central bank of the country (which controls all the banks in the country), legislation related to money laundering and any specific act under which the bank is incorporated.

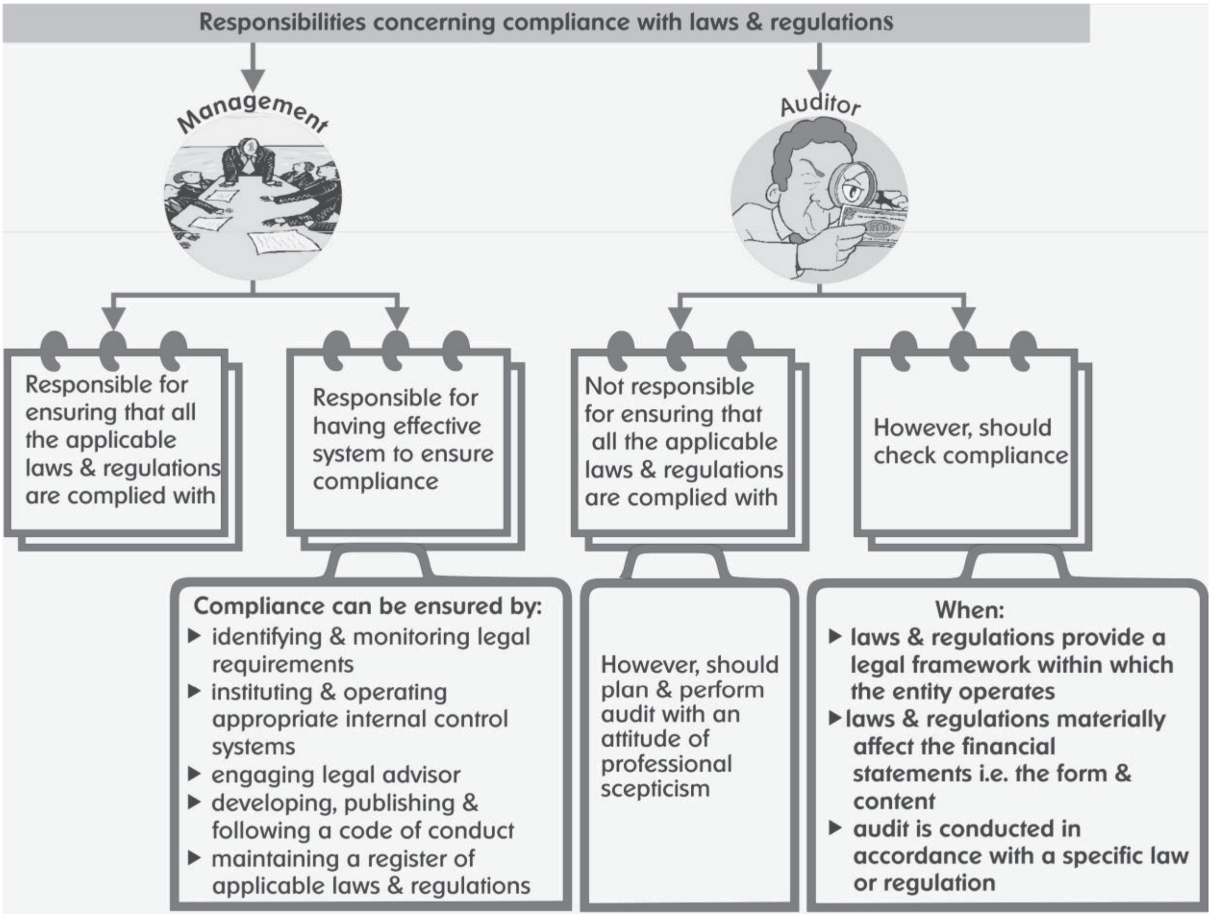
In short, he should plan and perform the audit with an attitude of professional scepticism (towards testing compliance with laws and regulations). He should check the compliance with applicable laws and regulations in the following cases:

When the laws and regulations provide a legal framework within which the entity conducts its operations such as the laws and regulations for insurance companies and banking companies.

When the laws and regulations determine the form and content of the financial statements such as the Companies Act.

When an auditor is conducting an audit in accordance with specific statutory requirements and is asked to report on non-compliance such as when an auditor conducts a tax audit under the Income Tax Act.

Diagram 1: Responsibility of the auditor and management for ensuring compliance with laws and regulations



Test Yourself 1

Under which of the following circumstances is an auditor responsible for testing compliance with the applicable laws and regulations? Justify your answer.

(a) An audit conducted under the Income Tax Act to check whether all the expenses claimed by the client are allowed by the Act and to identify any understatement or overstatement of the income and expenses.

(b) An audit of the financial statements conducted to express an opinion on the truth and fairness of the financial position of the entity.

(c) An audit conducted under the Companies Act, according to which the auditor has to report on whether the entity has complied with the laws relating to the payment of statutory payments.

(d) An audit of a financial institute. The financial institutes in the country are regulated by the central bank of the country and the company is established under a special act (which determines the form and content of the financial statements of the entities established under the act).

2. Describe the auditor's considerations of compliance with laws and regulations and plan audit procedures when possible non-compliance is discovered.
[Learning Outcome b]

In Learning Outcome 1, the circumstances in which the auditor should test compliance with laws and regulations are discussed in detail.

2.1 Auditor's Consideration of Compliance With Laws and Regulations

In the circumstances mentioned above, the **auditor should plan and perform the audit procedures with a view to testing for non-compliance**, if any. To do this, the auditor should obtain a general understanding of the applicable laws and regulations.

Example

Hang out is a beverage company. According to the local laws, in order to run a beverage company, the owner needs to have a licence which should be renewed every year. However, there are certain companies which sell wine, beer etc. without having a licence. Hang out has a licence but Peter, the auditor, notices that it expired one month ago and Hang out has not yet renewed it.

In this case, the auditor should know what the consequences will be if the licence is not renewed within a reasonable period. In addition, he should consider that even if the licence is renewed, Hang out may have to pay a penalty for late renewal.

ISA 250, Para 10 states that the objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements;

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

According to **ISA 250, Para 12**, as part of obtaining an understanding of the entity and its environment in accordance with ISA 315, the auditor shall obtain a general understanding of:

(a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and

(b) How the entity is complying with that framework.

Therefore, the auditor should obtain **sufficient appropriate audit evidence about compliance with those laws and regulations** generally recognised as having an effect on the determination of material amounts and disclosures in financial statements. The auditor should have sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made.

Example

Brad has been appointed as an auditor of Dowell, a UK based multinational company. Two divisions of Dowell are trading with each other. Dowell has set the transfer price in such a way that it will pay the minimum tax. Accordingly it is paying less tax in the UK. Brad noticed this fact during the course of audit.

In this case, Brad should consider that Dowell may have to pay high penalties due to tax avoidance. If a legal case has already been filed by the tax authorities of the UK for avoidance of tax, Brad should consider the amount of penalty and its impact on the financial statements of Dowell. Accordingly, he should consider the disclosures to be made in the financial statements of Dowell.

The auditor should be aware of the fact that audit procedures performed for the purpose of forming an opinion on the financial statements (such as reading minutes of board meeting, checking correspondence with legal advisor and tax authorities and obtaining management representation) may bring instances of possible non-compliance with laws and regulations to the auditor's attention. This non-compliance may have an impact on the operations of the entity and on its financial statements.

Apart from the abovementioned audit procedures, the auditor should obtain written representation that management has disclosed to the auditor all known actual or possible non-compliance with laws and regulations whose effect should be considered when preparing financial statements.

Tip

In the absence of any audit evidence which proves the contrary, the auditor should **assume that the entity has complied with all the applicable laws and regulations.**

Example

Albert is an auditor of Clean Co. He has obtained written representation from the management of Clean that all the applicable laws and regulations have been complied with except one of the provisions of the Environmental Protection Act for which the company has to pay a penalty. Provision for the penalty has been made in the financial statements and it has no material effect on the financial statements.

From the audit procedures conducted by him and the audit evidence gathered by him, Albert concluded that there is no indication of any other non-compliance by Clean.

2.2 Planning Audit Procedure when Non-Compliance is Discovered

When an **auditor discovers any non-compliance**, he should perform the following procedure:

1. Understand the nature of the act and the circumstances in which it has occurred

When an auditor obtains information concerning a possible non-compliance, the auditor should obtain an understanding of the nature of such non-compliance i.e. whether the non-compliance has an effect on the operations of the entity or on its financial statements. The auditor should also obtain an understanding about the circumstances in which the non-compliance has occurred i.e. whether it is intentional or unintentional.

It is important to know this because if the non-compliance is intentional, the auditor has to consider the reliability of the management and also the reliability of the representation given by management.

The auditor should understand the nature of the act and the circumstances in which it has occurred because depending on the nature of the business of the entity, the impact / importance of these laws and regulations may vary.

Example

In the case of a restaurant, the laws and regulations relating to food hygiene (such as the Tanzania Food, Drugs and Cosmetics Act in Tanzania) are very important but these laws are comparatively less important for a manufacturing company which has a canteen for its employees. In the same token, any fines relating to a restaurant's hygiene are likely to be significant for the financial statements, as opposed to fines relating to a canteen for staff.

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2. Obtain sufficient information to evaluate the possible effect on the financial statements

The auditor should evaluate the impact of non-compliance on the financial statements. Non-compliance can have an impact on the financial statements due to the following:

- the potential financial consequences such as penalties, fines, enforced discontinuation of operations.
- the disclosure requirements of the financial statements.
- may affect the true and fair view (fair presentation) given by the financial statements.

Example

Explore Plc is a company engaged in coal mining. The company has not complied with the health and safety norms for employees, as prescribed in the local laws. As a result, the regulatory authorities have forced the company to discontinue operations until it meets all the provisions relating to its employees' health and safety.

In addition, the court ordered the company to pay a penalty for non-compliance with the safety norms and awarded compensation for the damage caused to the employees' health.

In this case, the auditor should consider the effect of such compensation and discontinuation of operations on the financial statements. The auditor should consider the following:

Whether the compensation is recorded appropriately in the financial statements.
whether appropriate disclosure is made about the discontinuation of operation and its impact on the profitability of the company.
Whether it has any impact on the fair presentation of the financial statements.

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3. Discuss them with management

According to ISA 250, when the auditor believes that there may be non-compliance, the auditor should discuss them with management or, where appropriate, those charged with the governance.

If the auditor does not get sufficient information from management regarding compliance, the probability of material effect on financial statements due to non-compliance in that case is high. He should consult a lawyer about the laws and regulations applicable in that situation and the possible effect on the financial statements. He should seek legal advice to determine whether a violation of a law or regulation is involved, the possible legal consequences and what further action, if any, he should take.

4. Consider the implications of non-compliance

The auditor should consider the implications of non-compliance in relation to other aspects of the audit such as the reliability of the internal control procedures and management representation. This means that if the non-compliance identified by the auditor is not identified by the internal control procedure or not included in the management representation, he should re-consider the reliability of management and of the representation given by management.

Example

Patrick is an auditor of Solo Plc. During the course of audit, he identified and confirmed from his lawyer that the company has not complied with the Minimum Wages Act (in force in the country and applicable to Solo) and therefore is liable to pay a penalty.

He found that this non-compliance was not included in the representation already obtained from the management. On enquiry, the management said that it had not realised that it was violating the act and that it had only done so because the internal control system had failed to identify the violation.

In this case, if the auditor has relied on the internal control system and conducted test checking, he should reconsider the reliability of the internal control system. He may have to increase the extent of the audit procedures. However, he is unlikely to doubt the management's integrity as it seems to have been an oversight because the internal control system had not picked up on the error.

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5. Consider the effect of lack of sufficient and appropriate audit evidence

According to ISA 250, when adequate information about the suspected non-compliance cannot be obtained, the auditor should consider the effect of the lack of sufficient, appropriate, audit evidence on the auditor's report. In this situation, an auditor may issue a modified audit report.

6. Report the non-compliance

Reporting of non-compliance is discussed in detail in the following Learning Outcome.

The auditor should report the non-compliance to the appropriate person in the appropriate manner.

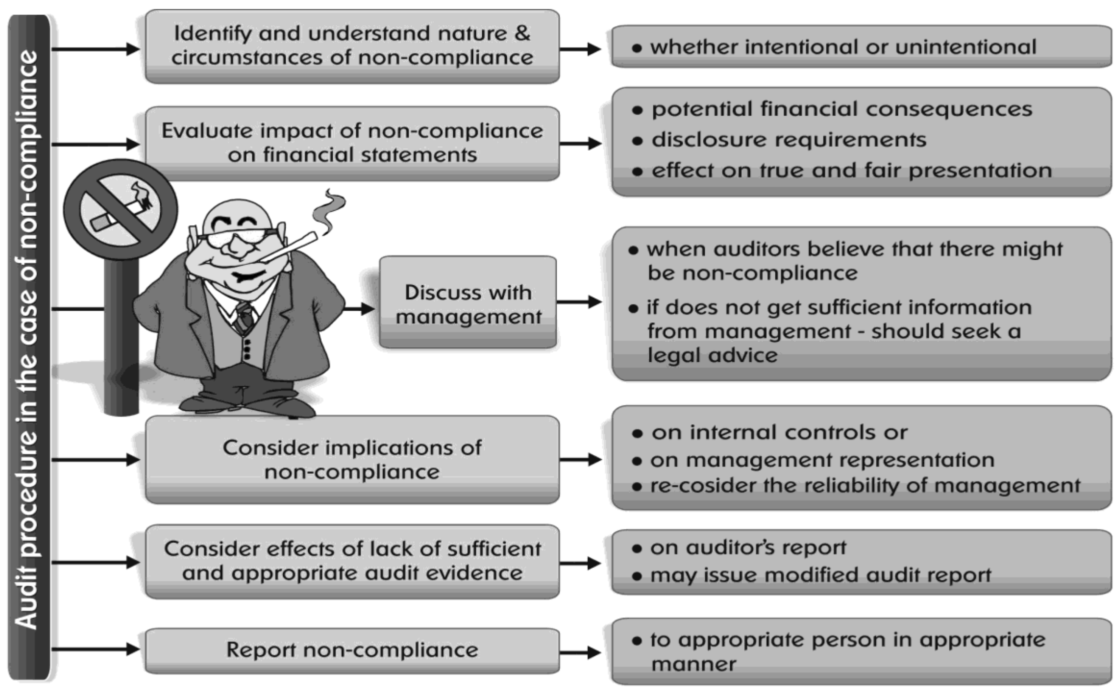
Tip

Indications that non-compliance may have occurred:

- ❖ Investigations by government departments or payment of fines or penalties
- ❖ Payment for unspecified services or loans to consultants, related parties, employees or government employees
- ❖ Sales commission or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received
- ❖ Purchasing at prices significantly above or below market price
- ❖ Unusual payments in cash, purchases in the form of cashier's checks payable to bearer or transfers to numbered bank accounts
- ❖ Unusual transactions with companies registered in tax havens
- ❖ Payments for goods or services made other than to the country from which the goods or services originated
- ❖ Payments without proper exchange control documentation
- ❖ Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence
- ❖ Unauthorised transactions or improperly recorded transactions
- ❖ Adverse media comment

ISA 250

Diagram 2: Audit procedure when non-compliance is discovered



Test Yourself 2

Ackley is the auditor of Jazz, a well-known international beverages company. He noticed that, for the last few weeks, Jazz has been in the headlines of various newspapers all over the world. The newspapers reported that Consumers in Belgium had suffered food poisoning after consuming soft drinks produced by the company. It is alleged that Jazz uses animal feed and bones in its products and, due to negligence, high pesticide levels have been found in the soft drinks.

Ackley has also noticed a media report stating that people in Somalia are demanding that Jazz's bottling plant in Somalia is shut down as the plant is depleting scarce water supplies in the area.

The executives of Jazz did not respond to the allegations made by the media.

Required:

State the audit procedures that Ackley should perform in this situation.

3. Discuss how and to whom non-compliance should be reported.
[Learning Outcome c]

Non-compliance should be reported to the following:

3.1 To management

An **auditor should**, as soon as possible, **communicate any non-compliance** that he has noticed **to those charged with governance**. Otherwise, the auditor should obtain audit evidence that they have been appropriately informed of the non-compliance that he has noticed.

However, for insignificant matters, the auditor may enter into an agreement with those charged with governance (in advance) on the nature of such matters to be communicated to them.

Tip

Those charged with governance include an audit committee or a supervisory body.

ISA 250 states that when the auditor **suspects that a member of senior management**, including members of the board of directors, is **involved in non-compliance**, the auditor should **report the matter to the next higher level of authority at the entity**, if it exists, such as an audit committee or a supervisory board.

Example

Greg, the auditor of Style Plc found out that a potential bad debt had not been provided for. The accounts receivables had been outstanding for over 120 days and the usual credit terms were 30 days. The amount was material. When he discussed this with the finance director of Style, the director told him that the CEO had specifically asked for the debt not to be shown as a bad debt and so the finance director was not ready to make the adjustments suggested by Greg.

In this case, Greg should communicate this matter to the next higher level of management. This is because this non-compliance has an impact on the financial statements of Style Plc and therefore on the audit opinion.

The auditor should seek **legal advice** in the following cases:

- where no higher authority exists
- if the auditor believes that the management may or may not take action
- if the auditor is unsure which person he should report to

Example

Continuing the previous example of Style Plc

Suppose Greg has noticed this non-compliance in a sole proprietorship, and the owner has refused to make the adjustments required by Greg. In this case, Greg should seek legal advice.

OR

Suppose, in the case of Style Plc, Greg knows that the finance director has acted according to the guidelines given by the next higher level of management. In this case, Greg believes that the higher level of management knows about this non-compliance and his recommendations will not be accepted by the management, therefore he should seek legal advice.

3.2 To the users of auditor's report on financial statements

The auditor should communicate non-compliance to the users of the financial statements, by expressing a modified opinion on the financial statements.

1. Qualified / adverse opinion

The auditor should express a qualified or an adverse opinion when:

- The **non-compliance has a material effect** on the financial statements; and
- Has **not been properly reflected** in the financial statements

Example

Continuing the example of Style Plc

The management of Style fails to make any adjustments in the financial statements or any disclosure relating to the non-compliance. However, Greg believes that the non-compliance has a material effect on the financial statements and therefore the financial statements do not give a true and fair view. In this case, Greg should express a qualified or adverse opinion.

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2. Qualified / disclaimer of opinion

If the **auditor is prohibited from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may have a material impact on the financial statement,** has, or is likely to have occurred, this will be considered a limitation placed on the scope of the audit. In such a case, the auditor should express a qualified opinion or a disclaimer of opinion on the financial statements.

According to ISA 250, if the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by the entity, the auditor should consider the effect on the auditor's report.

3.3 To regulatory and enforcement authorities

Due to the **professional duty of confidentiality,** auditors are **prohibited from reporting non-compliance to a third party**. However, in certain circumstances, the duty of confidentiality is overridden by statute, law or by courts of law.

Example

FATF Recommendations relating to money laundering and terrorist financing are considered international standards on money laundering and are followed by many countries.

According to FATF Recommendations, accountants are asked to report the money laundering cases only when they are engaged to provide the services stated in the Recommendations (services in which accountant is managing client money, securities or other assets). This means that the accountant should maintain the confidentiality in all other engagements (including audit).

However, FATF has recommended that countries include audit services in the category of the services in which legal duty overrides professional duty of confidentiality. Therefore, in most countries legal duty of disclosure of money laundering cases overrides the professional duty. Accordingly, if, during the course of audit, an auditor notices any tax evasion or wrong accounting, he should communicate this to the third parties (i.e. tax authorities in the case of tax evasion, compliance officer of the country in the case of money laundering).

If the auditor is not sure whether reporting the non-compliance will be considered a breach of his professional duty of confidentiality, he should seek legal advice.

Example

If an auditor comes across a case of money laundering, but is not sure whether the local laws prohibit auditors from disclosing client information, he should take legal advice from a lawyer.

3.4 Documentation

According to ISA 250, the auditor should document all identified and suspected non-compliance with laws and regulations along with the results of discussion with the management and, where applicable, those charged with governance and other parties outside the entity.

Test Yourself 3

Alice is an auditor of Alston, a refinery. She has just read in the newspaper that the management of Alston is responsible for an explosion which took place in March last year. According to the report, the management was aware of problems with maintenance and the poor condition of the equipment. In spite of various comments on the safety standards in Alston, the management had not taken any action. It had neglected safety in order to save on cost.

In addition, Alice found that Alston has received a letter from the tax authorities stating that the company has claimed credit on certain input goods twice and therefore is liable for additional tax and penal interest on the tax.

During the course of audit, she found that Alston has made major purchases from Seal Co. However she could not find the purchase invoice from Seal. When she asked for the statement from Seal, she did not receive any reply. As a result, she suspects that this may be a case of money laundering.

Alice found that the costs incidental to the non-current asset such as transportation and assembling costs have not been capitalised. As a result, the financial statements do not show a true and fair view.

Required:

Explain how and to whom Alice should report the non-compliance.

Answers to Test Yourself

Answer to TY 1

(a) Yes, the auditor is responsible for testing compliance with the applicable laws and regulations. When an audit is conducted in accordance with a specific law and the auditor is asked to report on the compliance with that law, it becomes his duty to check the compliance with that law. Therefore, if the auditor is required to report on whether the income and expenses claimed in the financial statements are in accordance with the provisions of the Income Tax Act, the auditor is responsible for testing compliance.

(b) No. When the audit of the financial statements is conducted to express an opinion on the truth and fairness of the financial position of the entity, the auditor is not responsible for preventing or detecting non-compliance.

However, according to ISA 200, the auditor is required to plan the audit while maintaining an attitude of professional scepticism. While designing and performing the audit, it is the responsibility of the auditor to evaluate, recognise and make provisions for the non-compliances which directly affect the financial statements.

(c) Yes. ISA 250 states that when an auditor is conducting an audit in accordance with specific statutory requirements and is asked to report on non-compliance, the auditor should check the compliance with the applicable laws and regulations. In the given case, the audit is conducted in accordance with the Companies Act. Therefore it is the statutory requirement of an auditor to check the compliance with the laws relating to the payment of statutory payments.

(d) Yes. In this situation, the company is established under a special act which determines the form and content of the financial statements of the client entity. In addition, when the entity works within the framework given by any law, non-compliance with which will have a fundamental impact on the operations of the entity, the auditor should check the compliance with such law.

Answer to TY 2

Allegations from different parts of the world about the quality of Jazz's products will indicate to Ackley that Jazz may not have complied with all the applicable laws and regulations such as those related to health and safety, food hygiene and environmental protection.

In order to dispel his suspicion, he should plan the audit accordingly.

To plan the audit of Jazz, Ackley should first of all obtain a general understanding of all the applicable laws and regulations such as those related to health and safety, food hygiene and environmental protection.

Ackley should perform the following procedures:

1. Identify and understand the nature and the circumstances of the non-compliance

After becoming aware of the possible instance of non-compliance (which the auditor came to know of from the media), Ackley has to identify and understand the nature and the circumstances in which it occurred. He should also find out whether the non-compliance is intentional or unintentional. **If the non-compliance is intentional then the auditor has to consider whether he can still rely on the management, or whether there is now a lack of trust (leading to doubt on the integrity of the management, and therefore less reliability on the figures in the financial statements).**

In the given case, the non-compliance may or may not be intentional but the nature of the non-compliance is serious and this may affect the financial position of Jazz.

2. Obtain sufficient information to evaluate the possible effect on the financial statements

Ackley should contact Jazz's lawyer and ask him whether there are any laws or regulations which Jazz has not complied with. If the lawyer confirms the non-compliance by Jazz or, from the information given by the lawyer, Ackley concludes that Jazz has not complied with a law or regulation; he should evaluate the impact on the financial statements. **The lawyer may help the auditor in evaluating such an impact by estimating the penalty or compensation.**

In this case, it is possible that the plant in Somalia may be closed down by the regulatory authorities. In addition, the company may have to pay compensation to the consumers whose health was affected.

In short, the non-compliance may have the following effects:

- payment of penalties, fines etc
- detailed disclosures in financial statements (about the effect of non-compliance)
- may affect the truth and fairness of the financial statements
- potentially discontinuing operations in Somalia

In the worst case scenario, the entity may be forced to discontinue its operations, due to the poor publicity in the media and customers refusing to buy Jazz's products.

3. Discuss them with management

When an auditor has confirmed the non-compliance then, according to ISA 250, he should then discuss the non-compliance with management and obtain information from management. If the information received from the management is not sufficient, his reliability on the figures in the financial statements will be reduced.

In the given case, he should document the information gathered from the media and then consult with a legal advisor to determine the legal consequences of the non-compliance.

Answer to TY 3

The auditor is required to report non-compliance to the following authorities:

1. Management
2. The users of the auditor's report on financial statements
3. The relevant regulatory authorities

Alice is required to report the non-compliance to the required authority in the following way:

1. Report to management

As the management is also involved in the non-compliance, Alice is required to communicate the non-compliance to a supervisory board. She should check whether, after the explosion at Alston, the company has complied with all the laws and regulations.

Any further non-compliance with regard to the safety etc. of the employees, non-compliance with income tax acts (e.g. absence of supporting documents for purchases may be considered overstatement of expenses and thereby tax avoidance), and non-capitalisation of incidental expenses should be communicated to those charged with governance. This could be the audit committee or supervisory board.

Alice should also carry out further investigations into the potential case of money laundering to confirm or dispel her suspicion. However, if she confirms that money laundering has taken place, she might not want to disclose this to the management as they may be involved with the illegal activities. In this instance she should consider speaking to the relevant regulatory authorities, without first informing the management. This is acceptable under money laundering regulations.

2. Report to the users of the auditor's report on the financial statements

Alice should consider the effect of such non-compliance on the financial statements and also consider the going concern status of Alston. There will be doubt for fines for claiming back input Vat twice. There are bound to be fines or penalties for non compliance with safety standards. In addition, she should also consider the overstatement of purchases in the financial statements.

Considering this, if she concludes that the non-compliance has material effect on the financial statements and has not been properly reflected in the financial statements, the auditor expresses a qualified (i.e. 'except for disagreement') or an adverse opinion.

She should ask management to make necessary adjustments in the financial statements such as adequate disclosure of non-compliance of safety standards and claiming back input Vat twice. If these adjustments are done she does not need to qualify the report. However, for money laundering she cannot ask for adjustments, but she will have to wait to see what the regulatory authorities ask her to do.

This will help the users of the audit report to understand how non-compliance has affected the financial statements.

3. Report to the regulatory authority

Alice should report to regulatory authorities, if she feels that the purchases from Seal are not genuine and have been included in the accounts for the following purposes:

to avoid tax liability
to launder money

Quick Quiz

1. Who is responsible for ensuring that all the applicable laws and regulations are complied with?

2. Why should the auditor obtain written representation from management?

3. In what circumstances should the auditor seek legal advice?

4. When should the auditor report a matter of non-compliance to regulatory and enforcement authorities?

5. Explain two responsibilities of management relating to consideration of laws and regulations in an audit of financial statements.

Answers to Quick Quiz

1. Management: they run the company and they have legal responsibilities.

2. In order to ensure that the management has disclosed all known or possible cases of non-compliance that is to be considered while preparing financial statements.

3. The auditor should seek legal advice:

   where no higher authority exists
   if the auditor believes that the management report sent to the management may not be acted upon
   if the auditor is unsure to whom he should report
   if the auditor is not sure whether he should disclose confidential information to regulatory authorities
   If the auditor is not sure whether he should continue with the audit engagement.

4. When the duty of confidentiality is overridden by statute law or by courts of law.

5. It is the responsibility of the management to **ensure that all the applicable laws and regulations are complied with**. It is also responsible for establishing an effective system to ensure such compliance.

Self-Examination Question

Question 1

Toyworld Plc is an international company which has been manufacturing plastic toys for the last three years. Its factory is located in a city called Farland. It sells its goods worldwide. In spite of having many competitors, the company has been making good profits since its first year of operation. Toyworld's strategy is to keep its costs at a minimum and compete on the basis of price.

Grace has recently been appointed as the auditor of Toyworld. She noticed that Toyworld has been in the headlines of various newspapers all over the world. The newspaper reports made the following allegations:

The production department of Toyworld uses substandard material to make the toys. This material may be dangerous to health if children put the toys in their mouths. However, the company has not given any warning on the packaging of the toys. Rather, Toyworld products are advertised as being safe and are claimed to improve children's memory and motor skills at a faster rate than the toys manufactured by other companies (which has not been scientifically proven).

All the workers (including child labourers) of Toyworld are required to work for more than 90 hours a week which is far above the maximum working hours prescribed by legislation.

Toyworld is producing miniature aeroplanes of Aerospace Company (as toys) without obtaining copyright permission.

Furthermore, the company has recently received adverse publicity through a local newspaper which reported that the emissions from Toyworld's factory are polluting the environment of Farland. Toyworld doesn't have an emission treatment plant. In addition, the material used by Toyworld is bad for the environment.

The newspaper has also highlighted, and published photographic evidence of, the poor hygiene conditions in Toyworld and the fact that female workers who have young children are allowed to bring their children inside the factory, which could be dangerous.

Grace was also prohibited by the management from obtaining sufficient appropriate audit evidence to evaluate its financial statements.

Required:

With reference to Toyworld, discuss the audit procedures that should be undertaken when possible non-compliance is discovered and to whom the non-compliance should be reported.

Answer to Self-Examination Question

Answer to SEQ 1

Grace is not responsible for ensuring that Toyworld has complied with the applicable laws and regulations. However, she should obtain a general understanding of all the laws and regulations applicable to Toyworld, such as laws and regulations related to health and safety, children's safety standards and environmental protection.

The newspaper reports about Toyworld will indicate to Grace that Toyworld may not have complied with all the applicable laws and regulations such as those related to health and safety, children's safety standards, environmental protection and child labour.

In order to dispel her suspicion she should plan the audit accordingly. To plan the audit of Toyworld, Grace should first of all obtain a general understanding of all the applicable laws and regulations such as those related to health and safety, children's safety standards and environmental protection.

Grace should perform the following audit procedures:

1. Understand the nature of the acts and the circumstances in which they occurred

After identifying the possible non-compliances, Grace has to identify and understand the nature of the non-compliances and the circumstances in which they occurred i.e. whether they are intentional or unintentional.

In the case of Toyworld, the nature of the non-compliances is very serious and they are intentional. The management of Toyworld Plc was aware of the non-compliances such as the use of substandard materials, the excessive working hours and the employment of children but has not taken any corrective action.

This brings into question the reliability of the management. It seems that the management is concentrating on reducing cost in order to make a higher profit and therefore there is the possibility that the management is violating the laws and regulations intentionally.

2. Obtain sufficient information to evaluate the possible effect on the financial statements

Grace should contact Toyworld's lawyer and ask him whether there are any laws or regulations which Toyworld has not complied with. Grace should then evaluate the impact of non-compliance on the financial statements of Toyworld e.g. whether customers can claim compensation and whether Toyworld will have to pay a high amount as a result of litigation.

Therefore the non-compliances may have one or more of the following effects:

- payment of penalties, fines etc.
- detailed disclosure of the effects of non-compliance in the financial statements.
- may affect the truth and fairness of the financial statements.
- the entity may be forced to discontinue its operations (which will affect the financial position of Toyworld).

3. Discuss them with management

According to ISA 250, after discovering any non-compliance, the auditor is required to discuss them with management. In the case of Toyworld, Grace is required to gather and document the information (which shows that Toyworld has not complied with the applicable laws and regulations) and should then discuss the non-compliance with management and obtain information from management. Grace can also consult a lawyer to determine the legal consequences in such situation.

4. Consider the implications of the non-compliance

If, after consulting the lawyer and discussing her findings with management, Grace finds that the non-compliance was intentional and due to the management's negligence, she should then check Toyworld's internal control system to see whether it has an effective system for identifying the applicable laws and regulations and copyrights. This will help her to decide whether any change in the audit plan is required as a consequence of the non-compliance, for example, to increase substantive testing.

In addition, she should consider such non-compliance while forming an audit opinion.

5. Report the non-compliance

After checking the internal control system, the auditor is required to report the non-compliance to the appropriate authority. Grace should report the non-compliance to the following authorities:

(a) To management

The auditor is required to communicate the non-compliance to those charged with governance. However, in the case of insignificant matters, the auditor may enter into an agreement with those charged with governance (in advance) on the nature of such matters to be communicated.

Grace should report the matter to the next higher level of authority in Toyworld as the management is also involved in the non-compliance i.e. the audit committee of Toyworld.

However, Grace should seek legal advice in the following cases:

- Where no higher authority exists
- If she believes that the report may not be acted upon
- If she is unsure which person she should report to

(b) To the users of auditor's report on financial statements

The auditor of Toyworld is required to communicate the non-compliance to the users of the financial statements, by expressing a modified audit report.

SECTION B

ACCEPTING ENGAGEMENTS AND MANAGING ASSIGNMENTS

B1

STUDY GUIDE B1: ACCEPTING ENGAGEMENTS

Get Through Intro

An audit firm has to follow set procedures when it is approached by a potential client. The auditor must comply with the Code of Ethics for professional accountants, issued by the International Federation of Accountants.

An auditor must ensure that his acceptance of a new client / engagement will not compromise his independence, integrity and objectivity in any manner, and he should have the professional competence to conduct that audit. An auditor cannot compromise on any of the ethical principles which guide his professional responsibilities.

For example, Robert is a qualified certified accountant and has the technical competence to conduct the audit of Refreshers Inc. However, his wife holds 60% of the shares in Refreshers Inc. In such a situation, Robert should not accept this engagement because such an appointment may cloud the objectivity with which he conducts the audit. It will also compromise his independence and integrity.

This Study Guide discusses these matters as well as how an auditor accepts an engagement, how the client and the auditor agree to the terms of an engagement and the various other issues which an auditor needs to tackle while obtaining audit work. Accepting audit / non-audit proposals from prospective clients is the stepping stone for building a flourishing career! Therefore, this knowledge is extremely important for you, as a future auditor, in order to be able to build your practice.

Learning Outcomes

a) Analyse and evaluate the issues during the process of obtaining audit work.
b) Identify and explain the legal, professional and ethical issues during the acceptance of assurance or audit assignments.
c) Analyse and evaluate the potential issues that determine the nature, scope and extent of an assurance or audit engagement.
d) Analyse and evaluate the considerations for an auditor of risk issues identified prior to accepting an engagement.

1. Analyse and evaluate the issues during the process of obtaining audit work.
Analyse and evaluate the potential issues that determine the nature, scope and extent of an assurance or audit engagement.
Identify and explain the legal, professional and ethical issues during the acceptance of assurance or audit assignments.
Analyse and evaluate the considerations for an auditor of risk issues identified prior to accepting an engagement.

[Learning Outcomes a, b, c and d]

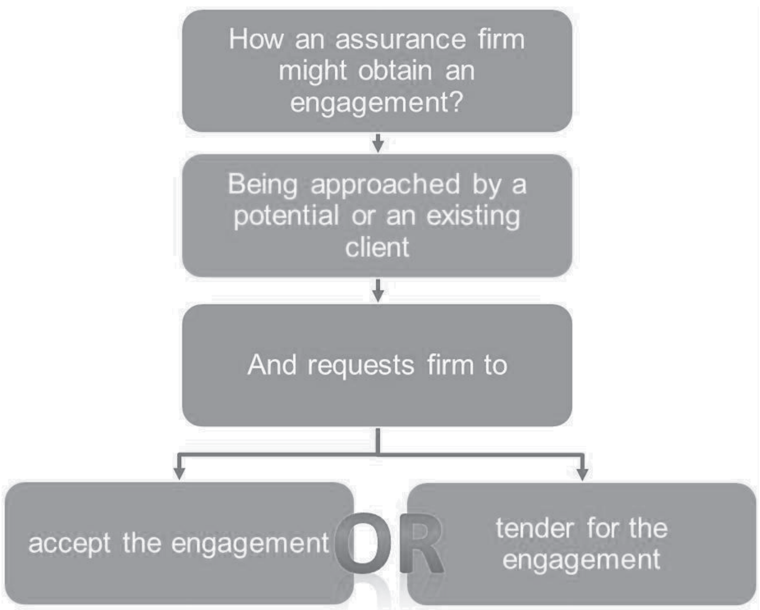
Definition

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

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.

Diagram 1: Method of obtaining audit work



1.1 Issues relating to obtaining audit work / consideration of risk issues

An audit engagement occurs when an organisation has enlisted the services of an accountant to conduct an audit.

It is important to note here that 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, the two ways by which an audit firm obtains work is by being approached by a potential client, or tendering to undertake audit work.

Tendering

Auditors are often approached by **interested clients to submit quotations for fees** to conduct particular work.

The most popular method, of obtaining an audit is by tender. The process of calling for quotations and submitting quotes is known as tendering.

Tendering is a process through which an interested party (i.e. the client) tries **to obtain quotations for fees** from the provider of services (i.e. the auditor) for a particular kind of work to be done. It is customary to submit tenders in sealed envelopes. Such sealed offers, including firm / company information, a project outline, and a price quote are known as tenders or bids.

The process of tendering makes auditors more competitive as they have to quote the best possible prices. However, it sometimes results in lowballing (i.e. price cutting in order to win the tender).

When an invitation to submit a proposal or fee quote is received by the auditor, the auditor must decide whether it wants to undertake that work.

Several issues that require consideration are categorised below:

1. Ethical considerations

The following questions must be addressed:

(a) **Will the new assignment affect the independence of the auditor?** For example, if the auditor has taken a loan from the client (which is not a bank), its independence might be affected.

(b) **Has the auditor taken due care in estimating the time and staff required to conduct the work?**

Sometimes auditors might try to underestimate the resources required to conduct the work so that they can arrive at a lower fee in order to win the client. This will definitely hamper the auditor's performance later on when it is not able to exercise due care and competence due to lack of time and staff.

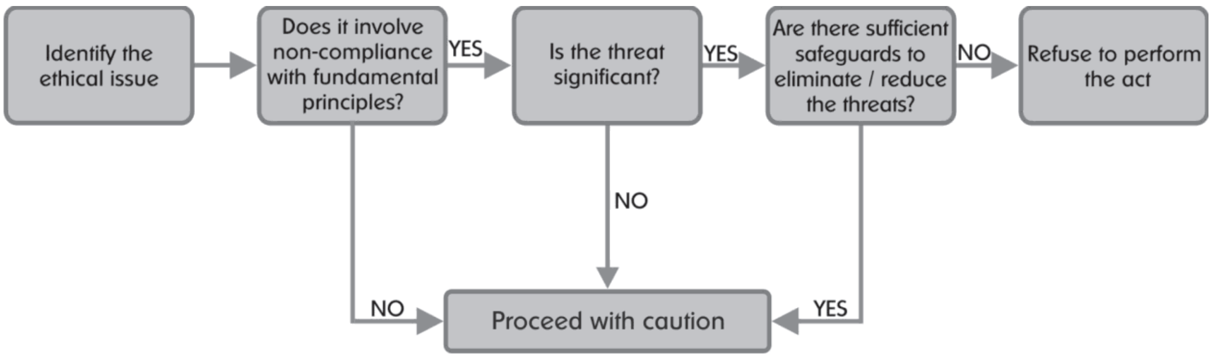
(c) **Is the fee quoted fair and reasonable?** The auditor may quote low fees in order to win the client (known as lowballing). This might then induce the auditor to adopt shortcuts to complete the assignment as it may not be willing to do detailed work for the low fees.

(d) **Does the auditor possess the required professional competence to conduct the work?** For example, if an auditor's client is a manufacturer and has started a new software business, the auditor must consider whether it has the required knowledge to carry out the audit of a software business prior to submitting the fee quotation.

If the answers to the above questions are yes, it indicates that the auditor faces the risk of non-adherence with the IESBA code of ethics (discussed in detail in Study Guide A1).

The auditor would have to carry out the following analysis to decide whether to tender for the assurance assignment:

Diagram 2: Procedure for analysis



2. Work considerations

This includes an analysis of the actual work involved, how much time each process would require, who should be assigned to each process and what fees should be charged for the assignment.

(a) Analysis of the actual work involved

The auditor must identify the various processes involved in the assignment. This will help the auditor to estimate the time that would be required to complete the assignment.

(b) Evaluate the time taken for each process

Total time required for the assignment can be ascertained on the basis of the time taken for each process involved in the assignment.

(c) Assigning staff

After identifying processes and estimating the approximate time that would be required for each process, staff can be assigned to the work, keeping in mind:

- the total time available for completing the entire assignment
- the expertise of each member of staff
- specialised skills, if any, required to complete the assignment
- any additional training required to perform the duty

(d) Setting fees

Once the total time and staff required for the assignment is ascertained, it should be easy for the auditor to determine the approximate fees that need to be charged. However, fees will not only be based on the time and staff required, but also on the following:

- importance of the work to the client
- urgency of the work
- complexity (which relates to time)
- need for travel (for e.g. to branch offices)

(i) Lowballing

When entering into negotiations regarding professional services, members may quote whatever fee is deemed to be appropriate, as long as it is fair and reasonable. **The fact that one accountant may quote a fee lower than another is not in itself unethical.**

Lowballing refers to setting initial audit fees at a lower level in order to win a client in the hope that additional work can be obtained from that client in the future. Audits can even be offered for free. Lowballing is observed in many cases where the auditor is keener about the audit than the client.

Lowballing in itself is not a crime; however, the level of fees quoted may pose a **threat to compliance with fundamental principles**. For example, a self-interest threat to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price.

The significance of such threats depends on factors such as the level of fee quoted and the services to which it applies. **Safeguards** should, therefore, be considered and applied as necessary in order to eliminate threats or to reduce them to an acceptable level. These safeguards include:

making the client aware of the **terms of the engagement** and, in particular, the basis on which fees are charged and which services are covered by the quoted fees
assigning appropriate **time and staff** to the task

(ii) Contingency fees

This is discussed in detail in Learning Outcome 1 of Study Guide A1.

(iii) Legal and other considerations

There are various legal issues which an auditor must bear in mind while taking up an audit. Company law imposes several restrictions on auditors for accepting an audit.

Legal considerations are:

There are various legal issues which an auditor must bear in mind while taking up an audit. Company law imposes several restrictions on auditors for accepting an audit.

Eligibility of an auditor

An auditor must be independent of the company, i.e. it should **not be related to the company in any capacity** other than as an auditor. For example, an auditor should not be an officer or an employee of the company, the parent company or the subsidiary company.

Restriction on the number of audits

In some jurisdictions (such as in India), there is a **maximum limit** to the number of audits that can be accepted by a member or audit partner. If any such rule is applicable to the auditor, the auditor must ensure that the maximum number is not exceeded.

Other considerations are:
What is the **level at which fees are generally charged** for the work concerned? For example, the fees that are charged by other auditors can be determined from the annual reports of public companies.

Would it be advantageous to the auditor to accept the assignment? For example, obtaining professional work from a particular client may enhance the auditor's image.

At what level of fees was the tender accepted **last year**?

(iv) Information to be included in proposal

Before submitting the proposal or fee quote for an audit or other professional engagement, the bidder must be aware of certain facts regarding the prospective client in order to be able to draw up a proposal. Such information can be obtained through discussions with the client or may have been made available by the prospective client at the time it invited the bids.

In general, the bidder would require information on the following areas:

Nature of business
Duties of bidder towards client
Future plans / opportunities
Client's intention for changing existing auditors

3. Preconditions for an audit

According to ISA 210, agreeing the terms of audit engagements. an auditor accepts or continues an audit engagement only when the basis upon which it is to be performed has been agreed, through:

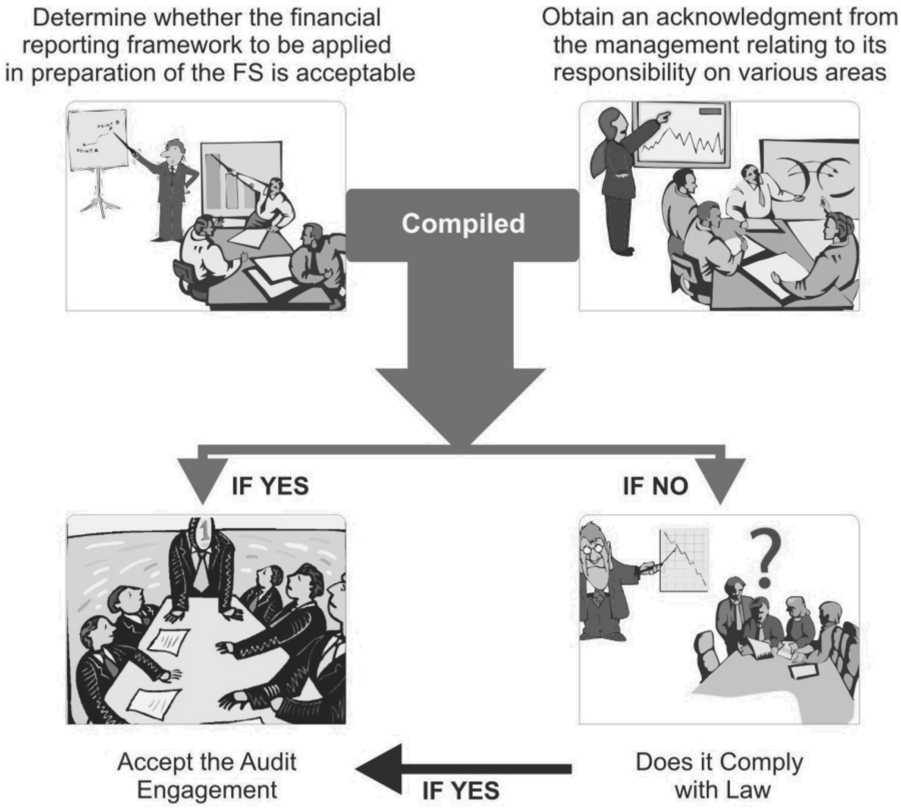
Establishing whether the preconditions for an audit are present; and
Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Definition

Preconditions for an audit – The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

ISA 210

Diagram 3: The preconditions in relation to the acceptance of new audit engagements



Tip

The preconditions in relation to the acceptance of new audit engagements have been discussed in detail in Paper B3.

If the preconditions for an audit are not present, there is an engagement risk, which the auditor shall discuss with management. If any of the preconditions mentioned above are not met, the auditor shall not accept the proposed audit engagement on account of assurance engagement risk, unless required by law to do so.

If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Tip

This is a risk issue identified prior to acceptance of audit work.

1.2 Process of obtaining audit work

1. Preliminary discussions

The organisation requiring audit services generally describes the type of audit work it would like conducted. The types of t**opics that would be covered and agreed upon** in these talks would be:

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

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

(c) 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);

(d) 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);

(e) 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

(f) The **remuneration** that would be paid to the auditor.

2. Compliance with Code of ethics

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

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.

Tip

If the audit fees are not in accordance with the parameters, it will be a risk issue identified prior to acceptance of audit work. In this case, the auditor will have to refuse the audit work.

3. Communication with previous auditors

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; (such communication usually takes place in the form of an etiquette letter or professional enquiry letter).

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

> This is a risk issue identified prior to acceptance of audit work.

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.

4. Etiquette letter

An etiquette letter / professional enquiry letter enables the new auditor to communicate with the existing auditor and know if there are **any areas of concern** which he must consider before accepting the new engagement. Many times, the apparent reason for a change of auditors may not fully reflect the facts and may indicate disagreements with the existing accountant that may influence the decision to accept the appointment.

Example

DipCo is the existing auditor of FrankCo. FrankCo is not happy with the audit provided by DipCo and asks JaiCo to become its new auditor. When JaiCo's partner, Zara asks FrankCo what the problem was with DipCo, she finds out that there was a difference of opinion with the management of FrankCo over accounting policies – DipCo felt that the accounting policy of revaluations of properties being carried out every 2 years was not frequent enough. Zara asked FrankCo's management to explain why they did not revalue properties annually.

FrankCo explained that the properties were in a remote part of the country, where prices were fairly stable and therefore there was no need to revalue annually, as this was an excessive cost to the company. Zara, now satisfied with the reason, decided to accept the audit.

An etiquette letter / professional enquiry letter is also required to express professional courtesy to the former auditor because the new auditor replaces the former auditor.

It is the duty **of the former auditor to reply** to such an enquiry from the new auditor within a reasonable period of time; if he fails to do this, he could be held responsible for professional misconduct. However, before replying to the new auditor, the **former auditor must obtain permission from the client** to do so, as he is bound by the fundamental **principle of confidentiality**.

5. Audit engagement letter (ISA 210)

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).

It contains:

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

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

3. **Details** on:

(a) The **objective and scope of the audit** e.g. statutory audit or internal audit

(b) 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, management's responsibility for establishing and maintaining effective internal controls

(c) 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

(d) Identification of applicable financial reporting framework for preparation of financial statements e.g. IFRS or US GAAP

(e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content

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

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

(h) 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 (by sending the etiquette letter)

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.

access to all the records, documentation and other information requested in connection with the audit, e.g. customs documents to verify whether the goods are being held by customs

request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter (especially in the case of first assignment).

Deliverables: the form in which the auditors must report e.g. letters, certificates or audit report

Tip

The audit engagement letter need not contain the terms of an audit engagement if the law or regulation prescribes in sufficient detail the terms of the audit engagement. At such times, the engagement letter can only mention that such law or regulation applies and that management acknowledges and understands its responsibilities.

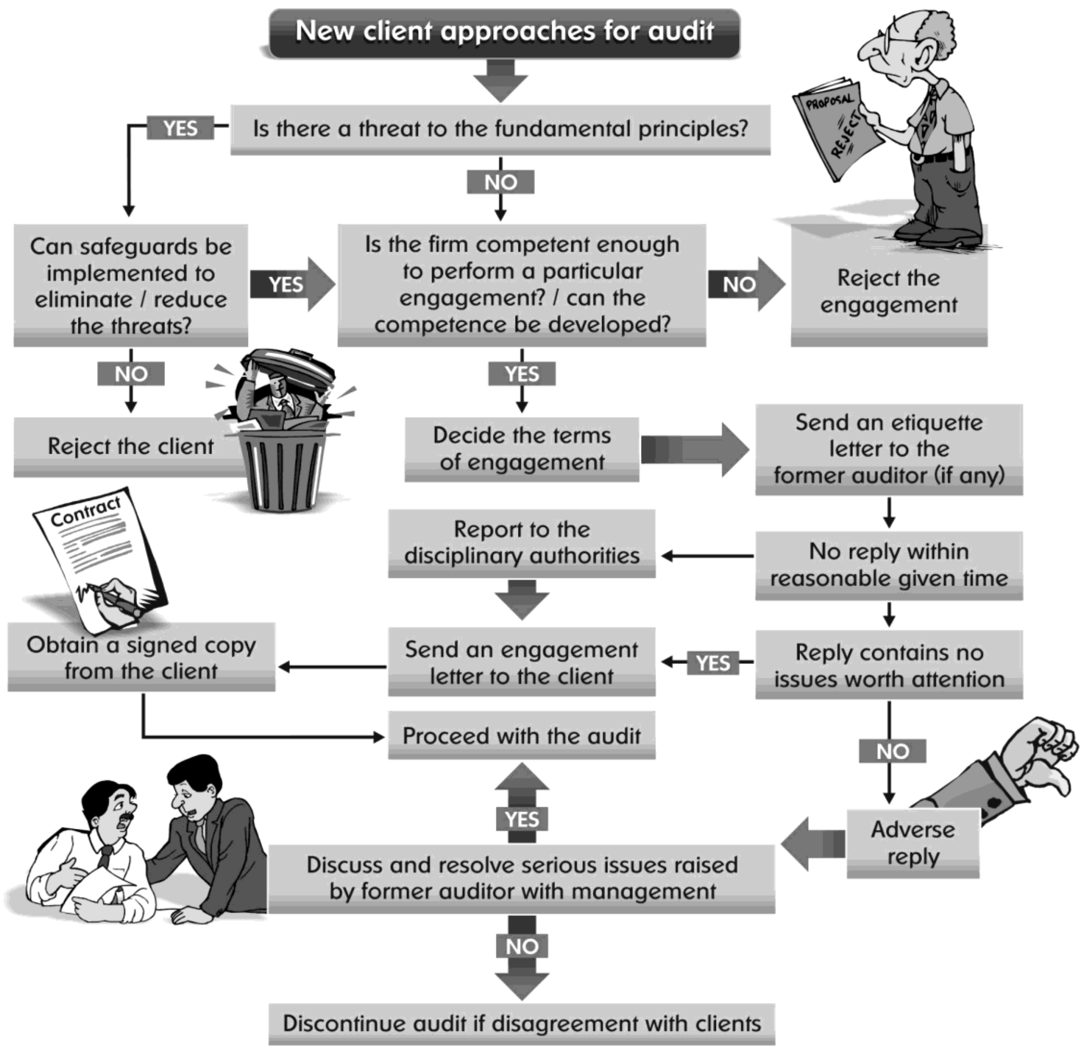
4. **Recurring Audits**

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

The following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

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

Diagram 4: Acceptance of professional appointments



1.3 Pro- forma 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 our 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.

Continued on the next page

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 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.

Auditor disowns responsibility of efficiency of the internal controls used by the organisation.

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

The form and content of audit engagement letters may vary for each client depending on the nature of the audit engagement.

Example

The engagement letter of a client that is a manufacturer will include content on terms regarding physical inventory verification, whereas this will not be present in the engagement letter of a client who is a service provider.

Tip

The legal, professional and ethical issues during the acceptance of assurance or audit assignments are explicitly discussed in Study Guide A1 of this Study Text.

Test Yourself 1

John Jones has directly telephoned the CFO of an organisation and asked to be their auditor. During the course of the conversation John 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?

Test Yourself 2

Crusoe Ltd is a public limited company which manufactures and distributes food products. It invited quotations for fees from several auditors and selected a proposal from Frasier & Co, which accepted the audit assignment for a fee of Tshs1 million.

Later, it was noted that the senior accountant of Crusoe was a family member of one of the audit managers, Eddy.

Required:

Discuss what the auditor neglected to consider while submitting the audit proposal.

Answers to Test Yourself

Answer to TY 1

Yes, John 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. John 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 John should have formally discussed the audit assignment with the prospective client. The discussion would have allowed John to ascertain whether he has the required expertise, knowledge and resources to conduct the audit.

(c) Unfair criticism of a fellow auditor: John 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.

Answer to TY 2

The auditor, Frasier & Co, should have considered various aspects (such as ethical considerations, work related considerations and legal considerations) prior to submitting the audit proposal to Crusoe. Apparently, Frasier has failed to consider some ethical and legal issues.

(i) Ethical issues

Before accepting the audit the auditor must ensure that the new assignment will not create threats to its independence. In this case, there is a threat to the self-interest of Frasier because the senior accountant of Crusoe is a family member of the audit manager, Eddy.

Hence, there is a possibility of significant influence over the audit opinion.

(ii) Legal issues

According to the IESBA i.e. the IFAC's 'Code of Ethics for Professional Accountants', if any of the members of the audit team is related to the client or any of its employees then he should be removed from the audit assignment or the auditor should withdraw its interest from the audit. Therefore, the audit manager Eddy should be removed from the audit team or Frasier should not bid for the audit.

Quick Quiz

1. What is lowballing?
2. What is tendering?
3. What are the important aspects that need to be considered while setting a fee?
4. List the various legal issues which an auditor must bear in mind while taking up an audit.
5. What is the significance of an audit engagement letter?

Answers to Quick Quiz

1. Lowballing refers to setting initial audit fees at a lower level in order to win a client in the hope that additional work can be obtained from that client in the future

2. Tendering refers to invitations by prospective clients to prospective bidders for bidding for an audit / other professional engagement, and submission of proposals by interested bidders to conduct that particular work

3. Seniority and professional expertise of the staff assigned for the work, time spent by each member of staff on the work, the degree of risk and responsibility, and usual custom of charging fees for a particular type of work.

4. The following are various legal issues which an auditor must bear in mind while taking up an audit

   Eligibility of an auditor
   Restriction on the number of audits
   Level at which fees are generally charged
   Information to be included in proposal

5. 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. It represents an official documentation of all the terms and conditions of the audit and is signed by both parties

Self-Examination Questions

Question 1

Tom Bowler is a partner with a large-sized firm of Chartered Certified Accountants. He has just been approached by Tartan Technologies, a large manufacturing firm to be their statutory auditor. Tom 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 Tom must now follow to earn an audit engagement from Tartan Technologies.

Question 2

Chuck is a senior audit manager in Martha & Jones, a firm of Certified Accountants. He has been delegated the responsibility of overseeing the staffing requirements of various audit engagements that the firm is involved in.

The firm has recently received an invitation to tender for the audit of a new client, Tiffany Motors Co, which are manufacturer and supplier of automobile components. Chuck has come to know from external sources that Sandra, the finance manager of Tiffany, does not consider audit to be a valuable exercise and has therefore resorted to tendering as a means of cost cutting. She has also refused to include the responsibility of an interim audit in the invitation in order to justify low audit fees.

Taking advantage of this knowledge, Chuck convinces the audit partner to quote a low fee in their proposal and subsequently wins the bid.

Required:

Discuss whether Martha & Jones has resorted to lowballing and whether there are any safeguards should a threat to its independence arise in the case of Tiffany's audit

Answers to Self-Examination Questions

Answer to SEQ 1

Tom should begin the process by first researching Tartan 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 Tom 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 Tartan 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 Tom 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.

Tom must then (with Tartan's explicit permission) contact their current / previous auditor. Tom must inform the auditor of his intention to become Tartan'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 Tom will be in position to evaluate whether he can and should take the auditing assignment.

If the auditor provides a favourable report then Tom can accept the assignment. If the report is unfavourable Tom should decline the assignment. If Tom 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, Tom is now reasonably certain that he can competently conduct the audit on the agreed upon terms and conditions. Lastly, Tom must then draft an audit engagement letter to Tartan 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 2

While bidding for the audit of Tiffany Motors Co, the audit partner of Martha & Jones, upon the suggestion of its senior audit manager, Chuck, has taken into consideration the fact that Tiffany will choose the bidder which bids the lowest fees. On the basis of this information (or, more appropriately, rumour) it has quoted low fees and fortunately won the bid. It can therefore be said that Martha & Jones has resorted to lowballing.

However this action of lowballing is encouraged by Tiffany (client) rather than initiated by Martha & Jones (auditor). This is evident from the fact that Sandra herself, who is the finance director of Tiffany, gives low importance to audit and therefore prefers to go through a tendering process so that she can select the bidder which quotes the lowest fees.

Whether there is a threat to independence due to lowballing needs to be evaluated. Sandra has cut the audit process short by excluding the interim audit. The audit partner must evaluate whether this will affect the independence of the audit manager. In the absence of an interim audit, there is likely to be a lot of work at the year end.

Since the management of Tiffany does not give importance to audit, the audit manager may have to wind up the audit quickly without wasting much of management's time (in asking for management representations etc.). This is where the independence of Martha & Jones could be affected.

Threats to independence can come in various forms such as:

- self-interest threat
- self-review threat
- familiarity threat
- intimidation threat

A self-interest threat arises when the audit firm or a member has a financial interest in the client. In the case of Tiffany's audit, a threat to independence may arise due to Martha & Jones' self interest in the audit caused by lowballing. As it has quoted low fees, it will want to maintain a professional relationship with Tiffany in order to procure more lucrative work in future.

A self-review threat arises when the work done on a previous engagement needs to be re-evaluated. Since Tiffany is a new client of Martha & Jones, a threat to independence due to self-review will not exist.

A familiarity threat arises when the auditor becomes too close to the client and the professional relationship turns into a friendship. This happens when the same auditor audits the accounts of a particular client for many years or shares an excellent rapport with the client which is not the case with Tiffany because it is a new client of Martha & Jones.

Martha & Jones' independence is most likely to be affected by an intimidation threat. An intimidation threat occurs when the client deters the auditor from acting objectively. Such threats may be actual or perceived. In the given scenario, Chuck is aware that Sandra does not consider auditing an important activity.

This may create a fear in the mind of Chuck regarding the keenness of Tiffany's management to help the audit team in case of difficulties and therefore prevent Chuck from acting independently, for example by overlooking certain non-compliances.

Safeguards against threat to independence

Effective quality controls

Martha & Jones can ensure that there are no threats to independence by implementing an effective quality control system which will ensure that various important factors are taken into account while accepting an audit engagement. Martha & Jones should discuss the importance of having an interim audit with the management of Tiffany. Martha & Jones must adhere to the ethical requirements of its profession by demonstrating integrity and acting with dignity while obtaining new work and must not succumb to the requirements of the client without weighing their disadvantages. In the presence of effective quality control procedures, this may be ensured.

Assigning senior staff to Tiffany

Since Martha & Jones is aware of the fact that its work may not be given much importance by the management of Tiffany, it must assign staff which will exercise professional scepticism and handle contentious issues with due care and diligence. Senior, experienced audit managers like Chuck should probably be assigned to ensure that independence is not compromised at any stage. It is likely that Sandra may try to reduce the extent of audit work further by not allowing access to some important records or not making information available on time.

The senior audit manager should highlight such obstacles to verifying audit evidence in the audit report. It would also be appropriate for a second senior partner / manager to carry out a peer review of the audit of Tiffany before the audit report is finalised.

SECTION B

ACCEPTING ENGAGEMENTS AND MANAGING ASSIGNMENTS

B2

STUDY GUIDE B2: MANAGING ASSIGNMENTS

Get Through Intro

Consumers today demand top quality products and, in most cases, are also not averse to spending some more for it! It is small wonder, then, that successful businesses place so much emphasis on quality control. Remember that quality is rarely achieved by fluke it is the result of carefully planned steps taken to ensure that the goods / services truly meet the customers' needs.

When quality has become the buzzword in business, how can audits remain far removed from it? This Study Guide discusses the principles and purpose of the quality control of audits and other assurance engagements. Without the knowledge and application of these principles, it is difficult to satisfy quality-conscious clients and their stakeholders. Dissatisfied clients will eventually move away, and so the earlier quality control procedures are implemented, the better it will be for an audit firm!

In **today's world** of **global integration, specialisation** and **diversification**, it has become **almost impossible** for a statutory auditor to **conduct an audit without relying on 'others'.**

These 'others' on whom the statutory auditor relies, albeit **with varying degrees of confidence,** are the internal auditors, experts who possess skill in specialised areas, component auditors in the case of audit of group financial statements, and service organisations to whom some tasks are outsourced.

The most important job of an auditor who relies on others is to **assess the extent to which they can and should rely** on these people. Any **error** on their part while making this judgment could jeopardise the entire audit exercise.

In this Study Guide, we discuss the above issues which need to be considered by auditors while carrying out audit work.

Learning Outcomes

a) Evaluate and apply appropriate procedures and personnel for management of an assurance or audit engagement.
b) Evaluate and apply appropriate quality control measures that may be used by a firm and during the course of an assurance or audit engagement.
c) Analyse and evaluate the extent to which assurance and audit functions within an entity can be used or relied upon.
d) Evaluate and apply appropriate monitoring and review procedures to effectively manage an audit or assurance engagement.
e) Identify and explain the purposes and how external monitoring of audit and assurance engagements might operate to ensure firm or engagement quality.
f) Analyse and evaluate how engagement terms can be agreed and recorded by an auditor including those agreed with a client and those imposed by laws or regulations.

1. Evaluate and apply appropriate procedures and personnel for management of an assurance or audit engagement.

[Learning Outcome a]

Generally, the national legislation which governs an audit provides for the appointment of the auditor.

Personnel for management of an assurance or audit engagement

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 e.g. Certified Public Accountants holding membership with the NBAA under CPA-PP category.

Generally, an **auditor is appointed by the shareholders in the Annual General Meeting (AGM)** 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.

The appropriate procedures and personnel for management of an assurance engagement are part of the quality control measures used by a firm during the course of the assurance engagement. They are discussed in detail in Learning Outcome 2 below.

2. Evaluate and apply appropriate quality control measures that may be used by a firm and during the course of an assurance or audit engagement.
Evaluate and apply appropriate monitoring and review procedures to effectively manage an audit or assurance engagement.

[Learning Outcomes b and d]

Quality control management basically deals with how an audit assignment must be handled to ensure that the professional standards are maintained and work is performed satisfactorily.

An audit firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances.

This is because assurance provided by a professional accountant on any subject matter which the user is interested in enhances the user's confidence and reduces his risk. It is therefore essential for audit firms to have a system of quality control to ensure that their work is of a professional standard and satisfactorily performed.

Example

Diamond Accountants is a firm of CPAs. It has a quality control system under which each engagement partner submits his work schedule for the next six months to the managing body. This enables the planning department to properly schedule all the audits throughout the year and avoid delays due to non-availability of partners. This is possible due to the existence of sound quality control policies within the firm.

2.1 Regulatory Framework

Quality control procedures are governed by two standards:

ISA 220 Quality Control for Audits of Historical Financial Information issued by the IAASB. Its aim is to establish standards and provide guidance on specific **responsibilities of firm personnel** regarding quality control procedures for audits of historical financial information, including audits of financial statements.

For example, if an audit firm undertakes an audit of a company, then the quality control policies would include appointing an engagement partner, informing him about his responsibilities with respect to the audit, assigning appropriate team members for conducting the audit, defining the objective of the audit etc.

ISQC 1 Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements issued by the IAASB. Its aim is to establish standards and provide guidance regarding a **firm's responsibilities** for its system of quality control for audits and reviews of historical financial information, and for other assurance and related services engagements.

For example, an audit firm should have a system of quality control to check that **every audit or any other assignment** taken up by the firm is conducted according to the quality standards laid down by ISQC 1, i.e. every audit must be conducted by skilled professionals, the work done by the junior assistants must be reviewed and documented, and important decisions must be reviewed for their appropriateness before issuing the audit report etc.

Hence, it can be seen that **ISQC 1 has a wider scope than ISA 220 as it covers not only engagements relating to the audit of historical financial statements but also assurance and audit-related engagements**. Nevertheless the quality control aspects covered by both the standards is similar.

ISA 220 states that the engagement team should implement quality control procedures that are applicable to the individual audit engagement. For example, while auditing the accounts of a school, the audit firm may require the team members to summarise the data with respect to the teachers' annual attendance in a specially designed format. This document would serve as a control document for the verification of the teachers' salaries. The team members should therefore follow this documentation process in order to maintain the quality of the audit.

ISA 220 gives the entire responsibility of the implementation of quality control procedures to the engagement partner. An **engagement partner** is defined by ISA 220 as follows:

Definition

'The partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.'

ISA 220 defines an **engagement team** as follows:

Definition

All partners and staff performing the engagement, and any individuals engaged by the firm or a network firm, who perform audit procedures on the engagement. This excludes an auditor's external expert engaged by the firm or a network firm.

Example

Geremy Accountants, a firm of CPAs, has been appointed to undertake an audit of Classic Hotels Plc. One of the partners of the firm, Bill, is responsible for the audit. He assigns two of his senior staff, Rick and Suzie, and three junior assistants to conduct the audit. He also gives the contract of valuation of Classic's non-current assets to another individual practitioner, Mr Gibbs.

The engagement team will therefore comprise the following:

Bill (engagement partner)
Rick and Suzie (senior staff)
Three junior assistants

Engagement team excludes an external expert engaged by the firm; therefore Mr Gibbs will not be considered a part of the engagement team.

2.2 Principles of Quality Control of Audit And Other Assurance Engagements

Quality control is not done for bureaucratic reasons – it is done because there is a genuine need for it! Remember, an audit is conducted to give assurance that the financial statements give a true and fair view – this is the overriding objective. As auditors, we have to make sure that our procedures are robust so that we give the correct opinion. However, remember that audit firms perform thousands of audits every year.

It is important that they are all performed well and meet certain standards. Many users of financial statements are relying on the auditors performing an efficient and effective job. As a result quality control is necessary to ensure that there are no lapses in the way the audit is conducted. By having quality control procedures, an auditor can be confident that that the audits performed are of a reasonable standard and that if there are lapses, they will be spotted immediately and rectified.

There are many **principles** which form the basis of a good quality control system. A few of these principles are discussed below.

Appropriate allocation of staff: by having procedures to allocate engagement partners and appropriate staff on a particular assignment, the firm can be sure that only experienced people are included in the audit team. For example, an IT systems audit should be conducted by an accountant who is CISA certified.

Proper working practices: proper planning, executing, monitoring and documenting procedures will exist within a quality control system. This will ensure that an appropriate audit opinion is given in the timeframe required.

Healthy client relationships: a healthy client auditor relationship should be developed, which will add to the reputation of the audit firm.

Proper training: to staff from time to time, giving them guidance whenever required and supervising their work will ensure staff is satisfied.

Ethical values: there would be no disciplinary action from professional bodies like NBAA for professional misconduct or legal suit by a client due to unsatisfactory work.

2.3 Purpose of quality control of audit and other assurance engagements

Advantages of quality control processes are as follows:

1. Internal

(a) Helps in allocating appropriate audit staff to audit assignments

An audit firm may have many employees with varying technical skills. Some may be good at analytical skills whilst others may be good at reviewing. A sound quality control system will ensure that the correct person is assigned the correct task resulting in good quality work.

(b) Mitigating business risks

It is vital for any type of business that aims to be profitable to maintain good quality over the services it provides to its customers. Good quality control for firms of practising accountants will minimise risks such as:

Key staff leaving,
Disciplinary action from NBAA, for disregarding the code of ethics and conduct,
Issuing incorrect audit opinions, and
Litigation if the client sues the auditor for unsatisfactory work.

Quality control procedures such as key staff always having a 'second in command' who is ready to take over should the key staff leave, will ensure that there is continuity on audit assignments and an understanding of the audit work.

Example

Jake is the partner in charge of the audit of Environ, an environment risk agency. Malcolm is the senior manager on the assignment. The supervisor on Environ is Lakshmi, who has worked on the audit for the past 3 years. Teo and Lam, 2 senior auditors have worked on Environ for 2 years.

If Malcolm leaves, Lakshmi would be able to take on more responsibility as she is familiar with the client. Jake, the partner will need to give Lakshmi greater assistance, but there will be continuity. This is one of the reasons of having audit staff work on the same client in subsequent years – so they can pass their knowledge to others and that they understand the systems.

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2. External

(a) Enhancing reputation of the audit firm

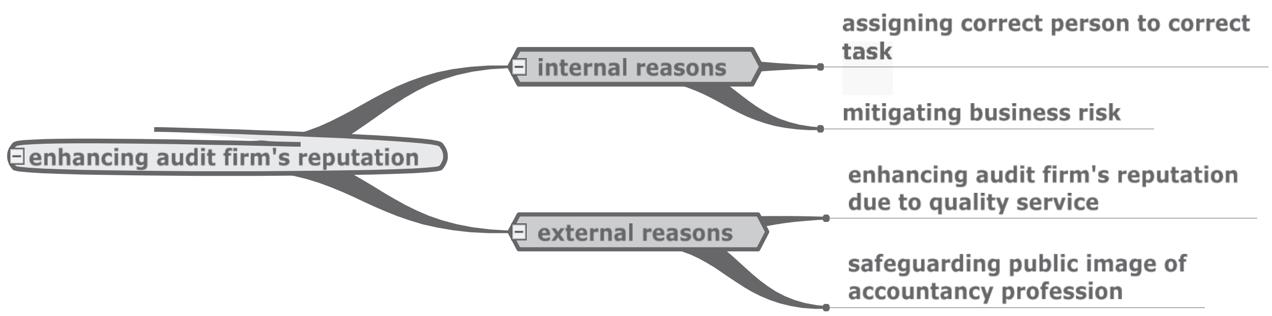
A firm which provides quality service will certainly have a good reputation in the market. Its business will prosper as more and more clients will approach it for various audit / assurance assignments. This is because the public and other clients realise that the audit firm is following procedures which will ultimately lead to true and fair financial statements and correct audit opinions.

(b) Safeguarding the public image of the accountancy profession

The professional accountant must ensure that he refrains from indulging in any activity which will bring disgrace to the profession of accountancy and taint its public image. If an audit firm does not have proper quality control systems it will not provide a satisfactory service which will ultimately hamper its own, as well as the accountancy profession's image. It will also affect public confidence in the accountancy profession.

All the above reasons are significant enough to warrant the need for a quality control system in an audit firm.

SUMMARY



Test Yourself 1

Grease Engineering Plc is a company which specialises in manufacturing parts for cars. This year the company has expanded its business operations and established a new unit for manufacturing car engines.

It has approached its existing auditor Wilson & Associates to conduct the audits of all the units of the company. However the auditor does not have a quality control system and is not sure about who to assign the audit, as many of the key personnel have left the firm recently.

Required:

Discuss the importance of a quality control system in the scenario described above.

2.4 Effective system of quality control

ISQC1 requires the firm to establish an effective system of quality control to obtain reasonable assurance that:

1. The firm and its staff comply with professional standards,
2. All applicable regulatory and legal requirements are met, and
3. Any reports issued by the firm are appropriate to the client's circumstances.

Example

Ross Brothers is a firm of CPAs. While undertaking the audit of an insurance company, Easy Life Inc, the audit partners should ensure that the quality control standards are met. These would include (among other things):

Whether Ross Brothers' staffs are qualified to conduct the audit of an insurance company i.e. are the staff members familiar with the insurance laws?

If the staff is not experienced enough to conduct the audit, would it be possible for Ross Brothers to train the staff to be able to decrease risk to an acceptable level? How much time would training take and what would the cost be?

Whether the previous auditor of Easy Life has been informed of the change in appointment?

Whether control procedures are in place. For example, are appropriate accounting records maintained?

The policies and procedures of the quality control system must be documented and communicated to the audit firm's personnel. Such communication would include:

(a) A description of the quality control policies and procedures and

(b) The objectives they are designed to achieve including:
   A statement that each member of the engagement team has a personal responsibility to comply with these policies and procedures and
   A statement of the firm's willingness to obtain feedback on its quality control system from its personnel.

This communication ensures an open dialogue between the firm and its personnel on quality control matters.

Example

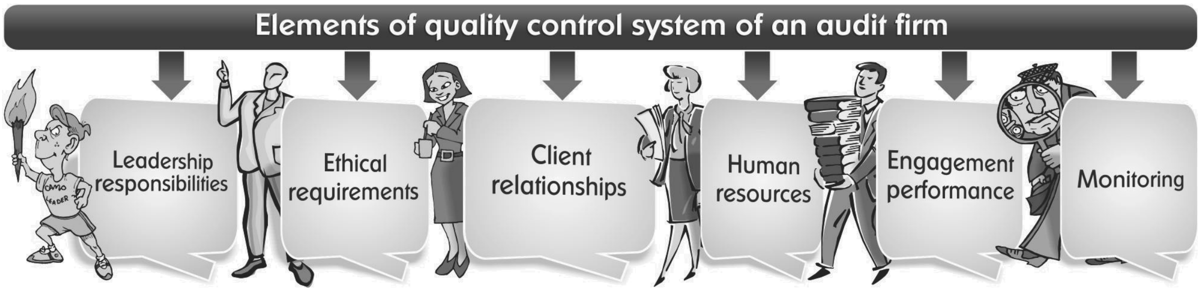
Example of a quality control document

XYZ Accountants		
Quality control document for a specific audit		
Name of the audit / client		
Quality control parameters	**Yes / No**	**Remarks**
Is there an engagement partner for the audit?		
State the name of the engagement partner.		
Has the engagement partner ensured that the ethical requirements are safeguarded prior to accepting the audit?		
Does the engagement team have the necessary technical skills to conduct the audit?		
State the names of the members of the engagement team.		
Has each member of the engagement team assigned appropriate audit tasks?		
Is the performance of the engagement team reviewed by the engagement partner on a regular basis?		
Has the team consulted a third party in case of difference of opinions? Give details.		
Signed by: (engagement partner) Date:		

According to ISQC 1, an audit firm's system of quality control should include policies and procedures addressing each of the following **elements**:

- Leadership responsibilities for quality within the firm
- Ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

Diagram 1: Elements of quality control system of an audit firm



1. Leadership responsibilities for quality within the firm

ISQC 1 emphasises that the policies and procedures established by the firm should significantly influence the internal work culture of the firm based on the recognition that quality is essential in performing engagements. The firm's leadership and the examples it sets significantly influence its internal work culture. Hence, the promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages from all levels of the firm's management emphasising the firm's quality control policies and procedures, and the requirement to:

(a) Perform work that complies with professional standards and regulatory and legal requirements, and
(b) Issue reports that are appropriate in the circumstances.

The standard provides that the firm should assign the operational responsibility of the firm's quality control system only to a person who is capable of handling it and who has:

- Sufficient and appropriate experience
- Required skill and ability to perform the task
- Necessary authority to handle the responsibility

Example

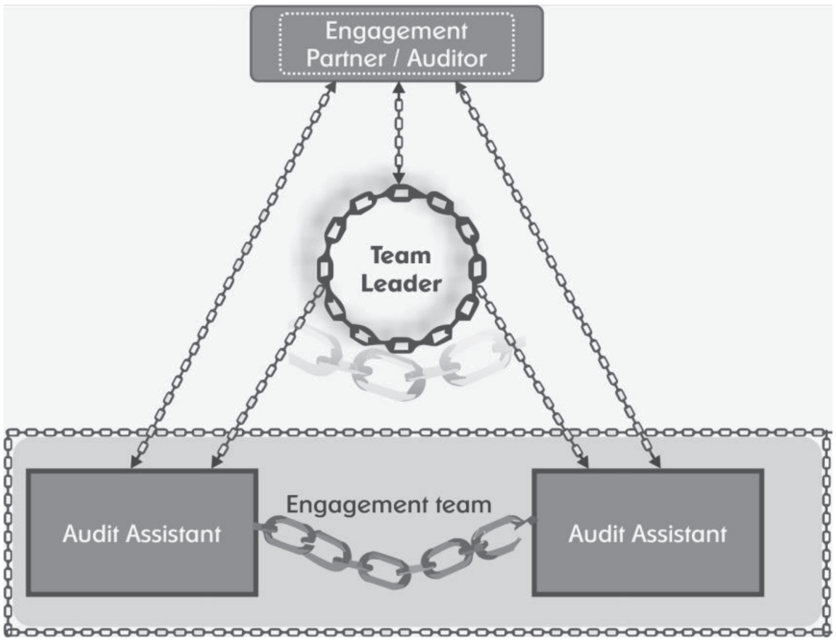
Modern Accountants, a firm of CPAs, has three partners, five senior employees and fifteen assistants, out of which some are qualified accountants and others are trainee accountants. One of the senior employees, Mack, has been appointed as the quality control manager as he is the senior most employee of the firm and has seen audits of many clients.

Mack is responsible for ensuring that the quality control policies are followed properly throughout the firm. He directly reports to the senior partner of the firm regarding the functioning of the quality control system and discrepancies found if any. In order to spread awareness about the quality processes, he ensures that the quality control procedures form a part of the orientation material given to new employees in order to inculcate a sense of discipline among them.

In addition, Modern Accountants' mission statement includes a paragraph on the importance of quality. It states, 'Quality of our work is the most important factor for us. Our staff and whole company is founded on the ethos that quality is everything we do'.

One of the ways of ensuring that the quality control procedures are being followed properly throughout the firm is to have proper communication channels across the audit firm i.e. from engagement partner to the team members and vice versa.

Diagram 2: Communication among team members



2. Ethical Requirements

The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

Ethical requirements include the fundamental principles of professional ethics laid down by the IFAC Code. These are:

Integrity
Objectivity
Professional competence and due care
Confidentiality
Professional behaviour

Each of the above has been discussed at length in Study Guide A1, Learning Outcome 1.

The standard lays down the following guidelines with regard to safeguarding ethical requirements through quality control system:

(a) The firm must have policies and procedures to communicate its independence requirements to the entire staff and other people related to work. For example, the firm should ask all staff to fill a questionnaire each year, which indicates if they have shares, or any close contacts in any client company.

Example

May Lin works for Zarco Accountants and auditors as a senior manager. She has been asked to complete an independence questionnaire for working on Welcome travel's audit. In this she states that her cousin Zheng is currently on a gap year from university and working part time as an administrative assistant at Welcome Travels, a billion dollar Travel Company.

Terry, the independence partner needs to make a decision as to whether the relationship will cause an independence issue and whether May Lin should be stopped from working on Welcome Travels' audit. In this case, it is highly unlikely there will be an independence issue as Zheng is in a junior position in a very large organisation.

(b) The firm must appoint a capable person to identify and evaluate any threats to independence so that appropriate action can be taken to eliminate / reduce the risk of threats.

(c) The engagement partners should provide the firm with relevant information regarding various client engagements, which they might be responsible for, so that the firm can evaluate its impact on the firm's independence. For example, if a particular client has offered some additional work to the firm, the audit partner must inform this fact to the management of the firm to enable it to evaluate whether any independence related issues arise by accepting such additional work.

(d) Employees and other staff of the firm must inform management of any circumstances or relationships that create a threat to independence so that appropriate action can be taken. For example, if an audit manager gets married to the daughter of a client's director, he should inform management about it. Management can then evaluate its impact on his independence and if required, transfer him to another audit.

(e) The firm should, for future reference, document the various records relating to independence and also note down the action taken by the firm to reduce / eliminate the risk of any threat to independence.

(f) The firm should also obtain written confirmation of compliance with its policies and procedures on independence from all the staff of the firm, at least annually.

(g) The firm should keep a check on the familiarity threat that may arise due to non-rotation of audit partners. A familiarity threat may arise due to using the same senior personnel on the same engagements over a prolonged period. According to the IFAC Code, in the case of audit of financial statements of listed entities:

- A firm should keep a yearly record of the engagement partner for each client so as to check that no engagement partner conducts the audit of a particular client for more than the specified period (i.e. not more than five years).
- For other key audit partners, such rotation after a specified period (i.e. not more than seven years) is compulsory.
- The engagement partner should not handle the audit of that particular client until a period of five years (Two years for key audit partners) after the end of the specified period.

This will help the firm in rotating the partners amongst clients, therefore avoiding the familiarity threat.

Tip

The IFAC code of ethics has set the principle of audit partner's rotation as a measure to safeguard against the familiarity threat. However, in some cases it is impracticable to follow this principle. For example, if, in a firm, there is lesser number of partners having the expertise required to perform the audit engagement, then the rotation of partners is not a proper measure against the familiarity threat.

In such circumstances, a key audit partner can continue the same audit for more than seven years subject to exemption from the relevant applicable jurisdiction. The jurisdiction should specify other alternative measures such as appointment of an independent external reviewer as a safeguard.

3. Acceptance and continuance of client relationships and specific engagements

Client acceptance and engagement acceptance is discussed in detail in Study Guide B1, Learning Outcome 1.

Quality control in this respect covers compliance with appropriate procedures regarding the acceptance and continuance of client relationships and specific audit engagements.

Such appropriate procedures would include:

- Reviewing the firm's existing clients on an ongoing basis. For example, an existing client may be facing financial difficulties. In this case, the firm must review whether the client will be able to pay the audit fees.

- Evaluating prospective clients in order to expand the business and establish the firm's name in the market.

These procedures should be carried out taking into consideration:

(a) The independence of the audit firm (i.e. the audit partner)

Example

Joseph has been the audit partner of Darvey Co for the last six years. In the sixth year, Joseph inherits a small shareholding in Darvey. The audit firm should have annual procedures to review whether Joseph should continue to be the audit partner of Darvey as his independence is likely to be affected. In fact, there should be rules that Joseph must disclose his inheritance as soon as he realises that there are shares in a client company.

(b) The integrity of the client's management

Example

While auditing the books of Saint Lauren Inc last year, the auditor observed that the management had manipulated the working capital figure. Although the matter was solved and the inventory was correctly valued before finalising the accounts, the auditors had doubts regarding the integrity of the management. Due to this, the auditor was not sure whether to accept the audit engagement for Saint Lauren for the current year. There should be clear quality control procedures to flag the doubts to the partners of the audit firm and there should be meetings regularly to discuss whether client relationships should continue or not.

(c) The firm's competency to serve the client appropriately

Before accepting an assignment the firm must consider whether it is competent enough to perform the engagement and whether it has sufficient time and staff required for the engagement.

Where the firm has to decide whether or not to continue a client relationship, significant matters that have arisen during the current or previous audit engagement and their implications for continuing the relationship must be taken into account.

Example

LMP Brothers is the auditor of Techsoft Inc, an IT company, and all its subsidiaries. In the current year, Techsoft has floated a new subsidiary to launch its new KPO (Knowledge Process Outsourcing) business. Since this is a new line of business involving new technology, LMP Brothers may have to review the processes involved in the KPO business to decide whether it is competent enough to undertake the audit of the new venture.

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4. Human resources

The firm should have appropriate human resources policies in order to ensure the quality of personnel recruited which would ultimately affect the quality of work conducted. The various aspects of human resources include:

- Recruitment
- Performance evaluation
- Capabilities
- Competence
- Career development
- Promotion
- Compensation
- The estimation of personnel needs

Effective recruitment processes and procedures help the firm to select capable individuals who have good technical knowledge as well as the capacity to develop the competence necessary to perform the firm's work. Employees can be encouraged to perform better by giving them the opportunity to develop their competences. Some of the ways in which a firm could do this are:

- Imparting professional education through training or seminars
- Giving work opportunities to less experienced staff so that they can learn through work experience
- Coaching by more experienced staff, for example other members of the engagement team
- Providing independence education to the employees who are required to be independent

A firm should employ such performance evaluation procedures which will give importance to the competences of the employees and their commitment to the ethical principles.

There are four simple factors that an audit firm must ensure while assigning engagement teams to a particular assignment as follows:

The engagement partner is aware about his roles and responsibilities with respect to that assignment,
The client's management has been informed about the engagement partner who would be responsible for handling their work,
The workload and availability of engagement partners is monitored so that each engagement partner has sufficient time to adequately discharge his responsibilities and appropriate staff is assigned to each audit engagement.

5. Engagement performance

The quality control policies of an audit firm should aim at ensuring that all the engagements (whether audit of financial statements or assurance services or other audit-related work) are consistently performed in accordance with the applicable professional standards and regulatory / legal requirements. This is important to ensure that the correct audit reports are issued and that they convey the correct audit opinion. Three areas of control under this are:

(a) Consistency in the quality of engagement performance
(b) Supervision responsibilities
(c) Review responsibilities

There are two more aspects in relation to the quality control of engagement performance. These comprise of:

Consultation required during the engagement; and
Engagement quality control review.

Consultation

Consultation refers to taking advice from another person who may have more knowledge on the subject matter. During various audit / assurance engagements, the engagement team members may feel the need to consult a subject expert before arriving at a conclusion. For example, accounting treatment of certain items such as intellectual property rights or goodwill may be difficult to understand. The audit partner may want to then consult another person, say another engagement partner who has handled such transactions, so as to understand whether the accounting treatment is correct.

Therefore the firm should have policies and procedures to ensure that reasonable assurance is provided in respect to the following:

(a) The engagement team seeks consultation on important matters whenever required e.g. valuation of specialist inventory (diamonds and other precious stones).

(b) The firm provides sufficient resources to enable appropriate consultation to take place (for example, existence of a good professional network comprising of subject experts on various topics).

(c) The engagement team documents the:
Nature of
Scope of and
Conclusions resulting from such consultations.

2.5 Engagement quality control review (EQCR)

The objective of an engagement quality control review is to review and evaluate significant judgements made by the engagement team and conclusions reached in formulating the auditor's report. It is conducted before an auditor's report is signed.

EQCR is also known as a **'hot review'**. It enhances the quality of the work performed by the engagement team by giving assurance on significant judgements made during the engagement.

An audit firm should establish policies and procedures to ensure that an EQCR is conducted for appropriate engagements. Such policies should also set out the nature, timing and extent of the review.

The policies must include:

- That an EQCR must be conducted for all audits of financial statements of listed entities,
- The criteria for deciding whether an EQCR should be conducted for any other audit/assurance engagement (Other than audit of financial statements of listed entities),
- That an EQCR must be conducted for other engagements which meet such criteria and
- That the audit / assurance report will not be dated until the completion of the EQCR.

Example

Flossy & Co is a firm of CPAs. As a part of its EQCR policy, it has decided that any audit engagement which is conducted while the engagement partner is absent (due to business travel) for 75% of the total time spent on such engagement, will go through an EQCR.

Accordingly all the audits meeting such criterion were subject to the EQCR.

An engagement quality control review is conducted by a quality control reviewer who is especially appointed for this purpose. A quality control reviewer may be a partner, another person in the firm, a suitably qualified external person or a team made up of such individuals. The reviewer should have sufficient and appropriate experience and authority to evaluate the significant judgments made by the engagement team and the conclusions arrived at by them in formulating the audit / assurance report.

A quality control review is compulsory for audits of financial statements of listed entities. For other audit engagements where an engagement quality control review is performed, the engagement partner may choose to follow the same requirements as applicable to listed companies. However, the reviewer should be rotated after a specified period (i.e. after a maximum of seven years) to avoid the familiarity threat. Moreover, the reviewer should not take up that particular engagement until two years after the end of the specified period.

6. Monitoring

It is important to monitor the effectiveness of the quality control system on an ongoing basis. The audit firm should establish policies and procedures to ensure that the system of quality control is adequate, relevant and is functioning effectively. Such policies should also ensure that all the quality control policies are followed and implemented regularly in practice. Under the monitoring process the following points must be considered:

- The firm should evaluate its quality control system on an ongoing basis.
- A periodic inspection of few completed engagements must be conducted to evaluate the effectiveness of such quality controls and to identify deficiencies in them. This is known as ‘cold review’.

Example

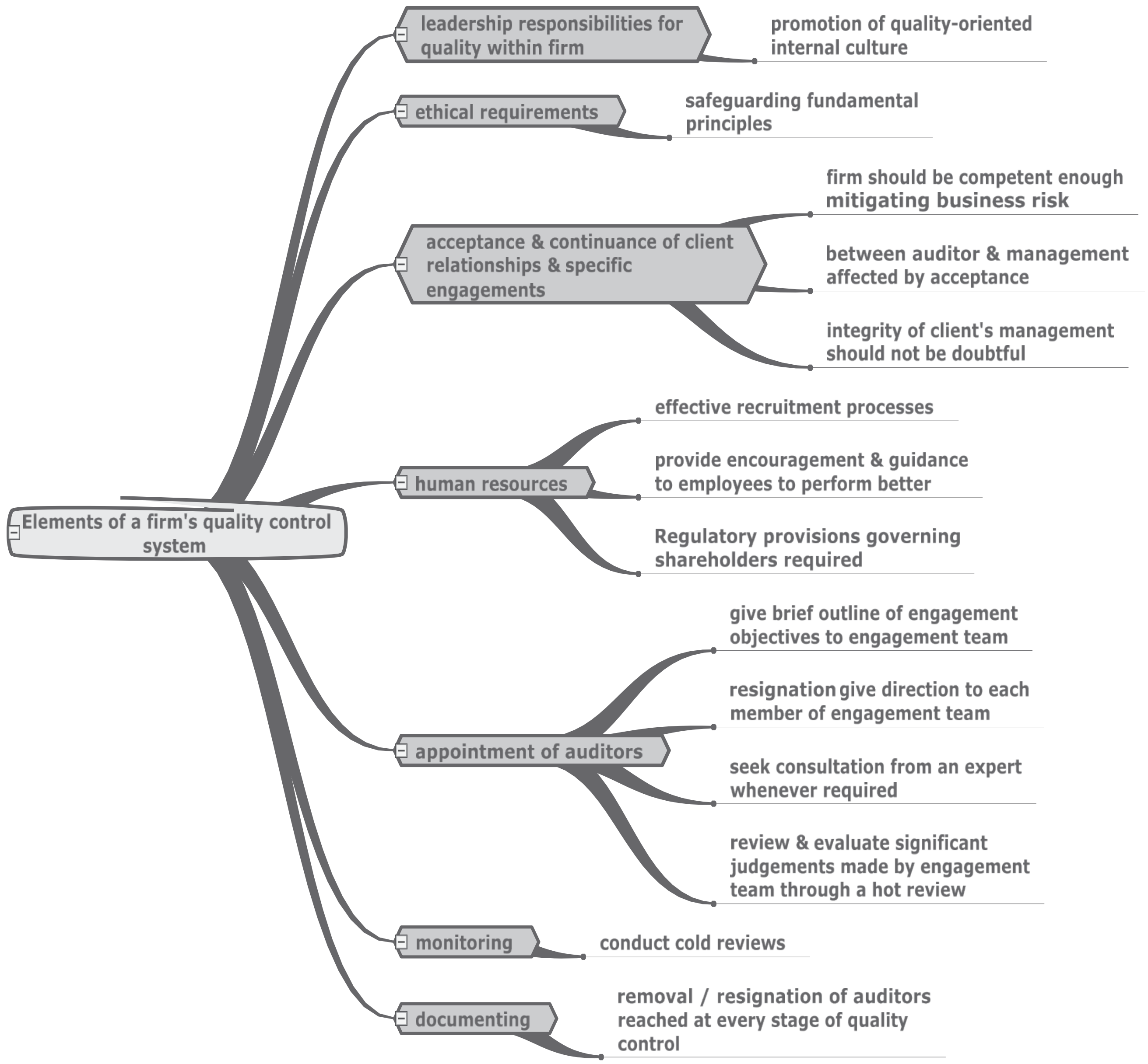
Saara is an audit partner of Kaylo & Co, a large audit firm. Saara is sent to the Moscow office of Kaylo, to review some files which were completed in the prior year. Saara will check through the completed audit files to ensure that the firm’s procedures were followed in various areas (e.g. ensure that an independence checklist was completed prior to starting the engagement, ensure the audit planning questionnaires were filled out appropriately) and that when reading a section, Saara comes to the same conclusion that the audit engagement partner would have.

- Such inspection (i.e. cold review) should not be conducted by those performing the engagement or the engagement quality control review.

- The responsibility for the monitoring process must be assigned to an experienced person who has sufficient authority in the firm, e.g. a partner or a faithful and experienced employee.

A deficiency in the firm’s system of quality control would mean that it would not indicate that a particular audit engagement was not performed in accordance with professional standards and regulatory / legal requirements, or that the auditor’s report was not appropriate.

SUMMARY



Test Yourself 2

Dennis Accountants is a firm of CPAs which comprises two partners, Tony and Hooper. In the current year the firm is successfully going to complete 5 years. The firm has had a system of quality control from the beginning which has ensured that each audit is conducted satisfactorily. However the partners have never monitored the functioning of the quality control system.

A professional colleague of Hooper suggested to him that the quality controls must be reviewed on a timely basis. Hooper too feels the need for it as he has observed mistakes in few audits conducted last year.

Required:

Discuss how Tony and Hooper can introduce this new element into the firm’s system of quality control.

2.6 Quality control procedures that are applicable to a given audit engagement / monitoring and review procedures to effectively manage an audit or assurance engagement

The quality control procedures applicable to a given audit engagement are similar to the quality controls procedures applicable to an audit firm. The only difference is that the elements of quality control are applied to a specific audit engagement instead of the entire firm.

According to ISA 220, an audit firm's system of quality control should include policies and procedures addressing each of the following elements in the case of individual audit engagements:

1. Leadership responsibilities for quality on audits

It is the responsibility of the engagement partner to ensure the overall quality of each audit engagement to which that partner is assigned. This is done by conveying to each member of the engagement team:

(a) The importance of:

Performing work that complies with professional standards and regulatory and legal requirements
Complying with the firm's quality control policies and procedures as applicable
Issuing auditors' reports that are appropriate in the circumstances

(b) The fact that quality is essential in performing audit engagements.

Example

Joe is the auditor of Space Plc, located in the UK. The company operates across three countries and the report issued by the auditor is read across these countries. Joe's team consists of three junior auditors who will be reporting to him. The engagement team has audited the financial statements according to the UK jurisdiction. Under UK rules, the auditor is required to express an opinion on whether the directors' report is consistent with the financial statements. However, this is not consistent with the international reporting standards applicable.

Being the leader of the engagement team it is Joe's duty to inform this fact to the other junior members of the team. If the report is prepared using the local rules applicable to the UK, the report loses its understand ability to readers in the outside countries. In this case, it is important for the auditor to follow internationally accepted principles of reporting to enhance the understand ability of the report to the readers. The expression of an opinion about the directors' report in the audit report may lead the readers in countries other than the UK, to think that some unusual circumstances exist.

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2. Ethical requirements

The engagement partner must ensure that every member of the engagement team complies with the ethical requirements. The engagement partner may assign a group of team members to deal with issues of confidentiality, integrity or objectivity and to monitor compliance with ethical requirements. This will ensure that the firm's independence is not compromised due to the actions of the team members.

The engagement team should carry out the necessary inquiry and observe ethical matters amongst themselves throughout the audit engagement. Any matters of non-compliance that come to the engagement partner's attention can be dealt with in consultation with others in the firm to determine the appropriate action. The matters identified and the action taken to resolve them should be documented for future reference.

Example

Walkers Co is a firm of accountants and auditors. One of the senior managers, Assad, has been instrumental in bringing in a new audit client, Wysecrax, which produces board games and sells them across the world. The CEO of Wysecrax is Steve Gibman. Assad and Steve went to school and later to college together. They have been friends for years. Over the years, Steve has often talked in confidence to Assad about issues that Wysecrax had with previous auditors and about an accounting fraud that took place a few years ago.

Continued on the next page

Assad is keen to be the audit manager as he has a good rapport with Steve and knows a lot about the company. However, Alan, the audit partner does not think that this is a good idea. He has a meeting with Assad and explains to him that his close friendship with Steve is likely to impair his objectivity, as he may be inclined to believe what Steve says rather than concentrating on the facts. In addition, an outsider would not view Assad as being objective, due to the history between Steve and Assad. There could also be issues with confidentiality as Assad has confidential information about the company. Hence, it was agreed that it was better to bring in an unrelated audit manager.

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3. Acceptance and continuance of client relationships and specific engagements

The engagement partner should be satisfied that the appropriate decision-making process for acceptance or continuance of an audit engagement has been followed and a proper record in this regard is maintained.

Any information obtained by the engagement partner that poses a threat to the independence of the firm or causes the firm to decline the audit engagement if that information had been available earlier should be communicated promptly to the firm, so that the firm and the engagement partner can take the necessary action.

Example

Capgem is a firm of CPAs. One of the partners of Capgem married the daughter of one of the directors of its client company during the current year.

As the audit partner has developed a relationship with the organisation on which he is reporting, his independence is likely to be affected. The reason behind this is that the auditor has become too close to the director and this may impair his judgement on the financial statements. Therefore Capgem must decide whether to discontinue the client relationship or re-appoint another audit partner.

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4. Assignment of engagement teams

(a) It is important to ensure that the engagement team consists of professionals who have the requisite technical knowledge and professional competence to carry out the audit with due care. This includes considering whether it would be possible for the audit firm to conduct the audit.

(b) The engagement partner should also be satisfied that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit engagement in accordance with professional standards and regulatory and legal requirements.

For example, an audit firm may conduct regular appraisals to evaluate the stronger and weaker areas of their employees. It can also conduct various professional training courses for the staff or encourage the employees to attend Continuing Professional Development (CPD) programmes so as to maintain, improve and broaden their knowledge and skills and develop the personal qualities required in their professional lives.

(c) Such procedures are aimed to ensure that the engagement team is capable of producing an auditor's report that is appropriate in the circumstances to be issued.

Example

The due date for filing the tax return of Bricks Construction Co, a listed company, is 31 October and it approached the auditor, Ryan Pickle on 18 October. Before accepting the audit engagement, Ryan must evaluate whether, given the short period of time available, he would be able to complete the audit with the available tax qualified staff in time, without any shortcuts. He must also ensure that that his personnel have the necessary skills, professional competence and certain basic qualifications such as the ACA or a similar qualification to carry out the audit of Bricks Ltd. After evaluation of the capabilities, competence and time to perform the audit, Ryan accepted the audit of Bricks Construction Co.

While performing the audit, Ryan noticed that during the last year, Bricks closed down one of its cement manufacturing units which contributed almost 20% of Bricks' total revenue. The information regarding this closure was given in detail in the directors' report. However, it was not disclosed separately in the financial statements.

Continued on the next page

Ryan's view was that under IFRS 5, there must be separate disclosure on the face of the Statement of Consolidated Income (i.e. the income statement) of the post-tax results of the discontinued operation, and of any profit or loss resulting from the closure. In addition, as Bricks is a listed company, IFRS 8 Operating Segments requires separate segmental disclosure of discontinued operations.

Therefore, Ryan issued a qualified audit opinion following disagreement on disclosure as he was aware that failure to disclose the above information in the financial statements is a material breach of International Accounting Standards.

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5. Engagement performance

The engagement partner should monitor the engagement performance through proper direction, supervision and review of the work conducted by the engagement team.

(a) Direction

The engagement partner should provide proper direction to the audit engagement by informing the members of the engagement team of:

- The objectives of the audit
- Their responsibilities
- The need for compliance with the applicable ethical requirements
- The required professional scepticism to plan and perform an audit
- The responsibilities of their respective partners where more than one partner is engaged in performing an audit
- The nature of the entity's business
- Risk-related issues of the audit
- Problems that may arise
- The detailed approach to the performance of the engagement

Members of the engagement team are encouraged to ask questions to more experienced team members to ensure that appropriate communication occurs within the engagement team. This is important for all members of the engagement team to understand the objectives of the work they must perform. Appropriate team-working and training will help to assist less experienced members of the engagement team to understand the objectives of the assigned work.

(b) Supervision

Supervision would involve giving direction as well as monitoring the work of the engagement team members from time to time. Supervision is different from direction and review in the sense that it is an ongoing activity throughout the audit engagement, whereas direction is given at the beginning of the audit and reviews are carried out at regular intervals.

The engagement partner can delegate the supervisory responsibilities to one of the members of the team. This member will be required to ensure that the team members have sufficient time to understand instructions and carry out their work, and that the work is carried out in accordance with the audit plan.

Supervision involves the following activities:

- Tracking the progress of the audit engagement.
- Considering the capabilities and competence of individual members of the engagement team.
- Addressing significant accounting and auditing questions arising during the audit engagement, considering their significance and modifying the audit plan appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members to resolve any differences of opinion between the team members.

Example

Peggy Rice is the auditor of Fastbucks Inc, a UK-based merchant bank. The audit team consists of the audit manager, Greg, and three other accountants out of which one, Mark, has worked on the audit previously whereas the other two, Robin and Sam are relatively newly assigned.

In adherence to the audit firm's quality control procedures, Greg appoints Mark to supervise the activities of the other two assistants. Mark explains the record keeping and accounting of several merchant banking-related functions such as issue management, portfolio management etc. to his juniors. He also keeps a track of the work conducted by them and solves difficulties faced by them.

During the audit, Robin and Sam were verifying the amount of goodwill recorded by the client. Robin felt that the most convincing audit evidence to verify goodwill was a comparison of the recorded value of assets acquired with the seller's book value as evidenced by financial statements. However, Sam did not agree. He felt that the comparison should be made against the insured value of the assets stated in the insurance policies.

As Robin and Sam could not reach an agreement, they sought the help of the senior member, Mark. Mark studied the situation and consulted the audit manager, Greg, who had much more audit experience. In Greg's opinion, the most appropriate evidence that an auditor could obtain while verifying the amount of goodwill was by comparing the recorded value of the assets acquired with the appraised value of the assets as evidenced by independent appraisals conducted by Fastbucks Inc.

This guidance provided by Greg helped Robin and Sam to conduct the audit smoothly.

(c) Review

Senior audit team members must review the work performed by junior team members. Review may be undertaken at fixed time intervals according to the audit plan. The review should include consideration of whether:

- The objectives of the audit engagement have been achieved.
- The work has been performed in accordance with the relevant professional standards and regulatory and legal requirements.
- Important matters have been raised for further consideration and appropriate consultations have taken place in this regard.
- Resulting conclusions on various matters have been documented and implemented.
- Revision of the nature, timing and extent of work to be performed is needed.
- The work performed supports the conclusions reached and is appropriately documented.
- The evidence obtained is sufficient and appropriate to support the auditor's report.

6. Consultation

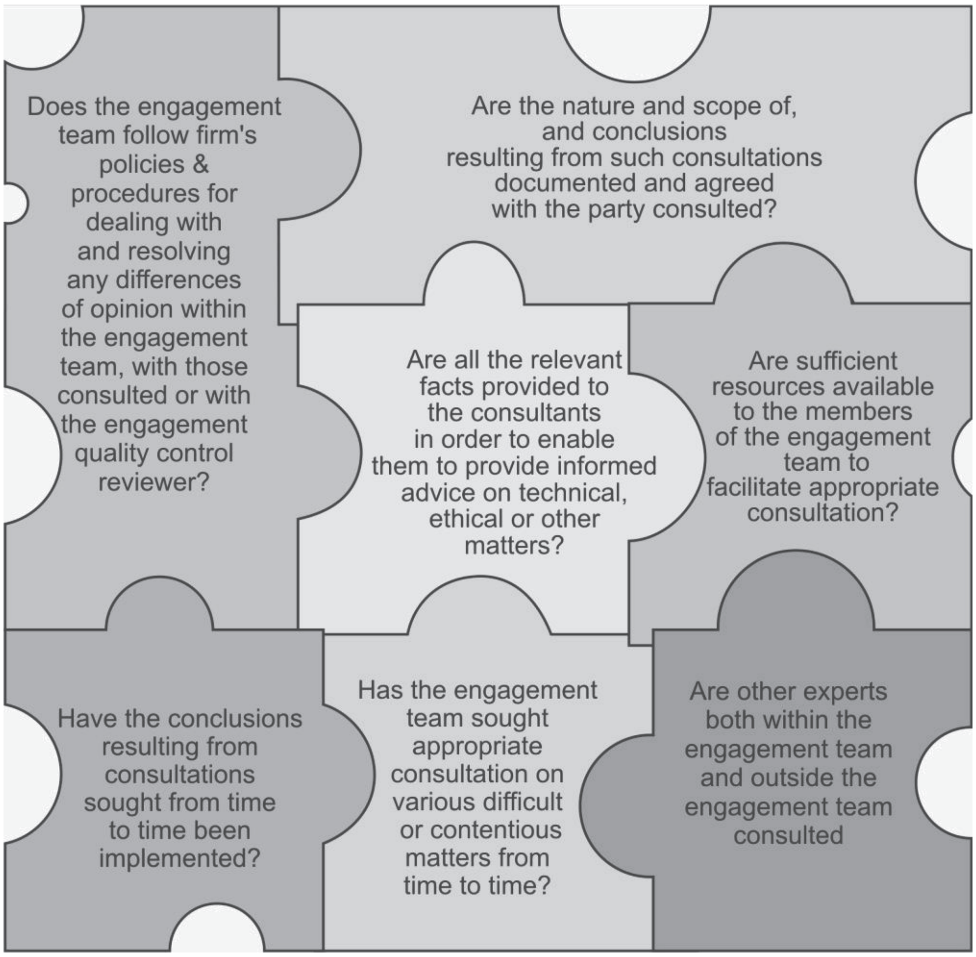
In some audits, it may be necessary to consult an expert to address difficult or contentious matters. If an expert is not available within the firm, it may be appropriate to consult an external expert.

If the internal resources of the audit firm are not sufficient to tackle contentious matters, the engagement team may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control services.

For example, while auditing the accounts of a jewellery merchant, the auditor may want to know how gold and diamonds are valued. To find this out, he may want to consult an expert valuer of jewellery. If the client has already had the inventory valued by a valuer, the auditor may review the basis of the work conducted by the valuer and the conclusions reached. Thereafter he may decide whether to rely upon the work of the valuer or to consult another valuer.

Such consultation must be carried out before the auditor's report is issued. The matters that the engagement partner should ensure are presented in a diagram below:

Diagram 3: Consultation



7. Engagement Quality Control Review (EQCR)

Under a quality control review, the engagement partner should ensure that:

An engagement quality control reviewer has been appointed.
Significant matters arising during the audit engagement, including those identified during the engagement quality control review, have been discussed with the engagement quality control reviewer.
The auditor's report is not issued until the completion of the engagement quality control review.

Example

Natalie is the audit manager in a firm of CPAs, Barbara & Co, currently assigned to the audit of Pacman Packagings Ltd, which is a listed company. Natalie has completed the audit along with her team. Now the quality control reviewer, Tony, has been appointed to review the objectivity of significant judgements taken during the audit.

Natalie has discussed the important features of the audit with Tony, who has reviewed the audit papers and other documentation related to the audit. Some of the significant issues reviewed by Tony are:

Disclosure of impairment losses according to IAS 36
Acquisition of 62% stake in Featherlight Packers
Actuarial valuation of employees' retirement benefits

Thereafter, Tony reviewed Natalie's proposed audit report and finalised it for submission to the client.

Where, at the start of the engagement, an engagement quality control review is not considered necessary, the engagement partner should be alert for changes in circumstances that would require such a review.

An engagement quality control review involves the following:

- Discussion of significant matters with the engagement partner
- A review of the selected audit documentation relating to the significant judgements made by the engagement team and the conclusions reached by them
- A review of the financial information and the auditor's report
- Consideration of whether the auditor's report is appropriate

An engagement quality control review for a listed entity's financial statements will also consider:

- Evaluation by the engagement team of independence of the firm in respect of the audit engagement.
- Whether the engagement team sought appropriate consultation on various difficult or contentious matters from time to time and the conclusions resulting from such consultations.
- Whether the audit documentation selected for review exhibits the nature and scope of work performed for Taking significant decisions and supports the conclusions reached.

The extent of the review depends on the complexity of the audit engagement and the risk that the auditor's report might not be appropriate in the circumstances. The review does not reduce the responsibilities of the engagement partner.

If there are any differences of opinion within the engagement team, with those consulted or with the engagement quality control reviewer, the engagement team must follow the firm's policies and procedures for dealing with and resolving such differences.

8. Monitoring

It is important to monitor whether the quality control measures are being followed in the case of a given audit engagement and whether the quality control system are relevant, adequate and operating effectively. The engagement partner should consider the results of the firm's monitoring process (undertaken to evaluate the firm's quality control system) in order to determine whether:

- The deficiencies noted in the quality control system would affect the audit engagement (which the partner is responsible for),
- The measures undertaken by the firm to rectify the deficiencies are sufficient in the context of that particular audit.

The engagement partner must ensure that all the findings of such a monitoring process are properly documented.

9. Documentation

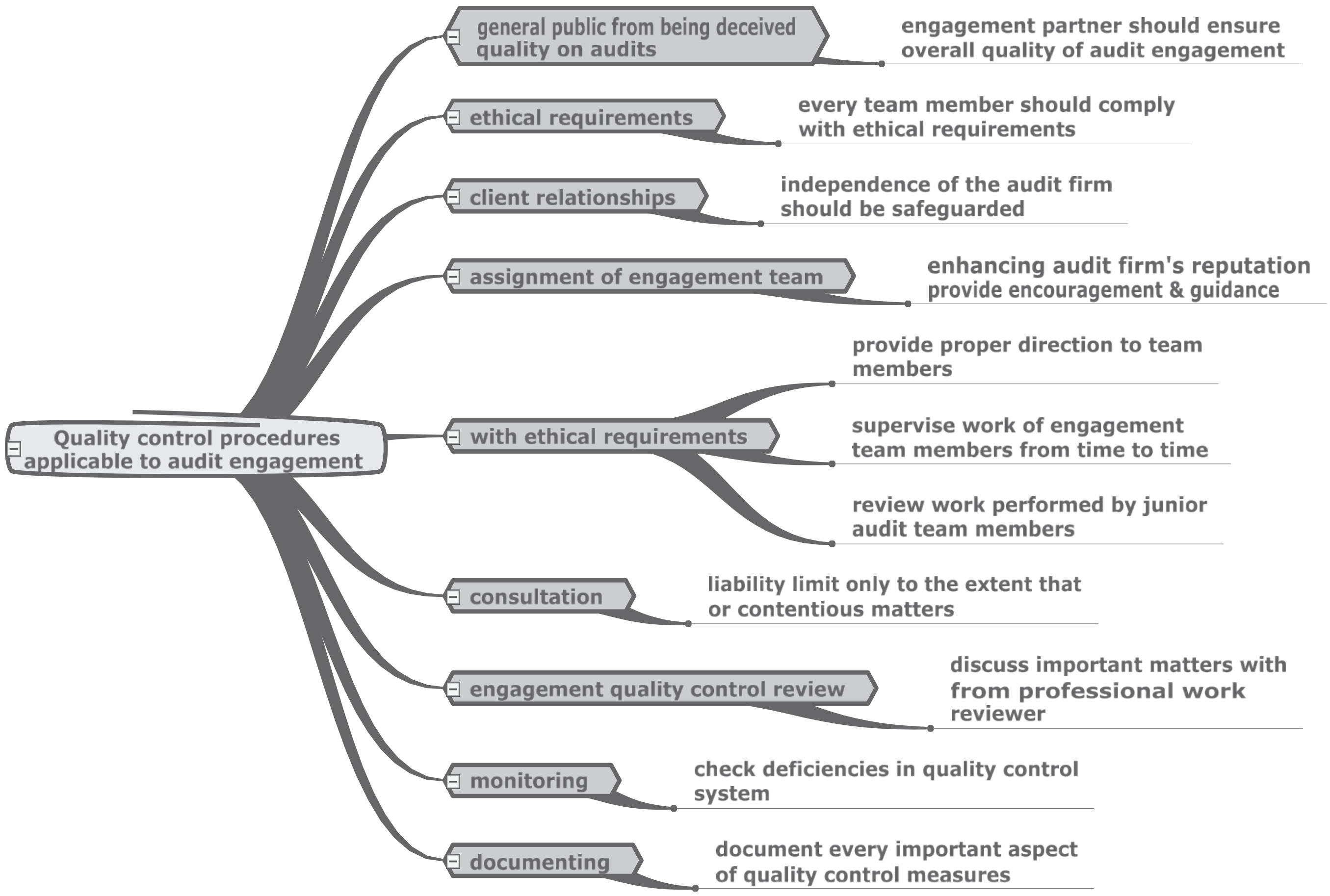
While conducting an audit, the auditor should document:

- Issues related to compliance with any applicable ethical requirements and their resolutions
- Conclusions arrived at and any related discussions to support those conclusions regarding compliance with independence requirements applicable to individual audit engagements
- Conclusions arrived at for acceptance and continuance of client relationships and audit engagement
- Nature and scope of, and conclusions resulting from any consultations during the audit engagement

According to ISA 220 Para 25, the engagement quality control reviewer shall document, for the audit engagement reviewed, that:

(a) the procedures required by the firm's policies on engagement quality control review have been performed; (b) the engagement quality control review has been completed on or before the date of the auditor's report; and (c) the reviewer is not aware of any unresolved matters that could cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate.

SUMMARY



3. Analyse and evaluate the extent to which assurance and audit functions within an entity can be used or relied upon.

[Learning Outcome c]

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).

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)

SUMMARY

Internal auditors are required to review the risks that have been identified by management as well as evaluating the controls they have put into place to mitigate those risks. At the end of their assessment, internal auditors provide an opinion on whether the organisation's controls are sufficient and working effectively.

Therefore it is vital that the internal audit function always remains separate from the rest of the organisation's management team and they should not have any operational responsibilities.

Example

For instance many corporations have their internal audit department report directly to either their board of directors or their audit committee. This helps ensure that their work remains free from the risk of interference from any senior managers / executives of the organisation.

Therefore internal auditing is an independent appraisal function. Its main objectives are to:

Assess whether management has **met** its **responsibilities** (in terms of effective and efficient operations);

Determine whether the organisation is in compliance with all **laws and regulations**;

Determine if all prescribed **internal control policies** and **procedures** are being complied with;

Determine that the **size** and **scop**e of the **internal control system** is sufficient;

report any **unidentified risks** and **internal control weaknesses** as well as any instances of **non-compliance** with laws and regulations and

3.1 Factors to be evaluated before implementing an internal audit function

Organisations need to carefully evaluate the following factors before implementing an internal auditing system:

1. The scale, diversity and complexity of the organisation's activities

Obviously the larger, more diverse and complex the activities of an organisation the greater the needs for having an internal audit function will be. Small owner-operated businesses will derive little value from regular internal audits. These types of organisations generally have few employees and relatively few activities thereby making monitoring the work of employees fairly simple. On the other hand, multinational companies have staff that number in the thousands and conduct multiple activities thereby making monitoring the work of employees very complex.

Example

Joe's Ice Creams is a small owner operated ice cream parlor. The business has three employees (two salespersons and one accountant) and all operations are directly supervised by the owner on a daily basis. Whereas Baskin Robbins is the world's largest chain of ice cream specialty shops, with more than 5,600 retail shops in 40 countries. Given the greater reach, complexity and size of its operations, Basin Robbins will benefit much more from having an internal audit function than Joe's Ice Creams.

2. Whether there are any processes or departments that have a history of problems

The greater the number of processes or departments that have, historically, created problems for the organisation, the greater will be the need for an internal audit function. Past and ongoing problems indicate that the organisation's internal control system is either poorly designed or being poorly implemented.

Example

Second Home is an organisation that owns and operates a chain of high end bars and eateries. Over the years there have been frequent instances of cash registers not balancing at the end of a night as well as continual problems of pilfering of food and alcohol. Therefore Second Home would greatly benefit from implementing an internal audit function.

3. The probability or possibility for fraud and corruption

Internal audit becomes particularly relevant when there is a high probability and / or possibility for fraud and corruption taking place.

Example

Audioplay is an organisation that owns and operates a chain of stores that sell stereo equipment. All of Audioplay's stores operate solely on a cash basis both in terms of purchasing goods from their suppliers and selling to their customers.

Its sister concern Videoplay, owns and operates a chain of stores that sells DVDs and video cameras. However Videoplay only takes credit card payments from its customers and pays its suppliers by cheque.

Obviously Audioplay has a much stronger need for an internal audit function given the higher potential for instances of fraud.

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4. The costs versus benefits

As mentioned before, internal audit is an expensive and time consuming activity for an organisation. Therefore before implementing this function organisations need to assess and estimate both the costs and the benefits that will be involved.

5. Role of corporate governance

The greater the stress and emphasis an organisation places on good corporate governance the greater the need for a strong internal audit function. This is because internal audit is an integral part of the system of "checks and balances" which is a key aspect of good corporate governance.

3.2 Reliance on work of internal audit

The external auditor is solely responsible for expressing an opinion on the financial statements and determining the nature, timing and extent of auditing procedures. This responsibility cannot be reduced by using the work of others. However, they may use the work of others to decide their audit plan. The extent to which the external auditor can rely on an internal audit depends on **whether the work of the internal auditor can be used (along with an assessment of the areas where it can be used).**

1. Factors to be evaluated before deciding to rely on the work of internal auditor

(a) The extent to which the internal audit function's organisational status and relevant policies and procedures support the objectivity of the internal auditors

The external auditor should exercise professional judgment in evaluating the work of the internal audit function.

Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgment.

When using the work of others, the independence of that person is of prime concern. The external auditor should satisfy themselves that the work of the internal auditor is unbiased; if not, the work of the internal auditor will be unreliable.

The following factors need to be assessed by the external auditor in order to confirm the objectivity of the internal auditors:

(i) Level of reporting

The organisational status of the internal audit decides the authority to which the internal auditor will report. The ideal situation is one where the reporting is at the highest level i.e. the internal audit function reports directly to the audit committee and the internal auditors have direct access to those charged with governance.

If there is a system where the internal auditor should report to middle level management, the middle level management may not give proper feedback to the highest level of management. The middle level management may manipulate or ignore certain findings if they themselves are responsible for any weakness.

(ii) Freedom from conflicting responsibilities

The external auditor should enquire whether there is any operating responsibility undertaken by the internal auditor. The internal auditor should not be involved in carrying out any function / operation, so that while evaluating operations, their independence will be maintained. Otherwise, they may hide any mistakes they make.

(iii) Authority making employment decisions

This is related to whether those charged with governance oversee employment decisions (like determining the appropriate remuneration policy) related to the internal audit function.

(iv) Freedom from constraints or restrictions placed on the internal audit function

The external auditor should:

- determine whether there is any interference (including placement of restrictions or limitations) by management in the work of the internal auditor (for example, in communicating the internal audit function's findings to the external auditor); and
- Carefully evaluate this interference.

If the internal auditor is not free to perform their work, the external auditor may decide not to rely on the internal auditor's work.

(v) Compliance with professional standards

This relates to whether the internal auditors are members of relevant professional bodies and their memberships require that they comply with relevant professional standards relating to objectivity.

(b) The level of competence of the internal audit function

Competence of the internal audit function refers to the internal auditors possessing the necessary professional skill and knowledge (which are continuously updated) to handle the tasks that are assigned to them by their client. Factors that may affect the external auditor's evaluation include the following:

- Whether the internal audit function has sufficient as well as appropriate resources in relation to the size of the entity and the nature of its operations.

- Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.

- Whether the internal auditors possess relevant professional designations and experience in auditing.

- Whether the internal auditors possess the required knowledge and necessary skills to perform work related to the entity's financial statements. (For example, industry-specific knowledge)

- Whether the internal auditors are members of relevant professional bodies that oblige them to comply with the relevant professional standards including continuing professional development requirements.

Example

Before the introduction of computerised accounting systems, audits were carried out manually. With the introduction of computerised accounting systems, the scope of audit has changed. In order to perform audit work competently, an internal auditor should have knowledge of:

- The impact of computerised accounting systems
- Various risks associated with computerised systems
- Various controls to mitigate those risks
- Various techniques of auditing computerised systems

(c) Whether the internal audit function applies a systematic and disciplined approach, including quality control

Factors that are evaluated for this include:

The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programmes, documentation and reporting - the nature and extent of which is commensurate with the size and circumstances of an entity

Whether the internal audit function has appropriate quality control policies and procedures, for example, those policies and procedures in ISQC 1 that would be applicable to an internal audit function

Tip

The external auditor shall not use the work of the internal audit function if they determine that any of the three factors mentioned under (a) to (c) above are not met.

Diagram 4: Factors evaluated before using the work of internal audit function

Factors to be evaluated in order to decide whether the work of the internal auditor function can be used:

- **The objectivity of the internal auditors**
  - Level of reporting
  - Freedom from conflicting responsibilities
  - Authority making employment decisions
  - Freedom from constraints or restrictions placed on the function
  - Compliance with professional standards
- **The level of competence of the function**
  - Availability of sufficient & appropriate resources
  - Appropriateness of established policies for hiring, training and assigning internal auditors to internal audit engagements.
  - Possession of relevant professional knowledge, designation & experience in auditing
  - Membership of relevant professional bodies
- **Whether the function applies a systematic and disciplined approach, including quality control**
  - The existence, adequacy and use of documented internal audit procedures
  - The availability of appropriate quality control policies and procedures by the function

The work of the internal audit function will not be used if any of the three factors are not satisfied

3.3 Determining the nature and extent of work of the internal audit function that can be used

Once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, the auditor needs to assess the following matters:

(a) Relevance of the internal auditor's work to external audit plan and strategy

The external auditor will determine whether the planned nature and scope of the work of the internal audit function that has been performed / planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established.

For example, if the internal audit reports contain observations relating to inventory counts, this work of the internal auditor will be relevant to the external auditor as inventory counts are usually part of the external audit plans.

Example

Examples of work of the internal audit function that can be used by the external auditor include the following:

- Testing of the operating effectiveness of controls
- Substantive procedures involving limited judgment
- Tracing transactions through the information system relevant to financial reporting
- Testing of compliance with regulatory requirements

(b) Judgment in evaluating the work

The auditor uses judgment in planning, performing and evaluating the work of the internal auditor. Further

judgment is involved in:

- Planning and performing relevant audit procedures; and
- Evaluating the audit evidence gathered.

Example

Considerable judgment is required for the following matters:

- Assessing the risks of material misstatement;
- Evaluating the sufficiency of tests performed;
- Evaluating the appropriateness of management's use of the going concern assumption;
- Evaluating significant accounting estimates; and
- Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.

(c) Level of involvement of external auditor

The external auditor shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

(d) Level of assessed risk of material misstatement

The higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and therefore, the external auditor will need to perform more of the work directly, rather than relying on the work of the internal auditor.

For example, for a departmental store, the assessed risk of material misstatement will generally be high in the area of cash and inventory. This in turn will require that the auditor relies less on the work of the internal auditor in these account balances.

(e) Using the work of the internal audit function

Where the external auditor intends to use internal audit work, the following should be agreed upon in advance by the internal and external auditor:

- The timing of the work
- The extent of the work
- The materiality levels (for the financial statements as a whole as well as performance materiality)
- Methods of sample selection
- Documentation of work performed
- Review and reporting procedures

Example

Sara has been appointed as an external auditor of Tupper Ltd for the second year. She had already audited Tupper Ltd last year.

Riya is an internal auditor of Tupper Ltd. The inventory in Tupper Ltd is classified as ABC in accordance with their volume and value. Tupper Ltd has 200 different items in stores. As it is not possible to count all items of inventory at one time, inventory counting is performed on a continuous basis.

From past experience, Sara decides that she will rely on the work of Riya for the purpose of inventory counting.

How will Sara and Riya coordinate their work?

Sara and Riya meet in order to discuss the co-ordination of their work. In the meeting, they agree upon the following in advance:

Materiality levels: first of all they will agree upon the materiality level. If it is observed that Riya, in her internal audit, covers all the items which have a value greater than the materiality level acceptable to Sara, Sara may decide to rely on the work of the internal audit.

The timing of such work: timing refers to the actual time when an auditor will perform an audit procedure. They may decide that Riya will remain present most of the time for physical verification of the 'A' category items and may make a surprise visit to the entity when 'B' category items are physically verified. Sara may decide her visits on the basis of Riya's work. If satisfied with the internal audit work, she may decide to attend the inventory valuation at the reporting date or near the reporting date.

The extent of work: they will also agree upon the extent to which inventory counting should be performed. They may decide that for A class items, 100% checking will be performed. For B class items 60% and C class items just 10% checking will be performed.

Methods of sample selection: both Sara and Riya agree on the method for sample selection e.g. random sampling, systematic sampling etc. If this method is not agreed upon beforehand, it is possible that Sara will not be satisfied with the method of sample selection used by Riya, and may not able to rely on her work.

Documentation: they should also agree upon the documentation of the inventory counting. All the activities involved in the inventory counting procedure should be noted down in the working papers. Riya should document planning, supervision, findings etc. of the inventory counting attended by her.

Review and reporting procedures: if Riya appoints her staff for inventory counting, she should review the work performed by the staff and ensure that all the findings are properly presented in the audit report. If this is done, it will be easier for Sara to rely on the work of the internal audit.

Diagram 5: Factors considered determining the nature and extent of work of the internal audit function

Factors considered to determine the nature and extent of work of the internal audit function that can be used by the auditor

Relevance of the internal auditor's work to external audit plan and strategy	Judgment in evaluating the work	Level of involvement of external auditor	Level of assessed risk of material misstatement

3.4 Audit procedures performed on the work of the internal audit function

The external auditor shall read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed, and the related findings.

(a) Aim of audit procedures

The external auditor shall evaluate whether:

- The work of the internal audit function has been properly planned, performed, supervised, reviewed and documented;
- Sufficient appropriate evidence has been obtained to enable the internal audit function to draw reasonable conclusions; and
- The conclusions reached are appropriate in the circumstances, and the reports prepared by the internal audit function are consistent with the results of the work performed.

(b) Audit procedures

The procedures the external auditor may perform to evaluate the quality of the work performed and the conclusions reached by the internal audit function include the following:

- Making inquiries of appropriate individuals within the internal audit function
- Observing procedures performed by the internal audit function
- Reviewing the internal audit function's work programme and working papers
- Performing the audit procedures performed by the internal audit function to validate the conclusions reached by the internal auditors

Test Yourself 3

Describe four circumstances in which it would not be possible to rely on the work of the internal auditor.

3.5 The extent to which reference to the work of others can be made in audit reports

An external auditor is solely responsible for expressing an opinion on the financial statements and relying on the work of others cannot reduce it. Using the work of others will reduce their workload but not their responsibility.

According to ISA 402 and ISA 620, a reference to the auditor's expert's work should be made in the audit report containing an unmodified opinion, only if required by law or regulation, for example, to show transparency in the public sector. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion.

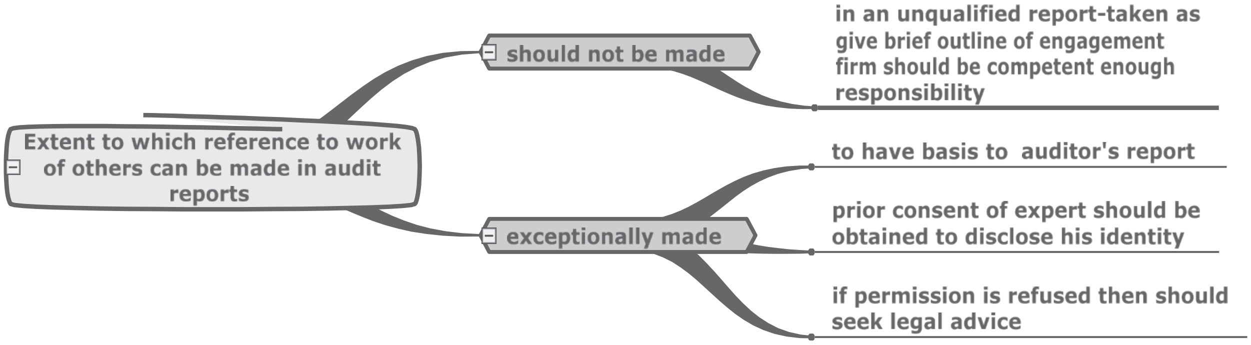
Reference to the work of an expert in an unqualified report might be taken as reservation or qualification of the auditor's opinion or division of responsibility when, in reality, it is not the intention of the auditor.

Exceptions

Exceptionally, reference to an expert can be made in an audit report when, on the basis of the expert's report, the auditor decides to give a report other than an unmodified report and personally feels that it may be beneficial to the readers of the report if the work explaining the nature of the reservation is referred to. Furthermore, the audit report must state that reference to the report does not reduce the auditor's responsibility for that opinion.

When the auditor decides and considers it appropriate to disclose the identity of the expert, they can do so provided they obtain prior consent from the expert, if it has not been already obtained.

SUMMARY



Test Yourself 4

Jenny is the statutory auditor of Crystal Ltd, a diamond jewellery shop. Crystal Ltd has engaged James, an expert, to value its diamond jewellery. While drafting the audit report, she does not want to take responsibility for the work done by James She wants to mention the name of James in her audit report as she is relying on his work. She wants to give a modified audit report.

Required:

Explain to Jenny the circumstances in which she can give a reference to an expert.

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4. Identify and explain the purposes and how external monitoring of audit and assurance engagements might operate to ensure firm or engagement quality.

[Learning Outcome e]

4.1 Principles of quality control of audit and other assurance engagements

Quality control is not done for bureaucratic reasons – it is done because there is a genuine need for it! Remember, an audit is conducted to give assurance that the financial statements give a true and fair view – this is the overriding objective. As auditors, we have to make sure that our procedures are robust so that we give the correct opinion. However, remember that audit firms perform thousands of audits every year.

It is important that they are all performed well and meet certain standards. Many users of financial statements are relying on the auditors performing an efficient and effective job. As a result quality control is necessary to ensure that there are no lapses in the way the audit is conducted. By having quality control procedures, an auditor can be confident that that the audits performed are of a reasonable standard and that if there are lapses, they will be spotted immediately and rectified.

There are many **principles** which form the basis of a good quality control system. A few of these principles are discussed below.

Appropriate allocation of staff: by having procedures to allocate engagement partners and appropriate staff on a particular assignment, the firm can be sure that only experienced people are included in the audit team. For example, an IT systems audit should be conducted by an accountant who is CISA certified.

Proper working practices: proper planning, executing, monitoring and documenting procedures will exist within a quality control system. This will ensure that an appropriate audit opinion is given in the timeframe required.

Healthy client relationships: a healthy client auditor relationship should be developed, which will add to the reputation of the audit firm.

Proper training: to staff from time to time, giving them guidance whenever required and supervising their work will ensure staff is satisfied.

Ethical values: there would be no disciplinary action from NBAA for professional misconduct or legal suit by a client due to unsatisfactory work.

4.2 Purpose of quality control of audit and other assurance engagements

This is explained in paragraph 2.3 of Learning Outcome 1.

4.3 Functioning of external monitoring of audit and assurance engagements

Before the auditor's report is issued, the engagement partner, through review of the audit documentation and discussion with the engagement team should be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

The engagement partner should take the following steps:

- Monitor the work of the engagement team and supervise the members of the team.
- Conduct regular reviews at appropriate stages during the engagement to ensure that significant matters are resolved on a timely basis before the auditor's report is issued.
- Review important audit documentation and evidence gathered to support the audit related workings.
- Document the extent and timing of each review.
- Ensure that the issues arising from the reviews are resolved.

If an existing engagement is taken over by a new engagement partner, he must review the work performed up until the date of the change in order to ensure that it has been planned and performed in accordance with professional standards and regulatory / legal requirements.

Where more than one partner is involved in the conduct of an audit engagement, it is important that the responsibilities of the respective partners are clearly defined and understood by the engagement team.

Apart from the review by an engagement partner, an assessment of whether an engagement has been performed in accordance with professional standards and whether reports issued are appropriate in the given circumstances can be carried out by conducting an engagement quality control review (EQCR) known as a hot review or inspection of completed engagement, known as a cold review.

1. Hot review

An EQCR or a hot review is conducted by an independent reviewer who is either a partner in the firm, a senior manager or an external expert. The main objective of conducting a hot review is to evaluate the significant judgements made by the engagement team during the engagement and the conclusions reached in formulating the audit report. The review process involves the following steps:

- Discussion with the engagement partner about the engagement in general and about any significant matters in particular,
- A review of the financial information and the auditor's report,
- Assessment of whether the auditor's report is appropriate in the given circumstances,
- A review of selected audit documentation (i.e. working papers) relating to the significant judgements made by the engagement team and the conclusions reached by the team.

The extent of the review depends on the complexity of the audit engagement and the risk that the auditor's report might not be appropriate in the given circumstances. It must be remembered that a hot review does not reduce the responsibilities of the engagement partner.

A hot review is compulsory in the case of listed companies. The processes involved are as follows:

- Assessment of the engagement team's evaluation of the firm's independence in relation to the specific audit engagement.
- Verification of significant risks identified during the engagement and how the engagement team addressed them.
- Review of the judgements made and decisions taken particularly with respect to materiality and significant risks.
- Consideration of whether appropriate consultation has taken place on matters involving differences of opinion or other contentious issues.
- Review of the conclusions arising from such consultations.
- Verification of the importance of misstatements identified during the audit.
- Consideration of the matters to be communicated to management or those charged with governance and regulatory bodies.
- Verification of the audit documentation to ensure that it reflects the work performed.
- Assessment of the appropriateness of the auditor's report to be issued.

A hot review is conducted before the finalisation of the auditor's report. It can therefore be said that the findings of a hot review can affect the auditor's decision and ultimately the auditor's report.

2. Cold review

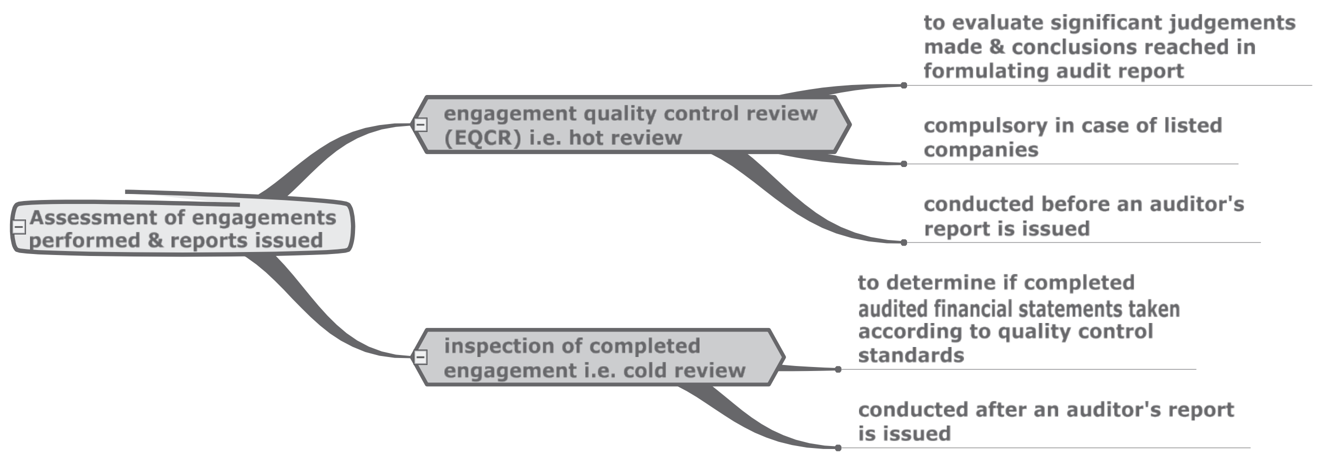
A cold review refers to an inspection of an already completed engagement(s) to determine whether it was conducted according to the quality control standards. It also helps in determining if there are any loopholes in the quality control system of the audit firm. It is conducted by an independent senior official of the audit firm who has not been a part of the engagement selected or its hot review.

Example

Gibsons & Co is a firm of CPAs. One of the partners, Mr Nelson has instructed a senior executive, Charlie, to conduct an inspection (cold review) of two past audits: Simmerton Wires Ltd and Global Inklock Co. Charlie was one of the team members of Simmerton's engagement team. He had also assisted one of the partners in performing the hot review of Global Inklock. In this situation, Charlie should not conduct the cold review of these audits as he has been associated with them in some manner.

A cold review is particularly useful in the case of those audits which have not gone through a hot review e.g. audit of unlisted companies. It brings out the deficiencies / discrepancies in the quality control system and its policies and procedures. Such discrepancies are communicated to the management and corrective action taken to avoid them in future. A cold review can help in improving the quality control system of a firm. For example, if a cold review suggests that the staff have not understood the importance of quality control measures, then appropriate training could be imparted to reinforce the firm's stand on quality control. However, unlike a hot review, a cold review does not affect the auditor's report as it is conducted after the finalisation of the audit and issue of an auditor's report.

SUMMARY



Test Yourself 5

Determine whether the following reviews are a part of a hot review or a cold review:

(a) Philip is the engagement partner of the audit for an electronics company. During the audit, he checks the inventory valuation workings done by his subordinate to arrive at the closing inventory figure.

(b) Sandra, one of the senior partners, while reviewing the audit of Jiggy Furnitures, questions Ditto, the engagement partner, on the capitalisation of certain expenses. The audit report has not yet been finalised.

(c) Jane is a senior executive in a firm of accountants. In one of the reviews, she finds that the work of a newly joined assistant was not reviewed by a senior person in the engagement team. This came to light when many mathematical errors were found during the last year's audit.

(d) An external expert was called upon to advise on the valuation of intellectual property rights during the audit of scientific research company.

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5. Analyse and evaluate how engagement terms can be agreed and recorded by an auditor including those agreed with a client and those imposed by laws or regulations.
[Learning Outcome f]

Engagement letter is covered in Study Guide B1

Answers to Test Yourself

Answer to TY 1

A sound quality control system ensures existence of up-to-date human resource policies to address staffing requirements and ensure that appropriate staff is assigned appropriate work.

As Wilson & Associates does not have a quality control system, it seems that it has not taken steps to assess its staffing requirements.

If Wilson had a quality control system the following steps could be taken in the given situation:

Replacement of the key personnel which has left the firm by new employees.
Regular assessment of the staffing requirements.
Proper assignment of staff to each engagement.

Answer to TY 2

Tony and Hooper seem to be running their business successfully. Their quality control policies are in place and have enabled the partners to perform satisfactory work. However it is important for the firm to monitor the quality control policies from time-to-time in order to assess its effectiveness.

Tony and Hooper can introduce the following policies on monitoring procedures as a part of the firm's quality control system:

The firm should monitor the effectiveness of the quality control system of the firm on an ongoing basis to ensure whether each audit is performed satisfactorily according to the quality standards.

The firm should ensure that all the quality control policies are followed and implemented regularly in practice.

A periodic inspection of a few completed engagements i.e. cold review must be conducted to evaluate the effectiveness of such quality controls and to identify whether there are any loopholes in the quality control system of the audit firm so that corrective actions can be taken to avoid them in future.

Such inspections should not be carried out by an employee who has previously worked on that particular engagement. The member of the audit engagement team of that particular audit who has handled those audits should not allow doing such inspections.

The responsibility for the monitoring process must be assigned to an experienced person who has sufficient authority in the firm e.g. a partner or a senior accountant.

Answer to TY 3

When an external auditor wants to rely on the work of an internal auditor, the prime considerations will be: (a)

The objectivity and independence of the internal auditor
(b) The level of competence of the internal audit function
(c) The application of a systematic & disciplined approach, including quality
(d) Under the following circumstances, it will be not possible for the external auditor to rely on the work of internal auditor:

Four circumstances in which it would not be possible to rely on the work of the internal auditor are as follows:

Lack of independence: the objectivity of the internal auditor is a crucial factor when the work of the internal auditor is being considered for use by the external auditor. Objectivity will be hampered if the work of the internal auditor is influenced by management. If the internal auditor is a relative of the directors of the entity or related to the entity in any manner, the possibility of a lack of integrity is more. If there is a lack of integrity, the external auditor will not rely on the work of the internal auditor.

If the internal auditor is vested with any other operational responsibility, the external auditor will not rely on the work of the internal audit because in that case, the internal auditor will be interested in the operations of the organisation and cannot remain sufficiently independent.

Organisational status of the internal audit: if the organisational status of the internal audit is such that the internal auditor reports to the middle management the extent of reliance on the work of the internal audit, by the external auditor will be decreased. This is because, in this case, the audit work is not checked by a competent person. On the other hand, if the internal auditor reports to the highest authority in the organisation e.g. the audit committee or board of directors, the extent of reliance by the external auditor will be increased.

Unskilled or incompetent: a person is said to be competent if they possess the required skill and experience in that particular field. If the internal auditor is a member of a professional body, the external auditor will get reasonable assurance that the internal auditor is competent to perform the work and the extent of reliance will be increased.

Technical competence and due professional care: while performing the audit, the internal auditor is expected to plan the work, document it and supervise it when performed by the assistants. If this is not done, the external auditor will not rely on the audit work because due professional care is not taken while performing the work.

Answer to TY 4

Jenny is solely responsible for forming and expressing an opinion on the financial statements and this responsibility cannot be reduced by relying on the work of others.

She can use the work of James only if she is satisfied with his work. She will evaluate James' work before relying on it. Deciding on the nature and timing of the testing of the work of James is her responsibility. Once she decides to use his work, she takes responsibility for the work done by James.

She can disclose the identity of the expert after obtaining his prior consent as she is giving a report other than an unmodified report. Provided the circumstances are such that it is beneficial to the readers of the report to refer to the work of an expert and the auditor feels it appropriate and essential to disclose the identity of the expert. That is why the audit report must state that reference to the report does not reduce the auditor's responsibility for that opinion.

Answer to TY 5

(a) The checks conducted by Philip are a part of the review process by an engagement partner while conducting the engagement. This seems to be done in order to verify the audit evidence or review the engagement performance in general. It is neither a hot review nor a cold review.

(b) This is a hot review. Sandra, the reviewer, seeks explanation on the capitalisation of certain expenses before the audit report is finalised.

(c) Jane is conducting a cold review of a past audit engagement. She has found a discrepancy in the review process of the audit where the work of a junior assistant has not been checked by a senior. The fact that this was found during the next year's audit suggests that it is a cold review.

(d) This is neither a hot review nor a cold review. In fact it refers to consultation sought from a subject expert during the course of an engagement.

Quick Quiz

1. Fill in the blanks

(a) ISQC 1 has a ______scope as compared to ISA 220 as it covers engagements pertaining to the audit of historical financial statements as well as assurance and audit-related engagements.

(b) _________responsibility includes policies and procedures where the work of a less experienced team member is reviewed by a more experienced team member.

(c) A _______________review is compulsory for audits of financial statements of listed entities.

(d) The main objective of conducting a __________is to evaluate the significant judgements made by the engagement team during the engagement.

(e) A __________refers to an inspection of an already completed engagement to determine whether it was conducted according to the quality control standards of the audit firm.

(f) _________on Terms of Audit Engagements provides guidance on agreeing the terms with the client and changes in the terms of engagement.

(g) Audit engagement of financial statements must be accepted after ensuring that the _______________ _________ adopted by the management is acceptable.

2. Answer in brief

(a) Which are the two international standards which govern the quality control procedures? (b) What is the definition of an engagement team according to ISA 220?
(c) What is the objective of an engagement quality control review (EQCR)?

Answers to Quick Quiz

1.
(a) wider
(b) Review
(c) engagement quality control
(d) hot review (e) cold review (f) ISA 210
(g) financial reporting framework

2.
(a) The two international standards that govern the quality control procedures are International Standard on Auditing (ISA) 220 on Quality Control for Audits of Historical Financial Information and International Standard on Quality Control (ISQC) 1 on Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements.

(b) Engagement team is defined by ISA 220 as – 'All personnel performing an audit engagement, including any experts contracted by the firm in connection with that audit engagement.'

(c) The objective of an EQCR is to review and evaluate significant judgements made by the engagement team and conclusions reached in formulating auditor's report.

Self-Examination Questions

Question 1

King Ltd is a limited liability company. King Ltd's main activity is trading in water purifying products. The products are purchased from approximately 200 different suppliers. King Ltd has 72 stores in four different countries. It has a well-staffed and qualified internal audit department, which reports on a regular basis to the audit committee. Areas where the internal auditors may carry out work include attending the year end inventory count in 24 stores annually. All stores are visited on a rotational basis.

Required:

State whether the external auditor will rely on the internal auditor, and if yes, the extent of that reliance.

Question 2

Raman is a partner in RR Associates, a firm of CPAs. The firm is newly established and Raman is responsible for monitoring the quality control system of the firm. In a review meeting with the managing body, the following issues of the quality control system arose for reconsideration:

(a) A senior employee was delegated with the task of suggesting policies of quality control with respect to independence among employees. His suggestions were as follows:

Quality control with respect to independence

To promote an independent mental attitude among the employees during supervision and review of their work.
To discourage employees from holding an account with a bank this, is a client of the firm.
To assign those employees whose independence is doubtful to some research work and avoid them participating in auditing.
To prohibit employees from owning shares of listed companies which are clients of the firm.
To maintain a record of details of those partners or employees who were previously employed by the firm's clients.

(b) While finalising the quality control policies with respect to assigning engagement teams, the following points were raised:

To rotate employees randomly from assignment to assignment in order to give them more hands-on training.
To devise a system for timely identification of staffing requirements of specific engagements in order to ensure availability of appropriate qualified staff.
To allow the employees to choose between assignments in order to enhance better client relationship and ensure good quality work.
To assign more employees than required for an engagement in order to ensure a better quality of work.

Raman is interested in knowing the appropriateness of the above mentioned policies.

Required:

Discuss whether the quality control measures suggested by the senior employee in respect of independence and the policies regarding assigning engagement teams are appropriate.

Question 3

Mr Dudley is the audit partner of a renowned audit firm of CPAs, Prudent Accountants. The following matters have arisen in relation to accepting professional appointments:

(a) The firm has been approached by a new client, Thompson Electronics Ltd, for the current year's audit. The client is a newly established company and has been referred by one of Dudley's close friends, whose son works at Thompson. At a business meet, Mr Dudley talks to a business associate who knows one of the four directors of Thompson Electronics, Mr Lordwick. The business associate tells Mr Dudley that Mr Lordwick was an accountant in an electronics company ten years ago and that he was found guilty of misappropriation of the company's assets.

(b) The firm is considering accepting the audit of Tetty Beverages Co In response to the company's professional enquiry letter, the former auditor of Tetty replied,

'We were in disagreement with the management over the provision of a contingent liability. The company owes us an outstanding balance payment of audit fees amounting to $12,500.'

(c) One of the existing clients of Prudent, Master Records Plc, is planning to establish a new business unit. This would be a film archive for outsourcing all kinds of entertainment all over the world. The company would be implementing high-end technology and computer systems to maintain the inventory of films. The management of Master Records wants Mr. Dudley, who is the audit partner for the company, to conduct the audit for the new business unit from the current year onwards. Although Mr. Dudley is excited about this new project, he has doubts over the firm's competence for conducting such an audit.

Required:

In each of the situations outlined above, discuss the issues that need to be considered by Prudent Accountants while deciding whether or not to accept the audit assignment.

Question 4

Spencer Plc has had its accounts audited by BBR & Co, a firm of CPAs, for the last 2 years. The company is engaged in manufacturing, mining and the construction of machinery. For the current year's audit, as in the previous years, BBR & Co has engaged 2 senior managers, Lionel and Antony, and 3 assistants.

In the current year, Spencer has established a new company, Diane Plc, to manufacture motor vehicle bodies. Spencer wants BBR & Co to audit the books of this new company. However, the firm does not possess the necessary knowledge in this area.

Required:

Discuss the quality control measures that the audit managers should consider before starting the audit of Spencer.

Answer to Self-Examination Questions

Answer to SEQ 1

Reliance on the work of internal audit by external auditor:

Where the external auditor intends to use specific work of internal auditing, **ISA 610** requires the external auditor to evaluate and test that work to confirm its adequacy for external auditor's purpose. Therefore to decide the extent to which the given areas can be relied on, the auditor should perform the following: King Ltd owns 72 stores in four different countries. It is not possible for the external auditor to attend the inventory count in all of these stores every time. Therefore they may think of relying on the work of the internal audit. Before relying on the work of internal audit, the external auditor should understand and assess this work.

To understand and assess the work of internal audit, the external auditor should consider:

The independence and objectivity of the internal auditor	Here, internal audit is carried out by a department in the organisation. This means that personnel are employed by management; a factor likely to affect independence. The external auditor should consult the personnel regarding the interference of management in their work. The external auditor should also ask them whether they are entrusted with any other operational responsibility.
Organisational status	It is mentioned above that the internal audit department has to report to the audit committee, which is the proper reporting authority.
The attitude of management to their reports	The external auditor should consult the members of the audit committee regarding their procedure for review of internal audit reports. The auditor should also consult other personnel including internal audit department personnel regarding the corrective actions taken by the audit committee, if any. However, as the audit committee is a reporting authority for internal audit, an external auditor can assume that the attention will be taken since it is one of their statutory responsibilities to take cognisance of the internal audit report.
Technical knowledge and professional qualification	The external auditor should review the recruitment policy of the entity for the personnel of internal audit department. The auditor has to check the technical knowledge and professional qualifications of the personnel of the internal audit department.
Training	The external auditor should ask whether adequate training is provided to perform internal audit work including inventory counting.
Due professional care: work carried out with due diligence	As the internal audit is carried out by a department of the entity; it has knowledge of the entity and its policies and procedures. The external auditor should check whether due care is taken while attending inventory counting. The external auditor should ascertain whether internal audit work is properly planned, supervised, reviewed and documented.

Continued on the next page

Audit evidence	The external auditor should ascertain whether sufficient appropriate audit evidence is obtained, to form reasonable conclusions, whether results of tests carried out and other findings of inventory counting procedures are properly recorded to form sufficient appropriate evidence. For this a surprise physical count of some inventory items must be carried out.
Appropriate conclusions	The external auditor should confirm that, on the basis of findings, the internal auditor has formed a conclusion and the conclusion is appropriate under the given circumstances.
Internal audit report	The external auditor should confirm that the internal audit report is prepared on the basis of results of tests of controls and inventory counting procedures.
Exceptional matter	The external auditor should enquire whether any exceptional matter is noticed at the time of internal audit and how it has been resolved.

Answer to SEQ 2

(a) Quality control with respect to independence

The suggestions made by the senior employee seem to be appropriate in some respects but inappropriate in some other respects.

Promoting independence during supervision and review of work: this suggestion might be effective but only to a certain extent. The employees can be encouraged to demonstrate independence in their dealings with the client and during audit engagements through training programs which are conducted before the start of an engagement. This would prove more effective rather than promoting such behaviour while supervising or reviewing their work in the middle of the engagement.

Prohibited relations: the senior employee has suggested that the employees must not hold an account with a bank or own shares of companies which are the firm's clients. While determining prohibited relations with clients, a firm must keep in mind that it may not be always possible for the employees to refrain from such relationships. For example, it is likely that at least one of the employees might have an account in a bank or hold the publicly traded shares of a company which is also a client of the firm. So what does a firm do then? Removal of an employee on such grounds would be unreasonable.

In this situation, independence can be more appropriately safeguarded by ensuring that such employees are not assigned to that particular client's engagement. The firm can have policies to identify employees with such relations and keep a record of the same so that it can be used while assigning engagement teams.

Employees who lack independence: assigning those employees who lack independence on other than audit work may be useful if the firm has such 'other' work to be done. For example, research work as suggested by the senior employee. In the absence of availability of other work, it would be difficult to deal with such employees. In this case, the firm can train such employees to enhance their ability to work independently. Also if the firm has insufficient staff, assigning employees on other work may not be possible.

Maintaining records of past employment with clients: this seems to be a very good suggestion. It is common to see an employee or a partner in the firm who was previously employed by one of the firm's clients. Maintaining a record of such employees as a quality control policy will help the engagement partner in assigning the right people on an engagement. The independence of those employees who have been previous employees of a client is doubtful. In such a situation, the firm's independence can be safeguarded by not assigning such employees to the engagement of that particular client.

(b) Quality control with respect to assigning engagement teams: The main objective to have quality control policies on assignment of engagement teams is to ensure that personnel having the appropriate technical competency are assigned to a particular engagement. The policies regarding assigning engagement teams as it currently stands have many flaws and must be revised.

Random rotation of employees: although it is important to encourage employees to perform work relating to different areas and gain technical experience, it may not be appropriate to randomly shift one employee from assignment to assignment. This would mean that he does not get to see any audit from start to end which in itself can be a good learning experience. It also means that more time would have to be spent on a particular audit as new people will be assigned each time not knowing the work already performed on that assignment. Such a practice should be avoided.

Timely identification of staffing requirements: such a practice will not only ensure that the correct person is assigned to the correct work but also ensure the timely completion of the engagement as there will be no difficulty in availability of sufficient staff at all times. Hence it is appropriate.

Choosing between assignments: if a choice is given to employees to choose between the assignments it is likely that each employee will select an engagement which he has worked on before. This gives rise to the familiarity threat. As a good quality control practice the firm should rotate the employees and no one employee should be assigned one particular engagement for too long.

Assigning more employees: this may not be always possible as the firm may not have sufficient staff available at all times. Also assigning too many employees would mean lack of co-ordination and dilution of responsibility. A good quality control measure would be to assign only as many people as are necessary to conduct an engagement satisfactorily.

In light of the above, Raman should consider revising the policies with the help of his team to make the quality control system more effective.

Answer to SEQ 3

(a) The situation that Prudent Accountants is facing in connection to accepting Thompson Electronics Ltd as a client poses many ethical issues, which are as follows:

The fact that the new client has been referred to Mr. Dudley by a close friend raises certain ethical issues. Mr. Dudley should not accept the client merely because it was referred to him by his close friend. Since the client is new and has no track record, it may be difficult for Mr. Dudley to judge whether it is appropriate to accept the client. Nevertheless, he should use his professional judgement in deciding whether to accept the new client. Also, quality control procedures should ensure that the firm is competent enough to conduct the audit and that there are safeguards (such as clearly laid out terms of engagement) to protect the independence of the auditors.

Any information regarding a new client obtained during the course of acceptance should be analysed with due care. Mr. Dudley must use his professional judgement to decide whether to rely on the information given by the business associate. The information about the director, Mr. Lordwick, has many aspects:

(i) The time the event occurred: the event occurred ten years ago, which is a long period of time. Mr. Dudley should try to investigate more into the matter, to find out if Mr. Lordwick was involved in any other such incidents since that time. He can also try to find out the seriousness of such misappropriation, as it relates to the integrity of the new client's management.

(ii) Influence of Mr. Lordwick: as he is one of the four directors, Mr. Dudley can try to ascertain the influence he has or the control he exerts on the company's management as a whole. This will help in determining whether his possible lack of integrity could affect the entire management's decisions. If it is found that the integrity of Thompson's management is doubtful, Mr. Dudley should probably refuse the working with the company.

(iii) Integrity of the business associate: Mr. Dudley must ensure that the information has come from a reliable source. In any case, Mr. Dudley should not ignore the information given by the business associate. He should use it to decide whether or not to take up the audit for Thompson Electronics Ltd.

(b) The purpose of an etiquette letter is to bring to light any contentious issues that the former auditor / professional accountant may have had with the client.

(i) Disagreement with the client: The fact that the former auditor of Tetty Beverages Co was in disagreement with its management on the issue of provision of contingent liability should encourage Prudent Accountants to take up the matter with Tetty's management.

It would be prudent to consider the opinions of both the former auditor and the client, and then use its professional judgement to decide how this would affect its acceptance. If Tetty's management is justified in its opinion on the provision of the contingent liability, then Prudent may consider accepting Tetty's audit.

Many times, both the former auditor and the client are correct in their own opinions. In this situation, the new auditor must decide what its opinion on the matter should be and proceed. It should try to convince the management of its point of view. If there is a major disagreement in resolving this issue, Prudent should probably not take up Tetty's audit.

(ii) Unpaid fees: ideally, unpaid fees should not be a reason for refusing a client engagement. The fact that there are unpaid fees should encourage Prudent to identify why the fees are outstanding. If the reason is a lack of funds, Prudent should probably not take up the audit, as it might face a similar situation. But if the fees are unpaid because some issues are pending, which do not affect Prudent's ethical principles, then the engagement should not be refused. For example, according to the terms of engagement, the fees may be payable after one month and may not be due on the date when the reply from the former auditor was sent.

Unpaid fees reflect the client's attitude towards the payment of fees that are due. Prudent must clearly state the terms regarding payment of fees in its engagement letter in order to avoid future conflicts with the client

(c) Mr. Dudley should consider certain ethical and professional issues prior to accepting the audit of the new business unit of Master Records Plc. These are as follows:

(i) Since Master Records is an existing client, Mr. Dudley should consider whether accepting the new audit would pose a threat to the independence of the firm if the share of revenue from the audits conducted for Master Records exceeds 15% (assuming it is an unlisted company) of Prudent's total revenue. If it does, Mr. Dudley should probably not take up the new audit.

(ii) Mr. Dudley must determine whether the firm has the required competence to conduct the audit, since the new business unit will employ high-end technology and computer systems which the audit team should be able to understand. Considering that Prudent Accountants is a renowned firm it may be assumed that they have well-qualified staff. However, the nature of the new business seems unusual and Mr. Dudley must consider training his staff for the audit if it has not performed a similar audit before.

(iii) If training cannot be given, then Mr. Dudley should consider using external experts according to ISA 620. Any such requirement should be agreed with the client and clearly mentioned in the engagement letter.

(iv) Mr. Dudley must also evaluate if sufficient time can be allotted to the audit of the new business unit. If training is required, training time must be taken into consideration while planning the audit.

(v) All the work done in respect to the new business unit should be documented and preferably reviewed by an external reviewer. Such arrangements must be agreed with the management of Master Records and included in the letter of engagement.

Answer to SEQ 4

As the audit assignment involves audit of a new undertaking which the audit team is not familiar with, the audit managers should ensure that the necessary quality control measures are in place. The following considerations should be taken into account before beginning the audit:

Ethical requirements / assignment of staff

The audit managers should ensure that their team has the necessary competence to conduct the audit. Since Spencer has started a new business of manufacturing motor vehicle bodies, the audit managers must consider introducing a new team member with the required knowledge in this area. It may not be appropriate to continue with the same audit team that was used in the previous two years.

Client relationships

The audit managers must ensure that the additional work taken on with Spencer does not hamper their independence, which is assumed to happen if the revenue from the audit exceeds the maximum level (i.e. 15%). If the audit managers foresee any such issue regarding independence, they should refuse to take on the additional responsibility.

SECTION C

PLANNING AND UNDERTAKING AUDIT WORK

C1

STUDY GUIDE C1: BASICS OF AUDIT RISKS AND ANALYTICAL PROCEDURES

Get Through Intro

An audit is a reasonable assurance engagement where the auditor gives an opinion on the truth and fairness of the financial statements. The sheer volume of transactions in a modern day business makes it impractical for an auditor to check 100% of the transactions. Furthermore, in some cases even 100% checking may not provide full assurance. These are some of the inherent limitations to any audit. In view of this, it is 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.

The auditor should obtain sufficient appropriate audit evidence to arrive at reasonable conclusions on which they can base their opinion on the financial statements.

Audit evidence is obtained through different techniques of audit testing. Analytical review (or analytical procedures) is one such technique. Analytical review procedures consist of studying significant ratios, trends and other statistics and investigating unusual or unexpected fluctuations and items, and expected fluctuations which fail to occur. Various types of ratio changes and trend analyses have become recognised in recent years as important audit tools.

This Study Guide discusses the important aspects of audit risk and analytical procedures which will enable you to plan the audit successfully.

Learning Outcomes

a) Evaluate and communicate the elements of audit risk including inherent risk, control risk and detection risk and their relationship to audit planning of procedures.
b) Identify and evaluate the components of risk for any assurance engagement.
c) Evaluate and apply analytical procedures that may be used to plan an audit or assurance engagement.
d) Identify and explain the differences between assurance engagements and audit engagements for profit and not-for profit entities include those in the public sector.

1. Evaluate and communicate the elements of audit risk including inherent risk, control risk and detection risk and their relationship to audit planning of procedures.
Identify and evaluate the components of risk for any assurance engagement.
[Learning Outcomes a and b]

1.1 Audit risk

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.

1.2 Elements (components) of audit risk

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**.

In other words, audit risk comprises of two elements: risk of material misstatement (which is assessed by auditor) and detection risk (which is managed by auditor).

Risk of material misstatement means 'the risk that the financial statements are materially misstated prior to audit. This is made up of two elements: inherent risk and control risk.'

Diagram 1: Audit Risk

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.

At the planning stage the auditor will plan to carry out tests of control in the areas of inherent risk. (Tests of control are explained in detail in Paper B3.)

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.

At the planning stage the auditor will plan to carry out tests of control in the areas of inherent risk. (Tests of control are explained in detail in Paper B3.)

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 extensive substantive procedures to mitigate the risk.

At the planning stage, the auditor will plan to carry out substantive procedures in the area of detection risk. (Substantive procedures are explained in detail in Paper B3.)

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

Dawson'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:

Inherent

Like almost all other organisations that operate in the retail industry, Dawson'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 Dawson's main assets) will not be accurate. Therefore, the auditor will plan to carry out tests of control in the area of inventory by conducting surprise inventory counts.

Control

To mitigate this main risk, Dawson'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. Therefore, the auditor will plan to carry out tests of control in the area of inventory by conducting surprise inventory counts.

Continued on the next page

Detection

Being aware of the existence of these risks, Dawson'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 plans to attend 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. Therefore, the auditor plans to carry out substantive procedures in the area of inventory, sales and purchases.

Tip

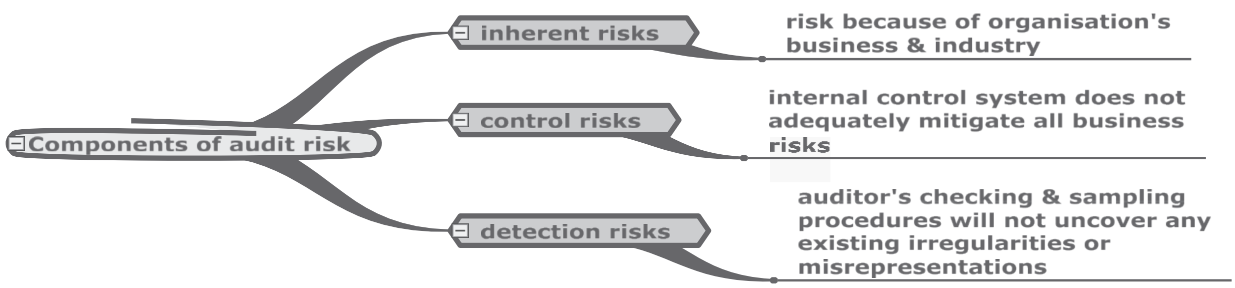
Inherent risk and control risk are within the entity and cannot be controlled by the auditor. Therefore, i**n circumstances where there is high inherent and / or control risk, the auditor must plan and perform a much more rigorous and thorough audit in order to compensate and therefore reduce the level 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. There might be scenario based questions on this topic in the exam, so you need to understand audit risk in a practical context. Although knowledge-based questions are sometimes asked, the number of marks for such questions may be very less. You therefore need to apply your understanding of audit risk to the scenario and come up with appropriate risk assessment procedures.

SUMMARY



Test Yourself 1

Linda is the new auditor of TrendZ Mobile Company, an organisation that sells mobile phones. TrendZ 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, TrendZ 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 TrendZ 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 TrendZ Mobile Company.

1.3 Example of relationship of audit risk and audit planning of procedures

Example

Inherent risks

When an entity undertakes major business expansion by depending on financing, it faces an inherent increased going concern risk if it does not meet its financial commitments. This must be taken account of when planning the audit, so that sufficient audit work is obtained to support management's assertion that the going concern basis is appropriate. The auditor plans to assess the liquidity position by planning audit procedures to include a careful evaluation of the cash flow statement on this count.

It is in the nature of the trading business that sales are transacted for cash. The entity faces an inherent risk of inaccuracies in the area of cash balances. If controls over the recording of cash income are inadequate, this would cast doubt on the truth and fairness of the financial statements as a whole. For example, cash may be spent on capital and/or revenue items and not recorded as business assets/expenditure. Therefore, the auditor plans to carry out surprise cash counts and also review records of all cash counts undertaken by the client.

Control risks

An entity which faces the risk of new purchase orders being raised without executing the purchase orders in hand faces the control risk of new purchases being made at higher rates, although the entity has some old purchase orders on the same items at lower rates. Therefore, the auditor obtains the list of open purchase orders and verifies the reasons for their existence and the steps taken to either close the order or procure the materials wherever necessary.

Detection risk

In order to avoid the detection risk of misstatements in the area of sales, the auditor carries out substantive procedures to ensure completeness of sales transactions. The auditor plans to carry out analytical analysis e.g. a comparison of the gross profit percentage (product-wise) with that of the earlier year and with the industry average. In the case of inconsistencies, the auditor needs to find out the reasons.

---

2. Evaluate and apply analytical procedures that may be used to plan an audit or assurance engagement.

[Learning Outcome c]

2.1 Definition of analytical procedures

Analytical procedures have been defined in ISA as follows:

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

Roger is the auditor of Black Ltd Roger made an analysis of the financial statements of Black Ltd by studying significant ratios. One of the ratios that he studied was the gross profit margin. The gross profit ratio of Black Ltd for the current year, 20X3, was 25% and the gross profit percentage for the previous year, 20X2, was 24.5%.

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

2.2 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

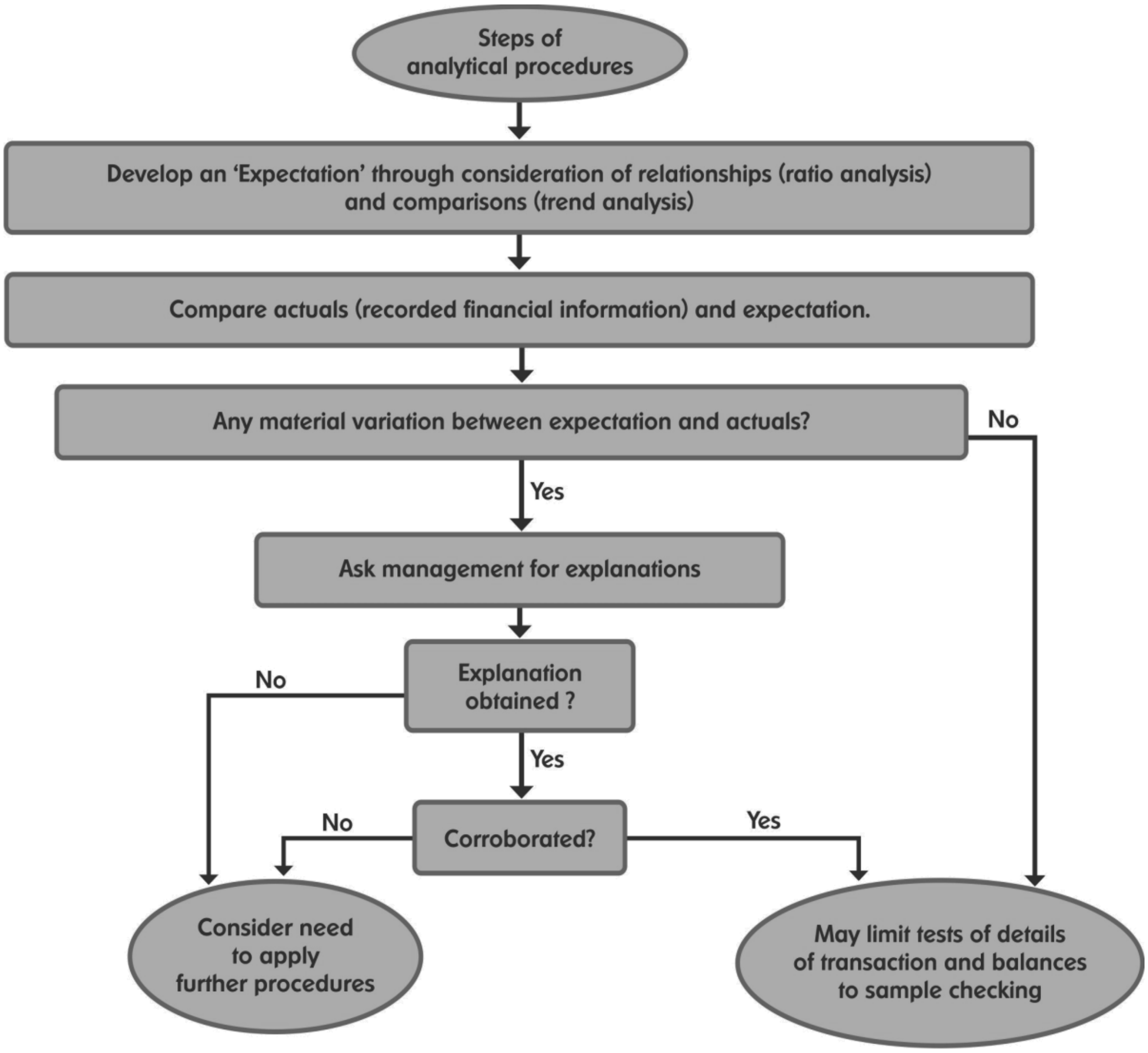
The budget of Tone Ltd for the year 20X3 had set the net profit margin (before tax) at 15%. As part of analytical procedures, the auditors decided to compare it with the actual net profit margin (before tax). The auditors decided that variations which exceed 3% of the expected results would be considered as significant.

The actual net profit (before tax) of Tone Ltd for the year 20X3 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 2: Steps involved in analytical procedures



2.3 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. The key accounting ratios will be discussed in detail in the next Learning Outcome.

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 K.K. Cements Co 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.

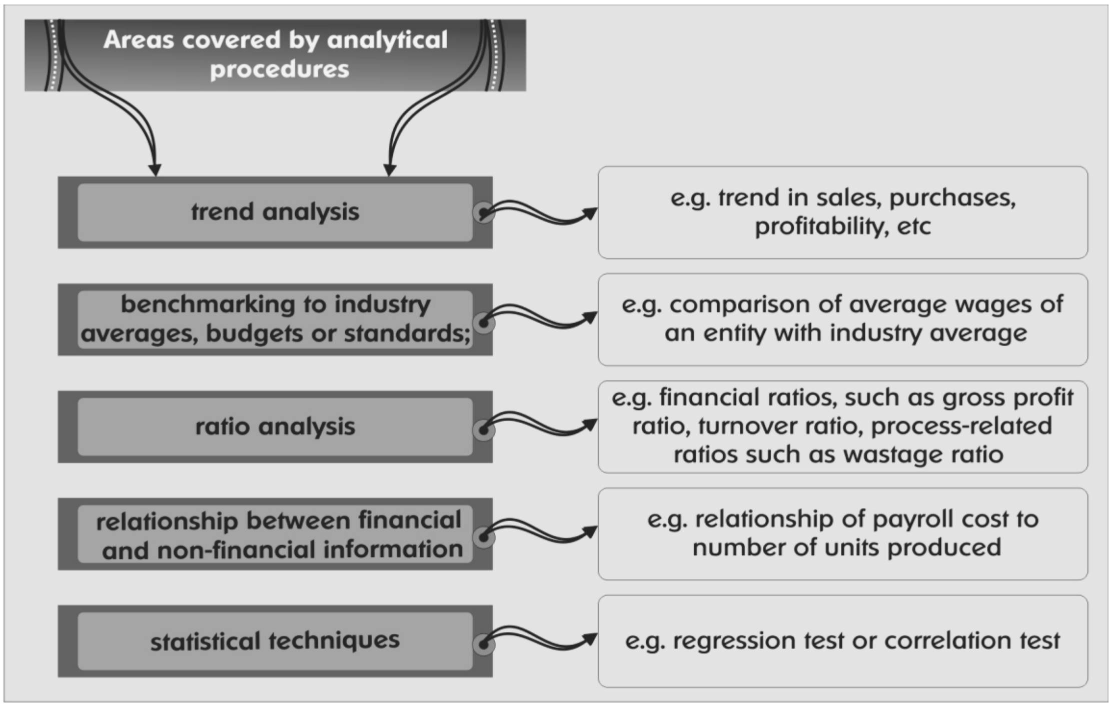
Many of the analyses consist of measuring ratios, and comparing the ratios obtained from the current year's financial results with:

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

Example

Jenny, the internal auditor of Fly Paint Ltd had also prepared a comparative financial ratio analysis of all the departments of the company. She gave her analysis to George, the director of the company, so that he could judge which department was the most profitable and which department needed improvements.

Diagram 3: Areas covered by analytical procedures



2.4 Additional points

If the key ratios are close to what they were expected to be, the auditor may take this as evidence that the relevant balances or transaction amounts are reliable and 'accurate'. If a ratio is very different from what is expected, the auditor should investigate the reason for the variation.

It may be noted that **lack of variation in the ratios could be as important as an unusual variation**.

Example

During a period of falling prices and falling profit margins in the industry in which Light Co operates, it would only be reasonable to expect a variation in the gross profit percentage of the company. If this expected variation fails to occur, it calls for further investigation to find out why the expected variation did not occur.

It is also possible that **particular conditions can cause variations in the relationships,** for example, specific unusual transactions or events, accounting changes, business changes, random fluctuations or misstatements.

Example

Upright Ltd is a trading concern. It trades in paints, chemicals, and tiles. The concern has discontinued trading in chemicals. The discontinuation of one of the operations of the concern is likely to cause variations in the relationships of data of the concern.

Test Yourself 2

What is the basis for application of analytical procedures?

2.5 Purpose of analytical procedures

Generally, **analytical procedures are used for the following purposes**:

1. Risk assessment procedures (at the planning stage)

Analytical procedures can be used as risk assessment procedures to obtain an understanding of the entity and its environment so as to determine the audit strategy. This will assist the auditor in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks i.e. in determining the nature, timing and extent of further audit procedures.

Example

Jane, the auditor of High Co finds that the cost of materials consumed is Tshs300 million. This is substantially higher than the corresponding figure for the previous year, which was Tshs200 million. As there has also been no material change in the volume of production, the prices of raw materials or the production process, she may decide to carry out a detailed examination of this aspect and plan her audit accordingly.

Example

Bartholomew, the auditor of Big Co, calculated the fixed asset turnover ratio for the year 20X3 and found it to be Tshs12,750 He compared it with the fixed asset turnover ratio of the previous year, which was Tshs7,980. He found a glaring difference between the two and when he investigated, he found that the difference was due to the purchase of high value machinery. Therefore, the auditor used the analytical procedures to identify the existence of unusual transactions and events that affected the financial statements and the audit planning.

The use of procedures may also vary widely depending on the size and complexity of the client.

Example

Ben is the auditor of two concerns, Blue Ltd and Green Ltd Blue Ltd is a small concern and hence, the procedures used by him for Blue Ltd may consist of reviewing changes in account balances from the prior year to the current year using the general ledger. Green Ltd being a large concern, the procedures might involve an extensive analysis of quarterly financial statements. The procedures for both companies serve as a basis for additional inquiries and effective planning.

---

2. Substantive procedures

The auditor can perform substantive procedures when their use can be more effective than tests of details in reducing the risk of material misstatement at the assertion level.

Example

Comparisons of aggregate salaries paid with the number of personnel may indicate unauthorised payments that may not be apparent from testing individual transactions.

---

3. An overall review of the financial statements

The auditor should apply analytical procedures at or near the end of the audit that will enable them to form an overall conclusion as to whether the financial statements are true and fair.

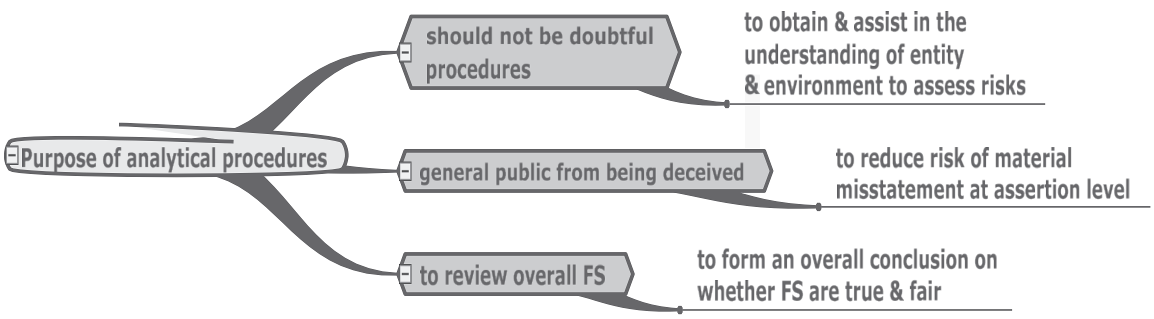
Example

Continuing with the example of Jane

Jane, 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 indicate the need for obtaining additional evidence.

While analysing the ratios, Jane finds that the quick ratio of the company is 1.35:1, while the quick ratios for the industry averages is 1.25:1. Although there is not much difference between the two figures, she needs to keep a watch on the situation that the quick ratio doesn't increase further.

SUMMARY



Test Yourself 3

An auditor can use analytical procedures in planning as substantive procedures and as an overall review of financial statements at the end of the audit.

Required:

Discuss the use of analytical procedures in planning.

2.6 Application of ratios in analytical procedures

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.

Key ratios used in analytical procedures

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

1. $$\boxed{\text{Gross profit ratio} = \frac{\text{Gross profit}}{\text{Sales revenue}} \times 100}$$

This ratio can be affected by the following:

Change in sales prices and sales mix
Change in gross profit as a result of purchases i.e. rise or fall in purchase cost
Change in other direct expenses

An unusual increase in the gross profit ratio gives an auditor reason to suspect:

Overstatement of sales
Understatement of purchases
Understatement of other direct expenses
Improper valuation of inventory

And vice-versa in the case of a significant decrease in the gross profit ratio.

Example

The financial statements of Wonderlands Ltd provide the following information:

	20X2 Tshs'000		20X3 Tshs'000	
Sales		30,000		40,000
Cost of sales				
Purchases	7,000		15,000	
Direct expenses	3,000	10,000	5,000	20,000
Gross profit		**20,000**		**20,000**

In this example

Gross profit percentage is	**67%**	**50%**
	20,000/30,000 x 100	20,000/40,000 x 100

This is a significant decrease. The decrease might have really happened (for example strong competition forcing down the selling price and mark-up, but the auditor will always bear in mind that the decrease is not 'real' and has been caused by fraud or error. With a decrease of this size, management explanation would be sought and more audit work would be performed on sales, purchases and inventory.

---

2. $$\text{Particular expense as a percentage of sales} = \frac{\text{Particular expense}}{\text{Sales Revenue}} \times 100$$

Any **insignificant increase or decrease** in this ratio raises the **auditor's suspicion** about the **validity of that particular expenditure**.

Example

The financial statements of Wonderlands Ltd provide the following information:

	20X2 Tshs'000	20X3 Tshs'000
Sales	30,000	40,000
Sales promotion expenditure	3,000	13,000
Sales promotion expense ratio	10%	32.5%
	(3,000/30,000 x 100)	(13,000/40,000 x 100)

In 20X8, the sales promotion ratio was 10% but the sales promotion ratio for 20X3 has increased significantly to 32.5%. This will raise the auditor's suspicion about the sales promotion expenditure in year 20X3.

---

3. $$\text{Current Ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

This ratio helps decide whether the **current assets will be able to generate sufficient cash to pay off the current liabilities as and when they fall due.**

An increase in the current ratio may indicate increased inventory, cash or receivables levels. The implications of this may be that the company is expanding, or alternatively that it is experiencing trading difficulties and is unable to sell its inventory. An increase may also be due to a decrease in trade payables or other current liabilities.

An example of the current ratio is given along with the quick ratio just below.

4. $$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

Generally it is accepted that inventory can be hard to sell in a hurry. Therefore a more prudent measurement of assets which can be converted into cash easily excludes inventory. This ratio helps decide whether the **quick assets of a company will be able to generate sufficient cash to pay off the current liabilities as and when they fall due.**

Example

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

	20X2	20X3
	Tshs'000	**Tshs'000**
Current assets		
Inventory	15,000	30,000
Trade receivables	20,000	35,000
Cash	5,000	3,500
Total current assets	**40,000**	**68,500**
Current liabilities		
Trade payables	12,000	26,000
Bank overdraft	10,500	8,000
Total Current Liabilities	**22,500**	**34,000**

In this example

Current Ratio is	1.77:1 (40,000/22,500)	2.01:1 (68,500/29,000)
Quick ratio	1.11:1 (25,000/22,500)	1.13:1 (38,500/34,000)

This means that East Life Ltd has Tshs2.01 of current assets for each Tshs1 of current liabilities. This is a good position as it is close to the standard current ratio and also means that the company would be easily able to pay its current liabilities.

However, the quick ratio indicates that much of the current assets are held as inventory. East Life has only Tshs1.13 of assets to cover Tshs1 of liabilities. This is acceptable (and is slightly better than the previous year) but the situation must be watched to ensure the company does not go below Tshs1 of assets to Tshs1 of liabilities.

---

5. $$\text{Inventory turnover} = \frac{\text{Cost of sales}}{\text{Inventory}} \quad (\text{times p.a.})$$

The inventory turnover ratio can also be reversed to find the number of days inventory has been held in the warehouse.

$$\text{Inventory Days} = \frac{\text{Inventory}}{\text{Cost of sales}} \times 365 \text{ days}$$

If the number of inventory days is **high,** it can indicate the overstocking of goods which will then be difficult to sell. Inventory valuation would then have to be investigated carefully.

Example

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

	20X2	20X3
	Tshs'000	**Tshs'000**
Cost of sales	130,000	210,000
Inventory	17,000	35,000

In this example

Inventory Turnover is	48 days	61 days
	17,000/130,000 x 365	35,000/210,000 x 365

Average collection period

The average collection period reflects the **number of days it takes for a customer to pay**. It is calculated as:

$$\text{Average collection period} = \frac{\text{Receivable}}{\text{Credit sales}} \times 365 \text{ days}$$

This ratio can also be calculated using average receivables. In that case, it reflects the number of days it takes for an average customer to pay up.

Example

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

	20X2 Tshs'000	20X3 Tshs'000
Credit sales	110,000	200,000
Receivables	13,000	28,000
Average Collection Period is	43 days	51days
	13,000/110,000 x 365	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.

6. Average payment period

The average payment period reflects the **number of days it takes for a company to settle its bills.** It is calculated as:

$$\text{Average payment period} = \frac{\text{Payables}}{\text{Credit purchases}} \times 365 \text{ days}$$

This ratio can also be calculated using average payables. In that case it reflects the number of days it takes on average for a company to settle its bills.

Example

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

	20X2	20X3
	Tshs'000	Tshs'000
Credit purchases	130,000	210,000
Payables	10,000	25,000
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.

7. Gearing ratio = Debt/(Debt + Equity) x 100

$$\text{Capital gearing ratio} = \frac{\text{Total long-term debt}}{\text{Shareholders funds}} \times 100$$

This ratio measures the company's risk and stability because it expresses the relationship between a company's borrowings and its own funds. A high level of gearing generally indicates that the company must service pay the interest on) high fixed interest borrowings. This means that there is less profit available for shareholders and that the profit available to them is volatile. If gearing is too high, the company might find it difficult to pay the interest.

Example

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

	20X2	20X3
	Tshs'000	Tshs'000
Long-term borrowings	600,000	800,000
Equity fund	450,000	450,000
Reserves and surplus	125,000	175,000
Total gearing ratio	51.06%	56.14%
	(600,000/600,000 + 575,000)	(800,000/800,000 + 625,000)

8. $$\text{Dividend cover ratio} = \frac{\text{Profit before interest and tax}}{\text{Dividend}}$$

Dividend cover ratio shows how many times a company could pay the dividends. If this ratio shows an increasing trend, it means that the company is paying out a smaller proportion of profits as dividends and investing more in the business.

Example

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

	20X2	20X3
	Tshs'000	Tshs'000
Profit before interest and tax	350,000	475,000
Dividend	80,000	90,000
Dividend cover	4.38	5.28
	(350,000/80,000)	(475,000/90,000)

The increase in the dividend cover shows that the entity is keeping a greater proportion of profits in the business.

9. Interest cover ratio = $\frac{\text{Profit before interest and tax}}{\text{Interest expenses}}$

Interest cover ratio shows the capability of the entity to pay the interest. This indicates how many times a company could pay the interest. **The higher the ratio, better the position the entity is in to pay the fixed charge of interest.**

Example

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

	20X2	20X3
	Tshs'000	Tshs'000
Profit before interest and tax Interest	370,000 75,000	475,000 84,000
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.

2.7 Limitations of ratio analysis

It is important to note that there is no single correct value for a ratio. The observation that the value of a particular ratio is too high, too low or just right depends on the perspective of the analyst and the nature of the business. Also, financial ratios are meaningful only when they are compared with some standard, such as another industry trend or ratio trend.

Example

The current ratio of 1.5 of Jet Ltd for 20X3 has little significance on its own. It becomes more meaningful when compared to the standard current ratio, i.e. 2, and with the industry ratios.

The reliability of the ratio analysis depends upon the following:

The **quality of the underlying financial information.**

Example

The net profit ratio of White Co for the year 20X3 was 12%. It was later found that the sales had been overstated by Tshs100 million, thereby increasing the net profit ratio. This shows that the reliability of the ratio depends upon the information available.

The **information must be calculated on a consistent basis for comparison purposes**.

Example

The accountant of Thomas Ltd, John, put the truck petrol expenses in the travel expenses account in one year and in vehicle maintenance in the next year. The ratios calculated for travel expenses and vehicle maintenance expenses for the two years abnormally varied for this reason. This shows that there was no consistency in the treatment of expenses.

The two figures used to calculate a ratio must be logically related.

Example

Current ratio is calculated on the basis of current assets and current liabilities.

The two figures are related to each other because they help to decide whether the current assets will be able to generate sufficient cash to pay off the current liabilities as and when they fall due.

The ratios are not a conclusive test of the accuracy of the financial statements.

Example

The current ratio of Fair Ltd for the year 20X3 was 2.1.

Apparently, the ratio was ideal as it was near the standard current ratio of 2. It was later found that there the values of inventories and receivables had been manipulated in order to arrive at the ideal figure.

Tip

Remember that single ratios are meaningless.

The exam questions generally 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:

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.

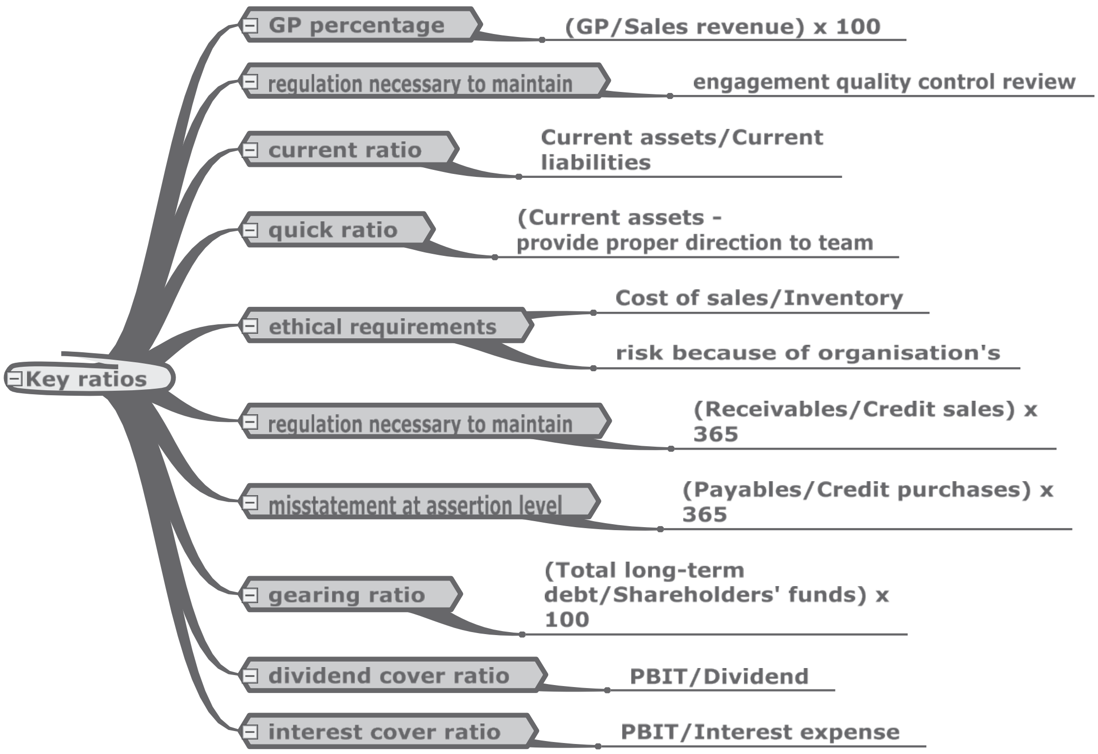
Is the change **genuine**? This means that if the increase in cash took place, it needs to be ascertained whether the increase is on account of a genuine reason (such as sale of some non-current asset) or accidental (on account of an error).

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)

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.

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.

SUMMARY



3. Identify and explain the differences between assurance engagements and audit engagements for profit and not-for profit entities include those in the public sector.

[Learning Outcome d]

3.1 Types 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 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** (which will be discussed in later Study Guides). 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, which will be discussed later in this Learning Outcome.

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"

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

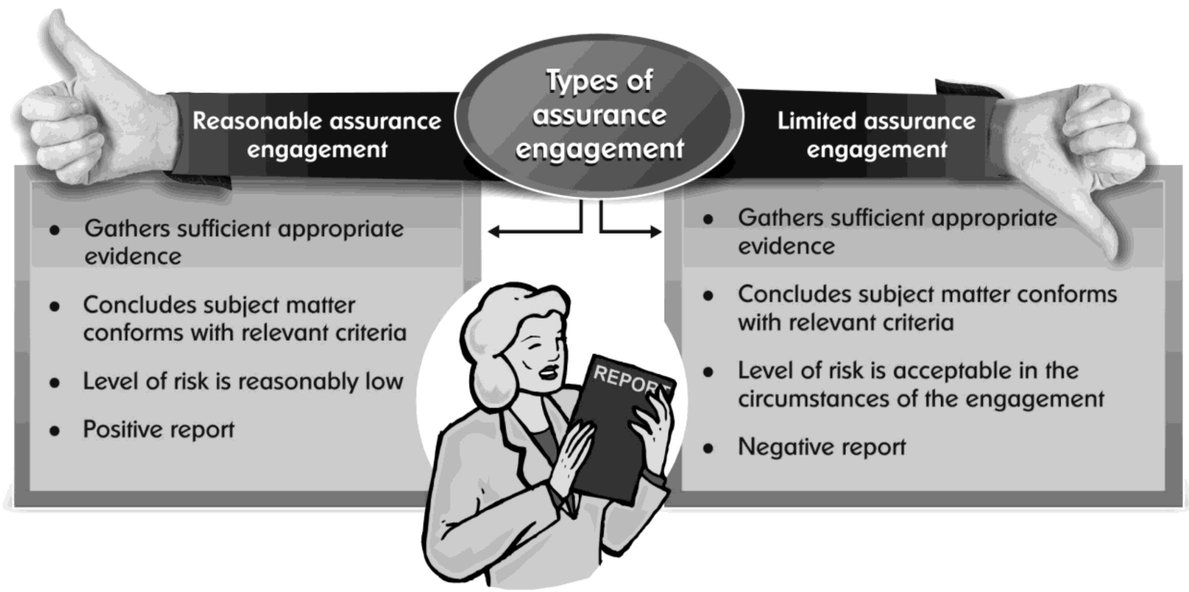
Objectives of a limited assurance engagement

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 we will discuss in Learning Outcome 5 of this Study Guide.

Diagram 4: Types of assurance engagement



An audit engagement is a reasonable assurance engagement, however assurance engagements can be reasonable assurance engagements or limited assurance engagements.

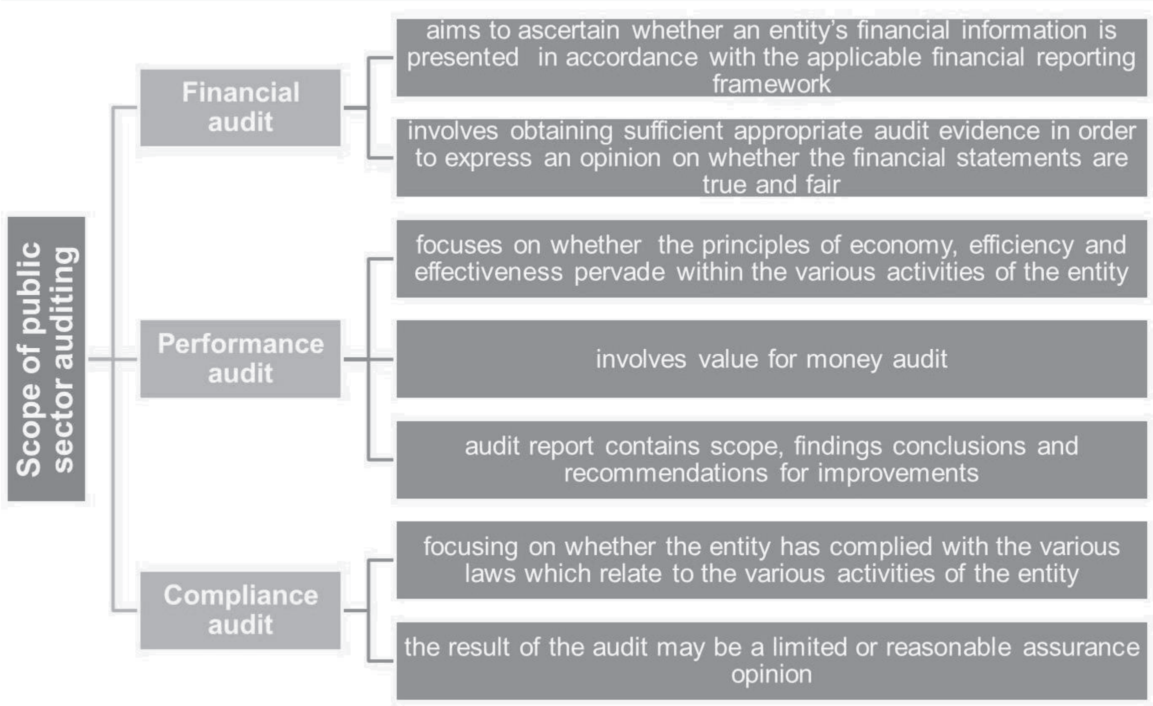
The methodology and aim of a reasonable assurance engagement is the same whether it is carried out for a 'commercial entity', 'not-for profit entity' or a 'public sector entity'.

3.2 Additional guidelines for public sector audits

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 objective relates to promoting independent and effective auditing and supporting the members of INTOSAI in the development of their own professional approach in accordance with their national laws, regulations and mandates.

The ISSAIs (International Standards of Supreme Audit Institutions) provide standards and guidance on the various fields of public sector auditing, which are explained in the following diagram.

Diagram 5: Scope of public sector audit



3.3 Not-for-profit organisations are governed by the 'Charities Act' of the country in which they are incorporated. Therefore while auditing such entities the auditor will also have to ensure compliance with the provisions of laws enacted by such bodies.

Case Study

The scope of audit of the financial statements of British Red Cross will include an opinion on whether the financial statements:

Are true and fair

Are prepared in accordance with the applicable accounting framework (i.e. United Kingdom Generally Accepted Accounting Practice); and

Have been prepared in accordance with the Charities Act 2011, the Charities and Trustee Investment (Scotland) Act 2005 and regulations 6 and 8 of the Charities Accounts (Scotland) Regulations 2006 (as amended)

Test Yourself 4

What is INTOSAI? Explain briefly about financial audit and performance audit of a public sector.

Answers to Test Yourself

Answer to TY 1 (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.

(b) 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.

(c) 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.

(d) Detection risk

This is the risk that the audit procedures will not uncover all irregularities or the misstatements.

(e) Situations that can give rise to audit risk for TrendZ (f) Many branches

Generally, an organisation with many branches scattered throughout the country us more prone to audit risk. It is more difficult to supervise staff, inventory and sales. Interbank transfers add complications to accounting.

(g) Small, high-value, desirable inventory

Mobile phones are very susceptible to theft. The disappointing profitability might be caused by this, at least in part.

(h) Ineffective MIS

Although TrendZ 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.

(i) Internet

TrendZ 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.

(j) Rapid expansion

This can often mean that staff are over-worked and that they have had little training. Supervision is likely to be patchy.

(k) 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.

(I) First year audit

Given that this is the first year Linda is conducting the audit, her unfamiliarity with the organisation, procedures etc. adds to the overall general risk of the audit.

Answer to TY 2

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, completeness and validity of the data produced by the accounting system
(iv) Changes raise the suspicion that errors or fraud might have occurred.

Answer to TY 3

Analytical procedures used at planning stage should focus on:

Understanding the business
Identifying areas of potential risk significant to audit

The auditor should consider the results of the analytical procedures while determining the nature, timing and extent of the audit procedures to be incorporated in the audit plan. The use of analytical procedures depends upon the nature of the business, the auditor's judgement etc. The use of procedures may also vary widely depending on the size and complexity of the client.

In the planning stage, analytical procedures can be used **to identify the existence of unusual transactions and events and amounts, ratios, trends** that have a **significant effect** on the **financial statements** as well as audit planning. Unusual transactions noticed by performing an analytical procedure, will give rise to the suspicion that the material misstatement may exist in the financial statements, and more work can be planned for those areas.

Answer to TY 4

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.

Financial audit:

Aims to ascertain whether an entity's financial information is presented in accordance with the applicable financial reporting framework
Involves obtaining sufficient appropriate audit evidence in order to express an opinion on whether the financial statements are true and fair

Performance audit:

Focuses on whether the principles of economy, efficiency and effectiveness pervade within the various activities of the entity
Involves value for money audit
Audit report contains scope, findings, conclusions and recommendations for improvement

Quick Quiz

1. Define audit risk.

2. State the three components of audit risk.

3. Complete the definition

   Analytical procedure is the ________________ of financial information made by a study of ________________ relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified ________________ and ________________ that are inconsistent with other relevant information or ________________ significantly from predicted amounts.

4. Choose the correct option that best completes the statements. (a) Analytical procedures are useful:

   (i) At the time of planning an audit
   (ii) While carrying out substantive procedures
   (iii) While finalising the audit conclusions
   (iv) At all stages of an audit

(b) Analytical procedures are:

   (i) Special tests of controls to identify areas requiring intensive investigation
   (ii) Tests of financial information conducted through a study and review of relationships among data
   (iii) Methods of determining sample size
   (iv) Tests conducted when the auditor has no time to undertake detailed verification of transactions and balances

(c) Where an auditor finds significant unexplained fluctuations in various financial ratios while performing analytical procedures, they should normally:

   (i) Qualify the audit report
   (ii) Issue a letter of weaknesses to the management
   (iii) Extend the substantive procedures for detailed verification of transactions and balances

5. Analytical procedures used at planning stage should focus on
   ________________ the business
   ________________ of potential risk significant to audit

6. Show the formulas for: gross profit percentage, current ratio, quick ratio, inventory days.

Answers to Quick Quiz

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

2.
   (a) Inherent risks are the risks which the organisations face because of their business and nature of their industry.
   (b) Control risk is that organisation's internal control systems do not adequately protect the organisation against inherent risks because they have not been adequately designed and / or implemented.
   (c) Detection risk is the risk that an auditor's checking and sampling procedures will not uncover any existing irregularities or misrepresentations.

3. evaluation, plausible, fluctuations, relationships, deviate

4. (a) - (iv) (b) - (ii) (c) - (iii)

5. Understanding, Identifying areas

6. Key ratios are:

(i) $\text{Gross Profit Percentage} = \dfrac{\text{Gross Profit}}{\text{Sales Revenue}} \times 100$

(ii) $\text{Current Ratio} = \dfrac{\text{Current assets}}{\text{Current Liabilities}}$

(iii) $\text{Quick ratio} = \dfrac{\text{Current Assets - Inventory}}{\text{Current liabilities}}$

(iv) $\text{Inventory days} = \dfrac{\text{Inventory}}{\text{Cost of sales}} \times 365 \text{ days}$

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 Pearl Plc (for whom he has been the auditor for the last 5 years) an organisation that manufacturers and sells LCD televisions.

Pearl has managed to increase their turnover from Tshs 50,000 million to Tshs75,000 million and has just started to diversify into cosmetics.

Andrew has also recently taken on a new client, Dollar Bank. Dollar 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 Pearl's audit manager for the last five years, he is completely familiar with their accounting procedures, policies and internal controls of Pearl. 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 Dollar 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

Define analytical procedures and explain the steps involved in using them.

Question 3

Green Meadow Resorts is a chain of hotels. Ivan is the auditor of Green Meadow Resorts for the year, 20X3. The hotels provide various facilities such as lodging, travel facilities, restaurant, conference facilities, party venues, swimming, badminton, golf etc. The financial information of Green Meadow Resorts for the year 20X3 is as follows:

	20X3 (Projected)	20X3 (Actual)
	Tshs million	Tshs 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**
	20X3 (Projected)	**20X3 (Actual)**
	Tshs million	**Tshs million**
Non-current assets (at net book value)	3,600	4,500
Current assets Inventory Receivables Cash		
and bank **Total assets**	200	1,278
Capital and reserves Share capital	7,245	7,017
Accumulated profits	500	1,590
Total shareholders' funds Non-current	**11,545**	**14,385**
liabilities Current liabilities		
Total equity and liabilities	1,000	1,000
	5,300	5,764
	6,300	**6,764**
	2,245	**5,023**
	3,000	**2,598**
	11,545	**14,385**

Other information

(i) Revenue includes credit sales of Tshs25,928 million in 20X3 (projected) and Tshs20,515 million in 20X3 (actual).
(ii) Cost of sales includes credit purchases of Tshs15,865 million in 20X3 (projected) and Tshs16,900 million in 20X3 (actual).
(iii) Dividend of Tshs1,400 million has been paid for the year 20X3. The dividend expected to be paid was Tshs1,200 million.

Required:

(a) Calculate the key financial ratios used in planning:

(i) Gross profit ratio
(ii) Current ratio
(iii) Quick ratio
(v) Inventory turnover
(vi) Average collection period
(vii) Average payment period
(viii) Dividend cover ratio
(viii) Interest cover ratio

(b) Interpret the key financial ratios and their impact on designing the nature, timing and extent of audit procedures.

Question 4

(a) Mwendokasi Ltd is a fast growing chain of retail shops that has fifteen branches in Tanzania. The company is considering listing on the Dar es Salaam Stock Exchange (DSE) largely because it wishes to raise additional capital for expansion.
The following information relates to Mwendokasi:

network.

2. The retail outlets use standalone cash tills that are not integrated with the inventory system. This results in unexpected stock outs of some product lines.

3. Store Managers arrange for inter store transfers of goods when necessary and they do not require third party authorization and transfers are recorded in a book of the transferring store.

4. All branches hold large cash balances during weekends and this cash is held by the Store Managers in unsecure safes bought for the purpose. The funds are banked on the following Monday.

5. Store Managers have authority to spend funds for operational use from sales proceeds up to a maximum of TZS.1,000,000 per week.

6. There are regular power outages in the city which most shops are experiencing. This has resulted in an increase in food stuffs going bad. Store Managers record and dispose of any food that goes bad. They do not require prior approval to do this.

7. Of late, the chain store has experienced a high staff turnover in middle management as well as strikes. The non-implementation of the minimum wages is the major cause of the industrial unrest.

8. Most of the merchandise is imported. There has been a noted depreciation of the local currency in the last six months. Mwendokasi Ltd enjoys one month credit from its suppliers abroad.

9. All accounting functions are carried out by a workforce of four with little segregation of duties.

10. As a result of a small accounting unit, none of the accounting staff has taken leave during the past four years. Members of staff are allowed to commute their leave days for cash.

REQUIRED:

(i) Identify and explain the business risks and other risks in Mwendokasi Ltd.
(ii) Recommend appropriate internal controls in Mwendokasi Ltd.

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 Pearl 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 Dollar 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 Pearl 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 Pearl Plc and Dollar Bank are as follows:

(i) 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 Pearl 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.

(ii) 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

Analytical procedure is the evaluation of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

The importance of analytical review procedures stems from the fact that, in many instances, known relationships exists between data. These procedures provide analytical evidence about the reasonability or otherwise of the data contained in the financial statements.

Steps involved in analytical procedures Analytical procedures' involve the following steps:

(i) Expectation

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

(ii) Identification

This step involves the comparison of the actual data with the expected data to see whether the former is reasonably close to the latter.

(iii) Investigation of unusual changes

If the recorded data and the expectations are not reasonably close to each other, the auditor should inquire or investigate why they are not so.

(iv) Performance of alternate procedures

If the auditor or management does not find the variation reasonable, then they investigate further and perform analytical procedures to satisfy themselves.

Answer to SEQ 3

(a) The key ratios used in analytical procedures are as follows:

(i) $\boxed{\text{Gross profit ratio} = \frac{\text{Gross Profit}}{\text{Sales Revenue}} \times 100}$

20X3(Projected) Tshs million	$\frac{7,930}{45,928} \times 100 = 17.27\%$
20X3(Actual) Tshs million	$\frac{8,951}{40,825} \times 100 = 21.93\%$

(ii) $\boxed{\text{Current Ratio} = \frac{\text{Current assets}}{\text{Current Liabilities}}}$

20X3(Projected) Tshs million	$= \frac{7,945}{3,000} = 2.648$
20X3(Actual) Tshs million	$= \frac{9,885}{2,598} = 3.805$

(iii) quick $\boxed{\text{ratio} = \frac{\text{Current Assets - Inventory}}{\text{Current Liabilities}}}$

20X3(Projected) Tshs million	$= \frac{7,745}{3,000} = 2.581$
20X3 (Actual) Tshs million	$= \frac{8,607}{2,598} = 3.313$

(iv) Inventory turnover ratio $= \dfrac{\text{Cost of sales}}{\text{Inventory}}$ (times p.a.)

20X3 (Projected) Tshs million	$= \dfrac{37{,}998}{200} = 189.99$ times
20X3 (Actual) Tshs million	$= \dfrac{31{,}874}{1{,}278} = 24.941$ 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 $= \dfrac{\text{Receivables}}{\text{Credit sales}} \times 365$ days

20X3(Projected) Tshs million	$= \dfrac{7{,}245}{25{,}928}$ x 365 days = 102 days
20X3(Actual) Tshs million	$= \dfrac{7{,}017}{20{,}515}$ x 365 days = 125 days

(vi) Average Payment Period $= \dfrac{\text{Payables}}{\text{Credit purchases}}$ x 365 days

20X3(Projected) Tshs million	$= \dfrac{1{,}245}{15{,}865}$ x 365 days = 29 days
20X3(Actual) Tshs million	$= \dfrac{2{,}965}{16{,}900}$ x 365 days = 64 days

(vii) Dividend cover ratio $= \dfrac{\text{Profit before interest and tax}}{\text{Dividend}}$

20X3(Projected) Tshs million	$= \dfrac{2{,}936}{1{,}200} = 2.447$
20X3(Actual) Tshs million	$= \dfrac{4{,}193}{1{,}400} = 2.995$

(viii) Interest cover ratio $= \dfrac{\text{Profit before interest and tax}}{\text{Interest expenses}}$

20X3(Projected) Tshs million	$= \dfrac{2{,}936}{2{,}000} = 1.468$
20X3(Actual) Tshs million	$= \dfrac{4{,}193}{1{,}800} = 2.329$

(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 average payment period is very much longer than expected, which might indicate that the company is having some difficulty paying its liabilities as they become due.

(vii) The dividend cover ratio has increased, which indicates that the entity is retaining a greater proportion of profits.

(viii) The higher interest cover ratio indicates that the company is better able to pay the interest on its borrowings.

Answer to SEQ 4

i. Business and other risks in Mwendokasi Ltd

(i) **Manual accounting records**

It seems inappropriate for a large company with so many retail outlets to maintain manual accounting records. There is a risk that this will result in delays in getting important accounting information required by management in running the company. Further, there is an increased risk of errors going undetected as well as fraud which may be difficult to prevent and detect.

(ii) **The use of standalone tills in the retail outlets**

Using tills that are not integrated with the inventory system could result in the company facing serious difficulties in managing inventory. This is the main cause of unexpected stock outs of products resulting in lost sales. An integrated sales and inventory system would be more efficient and helpful to management.

(iii) **Non-authorization of inter store transfers**

This could result in the loss of inventory through fraud. Verbal agreement between Store Managers without necessary authorization could be abused for personal gain. It is likely that Store Managers can cover up stock losses by claiming that items were transferred to another branch unless this is properly controlled.

(iv) **Holding of cash over the week end**

Cash balances in most retail businesses are material because almost all the transactions are on a cash basis. There is the risk that funds could be lost either through theft or the Store Manager taking business cash for personal use with a view to returning it in time for banking. It is clearly unsafe to keep large sums of money in the shops where there is no suitable safe in which to store the cash.

(v) **Spending of money for operational use**

Store Managers might spend money for non-business related activities because they are authorized to spend TZS..1,000,000 they may be tempted to spend the money even in their own use so long as they are within the limit.

(vi) **Frequent power**

The frequent power outages can result in the company losing large sums of money due to food stuffs going bad and hence disposed of. There is also a risk that some food that has gone bad may be sold to customers who could take legal action at a later date claiming damages for having been sold bad food. This could result in the company paying large sums of money in compensation claims.

The fact that Store Managers do not require prior authorization to dispose of bad food could lead to loss of products through theft. Managers could misappropriate inventory and claim that it went bad due to power outages.

(vii) **High staff turnover and increased strikes** will become more difficult to control and manage the company with a high rate of staff changes. Things could go wrong and these may not be detected early enough to take corrective measures.

Frequent strikes are a sign of bad human resource management. This could result in having a demotivated work force resulting in poor work culture. Further the reason of failing to pay the minimum wage could result in the company being penalized by the relevant authorities. There is a risk that provisions could be understated in this regard at the period and arising from the failure to pay the minimum wages.

(viii) **Devaluation of the local currency**
The company has liabilities in foreign currency due to the extended credit it enjoys. The depreciating local currency will affect the company adversely both in terms of maintaining its margins and also exchange losses on its monetary liabilities. The company will need more of the local currency to meet its obligations and this may result in poor cash flow position for the company resulting in poor liquidity to be able to sustain the company operations.

(ix) **Lack of segregation of duties**
The fact that the four accounting staff members carry out all the financial duties could result in errors and fraud being difficult to prevent and detect. This is more so that there is lack of segregation of duties which means that the same people process transactions from origin to the processing in the accounting system. In such a scenario fraudulent activities are more difficult to detect and with a high staff turnover the consequences can affect the company adversely.

(x) **Staff not taking leave**
Generally when staff take leave, this gives an opportunity by another person to do the work of the substantive job holder during their absence.

ii. Internal controls that may be implemented in Mwendokasi Ltd.

(i) **Move from a manual to a computerized accounting system**
It is recommended that the company moves from a manual to a computerized accounting system. This will result in the risk of errors and fraud going undetected reduced. This is because computerized systems have inbuilt controls.

(ii) **Integration of stores systems to the tills**
The store sales systems via the standalone tills should be integrated with the inventory system. This will result in a more efficient management of stocks and reduce incidences of unexpected stock outs as well as stock pilferage.

(iii) **Authorization of inter-store stock transfers**
All transfers of inventory between stores should be evidenced in writing on documentation designed for the purpose. This documentation should be retained for future reference and all stock movements must be authorized by an appropriate official and this approval should be evidenced in writing. This will reduce pilferage of inventory which can be easily perpetrated under the current system.

(iv) **Week end cash balances**
All cash raised during the week end should be counted in the presence of at least two people and recorded appropriately. Suitable secure safes should be installed and all such cash should be left in these safes over the week end. On the next working day the safe should be opened in the presence of at least two people who should verify the cash before arranging to bank it.

It would also be appropriate to:

- Arrange for week end banking with the bankers so that all cash is banked daily.
- Take insurance against loss of cash could also be taken to guard against loss of large sums of cash.

(v) **Spending TZS. 1,000,000 per week**
All expenditure should be review by internal auditor.

(vi) **Power outage**
Standby generator should be in place.

Make sure that the recommended minimum wages is implemented and working conditions are improved.

(viii) **Exchange loss**
Hedging against loss of exchange rate.

(ix) **Segregation of duties within the accounting department**
Segregation of duties is an important control in any business. It is clear that for Mwendokasi Ltd segregation of duties is lacking. This is worsened by the fact that staff does not take their annual leave.

Controls should be introduced in the accounts department so that no one person processes a transaction from origin to the recording in the financial statements. This could be achieved by having work done being checked independently by a difference person within the department.

(x) **Annual Leave**
It should be a requirement that all staff go on mandatory leave and not commute all their accrued leave days. In this way another person will sit in for them whilst they are on leave. This will act as a deterrent for fraudulent activities because staff know that someone else will do their job while they are on leave and this may result in detection of any fraud that may have taken place.

STUDY GUIDE C2: UNDERSTANDING AN ENTITY AND ITS ENVIRONMENT

Get Through Intro

A detailed knowledge and understanding of the client's business is the key to an effective and efficient audit. Audit planning can be effective only if it is based on a thorough understanding of the business. In order to plan his work adequately, the auditor needs to understand the nature of the business of the enterprise, its organisation, its method of operating and the industry in which it is involved, so that he is able to give a true and fair view of on the information contained in the financial statements.

Knowledge of the company and the industry in which it operates is essential for the development of a satisfactory professional relationship. It ensures that the auditor's advice is both relevant to and practical for the client's individual needs and the circumstances of his business. It enables the auditor to identify those areas in which a particular client could be expected to benefit from a service or services provided by the auditor. It demonstrates to each client an overall concern for and appreciation of his business extending beyond the audit itself. It also helps the auditor to meet the expectations of clients who increasingly assume that the professional knowledge and experience of the auditor is being brought to bear on his business.

In **today's world** of **global integration, specialisation** and **diversification**, it has become **almost impossible** for a statutory auditor to **conduct an audit without relying on 'others'.**

These 'others' on whom the statutory auditor relies, albeit **with varying degrees of confidence,** are the internal auditors, experts who possess skill in specialised areas, component auditors in the case of audit of group financial statements, and service organisations to whom some tasks are outsourced.

The most important job of an auditor who relies on others is to **assess the extent to which they can and should rely** on these people. Any **error** on their part while making this judgment could jeopardise the entire audit exercise.

This Study Guide explains how an auditor obtains the necessary information about the entity and its environment and the factors which the auditor has to consider while **deciding the extent of trust** to be placed in the work of others.

Learning Outcomes

a) Analyse, evaluate and explain based on a business scenario the areas of a business that may be important to understand to develop an effective strategy or plan.
b) Analyse and evaluate the techniques available to obtain an effective understanding.
c) Identify the needs to use experts, management representations and third parties in an engagement.
d) Analyse and evaluate the situations when third party expertise may be required.
e) Evaluate and apply suitable judgements on when it may be appropriate to refer to a specialist in preparing and opinion or report.

**1. Analyse, evaluate and explain based on a business scenario the areas of a business that may be important to understand to develop an effective strategy or plan.
Analyse and evaluate the techniques available to obtain an effective understanding.
[Learning Outcomes a and b]**

1.1 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.

Example

Hardy, the auditor of Gear Ltd, a small company, makes an audit plan without understanding the nature of the business. He thinks that he does not need to understand the nature of the business, as he has carried out the audit of similar entities in the same trade.

However, he needs to appreciate that there can be substantial differences between superficially similar businesses which depend on the drive and personality of their owners or managers. For example, the owners' attitude to risk and internal control can vary substantially. It is important for Hardy to understand the business of each entity individually and separately.

Before discussing the various facets of 'understanding an entity', we shall discuss the basics of audit strategy and audit plan.

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 Light 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.

Audit strategy includes the following information:

(a) Understanding the entity's environment

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

(i) 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

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

(ii) 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.

(iii) 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.

(iv) 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:

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

Example

Richard has been appointed as an auditor of Jet 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.

- **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 Heavy 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 Heavy 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, Clear 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.

(b) 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.

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.

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 C2, Learning Outcome 1, 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 2011) prepared by Ponting & Co, the auditors of Stan plant Enterprises which manufactures mining equipment:

Inventory
Nature: Physical verification
Timing: 30 June 2011 and 31 December 2011
Extent: 100% verification

Receivables
Nature: Direct confirmation
Timing: 30th June 2011 and 31 December 2011
Extent: For all account receivables which exceed Tshs2 million as on 31 December 2011 and all receivables having credit balances

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(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

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(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 D4, Learning Outcome 4 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.

1.2 Sources of information to obtain an understanding of the entity

Understanding the entity and its environment involves understanding the following:

1. Relevant industry, regulatory, and other external factors including the applicable financial reporting framework affecting the operations of the entity

(a) Industry conditions

An auditor should obtain basic knowledge of the industry in which entity is working. This includes knowledge of:

(i) Competition in the market

The knowledge of the competition in the market is important because the competitors may be a **threat to the client leading to a decline in the client's business.**

Example

Danny, the auditor of Fair Ltd needs to develop an audit plan. Fair Ltd is in the business of manufacturing bicycle parts. Before developing an audit plan, Danny needs to know the competitors in the bicycle industry and the alternative procedures / services offered by the client and his competitors. This will enable Danny to understand whether there could be risks associated with fierce competition e.g. financial problems if Fair Ltd loses market share.

(ii) Cyclical or seasonal activity

It is important for the auditor to know about the nature of the entity's operations i.e. whether its processes are cyclical or seasonal. This will enable the auditor to determine the nature of the audit procedures which need to be applied to the entity.

Example

Robert has recently been appointed as the auditor of Greenfingers Ltd. Greenfingers owns farms where they grow various organic fruits and vegetables. Robert needs to learn about the different types of fruits and vegetables grown, the seasons when they grow, etc. so that he will be able to understand the period of time when the entity's liquidity position would be tight. This understanding is also needed when examining sales and inventory patterns.

(iii) Technological and other developments in the industry and their impact on the entity

Knowledge of the client's technological environment is important. If the client is in a 'high tech' industry, changes in technology can be very rapid and, if the client is not investing enough and keeping up to date, the whole basis of the business could be undermined. Even in more traditional industries, technological change may change the way businesses operates, with serious consequences for those who do not adapt quickly enough. Changes in technology can also affect inventory valuations.

Example

Tom is the auditor of a printing press, White Ltd. Tom finds that the work in the printing press is still carried out by skilled operators, whereas the other printing presses have been fully automated. This could lead to White having to charge high prices and a decline in its business.

(b) Regulatory environment and external factors

An auditor should obtain an understanding of the laws and regulations that are applicable to the entity. This will help them in checking whether all the applicable provisions are complied with or not. These laws and regulations include:

(i) Accounting principles and industry specific practices

Example

Harry is the auditor of a small hospital. The hospital wants to change its method of accounting from a cash basis to an accrual basis. Harry should consider the reason for this change and think about the impact on the financial statements. He also needs to ensure this change has been correctly disclosed in the financial statements. It will also indicate that more testing will be needed to ensure that the new basis has been carried out properly in the financial statements.

(ii) Legislation and regulations applicable and affecting the entity

Example

Sophia obtains an understanding of the applicable laws and regulations and finds that the Minimum Wage Act is applicable to the entity she is auditing. During the course of the audit, she should determine how she will plan her audit to ensure that the Minimum Wage Act is complied with by the entity. If the entity is unaware of the effects of this law, Sophia will need to ask the entity to comply with the law. If it is not complied with, it may result in a heavy penalty to the entity and perhaps a provision in the financial statements will be needed.

(iii) Government policies and taxation

Example

Jimmy is the auditor of Light Ltd. The Government of Someland has changed the rates of tax deducted at source from 10% to 15%. Jimmy should ensure during the audit that the company has accounted for the tax at the revised rate of 15%.

(iv) Regulatory framework for a regulated industry

Example

The presentation of financial statements in line with the applicable financial reporting framework includes adequate disclosure of material matters. The auditor must consider whether the entity has disclosed a particular matter appropriately in light of the regulatory framework

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It is important to note that knowledge of the client's accounting policies and the laws and regulations applicable to the entity is vital to the auditor because the use of inappropriate accounting policies leads to manipulations of the financial statements. Without an adequate understanding of the laws and accounting policies, the auditor is unable to judge whether or not the financial statements give a true and fair view of the position of the entity.

2. Nature of the entity

The auditor should obtain an understanding of the 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.

Example

Sysco Ltd is involved in electronic commerce. Its sales are made through the internet. While obtaining an understanding of Sysco Ltd, the auditor may identify internet sales as a risky area and may decide to spend more time and perform extensive audit procedures on the sales of Sysco Ltd.

Apart from this, the auditor should also obtain an understanding of the investment and financing activities.

Example

Potter is the auditor of Fly Ltd. Potter needs to know whether Fly Ltd has been financed by bank loans, overdraft, a loan from a holding company or current accounts. He should also inquire whether there have been any problems with financing such as whether overdraft limits have been breached or other finance facility limits have been exceeded. In this way, Potter will be able to understand the investment and financing activities of the Fly Ltd and would be able to identify any problem areas for the audit.

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3. 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:

(a) **The methods the entity uses to account for significant and unusual transactions.** Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor in evaluating the appropriateness of the selection, and application of certain accounting policies.

(b) **The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.** For example in many local GAAPs there is no accounting standard for agriculture, hyperinflationary economies, etc.

(c) **Changes in the entity's accounting policies:** The auditor needs to consider whether the change in accounting policies is both appropriate and consistent with the requirements of the applicable financial reporting framework. For example if an entity changes its method of inventory valuation from FIFO to weighted average method. The auditor knows that weighted average method is applicable under IFRS. However, they must confirm that this method gives better results.

(d) **Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.** For example, if the accounting standards applicable to small and medium sized enterprises have been recently released, the auditor of a small entity will need to understand from the client, when and how the entity will adopt these standards.

Objectives and strategies and significant business risks of the entity

The auditor should also obtain an understanding of the objectives of the entity, the strategies to achieve those objectives and the risks associated with them. 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.

Example

Peter is the auditor of Smith Ltd. Smith Ltd manufactures sewing machines. The company is exposed to business risks from the development of new products that may fail or from an inadequate market. Polly needs to understand these risks and plan the audit so as to see if these risks affect the financial statements.

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4. Measurement and review of the entity's financial performance

The auditor should obtain an understanding of the measurement and review of the entity's financial performance. This 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 to achieve performance targets, auditors will be able to determine the areas in the financial statements where there is an increased risk of material misstatement.

Example

Ivan is the auditor of Dear Ltd. He should compare the available financial statements of Dear Ltd with the financial statements of the previous year so as to analyse the performance of the company. In case of any material variations are found, they should be investigated and incorporated into the planning his audit for the business. Where there are material variations, more testing will be needed.

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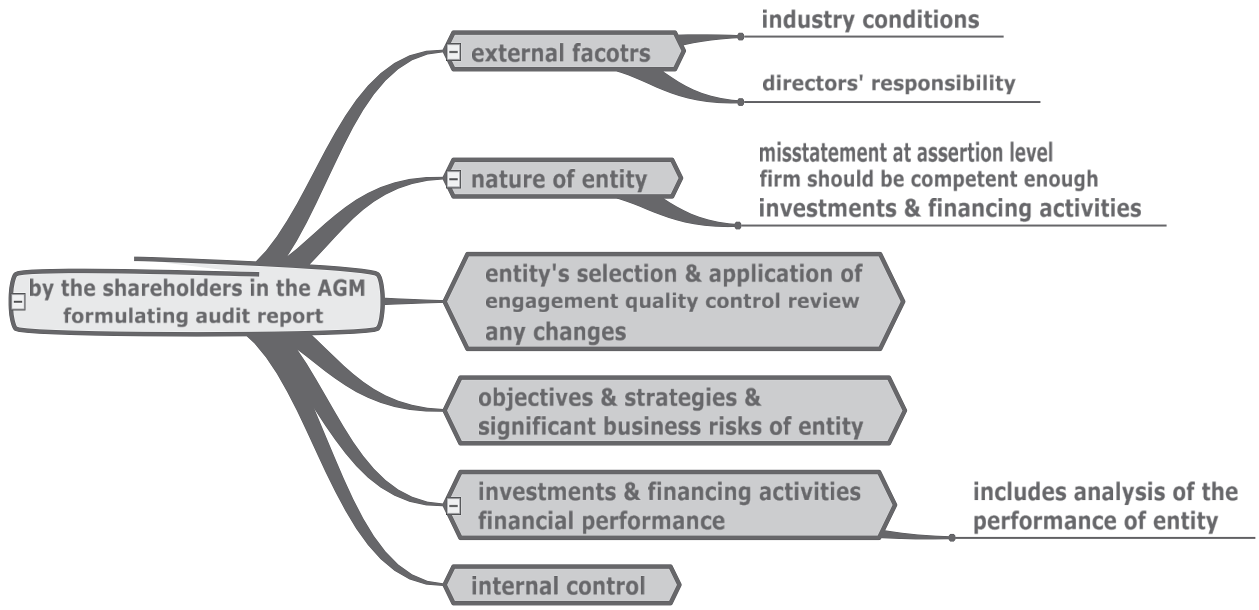
5. **Examinable internal control is discussed in detail in Paper B3.**

SUMMARY



1.3 Additional methods of obtaining knowledge of business

Knowledge of the business is a frame of reference within which the auditor exercises professional judgment. The auditor's knowledge of business for an audit engagement would include:

- a general knowledge of the economy within which the client operates
- a general knowledge of the industry in which the client operates
- a more particular knowledge of how the entity operates

Example

John has just been appointed the auditor of Heavy Ltd. Before starting the audit, he needs to know the nature of the business and a brief history of Heavy Ltd. He also needs to know the nature of the industry in which the client operates and the business's long term trends and prospects.

This will help him to gain knowledge of the business of Heavy Ltd and will help him to plan his audit accordingly. For example, if Heavy is a construction company and the economy is in recession, the company is likely to be very adversely affected.

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

1.4 Techniques available to obtain and effective understanding

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:

1. 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.

(a) Those charged with governance

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

Example

Jiten is the auditor of Fairwell Ltd. His preliminary meeting with the audit committee will help him understand what areas they have concentrated on during the year and why. If he find for example, the committee meets on a monthly basis and ensures implementation of recommendations of the internal auditor, Jiten will have more comfort that the audit risk of the entity is less than high.

(b) 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.

Example

Jessica is the external auditor of Right Co. She finds that there is a substantial increase in scrap value. On further inquiry from the chief internal audit executive, it is found that there has been no check on the quality of products produced. The same is reported to the management and more controls are exercised to have a check on the quality of products manufactured.

Furthermore, if any of the internal auditor's responses are relevant to the entity's financial reporting and the audit, the auditor may read related reports of the internal audit function.

(c) 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.

Example

The auditor obtains information from a person in the sales department that the sales orders are taken either by telephone or by e-mails. The auditor may feel that there is a risk that a fictitious person may order the goods and, when it is time for payment, the person will not be located. Therefore, the auditor may decide to concentrate on the sales.

(d) 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.

Example

George, the auditor of Blue Ltd, should consult the legal counsellor to find out whether or not all the applicable laws and regulations have been complied with and whether there are any pending litigations against the entity and their consequences on the financial statements. The non-compliance of laws and regulations will call for huge penalties on the company and the auditor should plan and perform the audit with the view that material misstatements will be identified.

(e) 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.

Example

Monica, the auditor of True Co obtains information on the following matters from the marketing personnel:

Number of products, product range
Sale and warehouse locations
Research and development i.e. nature, locations, resources
Product planning
Sales promotion

This information will enable Monica to understand the marketing strategy and the risks associated with the sale of the entity's products and its inventory. Monica will be able to plan her audit according to the information provided by the marketing personnel.

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2. 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.

Example

Ronald is the auditor of Black Ltd. Ronald made an analysis of the financial statements of Black Ltd by studying significant ratios. One of the ratios that he studied was the gross profit margin. The gross profit ratio of Black Ltd for the current year, 20X2, is 20% and the gross profit percentage for the previous year, 20X1, 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.

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3. 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

4. **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)

Test Yourself 1

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

Test Yourself 2

List eight possible sources of knowledge of a business.

The following is an example of an audit plan which has been developed by Borewell Associates, after obtaining an understanding of "Planet 1 Inc':

Example

Example of an Audit plan

Name of the client	Planet 1 Inc
Address of the client	15 Lay Street, New York
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. Borewell - manager Mr. Brook Miss. Grant Mr. Harvey Mr. David Ms. Martin

Continued on the next page

Engagement team of the current year	Mr. Borewell - manager Mr. Bernard Miss. Samuel Mr. Augustin Mr. Ivan Mr. David Ms. Martin
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 computerise 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. Samuel 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. Augustin.
Associated party transactions	Ledger scrutiny by Mr. Martin.
Materiality level	Materiality level appears to be accurate.

2. Identify the needs to use experts, management representations and third parties in an engagement. Analyse and evaluate the situations when third party expertise may be required.

[Learning Outcomes c and d]

2.1 ISA 620 'Using the work of an auditor's expert' gives guidance in this area

Definition

Auditor's expert is an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert. Management's expert is an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

IFAC, Glossary of Terms

Situations when third party expertise may be required

Example

Services where the auditor may need to use the work of an expert are as follows:

Valuation of post-retirement liabilities which involve specialised techniques or methods
Measurement of capital work in progress like stage of completion of construction of buildings
Valuation of assets which requires specialised knowledge, like the valuation of land, building, plant, precious stones etc.
Identification of remaining useful life of non-current assets
Determination of physical condition of assets like mineral and petroleum reserves
Providing legal opinion e.g. interpretation of statutes, pending litigations
Public sector auditors may use the work of experts from the police or anti-corruption bureaus when auditors have additional responsibilities related to fraud

Need to use experts and third parties in an engagement

The auditor is considered an expert in accounting and auditing and is knowledgeable about business matters in general, but the auditor is not expected to have expertise of any other occupation or profession e.g. actuary, engineer, valuer etc. Therefore, the auditor may seek an opinion or report from an expert for such services.

2.2 Written representation (management representations)

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.

Need to use written representations in an engagement

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 Tshs5 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"

Test Yourself 3

What is the need for management representations?

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3. Evaluate and apply suitable judgements on when it may be appropriate to refer to a specialist in preparing and opinion or report.

[Learning Outcome e]

An external auditor is solely responsible for expressing an opinion on the financial statements and relying on the work of others cannot reduce it. Using the work of others will reduce their workload but not their responsibility.

According to ISA 402 and ISA 620, a reference to the auditor's expert's work should be made in the audit report containing an unmodified opinion, only if required by law or regulation, for example, to show transparency in the public sector. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion.

Reference to the work of an expert in an unqualified report might be taken as reservation or qualification of the auditor's opinion or division of responsibility when, in reality, it is not the intention of the auditor.

Exceptions

Exceptionally, reference to an expert can be made in an audit report when, on the basis of the expert's report, the auditor decides to give a report other than an unmodified report and personally feels that it may be beneficial to the readers of the report if the work explaining the nature of the reservation is referred to. Furthermore, the audit report must state that reference to the report does not reduce the auditor's responsibility for that opinion.

When the auditor decides and considers it appropriate to disclose the identity of the expert, they can do so provided they obtain prior consent from the expert, if it has not been already obtained.

Answers to Test Yourself

Answer to TY 1

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:

- a general knowledge of the economy within which the client operates
- a general knowledge of the industry in which the client operates
- 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:

- How it affects the financial statements taken as a whole.
- Whether the assertions in the financial statements are consistent with the auditor's knowledge of the business.

Answer to TY 2

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

Answer to TY 3

Written representations are statements made to the auditor during the course of the audit which provide audit evidence in respect of specific matters.

Written representations are needed to:

(a) Ensure that the directors take up the collective responsibility for the preparation of financial statements and to make sure that they agree with what they have stated.
(b) Get confirmation of the matters material to the financial statements where the representations are crucial.

Quick Quiz

1. State the two sources of information which enable the auditor to assess risk.

2. Why should the auditors have an understanding and knowledge of the business?

3. Define written representation.

4. Which of the following options does not contain the purpose of written representations?

   A They acknowledge responsibility for the financial statements by auditors
   B They are used as audit evidence
   C They help to minimise misunderstandings between management and auditor
   D They provide reasonable assurance that the internal control system is effective

5. Which of the following statements is correct?

   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 Written representations acknowledge responsibility for financial statements by management.
   C Written representations need not be obtained on representations which were previously made verbally by management.
   D By obtaining a written representation the auditor automatically gets reasonable assurance about the effective working of the internal control system.

Answers to Quick Quiz

1.
   (a) Analytical procedures
   (b) Observation and Inspection

2. The auditor members of audit staff should have knowledge of the business for the following reasons:

   (a) 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.
   (b) To assess the inherent and control risks.
   (c) To determine the nature, timing and extent of audit procedures.
   (d) To evaluate audit evidence.
   (e) To make judgments about many matters throughout the course of the audit.

3. 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.

4. The correct option is **A.**

   Written representations acknowledge responsibility for the financial statements by management. The auditor should obtain representation from management when the matter is judgmental.

5. The correct option is **B.**

   Option A is incorrect as 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.

   Option C is incorrect as representations need to be obtained on verbal representations which were previously made by management.

   Option D is incorrect as written evidence can be considered sufficient and appropriate only if it is corroborated.

   Therefore, the reliability of the representation needs to be tested by the auditor.

Self-Examination Question

Question 1

Karl & Sons are appointed as the auditors of Norman Pharma this year. Norman Pharma is a pharmaceutical company which has a monopoly in producing medicines on AIDS. Norman Pharma has its manufacturing unit in Belgium and it has sales networks all over the world. There is a sales office in every country, which co-ordinates with the sales personnel of the country and the head office in Belgium.

As it is the first year of audit, Karl first has to obtain an understanding of the organisation. He finds that manufacturing unit has about 3,000 workers. The plant and machinery installed are complex and large scale. Norman is a well-known business tycoon and all the leading business magazines contain news of Norman. He has been in the news because of a legal case which was brought by a hospital in Nigeria against Norman Pharma for supplying substandard medicines which, it is claimed, killed a patient.

Required:

(a) Explain four factors involved in obtaining an understanding of the entity and its environment including its internal control system.
(b) Explain how the auditor will obtain an understanding of the entity and its environment based on risk assessment procedures.

Answer to Self-Examination Question

Answer to SEQ 1

(a) The factors that are involved in obtaining an understanding of the entity and its environment including the internal control system are:

(i) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework affecting the operations of the entity
(ii) Nature of the entity, including the entity's selection and application of accounting policies. (iii) Objectives and strategies and significant business risks of the entity
(iv) Measurement and review of the entity's financial statements
(v) Internal control

(i) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework affecting the operations of the entity

Industry conditions

Karl should obtain a basic knowledge the industry in which Norman Pharma is operating. This will include the competition in the market and the technological and other developments in the industry and their impact on the entity.

Regulatory environment

This includes accounting principles and industry specific practices, legislation and regulations applicable and affecting the entity, government policies and taxation and, for a regulated industry, the regulatory framework. While obtaining an understanding of the entity, Karl has to understand that the business of the entity is worldwide which means that international standards of auditing and accounting should be applied. He should consider the laws and regulations of the country in which the head office is situated and the regulations set up in the IAS. The auditor should also know the laws and regulations of each country where the entity is operating and find out whether or not all the applicable provisions are complied with.

(ii) Nature of the entity

Business operations

The auditor should obtain an understanding of the nature of Norman Pharma i.e. whether it is a manufacturing, trading or service unit and in which product the entity deals. The auditor should also obtain an understanding of the operations of the entity i.e. geographic dispersion, involvement in electronic commerce etc. The auditor should understand that its operations are worldwide and involve commerce, technological developments etc. and the entity has a monopoly and does not have any joint venture, subsidiary or any transactions with any other related parties. This helps identify the risk associated with these factors. The auditor should also obtain an understanding of the investment and financial activities and financial reporting framework of the entity.

(iii) Objectives and strategies and significant business risks of an entity

The auditor should also obtain an understanding of the objectives of Norman Pharma, the strategies to achieve these objectives and the risks associated with those objectives. Karl should obtain an understanding that the entity has a monopoly. Hence, the entity may be ruling the market by dictating its price or may be receiving a subsidy from the government to control the price.

(iv) Measurement and review of the entity's financial statements

This includes analysis of the performance of the entity. Karl should obtain an understanding that the business is doing very well, as it is has a monopoly. However, he has to analyse, identify and estimate the risks to the entity from government interventions, the policies of other countries and the reputation of the entity, as it is involved in a legal suit.

(v) Internal control

Karl should obtain an understanding of the internal control system. Since the organisation is very big and its operations are spread over different countries, the internal control system needs to be good and effective. But, of course, might not be.

(b) Obtaining an understanding of the entity and its environment based on risk assessment procedures

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

(i) Inquiry of management and others within the entity

This includes Inquiry of the staff including the management workers, legal advisors etc. The person(s) consulted depends on the type of information required.

Those charged with governance

The financial reporting framework can be audited after obtaining an understanding of it by consulting those charged with governance. Also, discussion with the audit committee will help the auditor to know the weaknesses in the internal control system, which has already been communicated to the audit committee.

Internal audit personnel

Inquiry of the internal audit department will also enable the auditor to determine the attitude of management towards the internal control system.

Employees

The practical problems of implementation of any policy can be identified and understood while interviewing the employees. This will also enable the auditor to identify the potential risks. This will give him an understanding of the operations of the Norman Pharma, 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.

Legal counsellor

Karl should get full first-hand information from the legal advisor of the entity as to whether or not all the laws and regulations have been complied with. He should also try to get an understanding of all the pending litigations against the entity as to how they will be settled and what impact they will have on the financial statements of the entity.

Marketing or sales personnel

Karl has to understand the risk of sales promotion of the entity. With the establishment of the Malaysian government's venture, Norman Pharma will no longer enjoy a monopoly and this will affect its sales figures. Hence, the entity should concentrate on promoting its sales by advertising or using its client and dealer base.

(ii) Analytical procedures

Analytical procedures will help the auditor to identify any unusual items. For this, Karl will have to compare the previous year figures with the currently available figures. The auditor will consider the items which raise a doubt or suspicion in his mind.

(iii) Observation and inspection

This is regarded as one of the best methods of obtaining an understanding of the entity and its environment. Observation includes observation of entity activities and operations and visits to the entity's premises and plant facilities. A better understanding can be obtained when observing the actual performance. Hence, Karl should arrange for surprise visits to the manufacturing unit to any department to obtain a better understanding or he can be present on the day of physical count of the inventory. However, he should not let the workers feel that they are being observed as this could make them behave in a cautious manner.

STUDY GUIDE C3: BUSINESS RISKS AND RISK OF MATERIAL MISSTATEMENT

Get Through Intro

“Planning is an essential stepping stone to business success!” Audit assignments are the commercial activities of an audit firm. Audit planning should be viewed as a structured plan of action to map the audit procedures to be carried out for effective and timely completion of audit. The auditor must decide his strategy with regard to the nature, timing and extent of the audit work to be carried out before the actual work begins. Without a proper plan, which is changed according to the findings during the audit procedure, audit resources will not be used optimally.

For example: in the absence of a proper plan and guidance, the junior auditors of an audit firm adopt an audit approach where equal prominence is given to all areas of the audit. At the last stage of the audit, the senior partner finds that the concerned company had excellent internal controls and a risk-based approach should have been adopted. In this case, a lot of time, effort and money are wasted because the firm did not prepare / review the audit plan during the audit procedure.

This Study Guide discusses some very important aspects of risks and business process effectiveness which need to be assessed by the auditor at the planning stage of auditing.

Learning Outcomes

a) **Evaluate and explain how business process effectiveness may affect an assignment.**
b) **Identify and evaluate the risks arising in a business scenario from accounting manipulation, error, fraud or other irregularities.**
c) **Identify and evaluate the risks arising in a business scenario from business and financial issues.**
d) **Identify and explain appropriate procedures for assurance engagements for corporate social responsibility and sustainability reports.**

1. Evaluate and explain how business process effectiveness may affect an assignment. [Learning Outcome a]

1. Business process

An organisation can be thought of as being a collection of people working towards achieving a shared objective and purpose. In addition it can also be described as being a resource processing machine. By this what is meant is that an organisation will take resources such as labour, money, materials etc and through its processes convert them into usable products / services.

The processes of an organisation represent how an organisation controls / wants its work to be done. More specifically as Davenport states they are "a specific ordering of work activities across time and space, with a beginning, an end, and clearly identified inputs and outputs". For instance ordering raw materials from a supplier would be an example of a process for a manufacturing organisation.

Business processes therefore then become sets of logically related tasks that use an organisation's resources to provide the goods / services its customers want and will enable the organisation to achieve its objectives. For instance developing and marketing a new product would be examples of business processes for a FMCG (fast moving consumer goods organisation).

A business process can be considered effective if the entity achieves its desired objective through the spending of available funds.

2. Reasons for ineffective business processes

Business processes become ineffective on account of:

(a) Existence of fraud, error, waste, inefficiency and carelessness of staff in various critical operations of the entity
(b) Unforeseeable events such as fire, earthquakes, riots etc.
(c) **Inaccurate records, data and statements caused due to fraud or error**

In order to ensure that the various operations of an entity are effective and lead to the achievement of its objectives, entities implement a system of internal controls.

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 auditors to determine the extent of testing to be carried out so as to ensure that there is no risk of material misstatement.

3. Internal control

Internal control is a process which is implemented by those charged with governance, management and other personnel. It provides a reasonable assurance regarding the achievement of the objectives in the following categories:

(a) Efficiency and effectiveness of operation
(b) Reliability of financial reporting
(c) Compliance with applicable laws and regulations

4. Tests of control

Definition

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.**

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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5. Effect of effectiveness of business process on an assignment

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 (Tshs)**
Sales	850	755,000
Sample selected for testing controls	75	165,000

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.

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6. 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.

From the above, we can conclude that in areas where controls on business processes are effective, the auditor will perform less extensive substantive procedures. However, in business processes where controls are less effective, the auditor will carry out extensive substantive procedures.

Test Yourself 1

Your firm has recently been appointed as auditor to Bouche Ltd, a private company that runs a chain of small supermarkets selling fresh, frozen food, canned and dry food. Bouche 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 would be the audit strategy adopted by the auditor to test inventories.

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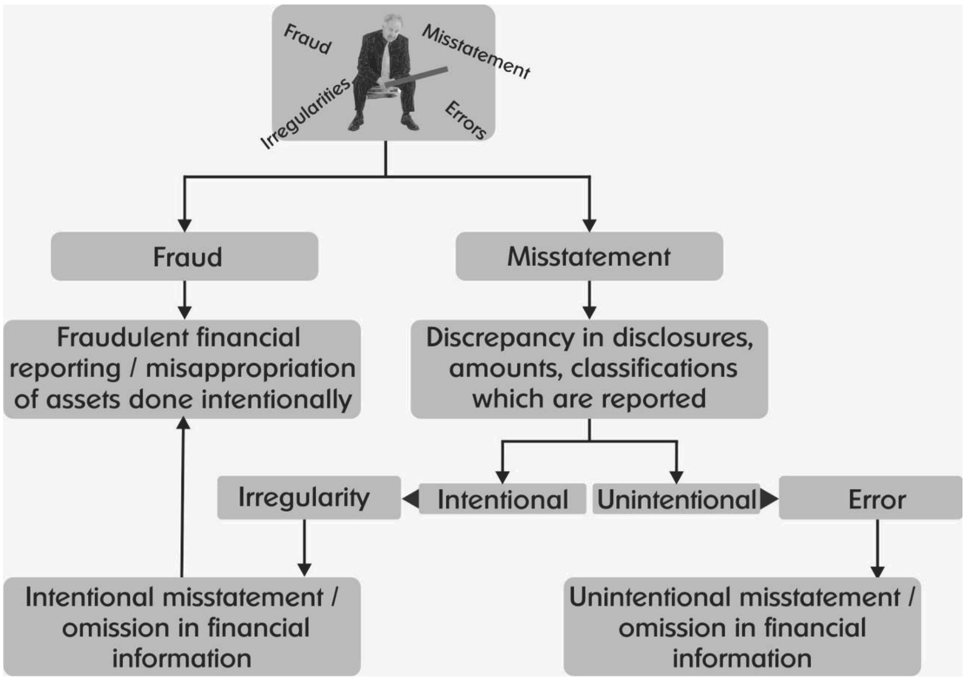
2. Identify and evaluate the risks arising in a business scenario from accounting manipulation, error, fraud or other irregularities.

[Learning Outcome b]

Diagram 1: Classification of fraud, misstatement, irregularity and error



2.1 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

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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:

(a) Inaccurate collection and processing of data in the financial statements
(b) Omission of an amount or non-disclosure of any fact
(c) Incorrect accounting estimates- by overlooking or misinterpreting facts
(d) Management's accounting estimates considered unreasonable by the auditor
(e) Management's adoption and application of accounting policies considered inappropriate by auditor

3. Fraudulent financial reporting

This means manipulation, i.e.

(a) 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.

(b) 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.

(c) 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:

(a) Theft of assets e.g. inventory, cash or non-current assets of the entity.

(b) 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.

(c) Making a payment for goods and services not received. For example, making payments to fictitious employees.

(d) Using the entity's assets for personal use e.g. employee's family members using the company car.

5. 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.

2.2 Auditing with professional scepticism

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.

2.3 Risk of material misstatement

When financial statements contain either false or missing information, they are said to contain misstatements. Misstatements are generally caused either due to fraud (i.e. they are intentional in nature) **or error** (i.e. unintentional mistakes).

Materiality refers to misstatements that either individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. (Materiality is discussed in detail in Study Guide C4). Therefore the books of account containing material misstatements (resulting from fraud or errors) cannot produce true and fair financial statements. Thus, the auditor’s opinion on the true and fair nature of the financial statements would be based on an examination of the books to discover any fraud or errors.

The risk of material misstatement is an important concept for auditors. It decides the audit approach and the nature, timing and extent of audit procedures. For a specified acceptable level of audit risk, if the risk of material misstatement is greater, the auditor has to gather a greater quantity and quality of evidence. In addition, for greater risk of material misstatement, they have to apply greater professional scepticism.

In accordance with ISA 315, the auditor identifies and assesses the risk of material misstatement due to fraud

2.4 Risk of material misstatement at the financial statement level

1. Meaning

The risk of material misstatement at the financial statement level refers to **risks that relate pervasively to the financial statements as a whole and potentially affect many assertions.** These risks are not specific to any assertion but have an overall effect on the financial statements.

Pervasive to financial statements means that the misstatements affect various elements of the financial statements.

Financial statements are a summary of management’s assertions. Assertions can be of the following types: Occurrence, Completeness, Accuracy, Valuation and allocation, Cut-off, Classification, Existence, Rights and obligations and Understandability. The assertions are what each figure in the financial statements proclaims.

Example

An entity does not consolidate the financial statements of a subsidiary (acquired during the current year) because it has not yet been able to ascertain the fair values of a few of the subsidiary’s material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under IFRS, the subsidiary should have been consolidated because it is controlled by the company.

Had the subsidiary been consolidated, many elements in the financial statements would have been materially affected. This is a misstatement at the financial statement level. The incorrect consolidation affects the following assertions: valuation and obligation, completeness, rights and obligations, accuracy, classification and understandability of financial statements.

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2. Response to risks

Some of the following methods are used by the auditor to address risks of material misstatements at the financial statement level:

Emphasising to the audit team the need to maintain professional scepticism in gathering and evaluating audit evidence

Assigning more experienced staff, or those with special skills, or using experts

Example

Harry has been auditing Brown Bells Ltd. He has assessed the risk of material misstatements as high. During the year, the factory building has been revalued at Tshs2 million. Instead of relying on management’s estimate, Harry should insist on obtaining an independent appraisal of the building to verify that its true value is indeed Tshs2 million.

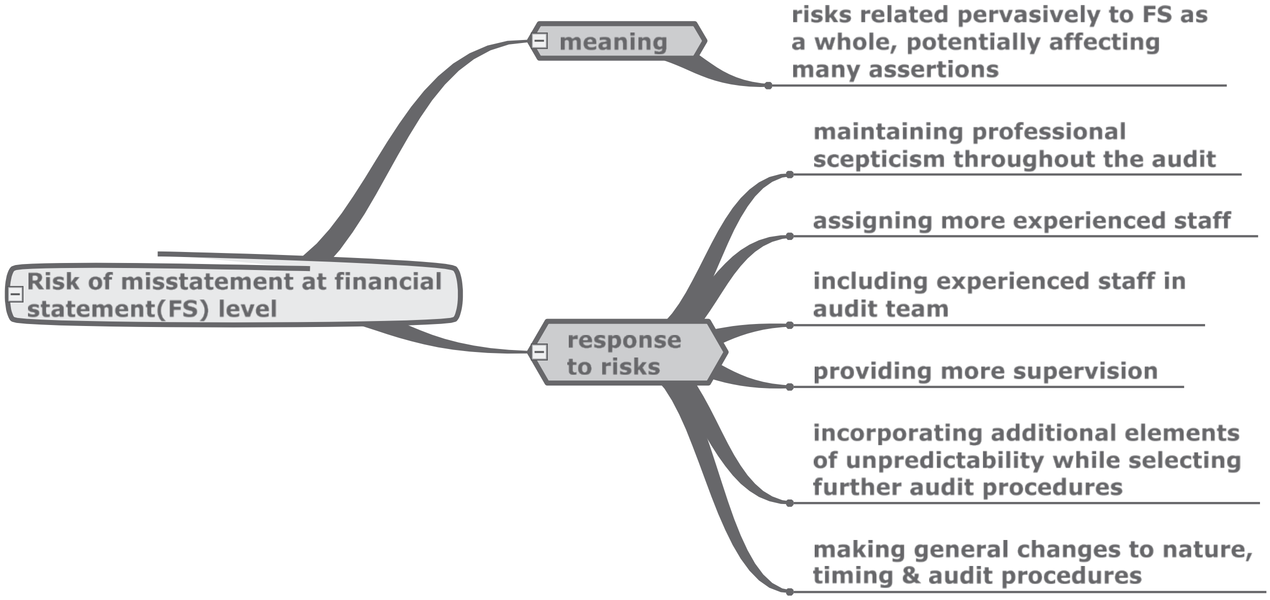
Including qualified / experienced people in the audit team instead of using an unqualified / inexperienced person

Providing more supervision

Incorporating additional elements of unpredictability in the selection of further audit procedures. For example surprise inventory verification, cash counts

Making general changes to the nature, timing and extent of audit procedures as part of the overall response to the risks identified at the financial statement level. For example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence

SUMMARY



2.5 Risk of material misstatement at the assertion level

1. Meaning

In addition to determining the risk at financial statement level, the auditor should also determine risks at the assertion level.

Definition

Assertions: representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

ISA 315

Definition

Risk of material misstatement: the risk that the financial statements are materially misstated prior to audit. This consists of two components: inherent risk and control risk. (Discussed in detail in Study Guide C1

IFAC Glossary of terms

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2. Risk factors affecting the assessment of individual account balances or transactions

(a) Complex calculations and transactions
(b) Changes to the IT system.
(c) Technological developments can cause overvaluation of inventories.
(d) Time pressure on preparation of the financial statements
(e) Inexperienced staff
(f) Pressure to perform.
(g) Risk of loss of assets like cash, inventory on account of theft.
(h) A lack of sufficient working capital to continue operations.

(i) Any account balances which require estimates or judgments such as provision for warrantees, provision for doubtful debts and pension provisions.
(j) Poor internal control

3. Response to risks

In response to the assessed risks of material misstatement at the assertion level, the auditor should design and perform further audit procedures. For this, the auditor should consider the following:

(a) The **significance** of the risk i.e. what impact the risk will have on the financial statements
(b) The **likelihood** that a material misstatement will occur i.e. whether the probability is remote, possible or almost certain; this is generally expressed in percentages
(c) The **characteristics** of the class of transactions, account balance or disclosure involved
(d) The **nature of specific controls** used by the entity (and whether it is manual or automated)
(e) Whether the auditor expects to obtain audit evidence to determine if the entity's controls are effective in preventing, or detecting and correcting, material misstatement

Example

Delicious is a speciality shop which deals mainly in cheeses, meats and fruits. Sandy is the auditor of Delicious. Sandy has assessed that the main risk associated with Delicious is that the inventory items regularly go bad. If the food goes bad, it will results in write-offs in the financial statements. Once the risk is identified, Sandy should determine the probability of its occurrence. In the absence of internal controls, it is extremely likely that the inventory items will go bad.

The auditor identifies the following controls:

Ensuring only required amounts of inventory are ordered
Keeping items in special refrigerators
Examining on a daily basis to ensure that food has not gone bad

The auditor should check the following:

Any food thrown out should be signed for by the manager
The quality of inventory not discarded
Purchase invoices to ensure that food is in the quantity and quality that was ordered

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The auditor's assessment of the risks identified at the assertion level provides a basis for considering the appropriate audit approach such as the nature, timing and extent of audit procedures.

Nature: may prefer substantive procedures rather than tests of control

Timing: may prefer to perform audit procedures at the period end (e.g. attending physical verification at the period end rather than at the interim period)

Extent: may prefer to perform extensive audit procedures and try to obtain more extensive audit evidence (e.g. including deciding to visit more client locations)

2.6 Risks arising in a business scenario from accounting manipulation, error, fraud or other irregularities

Example

Cornonation Co is coal mining company. It is a listed company. It has branches in various countries and other business connections with these countries. Cornonation presently extracts coal from eleven mines, eight of which are taken on lease. Each mine requires cranes, drilling equipment etc.

Each mine is depreciated on the number of units produced method. The life of the mine, i.e. the period over which it is estimated that coal can be extracted, is assessed annually. One of the mines owned by Cornonation has been flooded due to heavy rainfall. The mine has suffered substantial damage. As a part of its expansion programme, the management of Cornonation wants to raise additional capital by issuing equity shares. Grace has been appointed as an auditor of Cornonation.

Continued on the next page

Required:

Identify the audit risks related to Cornonation at financial statement level and at assertion level.

Answer

The audit risks (at financial statement level and at assertion level) relating to Cornonation, as identified by Grace, is as follows:

Audit risks: financial statements level

Being a listed company, the management of Cornonation will have to comply with the stock exchange's various requirements. In addition, the management has the pressure to meet the expectations of users, especially the shareholders' expectations. This increases the risk that the management may manipulate the figures to show a positive picture of Cornonation.

Since the management of Cornonation wants to raise additional capital by issuing equity shares, there is a possibility that the management may try to show Cornonation in an attractive financial position through creative accounting in order to attract more investors.

Cornonation has business connections outside the country and therefore is exposed to economic instability, currency fluctuation and inflation / recession. In addition, it has to comply with the disclosure requirements of various countries.

Assertion level risks

The useful life of mines may be misstated and therefore the valuation could also be wrong. Since the management estimates the useful life of the mines, Grace should check the basis for estimation. The useful life of each mine may be different but it should be properly estimated and reflected in the financial statements. The depreciation should not be overstated or understated. The value of the mine which is damaged may be overstated. If it is damaged beyond recovery, it should be derecognised in the books of Cornonation and the loss should be recognised. Even if it is not entirely damaged, its useful life may be reduced and therefore it should be valued appropriately based on the proportion of the mine that is still functioning.

If the mine that has been flooded with water, Cornonation has to extract water from the mine for which additional expenses may be incurred. Cornonation should make a provision for this in the financial statements. Grace should consider this while checking expenses and provision. Cranes and drilling equipment at each mine could be misstated. These items should be depreciated over their useful life.

Leasehold mines may not be accounted for properly. Grace should go through the lease agreements and find out whether each lease is an operating lease or a finance lease, and whether it has been properly classified and accounted for by Cornonation.

Test Yourself 2

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 Pearl Plc (for whom he has been the auditor for the last 5 years) an organisation that manufacturers and sells LCD televisions. Pearl has managed to increase their turnover from Tshs50 million to Tshs75 million and has just started to diversify into cosmetics.

Andrew has also recently taken on a new client, Dollar Bank. Dollar 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 Pearl's audit manager for the last five years, he is completely familiar with their accounting procedures, policies and internal controls of Pearl. 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 Dollar 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 the factors which could give rise to audit risk for both entities.

2.7 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.**

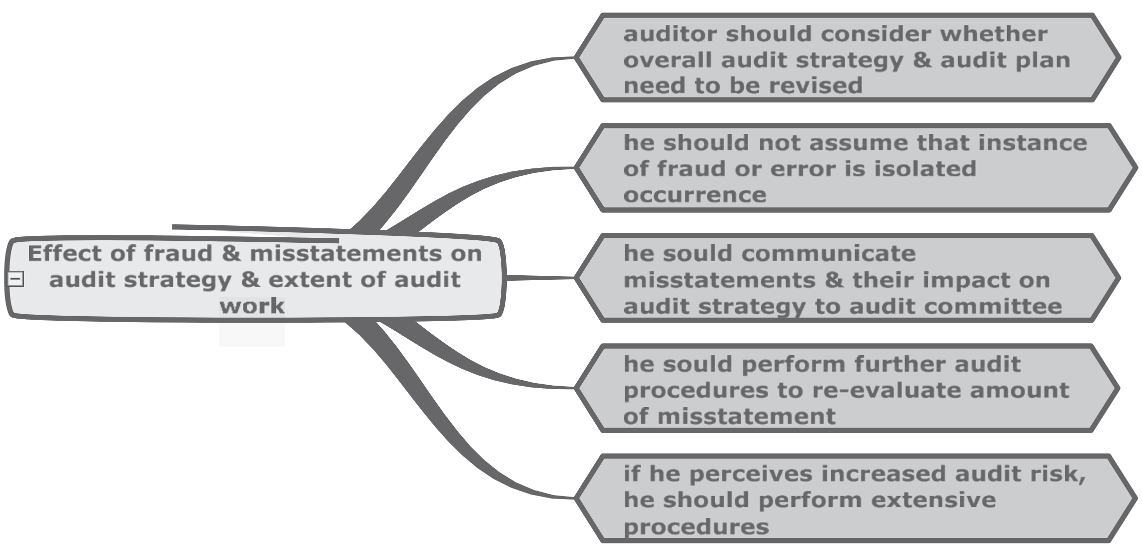
The audit committee should ask management to examine a class of transactions, account balances or disclosures to identify and rectify misstatements therein. After the examination and rectification by management, the auditor should **perform further audit procedures to re-evaluate the amount of misstatement.**

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 Tshs. 200,000 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 Tshs 200,000 and the total impact of such errors is to the tune of Tshs. 1,000,000.

Accordingly, he needs to reassess the risk of material misstatement and revise his audit plan.

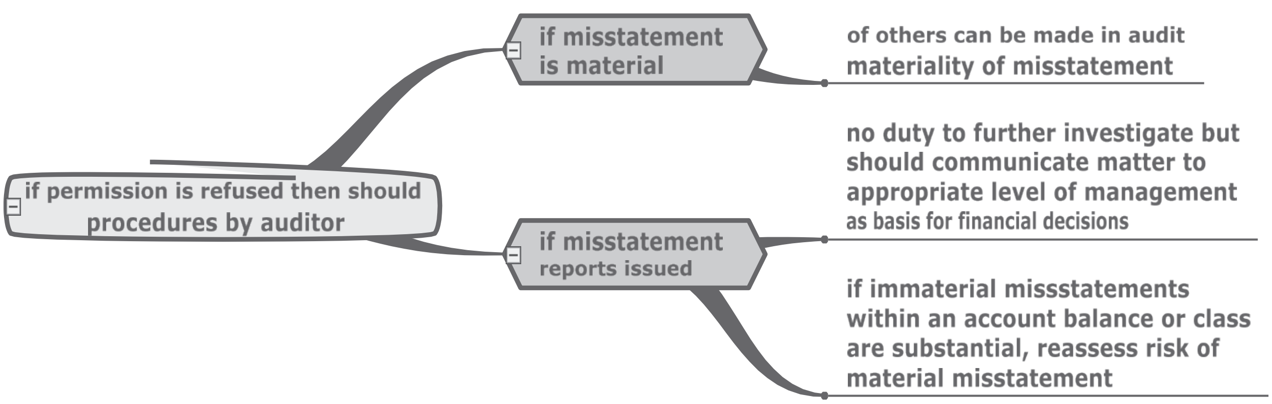
If non-compliance with the laws and regulations has no *direct* effect on the financial statements, the auditor should consult an expert to determine the effect of such non-compliance. If, in the opinion of the expert, non-compliance could have an impact on the financial statements or the going concern 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 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



2.8 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.

3. Identify and evaluate the risks arising in a business scenario from business and financial issues.

[Learning Outcome c]

3.1 Business risks

1. Meaning and types of business risks

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.

IFAC, Glossary of terms

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 Smith Ltd. Smith 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).

Business risks include any external or internal factors that affect the entity's ability to survive and be profitable.

Business risk may arise, from:

The development of new products or services that may fail;
A market which, even if successfully developed, is inadequate to support a product or service; or
flaws in a product or service that may result in liabilities and reputational risk.

2. Types of business risks

Business risks may relate to the following:

(a) Market risk

Market risk, better known as financial market risk, is the risk that the market prices of shares, bonds, currency holdings, options, derivatives or other asset values and commodities that are used by a company as instruments of working capital or short-term finance will change adversely and impact profitability, working capital liquidity and availability of finance.

SUMMARY

Many companies hold financial assets, either to maintain liquidity, to generate returns on working capital reserves, to speculate for gains, to build up investment funds or to act as hedges against other financial risks or as components in a portfolio of short-term financial investments. The impact of the market risks can also be on the management of other risks and can hence lead to the creation of liabilities.

Example

Money.Com Plc holds £80,000 as foreign currency holdings. The currency market has been extremely volatile in recent months since there is a threat of war. The risk may lead to a loss of $1 million. When the market risk is so high it will lead to a liquidity risk that the business will not have enough money in the short run.

As a result of this risk, the company cannot attempt to manage the smaller operational risks such as the risk of an increase in the working capital loan. This risk can be mitigated by increasing the product prices in the short run to recover the increased interest from the customers. However, in this case there is a possibility of losing customers since they may prefer substitute products with lower prices. This will again affect the share prices since the company's sales will decrease.

Market risks cannot be managed since they are outside the control of the organisation. Examples of such risks are interest rate risks and demand and supply issues in the national and global financial markets that lead to fluctuations in the prices of the shares, bonds etc.

Market risk discussed until now has been mainly the financial market risk. However, **market risk can also be related to risks within the goods or service markets in which a company operates**, either as a supplier or customer.

(b) Credit risk

Businesses are generally operated on a credit basis. **Credit risk is the risk that accounts receivables will not meet their obligations on time**. Credit risk impacts the business on a day-to-day basis since the recovery of dues from customers is affected.

Management of credit risk is carried out using techniques such as discounting bills of exchange, export credit insurance, export factoring and documentary credits. Credit risk has a particularly strong impact affects when the company exports products and does not receive payments on time.

The credit risk faced by an entity also depends upon factors such as the volume of credit sales made, the terms of credit offered to customers, the credit limits offered to various customers and the credit assessment procedures followed by the company to decide the credit limit and terms of credit to be offered to a particular customer. These are the internal measures that the company has control over and hence, if managed properly, may reduce the credit risk.

Credit risk may adversely affect cash flow and may require additional financing. Since credit risk may involve customers then there may be a risk that revenue streams may be lost and that operational overcapacity may result. There are immediate risks to operating profit and, in the longer term, to gross margin and contribution.

Example

The risk of accounts receivables not paying their debts on time can be high in the export market. In this case, if the company takes out export credit insurance, it will mitigate the risk in the case of late or non-payment.

(c) Liquidity risk

Liquidity refers to the non-availability of cash or cash equivalents in the business. The **liquidity risk refers** to the risk that the business will **not have enough liquidity to fulfil its current liabilities**. In other words there is a **mismatch between the inflows and the outflows** and the cash flow statements may be at a risk of showing a negative cash flow. This risk is the result of having insufficient cash or bank balance. Instead, the business may have illiquid assets that cannot be converted into cash quickly. Assets at times might not realise the expected value due to a lack of demand or the need to obtain funds quickly. Liquidity risk also arises due to the unavailability of easy loans in the market.

Example

In 19W0, the Bank of New England faced insolvency, because the foreign exchange and interest-rate derivatives held by it faced potential losses and severe illiquidity. Financial crises in Asia and Russia (along with certain other causes) in 19W8 led to a decline in liquidity and caused the collapse in values of several prominent hedge funds, including Long-Term Capital Management, and sizable losses at many major financial institutions.

The currency risk is the risk associated with fluctuations in foreign exchange rates. This risk is related to the liquidity risk since a company's foreign currency holdings are subject to fluctuations in exchange rates. Interest rate risk is the risk that the interest rates will rise or fall leading to gains or losses. This risk arises due to borrowing and lending. In the above example of the Bank of New England, the bank's liquidity was threatened due to its investments being exposed to currency and interest rate risks.

SUMMARY

Liquidity risk can refer to the risk of insolvency but is more likely to mean that working capital will require an injection of funds from the sale of an asset or the raising of longer term finance. If short-term facilities such as an emergency overdraft are required these may come at a high price and may be payable on demand, create additional risks for the future.

Liquidity risk may affect credit ratings and the ability to raise future finance.

Example

If a company's liquidity position deteriorates then banks and financial institutions may decline any credit facilities to the company, taking into account the poor repayment capacity. This is because if a company has a poor repayment capacity, its credit ratings will decrease and hence it will not be able to attract sufficient capital.

(d) Technological risk

Technological risk is the **risk that technology will change and will adversely affect the organisation**. Technological risk also creates opportunities for a business in that it gives the business the opportunity to innovate and advance its systems in line with changes in the market. Technological risk is associated with the various hardware and software technologies which the business uses. The advance in the technology will affect the business adversely if the technology base used by the organisation is not updated. Problems associated with updating the business systems are as follows:

- If the business adopts the new technology too early it may have to spend much higher amounts on the installation than would have been required had the business waited for the correct time.
- A delay in the adoption of a new technology is also a risk since a competitor may adopt it and thereby gain a competitive advantage.

Recent comments by former United Nations Secretary General Kofi Annan over the role of genetically modified seed in African agriculture have reopened debate over the risks posed by new technologies. This is another perspective on the technological risks that products that are produced using innovative techniques might not be accepted in the market.

(e) Legal risk

Legal risk arises when new laws, standards, codes and regulations are introduced or the existing ones are changed. The failure to adhere to the laws, regulations and codes may attract fines, penalties and damage to public reputation.

Businesses face this risk since they operate within the legal and regulatory parameters as responsible corporate citizens. They have a responsibility towards promoting lawful behaviour. The legal issues might involve employment issues, environmental legislation, health and safety and many more key areas.

Corporate governance codes are a part of the reporting regulations that a company needs to follow. Legal risk is largely associated with the risk of the regulatory and political environment in which an organisation operates.

Example

Bars and restaurants may have to train staff, provide facilities, enforce regulations and put notices in place as a result of laws that prohibit smoking in certain public places. They may also need to consider the strategic impact on their revenues if smokers change their habits.

SUMMARY

(f) Health, safety and environmental risk

These are threats to people and the environment arising from **defects in the design of products, processes** and **activities** or the **failure to manage processes and activities.** These failed processes may lead to adverse effects on the business.

Example

Industrially advanced countries often take advantage of their bargaining position to export hazardous products that are either banned or heavily regulated in the exporting countries. By doing so, they increase the risk to health, safety and the environment in the importing countries.

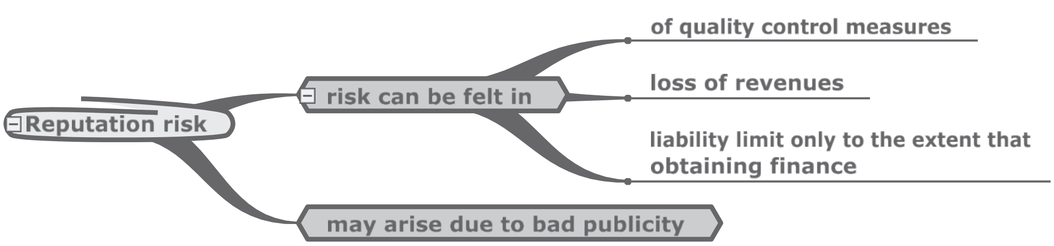
The impact is similar to that mentioned under legal risk. Industries such as agriculture, farming, chemical, mining and transportation are generally largely exposed to this type of risk. These industries pollute the environment the most and hence face a higher risk of being adversely affected. Waste disposal techniques should be appropriate in such cases in order to cause minimal harm to the environment.

(g) Reputation risk

Damage to reputation can arise out of almost all of the other risks. The damage can affect any stakeholder and their attitude towards the company. Damage to reputation can be felt in reduced customer loyalty, loss of revenues and difficulty in securing supplies or obtaining finance. Damage to reputation may cause the share price to fall.

Reputation risk can also arise due to bad publicity against the company. The reputation risk may result in a major loss of goodwill towards the company.

SUMMARY



(h) Business probity risk

Probity is about honesty and integrity and ultimately the risk here is the risk of fraud. Lack of integrity or perceived lack of integrity in business dealings can lead to damage to reputation. Fraud may have many consequences depending on the nature of the fraud.

Example

The following are some examples of fraud that may lead to a risk to business probity:

- Theft by customers or staff
- Theft by management
- Illegal transactions
- Bribes
- Deception
- Aggressive earnings management and window dressing
- Misleading statements to auditors and regulators
- False accounting

SUMMARY

Fraud is undertaken for many reasons including:

- Personal gain
- Corporate gain
- To cover up theft or other fraud
- To manipulate financial reports
- To distort markets

Directors at times may easily indulge in activities in their own self-interests rather than in the interests of the company. This is because they are in possession of sensitive information that can be shared with market competitors to earn a lot of money.

(i) Derivatives risk

Derivative risk is the risk related to derivatives, which are complex financial instruments that offer the potential to hedge other financial risks that are driven by interest rate, foreign currency rate and other financial issues.

Derivatives are however risky instruments with a high rate of return. The attractive returns on these derivative instruments generate a temptation to buy these instruments. However these instruments induce the investor to speculate rather than to hedge. If the derivatives are not properly structured, residual risks remain. Hedges only cover foreseen risks.

Example

John expects that six months from now the price of the US dollar with respect to the Canadian dollar will be higher than it is today, and would like to purchase US $1,000 six months from now at today's rate. Suppose the current price of US $1,000 is CAN $1,200.

In order to reduce the loss that may incur if the US dollar rate falls instead of rising, John enters into another forward contract to sell the US $1,000 at the current market today. This is a hedging technique used to mitigate the loss that may be incurred.

(j) Entrepreneurial risk

Risk which is related to any new business opportunity or new business enterprise is known as entrepreneurial risk. The risk could relate to uncertainties about entrepreneurial skills, unknown market competition, uncertainties in product design and manufacture and so on.

Example

Nimble is a finance company that borrows funds from the public as well as from small institutions and invests them in various kinds of market securities such as mutual fund schemes, shares and bonds. Nimble is one of the largest finance companies in Europe and has many branches spread all over Europe.

Nimble is presently facing several problems e.g. most of Nimble's competitors have adopted advanced technologies in their organisations which enable them to update the daily market conditions whereas the technologies that Nimble has installed are inadequate for this purpose. This is adversely affecting Nimble's business. Nimble has a strong team of analysts who invest customers' funds in the capital and the money markets. However these markets, by their very nature, are known to be very risky. Moreover there is a threat of emergency rule being imposed in the country and hence the stock markets have become very risky.

Required:

State the risks that the company is facing and the measures it should take to reduce these risks.

Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:

Details	Potential related business risk
Industry developments	The entity does not have the personnel or expertise to deal with the changes in the industry.
New products and services	There is increased product liability.
Expansion of the business	The demand has not been accurately estimated.
New accounting requirements	Incomplete or improper implementation or increased costs.
Regulatory requirements	There is increased legal exposure.
Current and prospective financing requirements	The loss of financing due to the entity's inability to meet requirements.
Use of IT	Systems and processes are incompatible.
The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements	Incomplete or improper implementation.

3. Financial risks

These are the risks arising from the way in which a business 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. Business risks also include financial risks.

These risks are sometimes categorised into the following:

(a) Capital: this risk is largely concerned with gearing, i.e. the mix of long-term debt and equity or shareholders' funds financing used to fund fixed asset, acquisition, development and project investment.

(b) Liquidity: this risk is concerned with the way in which cash, overdrafts and financial instruments are used to provide short-term liquidity for working capital purposes.

Example

If a commercial enterprise invests a lot of money in capital market instruments such as shares, stocks but a lower amount in bonds there is a risk that when the markets go against expectations the company might lose money. This risk increases if the company does not have balanced investments i.e. balance in the amount invested in low risk investments such as bonds as well as high risk investments.

(c) Foreign currency: when an entity trades with an overseas customer or vendor, there is a risk that the amount to be paid in domestic currency will change due to variations in the foreign currency rate. This risk is to be managed appropriately using techniques such as hedging.

(d) Interest rate risk: when an entity has debt liabilities / assets, it is exposed to interest rate risk. This is because it may contract the deal at a certain rate of interest, for certain duration. However, the actual interest rate during that agreed duration may be different from the contracted rate. This risk is also managed by using hedging techniques.

SUMMARY

4. Compliance risk: these risks arise from non-compliance with 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.

These risks are sometimes categorised into the following:

(a) Reporting: this risk is concerned with possible misstatement in external communications to stakeholders and shareholders including issues of truth, fairness and whether information is properly reliable and informative.

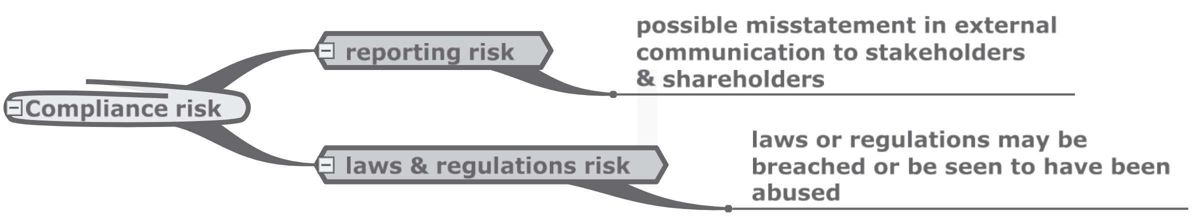
(b) Laws and regulations: this is concerned with the risk that any laws or regulations may be breached or be seen to have been abused.

Example

Reporting risk may arise if there is a failure to report on a specific issue such as the quality inspection followed at the various stores of the commercial enterprise before any of the products are displayed for sale in its shops.

The commercial enterprise may fail to follow the laws of health and safety under the state laws applicable if the suppliers supply them with substandard products for sale.

SUMMARY



Example of risks arising in a business scenario from business and financial issues

Example

Trend Plc sells designer wear in Mexico. Its designer wear is very popular in Mexico and the business is doing well.

In a recent board meeting, the following decisions were taken:

To trade in leather accessories and jewellery
To sell overseas
To sell through the Internet

The catalogue for the designs of all the products hosted on the website will be updated every six months.

Required:

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

Continued on the next page

Answer

The business risks involved in the decisions taken during Trend's board meeting include the following:

1. Trading in leather accessories and jewellery

(a) Although, Trend 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.

(b) Products which Trend 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.

(c) 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.

2. Selling overseas

(a) Although Trend's products are popular in Mexico, it is new in the global market and therefore has to face all the risks associated with being a new competitor i.e. competition from existing major competitors in the world market.

(b) When a business operates in the world market, it has to face the risk of currency fluctuation risk i.e. change in exchange rates.

3. Selling through the Internet

(a) The nature of Trend's business is such that it may face difficulty in selling its products through the Internet. This is because, while purchasing clothes, accessories, and jewellery, customers want to see, touch and feel them. In selling through the Internet, they will lose the ability to do this and therefore Trend may lose its existing customers.

(b) In addition, existing customers may not have Internet access or may not like shopping through the Internet; in such a case, Trend may lose its existing customers.

(c) The company may face resistance from employees. Employees who are totally out-of-touch with the concept of e-shopping may feel that they will be made redundant in this move.

(d) E-shopping may result in an increase in the price of the products and therefore Trend may have to struggle in its existing market.

(e) E-shopping will need considerable investment. It will need technical support and staff time to convert design and information relating to accessories, jewellery etc. into electronic form (e.g. scanning the designs).

(f) Internet technology is a fast-changing technology and needs to upgrade frequently to stay up-to-date. Technological skill is required for this.

(g) The Internet involves the additional risk of threats from hackers and computer viruses. The examples of risks involved in using the Internet are as follows:

  (i) Difficult to establish the identity of the customer, as a result of which, a fictitious person may disguise himself as a genuine customer and order goods which he will not payment for.

  (ii) Through hacking, competitors or other interested parties may obtain confidential information.

  (iii) As a result of possible Internet fraud, the customer may have to suffer and this will result in a loss of goodwill.

4. General

(a) In line with the above mentioned three decisions, Trend may need to change its various systems such as management information system and internal control system. As a result of this, risk is involved about checking the efficiency and effectiveness of the system being new in operation.

(b) Trend has to comply with international regulations since it is starting its business globally. In addition, it has to meet provisions relating to import and export. The company could face additional allegations for dealing in leather.

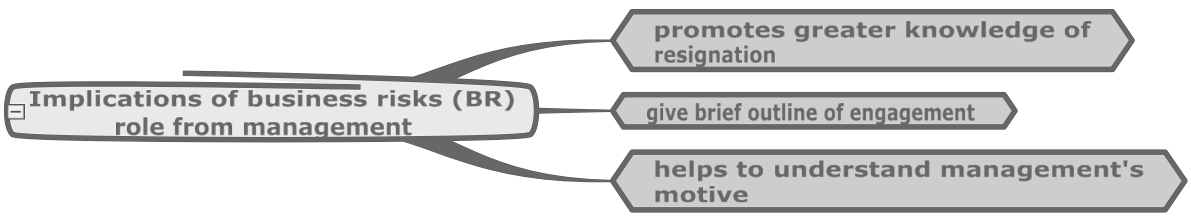
Business risks are important considerations at the planning stage. They allow an auditor to:

Understand the business
Decide the level of audit risk
Identify the scope of audit

While planning the audit, the auditor has to consider the following in relation to risk:

Does the management have an effective system to identify business risk?
Is there any financial risk e.g. lenders are no longer interested in financing the entity?
Is the control environment good? Is the internal control system effective?
Is the accounting system adequate?
Do any risks threaten the going concern status of the company?
What strategy has the management adopted to manage the risk (ways to manage risks include reducing the risk, transferring the risk, avoiding the risk or accepting the risk)?
Can the management manage risk effectively?

SUMMARY



3.2 Audit risk

Tip

Audit risk = Inherent risk x Control risk x Detection risk
In practice, an audit risk can also occur if the auditor gives a qualified opinion, when the financial statements are not misstated.

Audit risks are discussed in detail in Study Guide C1.

3.3 Relation between business risks and audit risks

From the definition of inherent risk, control risk and detection risk, it is clear that inherent risks and control risks are risks related to business and need to be managed by the management. **Inherent and control risks are risks related to business and therefore are business risks**. Hence, business risk is a much broader concept than audit risk.

In short, all these risks are interrelated. Most business risks lead to financial statement risks as a result of which audit risk (including detection risk) is affected.

While assessing audit risk, an auditor may assess the risks separately as inherent risks and control risks or may assess them together as risk of material misstatement. However the audit risk exists only in relation to the opinion given by the auditors. For example, the auditor provides an unqualified opinion although the audit evidence obtained by the auditor indicates that the audit opinion requires being qualified.

3.4 Relationship between business risks and financial statement risks (also referred to as risk of material misstatement, discussed in Learning Outcome 2)

Some business risks may lead to financial statement risks.

Example

Esteem Club Plc is a hospitality service provider and runs a chain of clubs, one of which is situated in a small town near London. The club provides restaurant services, bar services, lodging and boarding facilities, a swimming pool and recreation facilities such as boating, billiards, tennis, cards room etc. It has recently obtained permission from the state **to sell alcohol in its club**.

The business risks and related financial statements risks of this can be:

Business risks	Financial statement risks
The permission to sell alcohol in the club may be misinterpreted as being applicable to all the facilities that the club provides, whereas the company is actually allowed to sell alcohol only in the bar area. Hence, here there is a risk that the club will face severe penalties from the state since if it sells alcohol in areas that it is not permitted to sell in.	Breach of regulation may require paying a penalty. However, provision relating to breach of regulation may not be made. This means that the profit may be understated
In the restaurant, employees may misappropriate food items and indulge in fraud.	Fraud may remain undetected and therefore loss arising from such fraud may remain undisclosed in the financial statements

3.5 Significant risk

Definition

Significant risk: an identified and assessed risk of material misstatement that, in the auditor's judgement, requires special audit consideration.

IFAC Glossary of terms

As a part of the risk assessment, the auditor should determine whether any of the risks identified are, in the auditor's judgement, significant risks e.g. a particular inventory, or a particular receivable. While doing this, the auditor should exclude the effect of identified controls related to risk.

To decide whether a risk is a significant risk, the auditor should consider the following, at a minimum:

- Whether it is a risk of fraud
- Whether it is related to recent significant economic, accounting or other developments
- The complexity of transactions
- Whether the risk involves significant transactions with related parties
- The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual

If the risk is identified as a significant risk, it requires special audit consideration.

Apart from the risk assessment procedures mentioned above, the auditor can gather information from the following sources to obtain an understanding of the entity and the industry in which the entity operates:

- Auditor's previous experience with the entity and its industry
- Visits to the entity premises and plant facilities
- Auditor's firm industry expert
- Industry surveys
- The 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

Karma is a manufacturer of wooden and steel furniture. It produces all kinds of furniture, such as office furniture, home décor and school furniture. Karma's customers include big business houses, schools and individual clients.

Recently Karma has made an agreement with a big construction company, BSK, for providing furniture for their upcoming commercial site (i.e. an IT Park). The site contains 110 offices for various companies and, according to the contract; Karma is required to provide furniture for each office.

The accounting policy statements for such contracts in Karma's financial statements are as follows. The direct

cost incurred to this contract includes the following:

- Fees of furniture designer
- Material used for furniture
- Labour cost (i.e. carpenters)
- Transportation cost of resources to the site
- Insurance and telephone expenses

Charlie is an auditor for Karma. He has been auditing Karma's financial statements for the past two years. While auditing last year's financial statements, Charlie found that Karma's sales returns amount increased significantly. It was also found that most of the clients failed to pay on time, because of which Karma is facing a working capital problem and cannot pay the suppliers on time. Customers were not satisfied with Karma's work and alleged that Karma used low quality materials for its furniture.

Required:

Identify and explain the principle audit risks to be considered while planning Karma's audit.

---

4. Identify and explain appropriate procedures for assurance engagements for corporate social responsibility and sustainability reports.

[Learning Outcome d]

1. Meaning of Corporate social responsibility (CSR) and sustainability

Corporate social responsibility stands for the responsibility taken by the organisation relating to the impact of its activities on customers, employees, shareholders, communities and the environment in all aspects of its operations. This obligation extends beyond the statutory obligation to comply with legislation. In this case, organizations take voluntary steps to enhance the quality of life for employees and society at large.

Sustainability refers to the ability of meeting present needs without compromising on the capability of meeting the needs of future generations. It refers to policies and practices adopted by organisations which ensure that the rate of resource utilisation matches the rate at which they can be replenished.

Example

The following are the sustainability indicators of Super Oil Company:

- Managing the emission of carbon dioxide and other greenhouse gases from refinery activities
- Minimise the spills from oil tankers
- systematic approach to managing environmental impacts, using the required safety, health and environmental management systems
- not exploring the use of oil and gas in natural world heritage sites
- continuing to develop cleaner fuels

Sustainability reporting as defined by GRI is the practice of measuring, disclosing, and being accountable to internal and external stakeholders for organisational performance towards the goal of sustainable development.

A corporate social responsibility report contains details of the CSR activities (including all sustainability related issues) carried out by the company. These are generally referred to as sustainability reports now.

2. Reporting on sustainability of development and CSR

Traditional accounting methods include measuring the company's economic activity with respect to assets purchased / used, liabilities and expenses incurred and income earned. However, such accounting practices do not look at the results of economic activities on those assets which do not belong to the organisation, such as water, minerals, etc. and the liabilities that it does not have to pay, such as waste generated and emissions made. In short, such accounting methods do not examine the environmental and social impact of economic activities.

3. CSR audit

(a) Formal auditors are appointed. They can be internal or external auditors however, companies who adopt ISO 14000 must appoint independent external auditors as prescribed by the authorities. Normally, such an audit deals with:

(i) Compliance audit: to confirm that the organisation complies with all environmental regulations and policies and procedures set up by the organisation

(ii) Waste management

(iii) Adequacy of costing records to determine the various environmental and social factors.

(iv) Checking the accuracy of the information which is published by the company in the sustainability report

(v) Producing an Environmental Impact Assessment (EIA): an important management tool for ensuring optimal use of natural resources for sustainable development. It aims to predict environmental impacts at an early stage in project planning and design, find ways and means to reduce adverse impacts, shape projects to suit the local environment and present the predictions and options to decision-makers. The EIA process is also subject to audit.

(vi) Producing a SWOT (Strength, weakness, opportunity and threat) analysis of the internal and external environment. Such an analysis enables an organisation to match its resources and capabilities with the environment in which it operates. It is a useful tool in the strategic planning process. SWOT analysis is a strategy used in audit.

(b) Auditing an organisation's policies, procedures and impacts relating to employees, customers, suppliers and environment. Therefore it covers the sustainability report relating to the environment and society.

The CSR reports are part of the voluntary disclosures made by management in its annual reports.

4. Auditing techniques

A good audit will include some of the following methods:

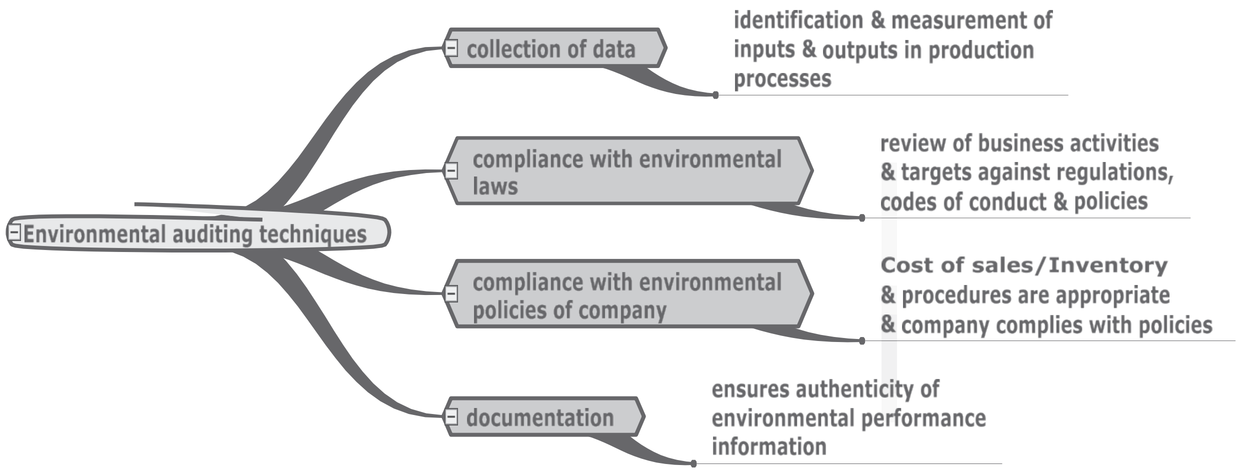
(a) Collection of data: this involves identifying and measuring all inputs and outputs in the various production processes. It thereby provides the information needed for comparison against targets. Such information can be used to determine the areas for improvement.

(b) Compliance with environmental laws: this requires a review of the company's activities and business targets against all relevant regulations, codes of conduct and government policies.

(c) Compliance with environmental policies of the entity: this also involves determining whether the policies and procedures are appropriate (i.e. meet with the environmental standards and laws and customers needs) and confirming that the company complies with the policies.

(d) Documentation: this requires documentation of all aspects of the audit such as audit planning, audit charter (scope of activities), all types of tests which are part of audit evidence, all supporting documents for policies, procedures, etc. The documentation adds credibility to the environmental performance information which is made available to regulators and the general community.

SUMMARY



Example

Sustainability audit is a management tool that integrates all three dimensions of sustainability: economic, social and ecological.

The steps involved in sustainability audit and review are as follows:

Identification of sustainability issues within the organisation

The first step for any organisation on the journey towards sustainability is to identify what sustainability issues are present within the organisation. This will span all three sustainability pillars of community, economy and environment. The audit and review process here will assess the extent to which sustainability issues have been properly assessed by the organisation.

Sustainability performance measurement and trends

Once the sustainability issues have been identified within an organisation, appropriate performance indicator can be established. The assessment process will test for these and how relevant they are to the sustainability issues that have been identified.

Sustainability goals, stakeholder engagement, linkages and systems thinking

Once an organisation has identified its sustainability issues and selected some performance indicators, attention can be directed towards setting goals for sustainability. This will need to take into account stakeholder views and links with the wider world. The assessment process here tests for the presence of organisational sustainability goals and its understanding of the wider world.

Values and community issues

Values are crucial in the behaviour of both organisations and individuals. They have to be real and not just recommended. Over time, human values have weakened and the result is a weaker and impoverished world. Good sustainability values will take an organisation towards better decisions. For example an organisation that is solely profit driven and has little or no consideration towards the wider society is unlikely to be sustainable in the longer term.

The audit and review process for values tests for the values that are present in an organisation. This will commence with an assessment of the ability of an organisation to articulate its values. This can best be assessed by what top management has to say and the extent to which this feels real. If top management does not fully believe in a particular value, it has little or no consequence.

Change management processes towards sustainability

Sustainability means change and the previous steps provide the basis for the change process. Auditing and review here will test for the change management programmes and the extent to which they are being implemented.

Continued on the next page

Vision and the future

Vision provides the leadership for an organisation. The audit and review process will test for the presence of a vision for sustainability and the extent to which the organisation is able to deliver on the vision. The vision may be included within a policy document.

Governance and sustainability audit

Governance involves the setting of policies and procedures that determine what an organisation does in terms of sustainability. The governance process may take the form of an oversight and scrutiny committee within local authorities. The assessment process will test for the presence of such functions.

Test Yourself 5

Briefly describe the advantages and disadvantages of a CSR audit.

Answers to Test Yourself

Answer to TY 1

Inventory will be a significant component of Bouche's financial statements. Therefore, it will be necessary to carry out tests of control on inventories. Furthermore, t**he auditor will have to perform tests of control throughout the accounting period, because when tests of control are performed at a particular time, the auditor only obtains audit evidence that the controls operated effectively at that time**.

Furthermore, efficiency of controls in the area of inventory can be reinforced only if the controls in the areas of purchases and sales are also effective. Therefore, tests of control will be performed in the areas of purchases, sales and inventories. If the controls in all the areas are effective, the auditor can perform less extensive substantive procedures. However, if the controls are ineffective, the auditor will perform extensive substantive procedures.

Answer to TY 2

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 Pearl 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 Dollar 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 Pearl 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 Pearl Plc and Dollar 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 Pearl 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 TY 3

Nimble is one of the largest finance companies in Europe. It borrows funds and invests them in a variety of securities. It has branches all over Europe. Recently, the company has been facing a problem of technological risk. Technological risk is the risk that technology will change and will adversely affect the organisation. On the other hand, technological risk also provides the business with the opportunity to innovate and develop its systems in line with changes in the market. Technological risk is associated with the various hardware and software technologies which the business uses. If the technology base used by the organisation is not updated, an advance in technology will adversely affect the business.

Nimble is facing a technological risk as most of its competitor companies have adopted technologically advanced software whereas Nimble has not yet done so. As a result, unlike its competitors, Nimble is unable to receive accurate information from reliable sources about the current market conditions. This is affecting Nimble's business. So, to remain in competition, Nimble must adopt the latest software in order to keep up-to-date with current market conditions.

The company is also facing the problem of market risk. Market risk is the risk that the market prices of shares, bonds, currency holdings, options, derivatives or other asset values and commodities that are used by any company as instruments of working capital or short-term finance will change adversely and impact profitability, working capital liquidity and the availability of finance.

Nimble is facing a problem of market risk as it is investing its customers' funds in the capital and money markets, which are known to be very risky. Furthermore, the stock markets have become even more risky as there is a threat of emergency in the country. To mitigate this risk, while investing in various kinds of funds Nimble should take into consideration all future as well as current market conditions, so that it can predict the future market conditions.

Answer to TY 4

Audit risk

The audit risk refers to the risk of wrong presentation of an organisation's financial statements by an auditor. The

following are the audit risks that Charlie should consider while planning Karma's audit:

The increasing cost of wood is one of the inherent risks for Karma. If it increases and Karma cannot increase its sales prices, Karma may not be a going concern.

The depletion of resources (i.e. forests) also needs to be considered as an inherent risk factor.

An inappropriately skilled labour force will cause heavy losses for Karma, which will mean losses, so returns will have to be examined carefully. If this continues, it may cause a **going concern risk.**

Investment in this industry is very large and, therefore, if periodical returns on investments are not achieved then it can lead to a **going concern risk**.

Accurate customer billing and timely completion of the project will reduce Karma's going concern risk. This is because it may result in timely recovery and could lower the risk of bad debts.

Charlie is required to ensure that internal control operations are in place and should also assess the internal control system.

Charlie can also assess financial records, personnel and physical properties, which have a material effect on the financial statements.

Charlie also needs to check the material cost, as poor physical control over materials' requisition may be misstated.

He is also required to check compliance with the required laws and regulations.

If there are any major financial reporting fluctuations, such as unusual losses or potential losses or significant deviations from peer financial performance, they should be brought to the attention of the board of directors.

Answer to TY 5

The **benefits of CSR audit** include the following:

It enables the organisations to determine the impact of their activities on the environment. (a) It enables the

organisations to Identifying problems before they occur.

(b) It enables the organisations to highlight areas of inefficiency in the various operations of business e.g. whether the levels of pollution exceeded the statutory norms.

(c) It enables the organisations to enhance its accountability to the stakeholders.

(d) It enables the organisations to determine whether they are living up to the values that they advocate.

(e) It enables the organisations to ensure compliance with environmental regulations: it is an effective risk management tool for confirming compliance with environmental legislation, and therefore assisting companies avoid the risk of prosecution and fines arising from potential environmental breaches.

(f) It enables the organisations to gain financial benefits by making production more efficient and reducing wastage.

(g) It enables the organisations to cultivate an enhanced brand image and better public relations.

(h) It enables the organisations to have the basis for making changes to existing environmental policies. (i) It

enables the organisations to educate stakeholders about environmental issues.

Disadvantages of social and environmental audit include: (a) cost

(b) Disruption of normal operations

(c) Liabilities brought on by the discovery of violations of environmental rules e.g. negative image, fines, loss of business / clients

Quick Quiz

1. **State whether true or false.**

   Once prepared, the auditor cannot revise the audit plan.

2. **Match the items in column A with the items in column B.**

A	B
(a) Financial risk	1. A risk that the auditor will fail to uncover irregularities or misstatements in the FS.
(b) Inherent risk	2. A risk that an entity faces due to an inadequate internal control system.
(c) Control risk	3. A risk that an organisation faces because of the business it is in and the nature of the industry.
(d) Compliance risk	4. A risk arising from the way in which a business is financed.
(e) Detection risk	5. . A risk caused due to non-compliance with required laws and regulations

3. What is financial statement risk?

Answers to Quick Quiz

1. **False**. An audit plan can be revised in response to a change in materiality or a change in the assessment of the risk of material misstatement changed.

2.

   (a) A risk arising from the way in which a business is financed.
   (b) A risk that an entity faces because of the business it is in and the nature of the industry. (c) A risk that an organisation faces due to an inadequate internal control system.
   (d) A risk caused due to the non-compliance of the required laws and regulations.
   (e) A risk that the auditor will fail to uncover irregularities or misstatements in the FS.

3. Financial statement risks refer to the probability that financial statements that are made available to the public, shareholders and the regulatory authority are materially misstated.

Self-Examination Questions

Question 1

Smokeronni Plc is a tobacco company which manufactures different varieties of cigarettes. The company has recently launched a range of cigarettes targeted at women. These cigarettes have become very popular and sales have increased by 15% in the last quarter. Certain organisations are spreading awareness of the ill effects of cigarettes on women's health. These organisations are spreading a bad image of Smokeronni since the company produces a range of cigarettes that is targeted at women and is quite popular in the market. This is a risk to the company's reputation. The company was until now paying a 35% income tax, but the authorities are likely to increase this to 40% in the next financial year, 20X8.

Smokeronni has come up with a special division to manufacture the range of cigarettes for women. The division has been set up within the factory premises but as a separate unit distinct from the main factory building. The contract for the construction of the unit had been given to a contractor who worked along with his team of 10 workers at the site to erect the structure. The state laws applicable to Smokeronni required the company to take out a health insurance policy for all employees who work on the company's premises.

The administrative department took out an insurance policy for the employees working in the various departments of the tobacco factory. However, the law required that it should also have taken out an insurance policy for the workers working on the construction site of the new division. There was a misinterpretation of the law in this case. The company's lawyer is in talks with government authorities and there is a possibility that the company might have to fund the health insurance of the workers who worked on the site.

Required:

What are the various risks that the company is facing considering the given information?

Question 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 Self-Examination Questions

Answer to SEQ 1

Smokeronni Plc is a tobacco company, which is exposed to many inherent risks such as political risk, legal compliance risk and health and safety risk. Moreover tobacco being bad for health there is the constant threat of reputation risk. According to the given information, the risks that the company is facing can be listed as follows:

1. A social organisation is creating bad publicity for the company. This is a reputation risk for the company. The bad publicity may result in a reduction in sales and hence there is a risk that the increased sales may not be maintained in the coming financial year.

2. The state authorities are likely to increase the tax rates on cigarettes and this is a political risk since the company might have to pay higher amounts to the government authorities. This will reduce the distributable profits of the company.

3. The company has insured the health of all its employees but the law requires that anyone who works on the premises should be insured. There is a legal compliance risk in this case since the company has misinterpreted the law and hence has insured only those people who work in the factory.

4. Apart from this, the company also faces a risk related to the health and safety of its employees who work in the factory since tobacco is harmful for the health of employees.

Answer to SEQ 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.

SECTION C

PLANNING AND UNDERTAKING AUDIT WORK

C4

STUDY GUIDE C4: MATERIALITY

Get Through Intro

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 entity to entity.

This Study Guide explains how to calculate the materiality levels from financial information and the effect of materiality and judgement on the nature, timing and extent of audit work carried out.

Learning Outcomes

a) **Analyse and evaluate how risk and materiality judgments affect the planning of an assurance or audit engagement, including the nature, timing and extent of work.**

b) Evaluate and apply judgments and measures of materiality in carrying out an audit or assurance engagement.

c) Specify and explain in accordance with appropriate local legislation and international auditing and Assurance standards the steps and procedures for audit and assurance work in the private and public sector.

1. Analyse and evaluate how risk and materiality judgments affect the planning of an assurance or audit engagement, including the nature, timing and extent of work.
Evaluate and apply judgments and measures of materiality in carrying out an audit or assurance engagement.

[Learning Outcomes a and b]

1.1 Materiality

The concept of materiality is a fundamental consideration in all auditing procedures and practices.

The dictionary defines the term materiality as **'important or essential'**. ISA315, Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement defines materiality as follows:

Materiality can be explained in simple terms as follows:

1. **Misstatements, including omissions**, which either individually or in aggregate, could reasonably be **expected to influence the economic decisions of users** taken on the basis of the financial statements

2. Judgements about materiality are **affected by the size or nature of a misstatement**, or a combination of both; and

3. judgements about matters that are material to users of the financial statements are **based on a consideration of the common financial information needs of the users** as a group.

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.

Tip

Professional judgement is affected by the auditor's perception of the financial information needs of users of the financial statements.

Materiality is not an absolute term and must be understood in its relative context. This means that the same item of the same magnitude may be material to one entity and non-material to another. The auditor decides what material is and what is non-material. This is a relative term which differs from entity to entity and may also differ from year to year.

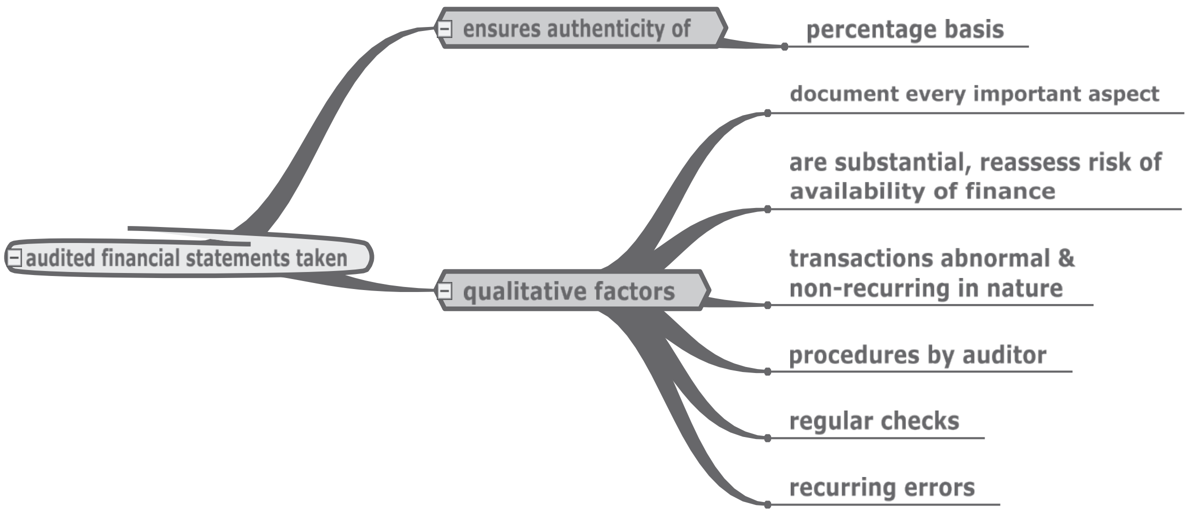
An auditor needs to consider materiality throughout the audit process i.e. while planning, while performing audit procedures, in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and also while giving an audit report.

1.2 Determinants of materiality

Materiality is considered at the overall financial information level, as well as 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. These factors have already been covered in detail in Paper B3. The following summary will help you revise these factors.

In order to ensure that the audit is conducted efficiently, it is important that materiality is assessed based on the latest (and most reliable) available financial statement.

SUMMARY



1.3 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:

1. The **elements of the financial statements** (e.g. assets, liabilities, equity, revenue, expenses).

2. 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).

3. The **nature of the entity, the industry and economic environment in which the entity operates.**

4. 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

5. The relative volatility of the benchmark.

The following benchmarks are often used, and acceptable in your 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 financial information of Esteem Co for the year ended 31 March 20X9:

	Tshs million
Revenue	700,000
Profit before taxation	8,200
Total assets	450,000

Continued on the next page

Preliminary materiality can be calculated as follows:

Revenue		Profit before taxation		Total assets	
Benchmark	Tshs million	Benchmark	Tshs million	Benchmark	Tshs million
0.5%	3,500	5.0%	410	1.0%	4,500
1.0%	7,000	10.0%	820	2.0%	9,000

Materiality cannot 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 Tshs4,500 million and Tshs7,000 million.

Furthermore, materiality must also take into account the qualitative factors (discussed below). Materiality is based on the auditor's judgement so different auditors may set different materiality limits on the same data.

Tip

Materiality is calculated based the above method. In addition, 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

1.4 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.

1.5 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:

1. The performance materiality would have to be revised and
2. 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 Tshs10,000,000 and performance materiality at Tshs9,000,000. 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 Tshs8,000,000. The auditor also determined that the performance materiality would also have to be revised downwards to Tshs6,000,000. The reduction in the material measures means that the auditor would have to perform more extensive audit procedures on revenue.

1.6 Application of materiality in financial reporting and auditing

In an audit, materiality should be considered by the auditor when:

1. Planning i.e. determining the nature, timing and extent of audit procedures
2. Reporting i.e. evaluating the effect of misstatements

When planning, the auditor determines the materiality, considers materiality with audit risk, and decides the nature, timing and extent of audit procedures. This is because it is not practical for an auditor to perform 100% of an audit. His duty is to confirm that the financial statements are not **materially** misstated. Therefore, he does not need to concentrate on matters that do not affect the financial statements materially.

Therefore, when planning an audit, the auditor considers what would make the financial statements materially misstated. The auditor's assessment of materiality, related to specific account balances and classes of transactions, helps the auditor to select audit procedures that, in combination, can be expected to reduce audit risk to an acceptably low level.

Example

When an auditor has obtained an understanding of the entity he is auditing and the industry in which the entity is operating, he may find that there is recession in the industry as a whole. However, the entity shows a very good growth rate. In such a case, the auditor should consider revenue a material item and should plan to check it extensively.

While applying materiality, the following points should be considered:

The **size, nature of the item** and its impact on the financial statements
Some matters, individually or **in the aggregate**, are important for the fair presentation of the financial statements taken as a whole
it should be considered at both the **overall financial statements level** as well as in relation to **an individual account balance**

Materiality has an impact on in the following:

Planning audit procedures: at the planning stage, an auditor sets levels of materiality and performance materiality on the basis of which the nature, timing and extent of audit procedures are decided. If an item is material, extensive audit procedures should be planned to be performed.

Deciding the sample size: for material items, a larger sample size is selected.

Assessing the risk: audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Materiality and audit risk are considered throughout the audit in order to reduce audit risk to an acceptably low level.

Deciding tolerable misstatement: the tolerable misstatement is the maximum amount to which an auditor can accept the errors and conclude that he can provide reasonable assurance that the financial statements are free from material misstatements. Materiality helps to decide the tolerable misstatement.

Example

The auditor of Raka Plc set materiality at 0.2% of sales turnover (Tshs1,000 million) for marketing expenses. Accordingly, he accepts errors in marketing expenses to the extent of Tshs2 million as tolerable in order to provide reasonable assurance that the financial statements are free from material misstatements.

Evaluating the results and reporting: at the review stage of an audit, the auditor should evaluate the sufficiency and appropriateness of the evidence obtained, in light of materiality. If he finds that the evidence obtained is not sufficient and appropriate, he may have to carry out additional procedures. If the auditor is unable to obtain sufficient appropriate audit evidence on a material financial statement assertion, the auditor should express a modified opinion.

While considering the potential impact of the misstatements, the auditor should not only consider the amount, but also the qualitative nature of such misstatements, for example, whether the material items are disclosed in the financial statements in accordance with the statutory or IFRS requirements.

Example

The unaudited financial statements of Champion Plc show a profit of Tshs500,000 and a turnover of Tshs500 million. During the course of the audit, a misstatement (overstatement of sales) of Tshs10 million is noticed by the auditor. The management has not adjusted the difference in the financial statements by saying that, considering the Champion's turnover, the figure is immaterial.

During his 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 Tshs500,000, the financial statements will show a loss of Tshs9.5 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.

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 aggregate of uncorrected misstatements that have been identified during the audit is material.

The auditor should obtain management representation stating that the aggregate of uncorrected misstatements are not material. However, obtaining management representation does not relieve him from his responsibility of obtaining additional evidence; therefore he 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, he 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 Tshs5 million (total receivables are Tshs400 million)
- An overstatement of sales by Tshs10 million (total sales are Tshs5,000 million)
- An overstatement of inventory by Tshs2 million (total inventory are Tshs1,500 million)

In this case, as the management considers these misstatements immaterial (individually as well as collectively, Tshs17 million i.e. Tshs5 million + Tshs10 million + Tshs2 million) it does not correct them.

In this case, the auditor should obtain a representation from the management that "it believes that the effect of the uncorrected financial statement misstatements aggregated by the auditor are immaterial both collectively and individually."

Under the following cases, the auditor may extend his audit procedures to reduce the risk or ask the management to adjust the financial statements:

- When an auditor concludes that the aggregate of unadjusted differences is material
- When the aggregate of the unadjusted differences is not material but approaches materiality, and could exceed the material level when aggregated with the undetected differences

If the management refuses to adjust the financial statements and the auditor, as a result of extended procedures, concludes that the unadjusted difference is material, he should consider modifying the audit report.

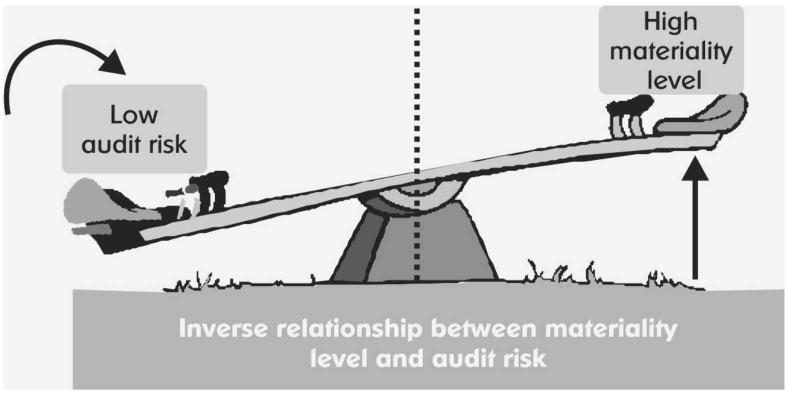
1.7 The impact of assessments of risk and materiality on the audit procedures

While determining the nature, timing and extent of audit risk, an auditor has consider both materiality and audit risk. This is because the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, Audit risk is the risk of giving a wrong audit opinion, however to do that there has to be a material error in the financial statements.

Therefore audit risk is defined in terms of a 'material misstatement'. Hence from both a theoretical and practical perspective, it is not possible to discuss audit risk in a meaningful way without linking it to the level of materiality.

Audit risk is a function of the risks of material misstatement and detection risk. Diagram 1: Inverse

relationship between materiality level and audit risk



Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

There is an inverse relationship between materiality and the level of audit risk, that is, if audit risk has been evaluated as being low, we can set a high materiality limit as we feel there will be less misstatement or error. Conversely, if audit risk is evaluated as high, a lower materiality level will be set as the auditor will feel that there may be more misstatements.

Example

Crystal Ltd is a company selling electronic goods such as televisions, refrigerators and washing machines. Sandra is Crystal's external auditor. She has assessed the audit risk as low. This is because Sandra has noticed that the internal control system is very effective and an internal audit is conducted every year and all the major areas are checked by the internal auditor at least once every two years. In addition, the management is very effective and takes appropriate actions on suggestions made by the internal auditor.

Since the audit risk is assessed as low, Sandra will set the materiality level as high. This means that the amounts below the materiality level will not have material impact on the financial statements.

Materiality and audit risk are to be considered at all stages of audit like:

- Identifying and assessing the risks of material misstatement;
- Determining the nature, timing and extent of further audit procedures and
- Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

As the audit progresses, the auditor needs to assess whether materiality and audit risks (determined at the planning stage) have changed or not.

Therefore, if **after planning for specific audit procedures, the auditor determines that the acceptable materiality level is lower than it was before, and that the audit risk has increased, the auditor should compensate for this by either**:

(a) Reducing the assessed risk of material misstatement, where this is possible, and supporting the reduced level by carrying out extended or additional tests of details.

Example

Linda has been auditing Kohinnoor Co, manufacturer of plastic furniture. Materiality has been set at Tshs. 5,000,000. However, Linda is aware of the fact that the audit risk has increased as a result other factors that have come to light during the audit (a fraud). But, in order to compensate the increased audit risk, she has decided to reduce the assessed risk of material misstatements.

Earlier on the basis of results of tests of control (on the basis of evaluation of the internal auditor's work which is performed in-house), she has assessed that there is a significant risk of misstatement in the inventory. In order to reduce this, she has decided to perform additional tests of detail such as agreeing the entries in the inventory ledger with the source documents. By doing this she can reduce the overall audit risk).

(b) Reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.

As the audit progresses, the auditor may need to change the nature, timing and extent of audit procedures, in response to the change in the auditor's assessment of materiality and the audit risk determined at planning stage.

1.8 Reasons for changes in the auditor's assessment of materiality and audit risk

The reasons for changes in the auditor's assessment of materiality and audit risk determined at planning stage are as follows:

1. a change in circumstances

Example

PNG & Co has been auditing Lasco, a listed company. As Lasco is a big company, PNG has decided to perform a continuous audit for the year ended 31 December 20X7 and accordingly planned to audit PNG from 1 May 20X7. At the planning stage, materiality was decided at Tshs10 million and an audit was planned and performed accordingly. However, on 5 August 20X7, Lasco acquired Nasco (a company established outside the country). As a result of this, Lasco's materiality and level of audit risk will change. This is because, with the acquisition of Nasco, Lasco will be exposed to other risk areas such as changes in foreign exchange rates, changes in ownership patterns and changes in employees.

As a result of the acquisition, capital structure and turnover etc. will also change.

2. a change in the auditor's knowledge as a result of performing audit procedures

Example

B-safe is an insurance company. Leander is an auditor for B-safe. This is the first time he is auditing an insurance company. Money laundering is a crime in the country in which B-safe operates. At the time of planning, Leander does not notice the money laundering legislation that applies to B-safe. However, while performing the audit, he comes across a transaction which he suspects involves money laundering. Then he notices the money laundering legislation that is applicable to B-safe. These factors change Leander's assessment of materiality and audit risk.

Sometimes, in order to reduce the likelihood of undiscovered misstatements and to provide the auditor with a margin of safety, the auditor intentionally set the acceptable materiality level at a low level initially.

Let us look at a comprehensive example on materiality and audit risk.

Example

Formax Plc manufactures and sells electronic goods such as mobile phones, CDs, pen drives etc. and is a wholly owned subsidiary of a well-known group. Marshal is the managing director of Formax and has been for the last 20 years. The company has decided to bring an issue into the market i.e. to issue equity shares and raise money.

Formax acquires Expro on January 20X8.

During a board meeting in June 20X8, the management decides to close one of the company's branches. The revenue from this branch is Tshs800 million. The company provides Tshs380 million for the compensation of employees in that branch. There will be no other major, direct effect on Formax.

Hillary has been reappointed as an auditor for the year ended 30 June 20X8. She has decided that, since Formax is a large company, she should start the audit before the period end. Accordingly, she starts the interim audit on December 20X7. She decides that, since financial statements for the current year are not available and there are no significant changes in the nature of Formax's business and accounting system, preliminary materiality would be same as that of the previous year i.e. Tshs100 million.

Initially, while planning, the auditor has assessed that the controls at the branch are effective and therefore has decided to carry out less substantive procedures for the branch.

The following information relates to Formax: Total revenue Tshs53,600 million
Total assets Tshs42,800 million
Profit before taxation Tshs2,300 million

Formax's management is of the opinion that Hillary does not need to check inventory since it has an effective in-house system for inventory. However, during the course of the audit, Hillary notices that security tags are not attached to all the assets and, sometimes, inventory items are mixed up with the items to be used as assets, such as pen drives, CDs and mobile phones.

Required:

Identify how, during the audit, the audit risk and materiality will change from what was planned, and explain the impact of this on the audit procedures determined at the planning stage.

Answer

Hillary may identify the following risks related to the audit of Formax.

Sale depends upon the current market trend. In Formax's industry, technology is changing very fast. Therefore, while valuing the closing inventory, Hillary should check the management's estimates for slow moving items and their valuation. Slow moving items should be valued at fair value. The auditor should gather sufficient appropriate audit evidence for valuation of inventory, perhaps by researching the market to identify the price of such products. Hillary should also check the obsolete inventory.

Initially, Hillary may assess the risk related to inventory (other than that for slow moving items) at a low level, as she felt the internal controls over inventory were effective.

Materiality

On the basis of the previous years' experience, the materiality (which is set before the year-end) has been decided at Tshs100 million.

Continued on the next page

Subsequent change in materiality and risk

However, subsequently, materiality will change in accordance with the following circumstances:

Formax has taken over Expro. As a result, Formax's materiality will change. This is because the financial statements will be materially affected by this acquisition, and revenue, cost of sales and expenses will increase. The overall level of materiality will increase.

After the closure of a branch, a provision has to be made in the financial statements. The auditor has to determine the materiality of the revenue and provision relating to the branch that was closed down.

As a result of the closure, Formax will lose revenue of Tshs800 million. In order to determine the materiality of revenue, we can look at the total revenue of the firm, which is Tshs53,600 million. Revenue from the branch is 1.49%, which is more than 1%; therefore, it is material.

The provision will have an impact on both the SOFP and the income statement. Therefore, its materiality should be determined on the basis of total assets as well as profit before tax.

The provision for the branch is 0.88% of the total asset and 16.52% of profit before tax. As a rule, an amount above 2% of total assets and 10% of profit before tax is material; therefore Formax's situation is material.

The auditor should also check the disclosure requirements for the branch that was shut down.

Change in risk

Initially, Hillary found that the internal control system over inventory was sound. However, subsequently, she found that security tags were not attached to all the assets and, sometimes, inventory items and the items to be used as assets were mixed up, such as pen drives, CDs and mobile phones. This will increase the audit risk since it may result in misappropriation of inventory items.
In addition, this will increase the control risk. This is because ineffective control over inventory will lead the auditor to question the effectiveness of the company's internal control systems in other areas.

Impact on the audit plan

As a result of the above, the audit risk increases. Subsequently, the materiality level will decrease. The auditor has to check areas such as revenue, provisions and disclosure related to the branch that was closed by Formax.

The auditor will have to perform extensive procedures over inventory as well as over non-current assets. This is because the control risk has increased, so we must make sure detection risk is very low, hence the extra tests.

The overall materiality level will change as a result of the acquisition of Expro.

1.9 Prescriptive rules

The factors (quantitative as well as qualitative) determining materiality have been discussed above. These factors provide a basis for determining materiality. The list of factors given above is not exhaustive. There can be several other factors. For determining materiality, an auditor needs to consider the impact of an item on the financial statements and as discussed earlier, this is based on judgement.

Therefore, materiality cannot be determined by prescriptive rules. It is difficult to have set rules for determining materiality. Materiality is not definite but relational. Not only does it differ from entity to entity and needs to be decided on the basis of the circumstances, the materiality level that is decided for the same entity may vary from one auditor to another, and the same auditor may change the materiality level from one year to the next. Therefore, the same auditor cannot use the same percentage for determining the materiality of all his audit clients.

Example

SK & Co has been auditing Richy-Rich for the last five years. Last year, one of the criteria for deciding materiality was 5% of the profit before tax (profit before tax was Tshs25 million). However, this year, Richy-Rich has incurred a loss of Tshs9 million. In such a case, last year's materiality criteria of 5% of the profit before tax cannot be used.

Example

A banking company is required to maintain a particular CD ratio, failure of which may lead the bank towards bankruptcy. This is material but it cannot be identified by prescriptive rules.

As studied earlier, **the materiality level is calculated as a percentage of total assets, revenue and profit. However, the auditor should also consider factors specific to the entity such as the nature of business and ownership pattern when deciding the materiality.**

Example

Hardy has been appointed as an auditor of Tattoo Co, a large manufacturing company. Tattoo has been paying handsome dividends to its shareholders for the last three years. In addition, Hardy has been auditing Tasmas, a sole proprietorship.

While deciding the materiality of Tattoo using the percentage basis, Hardy used profit before tax. This is because the dividend paid by Tattoo is an important item in Tattoo's profits; therefore Tattoo will be concerned with showing a higher profit before tax, rather than showing higher net assets etc.

However, he cannot use the same strategy for Tasmas since Tasmas is a sole proprietorship which does not pay any dividends.

In companies where the assets are important than the profit, the auditor should set materiality accordingly.

Example

Kohinoor diamonds is a diamond company. Hardy has been appointed as an auditor of Kohinoor. In this case, Hardy should change his rule and should assess the materiality of Kohinoor as high since Kohinoor's inventory is more important than its profit.

It is also important to realise that the percentage rule itself is not prescriptive – it is a **guide.** For example, if materiality is set at 10%, the something that is 9.9% or even 9.5% should be considered within the realms of materiality. The auditor should not say that just because it is under 10%, it is not material. So materiality is fluid rather than prescriptive in terms of its limits.

Example

Justeat is a café that has opened in downtown Budapest. The auditor, Laszlo has set materiality at 2% of turnover. When checking expenses, he came up with a misstatement that is 1.85% of turnover. Laszlo should not ignore this just because it is under the threshold of 2%.

Test Yourself 1

Easy Money Ltd is a large and well-established bank with eight branches. Easy Money has made steady progress over the last fifteen years.

GK & Co has been reappointed as an auditor for the year ended 30 June 20X8. George, a senior manager of GK & Co, has been auditing Easy Money for the last three years. During his previous audits, George began the audit of Easy Money before the year end. Therefore, he has decided to start the current audit on 1 December 20X7 i.e. before the end of the period.

Easy Money is gradually changing its accounting system from a manual system to a computerised system.

By December 20X7, four branches had become fully computerised and two were in the process of becoming computerised. The remaining two branches had neither started to become computerised nor shown any indication of switching to computerised systems by the period end.

Continued on the next page

Considering this, George has assessed the risk as follows:

The branches which were computerised in the last year are less risky. This is because he has already checked the internal control systems of these computerised branches and has knowledge of their working. In addition, the employees of these branches are now computer literate.

The branches which became computerised in the current year are more risky. This is because the internal control systems of these branches have changed substantially and therefore need to be focused on. In addition, the computerised environment is new to the employees and they may need training in the use of computers and computer security.

The two branches which are not at all computerised are less risky. This is because there has been no change in the internal control systems and the working environment. George has knowledge of the operations of these branches.

On the basis of the previous years' experience, George has decided that the materiality will remain the same as the previous year i.e. Tshs12 million. This is because he has not noticed any significant change in Easy Money compared to the previous year. On 30 June 20X8, George noticed the following developments in Easy Money which he should consider when revising materiality and the audit risk:

In the current financial year, Easy Money:

1. Started Internet banking and tele-banking
2. Opened a new branch
3. Completed computerisation of all eight branches

In addition, new legislation related to money laundering has come into force in the country. According to this legislation, all banks should have an anti-money laundering programme in place and the auditors of the banks should report any money laundering transactions noticed by them. On 30 June 20X8, the draft financial statements of Easy Money were made available to George. While reading the financial statements, he noticed that the loans and deposits of the bank have increased by 20% which is a substantial change compared to the previous year.

Required:

Identify how, during the audit, the audit risk and materiality will change from those planned, and explain the impact of these changes on the audit procedures determined at the planning stage to be revised as the level of materiality (for the financial statements as a whole) is revised to a lower amount.

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2. Specify and explain in accordance with appropriate local legislation and international auditing and assurance standards the steps and procedures for audit and assurance work in the private and public sector.

[Learning Outcome c]

2.1 Public sector audit

Public sector undertakings have either equity participation of over 50% by the government or meet other criteria as explained in Public audit Act 2008. The auditors of such government entities are appointed by the Comptroller and Auditor General (CAG) of the country. The CAG provides guidance to the auditors in respect of the manner of conducting the audit. The audit conducted on government companies involves financial audit, compliance audit and performance audit.

1. Financial audit

The auditor expresses an opinion on whether the financial statements are true and fair and in accordance with the applicable accounting framework.

2. Compliance audit

The auditor ascertains whether:

(a) The expenditure recorded in the books of account was authorised for the purpose for which it was made
(b) The expenditure incurred was in accordance with the laws and regulations relating to expending public money
(c) Every item of expenditure was approved by the competent authority for expending the public money
(d) Wisdom and economy of expenditure was ensured and instances of improper expenditure / waste of public money were reported whether collection and allocation of revenue was done in accordance with the law with no leakage of revenue

3. Performance Audit

Performance audit involves scrutinising the performance of various government programmes to confirm whether they have met their objectives at the lowest cost and also achieved the intended benefits.

Tip

Learning Outcome 3 of Study Guide C1 also explains public sector audit

2.2 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

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 statement of financial position;
    A statement of profit or loss and other comprehensive income;
    a cash flow statement;
    A statement of changes in equity;
    Notes and schedules to the accounts; and
    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.

2.3 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 appointed by the management of the companies 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:

(a) Carry out value for money audit which involves determining whether the entity has ensured economy, efficiency and effectiveness in the public-sector services provided.

(b) 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.

2.4 Steps for audit in public and private sectors

Financial / statutory audit work carried out by auditors in private and public sectors are quite similar.

Diagram 2: Steps in audit of private and public sector

Steps in audit of private and public sector

Appointment of auditors
- precondition to audit, engagement letter, conformity of ethical and professional issues with regulatory requirements

Planning the audit
- preliminary discussions, preparation of audit strategy and plan, assessment of materiality risks, etc.

Tests of control
- testing efficiency of internal controls within the entity

Substantive procedures
- carrying out tests of details and tests of accounting balances

Audit completion
- review of audit findings of audit team, by audit partner

Reporting
- issuing audit reports expressing whether FS are True and fair

2.5 Assurance work on public sector and private sector

Audit on areas other than financial audit are generally carried out by internal auditors. The **scope of internal audit** is not confined to routine checking of the accounting records but also **includes an appraisal of the various operational functions and providing of advice and recommendations on the activities and operations reviewed.**

The scope of internal audit is dependent on the objectives of the audit and on the regulatory framework within which the audit is to be performed. Study Guide C5 discusses the various kinds of assurance work which is carried out by internal auditors.

Test Yourself 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.

Answers to Test Yourself

Answer to TY 1

As the audit progresses, George should reconsider the risk and materiality assessed at the planning stage. This is because George has started the audit before the period end. Certain events have occurred between the date when George started the audit and the period end which have an impact on the materiality and risk of Easy Money. The audit risk and materiality will change as a result of these events. Accordingly, George has to change the audit procedures. The events which have an impact on the risk and materiality assessed at the planning stage include the following:

1. Starting new operations such as Internet banking and tele-banking

Internet banking and tele-banking will result in a significant increase in risk. This is because Easy Money will be exposed to Internet risks such as the risks of virus, hacking and stealing of sensitive information related to the bank. Therefore the auditor has to change his audit plan significantly. He has to assess the risks related to the new operation. He should check the effectiveness and efficiency of the internal controls over the operation etc.

The new operations may result in an increase in the loans and deposits of Easy Money. As a result, the materiality may need to be changed.

2. Computerisation of the remaining two branches

Initially, George assessed the risk neither of the two branches which were neither computerised nor in the process of computerisation as low. This was because there was no change in the internal control system and the working environment. George also had knowledge of the operations of these branches. However, following the computerisation of these branches, the risk related to the branches has increased. This is because the internal control systems of the branches have changed substantially and therefore need to be focused on. In addition, the computerised environment is new to the employees. They may not be aware of the importance of computer security such as the confidentiality of passwords. This increases the risk that the employees may share their passwords, which may prove damaging to the bank.

3. Opening of new branch

By opening a new branch in a new area, Easy Money will be exposed to new risks such as additional funds required for running a new branch and competition from existing competitors in that area. Taking on new employees for the expanded business may increase the risk as they may not be aware of the controls and operations of Easy Money. The risk of bad debts may increase as the customers to whom loans are given may not have a long history with the bank and may default on the repayment of loans given by the bank.

With the opening of the new branch, the deposits and loans will increase. This will result in an increase in the materiality level. Furthermore, the auditor has to change his audit plan significantly to include the checking of the effectiveness and efficiency of the internal controls over the operations of the new branch.

4. Enforcement of new legislation on money laundering

As a result of the new legislation, the auditor will become responsible for reporting money laundering transactions to the regularity authorities. In addition, he has to report on the report made by the bank on all transactions above Tshs10 million. The audit risk will increase as a result of the new legislation. The auditor will have to check whether Easy Money has implemented an anti-money laundering programme and, whether it has any system for identifying and reporting cash transactions above Tshs10 million and any other transaction which involves money laundering.

This will also affect the materiality. The auditor may have to lower his materiality level from Tshs12 million to Tshs10 million.

5. Draft financial statements

As a result of the significant increase in operations, the materiality may need to be changed. George should consider the draft financial statements made available to him to review the risk and materiality. Since there has been a significant increase in the deposits and loans of the bank, the auditor should apply analytical procedures to the financial statements to assess the risks.

Furthermore the performance materiality would have to be revised as the level of materiality (for the financial statements as a whole) is revised to a lower amount.

Answer to TY 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.

Quick Quiz

1. State whether true or false.

   (a) Materiality remains the same from entity to entity.
   (b) The auditor considers materiality only at the planning stage. (c) Once prepared, the auditor cannot revise the audit plan.

2. Which of the following statements is / are incorrect about materiality? (i) Materiality of an item is the same

   under all circumstances.
   (ii) Materiality is crucial for the auditor throughout the audit exercise.
   (iii) The concept of materiality is useful only at the financial information level.
   (iv) Whatever is important or essential in a given auditing situation would automatically be material.

   A (i), (ii)
   B (i), (iii)
   C (i), (iii) and (iv)
   D None of the above

3. Which of the following options does not contain the qualitative factors that help to determine materiality?

   A Ratio analysis
   B Possibility of imminent public stock offering
   C 1% of total assets
   D Possibility of imminent merger

4. which of the following options are not common benchmarks used to compute materiality?

   A 1% of revenue, 5% of profit before taxation and 1% of total assets
   B ½% of revenue, 10% of profit before taxation and 2% of total assets
   C 1% of revenue, 10% of profit before taxation and 2% of total assets
   D 0.5% of revenue, 10% of profit before taxation and 2% of total assets

Answers to Quick Quiz

1.
   (a) **False**. Materiality is a relative term and changes from entity to entity, from period to period and from auditor to auditor.

   (b) **False**. The auditor should consider materiality at the planning as well as at the reporting stage.

   (c) **False**. An audit plan can be revised in response to a change in materiality or a change in the assessment of the risk of material misstatement changed.

2. The correct option is **B**.

   Statement (i) is incorrect since materiality is not an absolute term and must be seen only in the relative context.

   This means that the same item may be material to one entity but may not be material to another. Furthermore, the same item could be material in a particular year but not material in another.

   Statement (iii) is also incorrect. Materiality is considered at both the overall financial information level and in relation to individual account balances and classes of transactions.

3. 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.

4. The correct option is **D.**

Self-Examination Question

Question 1

Big Bags Co produces different types of bags such as school bags, hand bags and office bags. It has 10 branches all over Europe, 2 branches in China and 1 in Sri Lanka. On 1 December it closed a branch in Sri Lanka as it was found not to be very profitable.

High Hope, a firm of certified chartered accounts has been performing audits for Big Bags for the last three years. It is a local firm.

The Annual General Meeting of Big Bags is scheduled for 15 May 20X8. Considering the pre-meeting work, such as sending notice to all members (along with FS), the expected date of submission of the audit report was decided as 1 May 20X8.

The staffs of High Hopes consist of 20 assistants, 17 junior auditors, 8 audit managers and 5 partners. 3 of the audit managers are also experts in IT and are up-to-date with knowledge of how to use computers for performing an audit. However, all three will be busy in auditing other firms and will not be available for the audit of Big Bags. One of them will be performing work which does not require computer skills.

Big Bags has requested that only certain staff members (especially Eddy, one of the audit managers in High Hope, who was in the audit team last year) be included on the audit team so as to avoid unnecessary disruption to the accounting department.

The following information is available from the HR department of High Hopes about the request for leave during the audit period:

> One of the female employees will be on maternity leave for 3 months.
> Two of the assistants are appearing for an exam and therefore will be on exam leave (study leave for 1 month).

High Hopes has decided to start audit work only after the preparation of Big Bags' financial statements for the year ended 31 December 20X7. The expected date is 15 February 20X8.

Big Bags has changed its accounting system from manual to computerise last year. Last year, Eddy did not use a computer for auditing since he is not an expert. However, he is experienced.

The financial status of Big Bags on 31 December 20X7

Income Statement	20X7 Tshs million	20X6 Tshs million
Revenue	269.20	216.60
Material expense	146.70	112.05
Staff costs	67.70	53.40
Depreciation and amortisation	14.16	14.25
Other expenses	32.70	34.80
Financial costs	2.50	2.30
Total expenses	**263.70**	**216.80**
Profit / (loss) before taxation	**3.17**	**1.20**

Statement of financial position	20X7 Tshs million	20X6 Tshs million
Intangible assets Tangible assets	10.00	9.30
Property		
Plant and machinery	93.80	80.70
Other equipment	27.30	24.00
Inventories	12.30	13.90
Trade receivables	1.00	0.75
Cash and cash equivalents	22.80	20.10
Total assets	5.70	4.20
	173.00	**153.00**
Equity		
Share capital Share premium		
Retained earnings **Provisions**	10.77	10.77
Employee compensation etc.	18.20	18.20
Tax provision	76.70	74.78
Liabilities		
Finance lease liabilities	16.17	2.20
Trade payables	5.00	4.95
Other liabilities		
	9.00	7.60
Total equity and liabilities	23.00	21.65
	14.17	11.85
	173.00	**153.00**

Intangible assets include industrial licence and software and the internally generated intangible assets. Other

liabilities include accrued expenses.

Big Bags is growing fast and has shown a growth rate of 13% from last year. However, Big Bags has decided to close the branch at Sri Lanka.

The inventory of Big Bags is with a third party. The management is of the opinion that since the inventory is with a third party which provides certification for the existence of the inventory; High Hopes does not need to check the inventory.

In addition, Eddy is of the opinion that since the internal control system of Big Bags was checked last year and found effective and efficient to detect, prevent and correct errors, High Hopes does not need to check it thoroughly.

Required:

(a) Identify the matters to be considered while planning the audit of Big Bags
(b) Calculate materiality for the financial statements as a whole and justify the suitability of your assessment.
(c) Identify and explain the financial statement risks to be taken into account in planning the final audit

You are facilitating an induction course to the newly recruited auditors within your audit firm and upon presentation of your topic on public sector audit the junior auditors have requested to get an understanding on public entity.

REQUIRED:

(i) Explain the meaning of 'Public Sector Entity'.

(ii) Elaborate on the scope of the 'Public Sector Audit'.

(b) Kibonge has approached you as a mentor, and he wants to change an employer from private audit firm to become an employee of the National Audit office. Kibonge has three years post-qualification experience of auditing private sector organizations and is confident that he can handle public sector audit without difficulties.

Required:

Explain three areas where Kibonge, as a new public sector auditor, is likely to face challenges in his new occupation.

(c) Value for money is the term that is said to be more complex and its applicability is difficult as it is unlikely to attain the maximum results aim only at sufficing as opposed to maximizing satisfaction.

Required:

Briefly discuss the deficiencies of values for money audit.

Answer to Self-Examination Question

Answer to SEQ 1

(a) In order to perform an audit of Big Bags effectively, High Hopes will plan its audit considering the following elements:

Since High Hopes has already audited Big Bags for the last two years, it can be assumed that it has knowledge of the business. It may gather information regarding the any significant change in the business and recording system etc. which has an impact on the financial statements. It is stated in the audit that High Hopes has decided to start the audit before the period end. Therefore it has to consider that the audit plan may change subsequently if any significant change to the date of financial statements takes place.

Logistics

For logistics, the auditor should consider the following:

The time available for the audit: it is stated that High Hopes can start an audit of Big Bags only after 15 February and has to submit the audit report on 1 May 20X8. Therefore, it has approximately five months to perform an audit of Big Bags. On the basis of information gathered about Big Bags and previous experience, it should determine the scope of work and accordingly should work out the number of days required for performing the audit. Although it has five months, it should consider the staff available during that period. This is because it has to consider the manpower required for other assignments. In addition, two employees have applied for leave during that period.

Big Bags has a computerised accounting system, therefore High Hopes should have at least one person who has computer knowledge. High Hopes has three IT professionals, to whom other assignments have already been allotted. However, it is mentioned that one of those experts has been given an assignment in which he will not be able to use his IT knowledge.

Big Bags has demanded to include Eddy (who performed Big Bags' audit in the previous year) in audit team. Including him in the audit team would have an advantage because he has experience with Big Bags and therefore can perform more effectively than others. This will save time. However, High Hopes should also consider that having the same team for the audit may hamper its independence. In addition, since Eddy is experienced, he can be utilised in other assignments. Therefore, High Hopes may consider giving Eddy the assignment allotted to the IT professional who could not use his computer knowledge for his assignment, and could include that person in Big Bags' audit team so that his computer knowledge can be used for the audit.

Other considerations

Although the internal control system was thoroughly checked last year and found effective, High Hopes cannot rely on this without checking it again. This is because the system has undergone changes after the first check since the accounting procedure has changed, this will have an impact on the internal control system.

Although the person who has the inventory is providing a certificate, High Hopes cannot be relieved of its responsibility for inventory checking. It should take due care before using a third party certificate and therefore should have some procedures to check the inventory.

Big Bags has closed a branch in Sri Lanka at the year end. This will have an impact on the materiality of Big Bags. High Hopes has to check the impact of such closure, such as provision for employees' compensation, revenue generated from that branch and disclosure requirements about the discontinued operations.

(b) Materiality for the financial statements as a whole

Revenue		Profit before taxation		Total assets	
20X7	Tshs million	20X7	Tshs million	20X7	Tshs million
1/2%	1.35	5%	0.16	1%	1.73
0.5%	2.96	10%	0.32	2%	3.46

This is because materiality should not be too low otherwise it may result in over auditing. If it is decided on the basis of profit before tax, it would be at a very low level. At the same time, it should not be too high otherwise, as the audit progresses, the auditor has to change the materiality and perform more audit procedures than what was decided initially.

In any case, the auditor has to check any change in the materiality level as the audit progresses. Therefore, the auditor should take care while deciding the preliminary materiality so that it does not change significantly during the subsequent reviews unless there is a change in the circumstances.

A suitable range of preliminary materiality which is determined from the above figures can be Tshs1,730 million –Tshs2,960 million. i.e. one that lies within the overlap of the ranges calculated for revenue and total assets. Tshs1,730 million is 1% of asset and is about 0.65% of the revenue and Tshs2,960 million is 1% of revenue and about 1.70% of total assets. This would be a prudent estimate of materiality.

(i) Financial statement risk (all amounts in Tshs million)

Financial statement risk can be referred as to the probability that the financial statements are materially misstated. The material misstatements can be of two types:

Non-compliance with any disclosure requirements
Errors in the amounts recorded in the financial statements

(ii) Revenue

The revenue has increased by 24.28% (Tshs269.2 - Tshs216.6/216.6 x 100) as compared to the previous year's financial statements for Big Bags. If rebates due to customers are not considered then an overstatement error may arise. High Hopes should check Big Bags' revenue recognition policy.

(iii) Accounts receivables

The trade receivables have been increased by 13.43% (22.8 –20.1/20.1 x 100) whereas the sales have been increased by 24.28%. This means that there may be an error in the cut-off. The auditor should check this.

(iv) Materials expense

Material expenses are increased by 30.92% (Tshs146.7 – Tshs112.05/112.05 x 100). The material expense has increased more than the increase in revenue. High Hopes should investigate the increase. If this is due to an increase in the cost of raw material then the auditor does not need to perform extensive audit procedures. However, if this is not the case, the auditor has to perform extensive audit procedures on material expenses. High Hopes should also check the capitalisation policy of Big Bags to understand whether capital expenses have been wrongly treated as revenue expenses.

(v) Depreciation / amortisation

The depreciation and the amortisation have been decreased by 0.63% (Tshs14.16 – Tshs14.25/14.25 x 100). High Hopes should check whether Big Bags has assets which are fully depreciated and dispel the suspicion that it is understated.

(vi) Other expenses

The other expenses have fallen by 6% (Tshs32.7 – Tshs34.8/34.8 x 100). There is a chance that these expenses might have been wrongly charged to material expenses.

(vii) Intangible assets

The intangible assets have been increased by Tshs0.7m i.e. 7.53% (Tshs10 –$9.3/9.3 x 100). This has a material effect on the financial statements. Although the increase is not significant, this is net movement and therefore is an important consideration.

High Hopes should consider the amount at which the internally generated intangible assets are capitalised and other requirements of the accounting standards.

(viii) Tangible assets

The tangible assets in the case of Big Bags consist of property which is increased by 16.32% (93.8 – Tshs80.7)/80.7 x 100, plant and machinery increased by 13.75% (Tshs27.3 – Tshs24)/24 x 100 and the other equipment that are decreased by 11.51% (Tshs12.3 – Tshs13.9)/13.9 x 100.

Therefore High Hopes should consider the following:

Whether equipment has been disposed of, if yes whether recorded properly.
Is there any impairment of assets? If yes, whether recorded properly.
Where the assets are recorded properly.
Is there any revaluation of asset? If yes, whether recorded properly etc.

Since in the statement of financial position, a finance lease is used, High Hopes should consider whether the leased assets are recorded properly and make sure there is no understatement in tangible assets if the finance lease is wrongly treated as an operating lease.

(ix) Provision for employee compensation etc.

High Hopes should calculate whether the provision is material to the statement of financial position and to the income statement.

While doing this, the auditor should consider the following:

The net effect of the provision on the income statement.
The risk of material misstatement is always high in the case of provisions. This is because they involve estimation and judgement.
The risk that all the obligations may not be considered.

(x) Finance lease liability

The finance lease liability has been increased by 8.42% (Tshs9 – Tshs7.6)/7.6 x 100. High Hopes should check the following:

Whether the lease is treated properly in the SOFP.
whether all the provisions of accounting standards related to the lease have been considered, such as disclosure requirements and capitalisation amounts (whether at fair value or NPV of minimum lease payment; according to the international standard it should be the lower of the two) .

(xi) Trade payables

The trade payables have been increased by 6.23% (Tshs23 –Tshs21.65)/21.65 x 100 as compared to the increase in the material expenses which is 30.92%. High Hopes should consider whether this is an understatement due to a cut-off error.

Answer to SEQ 2
ANSWER 2

(a) (i) **Public sector entity**
Shall include any authority or bodies:

- That has been 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;
- Which the Government has invested its monies;
- That is 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 CAG;
- Those accounts are, by or under a written law, required to be audited, or are open to inspection, by the CAG;
- In which the Government is the majority shareholder;
- Which has, in any of its financial years, received more than half of its income from public funds.

(ii) 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

which the grants were sanctioned by the Parliament.

(b) The challenges faced by Kibonge in his new occupation include:

(i) **Scope of work**
The scope of work includes value for money audit. Generally, public sector auditors have experience in auditing this area. However, as Kibonge has no experience in this area, he will face a challenge auditing whether public funds are economically, efficiently and effectively utilized.

(ii) **Assessing materiality**
While assessing materiality, Kibonge 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 often apply to public sector audit. Therefore, Kibonge 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 analyzing whether the construction of the road is profitable to the assurance client.

(c) **Deficiencies of value for money audit**

(i) **There exist no universal measures for outputs**
e.g., 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.

(ii) **Objectives of audit and measure of efficiency vary with the type of work being audited**
e.g., 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.

(iii) **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.

(iv) **It is not easy to measure effectiveness**

SECTION C

PLANNING AND UNDERTAKING AUDIT WORK

C5

STUDY GUIDE C5: PERFORMANCE AUDIT

Get Through Intro

In this rapidly changing era, where a new discovery in the morning becomes as stale as yesterday's newspaper in the evening **how can** the **functions and scope** of **internal audit remain constant?**

The winds of change have blown even in this area and now it is not unusual for an internal auditor to be **given assignments** which are **vastly different** from the **traditional ones** of evaluating the internal controls of the financial system, etc.

This Study Guide discusses these changes in the assignments being offered to internal auditors, which are important to understand if you wish to keep up with the times. The novelty of the topic might merit a question in the examination.

Learning Outcomes

a) Explain the nature and purpose of internal audit assignments like value for money.
b) Explain the nature and purpose of operational internal audit assignments like procurement.

1. Explain the nature and purpose of internal audit assignments like value for money. [Learning outcome a]

1.1 Value for money audit

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.

The absence of a profit measure requires an alternative focus in a not-for-profit organisation. 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.

1. Economy

Implies the principle of prudence i.e. the **least possible cost should be incurred to fulfil any need**.

2. Efficiency

Implies the **maximisation of output input ratio** i.e. the output per unit of input should be maximised.

3. 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.

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.

1.2 IT audit

An information technology audit is an examination of the controls within an information technology infrastructure. These reviews may be performed in conjunction with a financial statement audit, internal audit, or other forms of engagement. An IT audit is the process of collecting and evaluating evidence of an organisation's information systems, practices, and operations.

The evaluation of the obtained evidence determines if the information systems are:

Safeguarding assets,
Maintaining data integrity and
Operating effectively and efficiently to achieve the organisation's goals or objectives.

IT audits are a specific application of one of the key roles of the internal audit function, which is to assess internal controls. In the case of IT audits, the controls involved are those that operate within the organisation's computer systems.

Some of the key areas of an IT audit are as follows:

1. Auditing general controls

The aim of auditing general controls is to gain an overall impression of the controls that are present in the environment surrounding the information systems. These include **the organisational and administrative structure of the information systems function, the existence of policies and procedures for the day-to-day operations, availability of staff and their skills, and the overall control environment**. It is important for the IT auditor to obtain an understanding of these as they are the foundation on which other controls reside. A general controls review would also include the infrastructure and environmental controls as well as procedures in place for back-ups, firewalls, virus checking and contingency plans in case if major disasters affecting the IT system.

Example

A review of the data centre or information processing facility should cover the adequacy of the air conditioning (temperature, humidity), the power supply (uninterrupted power supplies, generators) and the smoke detectors / fire suppression systems, a clean and dust-free environment, protection from floods and water seepage as well as neat and identifiable electrical and network cabling.

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2. Auditing physical access control

Physical access control is another important area for review. Today in a higher networked world, logical access to computer systems is literally universal, yet there is a necessity to control physical access too. There are certain commands and settings that can be executed only from the console of the server and hence it is important to enclose all servers in a secure location protected by suitable mechanisms such as locked doors, access swipe cards, biometric access devices or a combination of these. In addition, usually the most important data is stored on the server.

The IT auditors should also **review** the **overall access control measures to the entire** facility for controls such as security guards at the entry gates, displaying of identification badges and logging **visitor** access.

3. Auditing application controls

Application software is the software that processes business transactions. The application software could be a payroll system, a retail banking system, an inventory system, a billing system or, possibly, an integrated ERP (enterprise resource planning) system. It is the application software that processes data with reference to their business context. The rules relating to the business processes are implemented in the application software. Most users interact with the computer systems only through application software. The application software enables and also limits the actions that a user can do.

It is very important to subject application software to a thorough audit because the business processes and transactions involving money, material and services flow through the application software package.

An application software audit is a review of points such as the accuracy and appropriateness of the application software and the business function or activity that the application software performs. In this context, it is necessary for the IT auditor to know the business process. For an application review, the IT auditor's knowledge of the intricacies of the business is as important as, if not more important than, their technical knowledge. Hence the first step in an application review is to understand the business function / activity that the software serves. This can be done through the study of the operating / work procedures of the organisation or other reference material. An additional source of understanding is by interviewing the personnel.

Once this is done, it is necessary to identify the potential risks associated with the business activity / function served by the application (what can go wrong?) and to see how these risks are handled by the software (what controls it?).

1.3 Best value audit

The best value audit is aimed at improving the effectiveness, efficiency and economy of the functions under review. This can be achieved by reviewing the functions under review and by recommending improvements.

A best value review involves the following:

- Reviewing whether the products / services meet the requirements of the customers
- Determining whether there is balance between the cost and quality of the service or not
- Comparing product / service with competitors to find out the best and the worst features in the products of the entity so as to make improvements.

The most important ingredients of a **best value review** are explained with the '**4 C**s'. These four C's are: Challenge, compare, consult and compete.

1. Challenge

Identifies **the need of the service and the way it is provided**. An entity should discontinue providing a service if the reason why the service is provided cannot be identified satisfactorily.

2. Compare

Compares **the attributes of the services provided with those provided by similar organisations**. Comparison paves the way for improvements.

3. Consult

Suggests consulting **with service users in order to know whether or not the services provided meet the needs of the consumers.**

4. Compete

Encourages fair competition **so as to secure efficient and effective services.**

Example

In order to get a job done through contractors, a tendering process is encouraged to evaluate contracts so that the best value (i.e. lowest offer with good enough quality) can be obtained.

Tip

A best value review **challenges** the way in which things are currently happening i.e. challenging the way services are provided or goods are produced (i.e. whether the organisation is producing the right quality of the service or product). A best value review also involves **comparing** the product / service with competitors and understanding the way in which they are providing their services, **consulting** customers to find out their needs and drawing a conclusion about how **competition** could be used for improvement.

The internal auditor should review the services and provide credible recommendations and improvement plans / ideas that will be implemented. This will provide the entity significant improvements in the functions reviewed. The

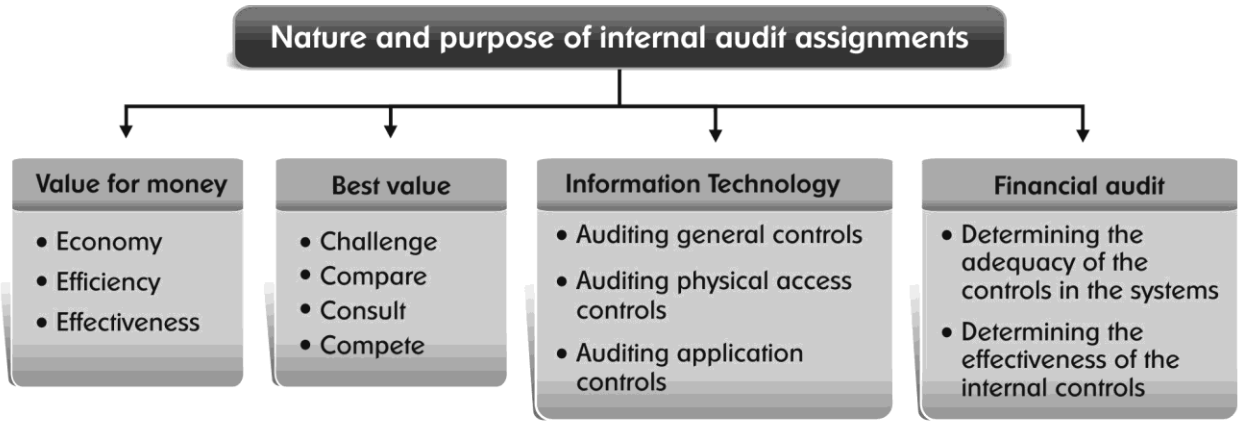
best value review aims to:

Examine the economy, efficiency and effectiveness of the services or economy, quality and quantity of products
Develop a plan for continuous improvements
Ensure that all services contribute to the strategic objectives

1.4 Financial audit

Financial audit is the traditional internal audit function. The scope of internal audit for financial functions may involve internal control topics such as the efficiency of operations, the reliability of financial reporting, deterring and investigating fraud, identifying errors, safeguarding assets and compliance with laws and regulations. Audit of financial statements, is generally performed by the external auditor to express an opinion on the financial statements prepared by the entity.

Diagram 1: Nature and purpose of internal audit assignments



Test Yourself 1

Eagle Hotels is a hotel chain. It has hotels in seven countries and a staff of 500. Management noticed that expenses on the housekeeping department have increased considerably at the hotel in Bolivia. Management discussed this matter with their internal auditor, Johnny. Johnny suggested that they should introduce a value for money audit. Management was not aware of the concept of a value for money audit.

Required:

Brief management on the nature and purpose of a value for money audit in relation to the hotel chain

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2. Explain the nature and purpose of operational internal audit assignments like procurement. [Learning outcome b]

2.1 Nature and purpose of operational internal audit assignment

An operational audit is an audit of the major operational processes of an organisation. The operations include procurement, marketing, treasury and human resources management. In operational internal audit assignments, the auditor measures the performance of the various procedures in terms of efficiency, effectiveness and economy.

1. Procurement

Procurement is a process of obtaining goods and services. In the case of both trading and manufacturing entities, purchasing is a significant function. The purchase function includes interface with the outer world and accordingly runs a higher risk that fraud might take place and one should take due care while purchasing goods and services. The economy of the transaction is also a major consideration while purchasing goods from outside. One should keep in mind the 4R's of purchasing i.e. purchasing the **right quality** and **right quantity** of goods at the **right price** and at the **right time.**

While conducting an internal audit for the purchase department, an auditor needs to keep in mind the following:

(a) Understanding the procedure for procuring goods and services

The internal auditors should understand the procedures for procuring goods and services in order to conduct their audit effectively. This **can be done by obtaining the purchase manual** (a written copy of the purchase procedure)**, reading it, and by observing the system of processing the transactions commencing from order placing to receiving materials and ultimately payment for the purchases**.

(b) Evaluating the system

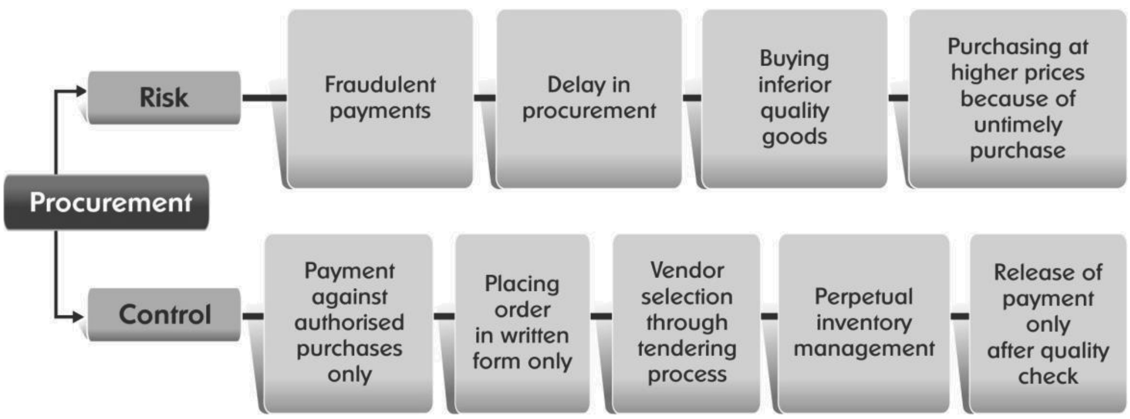
After understanding the system, **the auditor should assess the adequacy of the procedures and whether or not the internal control system is effective.**

If it is found that the procedure is not adequate, the auditor should suggest improvements to the board or audit committee. If the auditor is satisfied with the adequacy of the procurement procedures, they should assess their implementation and effectiveness.

They need to assess and report on whether different system controls such as making payment only against authorised purchases, placing orders in written form only, vendor selection through tendering process, perpetual inventory management, and release of payment only after quality checks are implemented. If the internal control system is in place, it will eliminate the risk of fraudulent payments, delay in procurement of goods, buying inferior quality goods, and purchasing at higher prices because of untimely, perhaps emergency, purchase.

In order to evaluate the performance of the procurement system and internal control system the internal auditors should resort to test checking unless they feel that there is a significant risk and therefore thorough checking is needed.

Diagram 2: Risks involved in procurement and the controls suggested to be applied



2. Marketing

The marketing function of an entity may be defined as follows:

Definition

Marketing is an organisational function and a set of processes for creating, communicating and delivering value to customers and for managing customer relationships in ways that benefit the organisation and its stakeholders.

Marketing involves assessing the demand of the targeted market and procuring the demand for the entity's product. The marketing function involves the following activities:

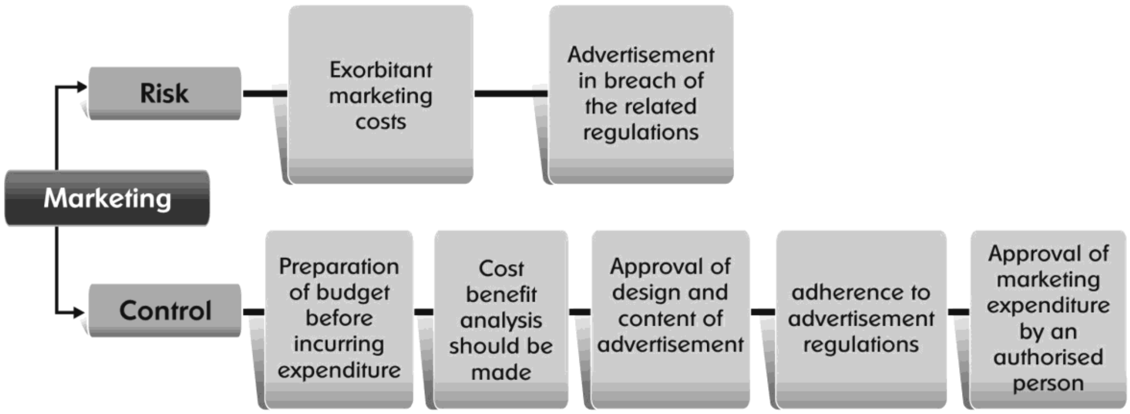
Research: assessing potential demand for the product or service and designing suitable products and services.
Advertisement: presenting the product and its features in the market to generate demand for it
After sales service: maintaining the entity's reputation and developing further goodwill

The internal auditor should:

- Assess the adequacy of the marketing procedure
- Identify the risks associated with the marketing procedure and the controls to manage those risks
- Determine the efficiency, effectiveness and economy of the marketing function

In order to perform an audit of the marketing function, internal auditors should have an understanding of the marketing procedures and need to review the strategies of the entity, customer feedback, etc.

Diagram 3: Risks related to marketing and the controls to overcome them



3. Treasury

The treasury function of an entity includes functions such as managing the cash flow, arranging working capital, arranging funds for the lowest possible cost, identifying the optimum cash balance, investing surplus cash in the most sensible manner and dealing with foreign exchange risk. It is a very important function in an organisation because it deals with how to **make best use of the available funds to maximise the organisation's wealth**. If the treasury function is not carried out effectively it will cause losses to the entity and may negate all the efforts made by the organisation to make profit. If the organisation runs out of funds, then receivership and liquidation are likely to follow soon.

The internal auditor needs to assess the strategies of the entity regarding managing the funds including raising working capital and investment of any surplus.

The auditor should determine the risk associated with the strategies made for managing the funds of the entity. These risks include:

- The risk of not raising funds from the cheapest possible source
- The risk arising from inadequate returns on investment
- The safety of the investment
- Foreign currency risk etc.

After identifying the risks associated with the entity, the auditor should identify whether the risks are managed effectively or not.

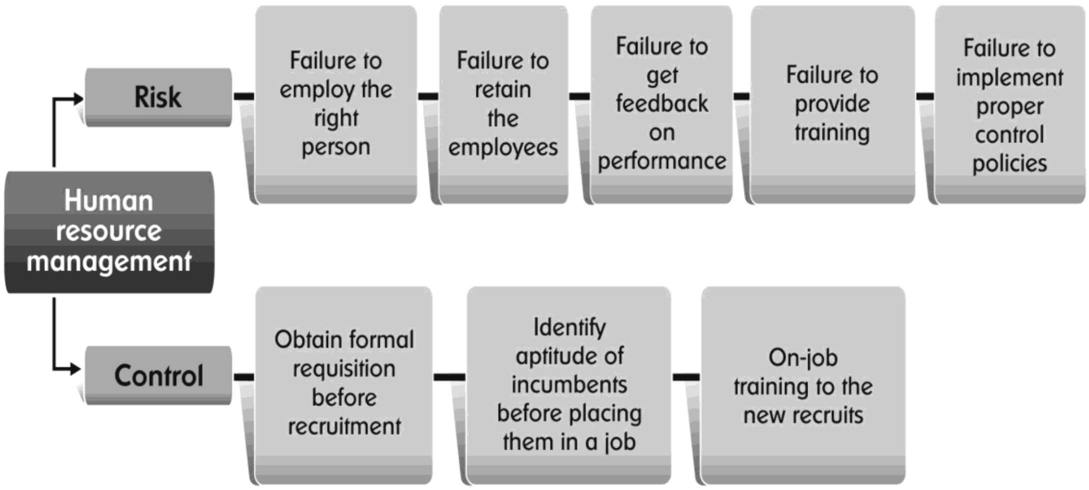
4. Human resources management

Human resources management is the process of **managing the various activities associated with the labour force of the entity** i.e. from the recruitment of the employee until their retirement.

The human resources function includes:

- Determining the need for staff and their qualification
- Deciding recruitment policy
- Deciding whether to employ them for permanent positions or to hire them from time to time as and when required
- Determining the training needs of the employees and devising training programmes
- Complying with equal opportunity legislation
- Deciding policies for pay, holidays and other benefits etc.
- Retaining good personnel

Diagram 4: Risks associated with human resources management and the controls to overcome them



Answer to Test Yourself

Answer to TY 1

A value for money audit is conducted to determine the economy, efficiency and effectiveness of an entity. For the hotel in Bolivia 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.

Quick Quiz

1. The scope of a value for money audit is to determine the three E's of the entity, namely:

   E_______________ E_____ E_____

2. The most important components of a best value review are known as the '4 Cs'. These four C's are:

   ____
   ____
   ____
   ____

3. Which department would look after foreign exchange and working capital?

   ____

4. The 4 R's of purchasing are:

   ____
   ____
   ____
   ____

Answers to Quick Quiz

1. **E**conomy, **E**fficiency and **E**ffectiveness.
2. **C**hallenge, **C**ompare, **C**onsult and **C**ompete
3. The treasury department
4. Right quantity, **R**ight quality, **R**ight time and **R**ight prices.

Self-Examination Question

Question 1

Contura is an automobile company which supplies cars all over the world. Its headquarters are in Ontario, Canada and its manufacturing unit is near the head office.

You are required to state the controls to be checked by an internal auditor in course of a value for money audit of the organisation.

Answer to Self-Examination Question

Answer to SEQ 1

Objective	Control
Economy The raw materials such as spare parts, paints, accessories are bought at the best price with the required quality	Obtaining market price of the items bought in order to check whether or not the items purchased are of the requisite quality and bought at the best price available Check whether or not purchases are made from approved vendors Check 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) While recruiting, the qualification, competency of the workers should be checked to ensure that only competent people are employed.
Skilled, qualified and competent labour	Check whether or not 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 or not personnel with the appropriate skills and qualifications are engaged in the jobs (i.e. whether or not 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 or not suitable on-job training is provided to the new recruits in order to ensure best performance.
Efficiency Wastage 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 or not all waste is recycled using green bins in 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.

SECTION C

PLANNING AND UNDERTAKING WORK

C6

STUDY GUIDE C6: ASSURANCE ENGAGEMENT

Get Through Intro

Auditors provide both audit and audit related services to their clients. Audit related services are services that reasonably relate to the audit, for example consultations concerning financial accounting and reporting standards or reviews of the internal control procedures.

There are many other services that an auditor can perform because of:

- His expertise in that area, e.g. tax planning for the client.
- The requirements of other statutory bodies, financial institutions etc., e.g. a project report for obtaining a bank loan, a certificate to any government authority.

Both the management and auditors have to ensure that the audit related services that an auditor performs do not impair the auditor's independence. This Study Guide explains the audit related services that an auditor can perform and also the diligence that an auditor has to exercise when he takes on such assignments.

All auditors require this knowledge! Studying this subject is one good way of obtaining this knowledge.

Learning Outcomes

a) Explain the circumstances under which audit-related services are availed and the levels of assurance provided by professional accountants.
b) Explain the difference between:
   i. Audit related services and an audit of historical financial statements
   ii. An attestation engagement and a direct reporting engagement.
c) Explain the level of assurance for an engagement.

1. Explain the circumstances under which audit-related services are availed and the levels of assurance provided by professional accountants.
Explain the difference between:
i. Audit related services and an audit of historical financial statements ii. An attestation engagement and a direct reporting engagement
[Learning Outcomes a and b]

Audit related services are the services given by the professional other than auditing. These services can be broadly categorised as follows:

Review engagements
Agreed upon procedures (AUP) engagements
Compilation engagements

These services are discussed in detail in Paper B3

1.1 Review engagements

Many clients (for whom audit is not compulsory) require some assurance on their financial statements. However, they do not want to incur the heavy cost of audit. For these clients, a review engagement may be the appropriate service to provide this assurance. This is because review provides limited assurance that the financial statements are reasonable and one can believe in them.

Generally, when a client approaches a bank for a loan, the bank asks for a review report.

Definition

The objective of a review engagement is to enable a practitioner 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 practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework.

IFAC Glossary of terms

The assurance provided in review engagements is limited and negative i.e. the practitioners (those carrying out review engagements) are required to state in their report whether anything has come to their attention that causes them to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework.

Negative assurance concentrates on the fact that the practitioner is stating that from the limited work he has carried out, everything looks reasonable and plausible. There is no detailed testing, hence using the phrase, **'nothing comes to our attention to believe that the accounts do not give a true and fair view'.**

Tip

ISRE 2400 Engagements to Review Financial Statements, uses the word **practitioner** for the reviewer; ISRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity, uses the word **Auditor**; ISRS 4400 Engagements to Perform Agreed Upon Procedures, uses the word **auditor;** and ISRS 4410 Engagements to Compile Financial Statements, uses the word **accountant**.

A review engagement is suitable in the following circumstances:

When an **audit** of the financial statements is **not required but management wants some assurance** on the financial statements
when the entity wants some financial assistance and the **financial institute or bank wants some assurance of the reliability of the financial statements**
When a **review of the interim financial information** is required
in due diligence assignments

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
Enquiry into the entity's accounting principles and practices, the entity's procedure from recording of transactions and events to preparing the financial statements and all material assertions in the financial statements
Analytical review

The whole premise behind a **review** is that the **auditor does not do the detailed testing** to gain positive assurance that the figures are true and fair. **He is just looking to ensure that they are plausible and reasonable under the circumstances.**

The example below explains the review engagement more clearly.

Example

St. Polly is a school owned by a trust called Holy Soles. Schools are not required to carry out an audit under local law but the trustees wanted some assurance that the financial statements are reliable. Therefore they approached NS & Co an auditing firm. NS & Co suggested that the school should carry out a review engagement.

NS & Co will follow the following procedure for the review of the financial statements: (a) obtain an understanding

of the school's activities:

Managing / controlling body (name and identity of trustees)
Purpose of the school (for profit or not-for-profit)
Sources of income (donations, grants etc.)
The petty cash holdings and payments
Applicable laws and regulations

(b) Enquire into and understand the accepted accounting policies and principles of the school such as depreciation method.
(c) Obtain an understanding of the financial risk and its potential impact on the financial statements. (d) Analyse the financial statements, conduct enquiry and analyse the result.
(e) Give an opinion (negative) on the financial statements (on the basis of the above analysis).

1.2 Agreed-upon procedures engagement

Definition

Agreed-upon procedures engagement: an engagement in which an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The recipients of the report form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

IFAC Glossary of terms

In an 'agreed-upon procedures' engagement, the auditor is **engaged to perform certain procedures which have been agreed between the auditor, the entity and any other interested third party** e.g. fraud investigations, verifying accounts payables, verifying accounts receivables and verifying non-financial data, such as waiting times in hospitals.

The procedures applied in an agreed-upon procedures engagement may include the following:

Enquiry and analysis
Recompilation, comparison and other clerical accuracy checks
Observation
Inspection
Obtaining confirmations

Example

Ronald is an auditor of Emerald Co. He is engaged to perform agreed upon procedures with respect to accounts receivables. He will perform the following procedure:

(a) Collect customers' account statements and compare them with the balances in the entity's books
(b) Obtain reconciliations and list outstanding invoices, credit notes and outstanding cheques etc. for large amounts
(c) Compare the balances of major customers with the related names and amounts in the sales ledger control account and the total of this to the trial balance
(d) Compare the total amount of account receivables in the trial balance with the total amount in the general ledger

Ronald will perform only the above listed agreed-upon procedures and will not perform any other feature which is required in a normal audit. He will not express his opinion but will give only a report which contains the factual findings.

In an agreed upon procedure engagement, **auditor does not express his opinion**; instead **he gives only the factual findings.**

Agreed upon procedures engagements are required in the following circumstances for example:

- Investigating fraud or irregularity
- Verifying insurance claims
- Reporting on non-financial data e.g. number of units sold

In this engagement, no assurance is given by the auditor. It is up to the person who has appointed the auditor to draw conclusions from the facts given by the auditor. Access to this report will be restricted to those parties that have agreed to the procedures to be performed.

1.3 Compilation engagements

A compilation of financial statements is an accounting service:

- In which **an accountant prepares or assists in preparing financial statements**;
- **Without expressing any assurance** that the statements are accurate and complete.

In other words, it is an engagement which **requires more accounting expertise than auditing expertise** and involves collecting, classifying and summarising financial information. Data is presented in a manageable and understandable form without a requirement to test the assertions underlying that information.

Definition

A compilation engagement is an engagement in which accounting expertise, as opposed to auditing expertise, is used to collect, classify and summarise financial information.

IFAC Glossary of terms

A **compilation engagement includes** the **preparation of financial statements** (which may or may not be a complete set of financial statements) but may also include the collection, classification and summarisation of other financial information.

Compilation engagements are required in the following circumstances:

- Preparing financial statements
- Calculating taxable income

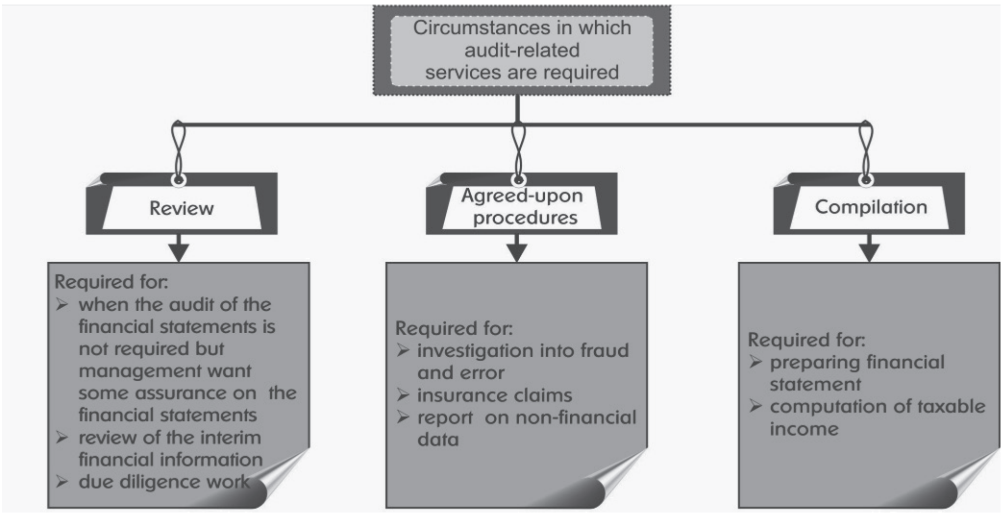
Compilation does not provide assurance; it only gives compiled information.

Example

BM Office sells office stationery. Arthur, the accountant of BM, has been asked to calculate BM's tax liability.

Arthur will compile information related to income (business income, capital gain, if any, other income etc.), expenses to be claimed, set off (if allowed) etc. and calculate the taxable income. Once he has arrived at the taxable income, Arthur will deduct taxes paid in advance and tax deducted at source, if any, to arrive at the tax payable. However, he will not express any opinion that the taxable income and tax calculated by him is correct.

Diagram 1: Circumstances in which audit-related services are required



Test Yourself 1

Blue Bell Club is a co-operative society. Blue Bell has applied for a loan from a bank. Blue Bell has appointed a part time accountant, who is pursuing a degree in accountancy. According to the laws of the country, the income of co-operative societies is exempt from tax.

Audit of Blue Bell is not compulsory under any Act. In one of the board meetings, the reliability of the financial statements was discussed. It was decided that since an audit is not compulsory and it would require more time, money and other resources than other related services, audit should not be conducted.

The accountant has informed the board that a professional accountant can provide the following services (other than audit):

- Reviewing the financial statements
- Performing an agreed upon procedure for an audit
- Compiling financial statements

Required:

Discuss the services mentioned by the accountant and which would be most appropriate for Blue Bell to use.

1.4 Audit-related services and an audit of historical financial statements

As studied in paper B3, the audit of historical financial statements is a reasonable assurance engagement where the practitioner:

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

The following table summarises the difference between the two types of services:

Audit of historical financial statements	Audit-related services
Audit provides reasonable assurance.	**Review**: offers limited but negative assurance.
	Agreed-upon procedures: no assurance, only factual findings.
	Compilation: no assurance.
The auditor decides the scope of the work to be carried out in an audit.	**Review:** reviewer decides the scope of audit.
	Agreed-upon procedures: client entity decides the scope
	Compilation: client entity decides the scope of work.
In many countries, an audit is required by law (for large and public companies).	These services are not required by law. These are voluntary services. In some countries, the law may state that a review must be carried out for certain small scale entities
Audit risk i.e. risk of mistakes, omissions or incorrect disclosures is lower in audit as compared to other engagements.	Risk of mistakes, omissions etc. is greater in review and other services than in audit, as generally less work is carried out or concentrated on certain areas.
Cost is higher than cost of review and other services.	Cost is significantly less than cost of audit.

Although both the types of services differ from each other, they involve the following:

- Obtaining an understanding of the entity
- Planning the engagement
- Evaluating the design effectiveness and testing the operating efficiency of the internal control system
- Conducting audit procedures
- Forming an opinion about, and reporting on, the subject matter:
  - The opinion in audit engagement will be positive and will provide a high level of assurance.
  - the opinion in a review engagement will be negative and will provide only a moderate level of assurance.

1.5 An attestation engagement and a direct reporting engagement

1. Attestation engagement

Attestation engagement is an engagement in which a practitioner is appointed to issue a written communication to convey **a conclusion about the dependability of the assertion** from the accountant who performs the attestation engagement.

It involves the following:

- Examining, reviewing and performing agreed-upon procedures on the subject matter of an assertion
- Issuing a written communication which expresses a conclusion about the reliability of written assertions prepared by a separate party

Example

The assertions made in an attestation engagement for attesting an organisation's internal control system are as follows:

- The internal control system is adequate considering the entity's volume of business.
- The internal control system is sufficiently efficient and effective to detect and prevent any fraud, error or misstatements.

Examples of attestation engagements

- Verifying compliance with applicable laws and regulations.
- Verifying internal control over financial reporting.
- Verifying accounting for reporting on grants and contracts.
- IT / system audit.
- Examining financial forecasts and projections.
- Examining pro forma financial statements (whether in accordance with the applicable law or not).

In all cases, the practitioner is attesting that something is correct or fairly stated, from the work they have carried out.

Example

On line Co has appointed Abraham, an accountant, to examine its IT system and express his opinion on the effectiveness and efficiency of the system.

The management has made an assertion that the IT system of On-line is sufficiently effective and efficient to record all the accounting and management information and is secure enough to prevent and detect any threat to its integrity.

In this case, Abraham will perform the following:

- Obtain an understanding of On-line, its business and the risk associated with its accounting system and internal control system
- Identify any changes in the abovementioned factors since the system was first installed
- Identify any updates made to the system as a result of any changes in the abovementioned factors
- Identify the person who developed and tested the system
- Perform penetration testing (a method of evaluating the security of a computer system or network)
- Test-check the operation of the system i.e. Recording, compiling and analysing of data by the system
- Perform other procedure to test the security of the IT system
- Evaluate his results
- Express an opinion on the assertions made by the management

---

Test Yourself 2

Alston Co is a US-based company which produces plastic toys and sells them all over the world through its 20 branches. Its turnover for the last year was $50 million. Under local laws Alston is required to submit a report attested by a professional accountant that Alston has complied with all the applicable laws and regulations. In order to comply with this requirement, the management of Alston appointed RA Co an audit firm.

Required:

Explain what an attestation engagement is with reference to Alston.

---

2. Direct reporting engagement

A direct reporting engagement involves the following:

- **An independent examination of financial information** or other information that has been prepared for use by another party
- **Engaging party may or may not make a written assertion or a set of assertions** (e.g. The engaging party may not state that the financial statements follow ias. However, the examining party will still need to state which standards have been used)
- Expressing an opinion in accordance with the agreed terms of the engagement

In a direct reporting engagement, the accountant is engaged to make enquiries into the accounts, organisation or activities of an entity.

Example

Barnyard is deciding whether or not to take over Lumber. While evaluating the proposed takeover, in order to obtain assurance that Barnyard is aware of all the relevant information and Lumber has disclosed all such information, the management of Barnyard asks Dino, an accountant, to prepare a due diligence report on the valuation of the assets and liabilities of Lumber.

Dino then collects all the relevant information from Lumber, consults various persons from the management of Lumber and reports whether he has noticed anything to indicate that the given information is not complete and relevant.

Note: due diligence is discussed in detail later in this Study Guide

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3. The following table summarises the differences between an attestation engagement and a direct reporting engagement:

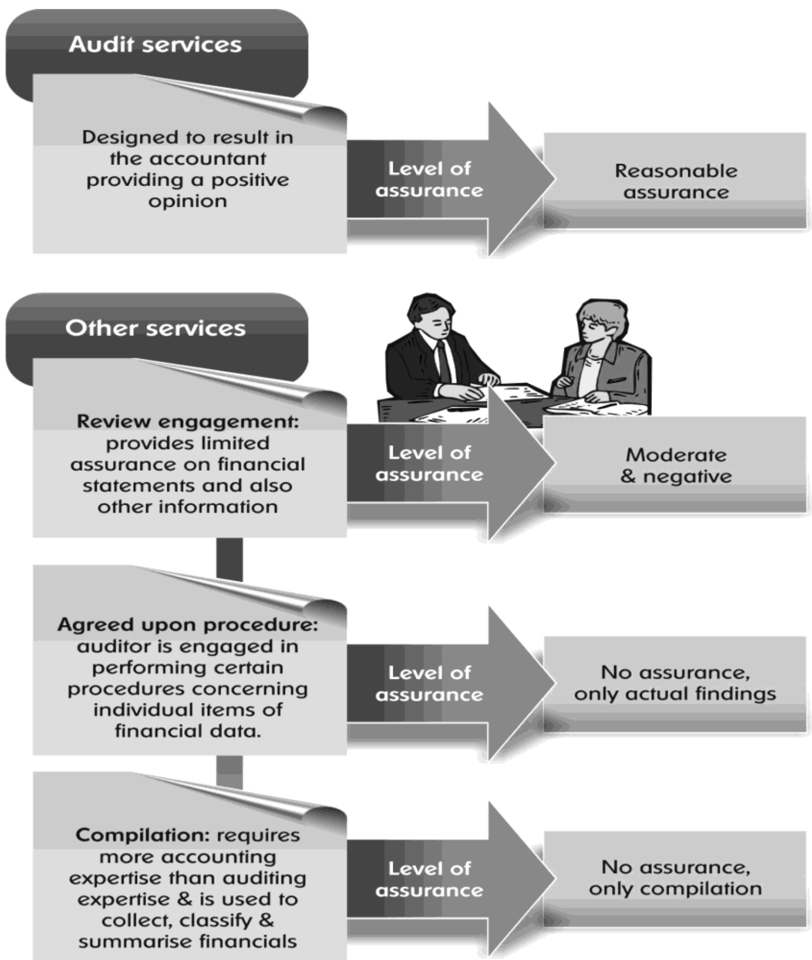
Attestation engagement	Direct reporting engagement
Assurance is provided on the written assertion, or set of assertions, made by one party, responsible for a matter of accountability, to another party.	Assurance is provided irrespective of whether the written assertion, or set of assertions, is made.
An audit of historical financial statements is an example of an attestation engagement where management makes an assertion e.g. the financial statements give a true and fair view and are free of material misstatements.	A direct reporting engagement is a kind of review engagement where opinion is provided but not always on the assertions made by the engaging party.
The assurance engagement risk is reduced to an acceptably low level.	The assurance engagement risk is reduced to a moderate level.
Comparatively extensive audit procedures are performed. Audit procedures generally comprise inspection, observation, confirmation, recalculation, re-performance, analytical procedures and enquiry.	Comparatively limited audit procedures are performed. Audit procedures generally comprise enquiry and analytical procedures.
"Reasonable assurance" is provided.	"Limited assurance" is provided.
The opinion is expressed positively such as "in our opinion subject matter conforms in all material respects to criteria."	The opinion is expressed negatively such as "nothing has come to our attention that causes us to believe that subject matter does not conform in all material respects to criteria."

Tip

Assurance engagement risk is the risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.

The following diagram summarises the levels of assurance provided by various audit related services. This was discussed in detail in Book B3.

Diagram 2: Level of assurance



2. Explain the level of assurance for an engagement.

[Learning Outcome c]

The International Standard on Assurance Engagements (ISAE No. 100, Para 28) states that in theory, it is possible to provide an infinite range of assurance from a very low level to an absolute level of assurance. However in practice it is not ordinarily practicable to provide such a range of assurance or to convey the level of assurance in a clear and unambiguous manner. Therefore professional accountants ordinarily undertake engagements to provide one of only two distinct levels i.e. a high level and a moderate level assurance.

ISAE 100 has been replaced by ISAE 3000 which prescribes only **two types of assurances: reasonable and limited**. Many studies have been conducted in the past by IFAC to provide guidelines on the issue of assurances other than high assurances because, in practice, professional accountants may need to provide various levels of assurances.

While the demand for assurance services continues to increase, professional accountants all over the world are encountering difficulties with determining the level of assurance for a given assurance engagement and reporting on them. The accountancy bodies worldwide realise the importance of having a common basis for determining assurance levels. In a survey conducted by the IAPC (International Auditing Practices Committee) which attempted to determine what, in practice, was leading to a differentiation between moderate assurance and high level assurance, the audit firms were asked questions relating to the following areas:

- Types of assurance services provided
- The corresponding level of assurance
- The determinants of the level of assurance
- Percentage of confidence for a moderate versus a high level of assurance

The majority of the findings of the survey highlighted the fact that **the level of assurance is determined on the basis of three main variables**, namely, the subject matter of the assurance engagement, the specific criteria and the work effort (i.e. the procedures applied and the quantity and quality of evidence obtained).

1. Subject matter

The level of assurance will depend upon the complexity of the subject matter of evaluation. The more complex the subject matter, the more convincing evidence required by the auditor to give a reasonable assurance.

Example

Let us suppose that a company has implemented a new accounting software package and appoints a professional accountant for providing assurance on the effective functioning of this software. If manual records are simultaneously maintained for a period of time, along with implementation of the software, a comparison of results will be easy.

In this case, the auditor can give a high level of assurance as he has a proper base to verify the results generated by the software package. However, if no manual records are available for comparison, the level of assurance will be affected and will vary accordingly.

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2. Specific criteria

Criteria refer to the rules or framework within which the subject matter must be evaluated. For example, in the case of an audit of financial statements, the criteria involve an acceptable accounting framework such as the IFRS.

Consider a case in which a professional accountant has to verify the salary reports of his client. He will probably decide the criteria of verification as the number of employees, the salary of each employee, and the number of days worked by each employee.

On the other hand, consider a case in which he has to verify the valuation of goodwill. Here, deciding the criteria may not be so easy, as the consideration given could include deferred / contingent consideration, fair value of assets etc. The level of assurance will depend on clear and specific evaluation criteria.

3. 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.

Reasonable assurance and limited assurance has been discussed in Learning Outcome 1. 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.

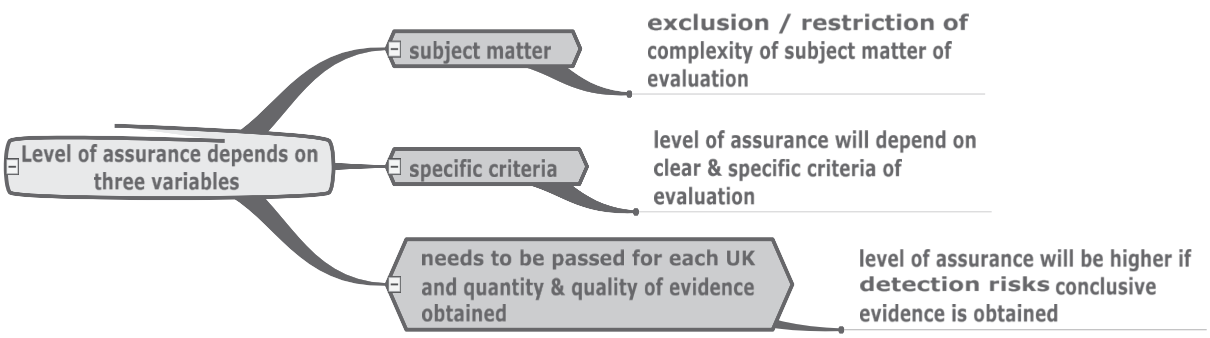
Negative assurance

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 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.

Answers to Test Yourself

Answer to TY 1

An audit is not required in the case of Blue Bell. However, which of the audit-related services is appropriate for Blue Bell will be decided after considering all the circumstances given in the question. The services and the circumstances in which they are appropriate are discussed below:

1. Review of the financial statements

A review of financial statements enables an accountant to state whether anything has come to the accountant's notice that causes him to believe that the financial statements are not prepared, in all material respects, according to an applicable financial reporting framework.

An entity may ask for a review engagement in the following circumstances:

- When the audit of the financial statements is not required but management wants some assurance on the financial statements
- When the entity wants some financial assistance and the financial institute or bank wants some assurance of the reliability of the financial statements
- When a review of the interim financial information is required
- in due diligence assignments

The first two situations are applicable to Blue Bell i.e. an audit is not required but some assurance is required by the management and Blue Bell has applied for bank loan. Therefore a review of the financial statements is suitable for Blue Bell.

2. Performing an agreed-upon procedures

An agreed upon procedures engagement enables an accountant to perform certain procedures (such as fraud investigations) which have been agreed between the auditor, the entity, and any other interested third party. In this engagement, the accountant does not express his opinion but gives only the factual findings of the financial data.

The circumstances in which an agreed-upon procedures engagement is required include:

- Verifying insurance claims
- Conducting fraud investigations
- Conducting forensic auditing i.e. when an entity wants to investigate fraud or irregularities in the financial system
- Verifying non-financial data such as waiting times in a restaurant

In short, an agreed-upon procedures engagement is required for special purposes.

In the case of Blue Bell, an agreed-upon procedures engagement may not be required since there is no indication of fraud, an insurance claim, taxation requirements etc. In addition, it seems that the management of Blue Bell is interested only in knowing the reliability of the financial statements. An agreed-upon procedures engagement will not be able to give this information (since, in agreed-upon procedures, only specific data are checked).

3. Compilation of financial statements

In a compilation engagement, the accountant prepares or assists in the preparation of the financial statements. It does not express any assurance of the accuracy or completeness of the financial statements.

The compilation of financial statements is required in the following circumstances:

- To prepare accounts
- To calculate taxable income and file returns
- To conduct a special enquiry into tax matters

Blue Bell's accountant has not yet completed his degree in accountancy therefore he may not be able to prepare the financial statements in accordance with the international financial reporting framework or local accounting standards. Therefore Blue Bell may require assistance in the preparation of financial statements.

Therefore, after evaluating the given circumstances, Blue Bell may require the services of review and compilation of financial statements. These services are not substitutes for each other and therefore more than one service can also be availed by an entity. Blue Bell should ask for review of its financial statements as the company has applied for a bank loan. In addition, it may ask for compilation of financial statements.

Answer to TY 2

In an attestation engagement, an accountant is hired to issue a written communication which conveys his opinion on whether an assertion or a set of assertions given by management is dependable or not.

Alston has appointed RA to perform an attestation engagement i.e. to express its opinion on whether or not Alston has complied with the applicable laws and regulations.

In this case, the management of Alston will give an assertion that it has complied with all the applicable laws and regulations. RA will perform the following audit procedures:

- Obtain an understanding of Alston, its business, the associated risks and the internal control system (relating to compliance with laws and regulations)
- Identify the applicable laws and regulations
- Identify the arrangements made by management to ensure compliance with the applicable laws and regulations e.g. Maintenance of register
- If such a system is in place, check the operation and reliability of the system
- Examine the extent to which the internal control system can be relied on
- Identify any incidents which may indicate non-compliance
- Check certain transactions on a test basis, such as filing of various returns on time
- Enquire with Alston's lawyer if there are any suits pending against Alston for non-compliance
- Evaluate the findings of the procedures
- Express an opinion on whether Alston has complied with the required laws and regulations

Since RA has been appointed for an attestation engagement, it should express an opinion on the assertion made by the management i.e. whether Alston has complied with the applicable laws and regulations.

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.

Quick Quiz

1. Match the following.

A	B
(a) Positive assurance	Complication engagement
(b) Negative assurance	Agreed upon procedures
(c) No assurance, only factual findings	Review engagement
(d) No assurance, only complied information	Audit of historical financial statements

2. **Answer in brief**

   (a) What is the meaning of an assurance engagement? (b) What are the two types of reporting?

3. **Choose the correct option**

   Under a limited assurance engagement the practitioner:

   A gathers sufficient appropriate evidence
   B concludes that the subject matter conforms with the relevant criteria
   C asserts that the level of risk is exceptionally low
   D expresses the opinion in a negative form

Answers to Quick Quiz

1.

A	B
(a) Positive assurance	Audit of historical financial statements
(b) Negative assurance	Review engagement
(c) No assurance, only factual findings	Agreed upon procedures
(d) No assurance, only complied information	Complication engagement

2.
   (a) An engagement in which a professional accountant, depending upon a predefined criteria, gives assurance on behalf of the responsible party on a subject matter to the intended users.

   (b) (i) attestation engagement
   (ii) direct reporting engagement

3. The correct option is **D.**

Self-Examination Question

Question 1

Henry and Fredrick are friends who are certified accountants having individual practices. One day during their morning walk together, they start having an argument. Henry has accepted many assurance services recently as he believes that assurance services involve less work and more money when compared with a traditional audit of financial statements. Fredrick, however, does not agree with this.

Required:

Assume that you are Fredrick and present your comments on Henry's belief about assurance services.

Answer to Self-Examination Question

Answer to SEQ 1

Assurance services are non-audit services provided by a professional accountant. This involves giving a level of assurance in the form of a report on a particular subject matter (e.g. a client's performance over the last five years on the basis of an increase in market share) to enhance the confidence of the users of such an assurance report and to increase the reliability of the subject matter. It is commonly believed that assurance services involve less work, less risk and a lower level of assurance. It is also believed to be a lucrative area of business for a professional accountant. There are many arguments in favour of and against this belief.

Assurance services involve less work

Similar procedures

Just like an audit, an assurance engagement involves providing assurance on the correctness of a subject matter. It includes similar procedures such as an assessment of risk, planning work based on such an assessment, collection of evidence, documentation of work done and arriving at a conclusion. Therefore, it involves similar challenges as a traditional audit. The only difference could be that an assurance is generally provided for 'some part' of the client whereas an audit is for the client's entire organisation. For example, an assurance may only be with regard to the valuation of non-current assets. In this respect the work involved may seem less, but it is not less when compared to a similar exercise carried out as a part of the audit i.e. verifying the value of non-current assets would involve the same amount of work under an assurance service as it would in an audit of financial statements.

Level of assurance

It may not be correct to say that an assurance service only provides low levels of assurance. Although an audit is aimed at providing a high level of assurance on the correctness of the financial statements, there are certain assurance engagements in which a high level of assurance is possible. The level of assurance varies depending upon the evidence collected. If the subject matter is clearly defined and sufficient evidence is available then it is possible to provide a higher level of assurance even under assurance engagements.

Therefore, a contention that assurance services involve less work due to the provision of lower levels of assurance cannot be justified.

Professional liability

A wrong or unacceptable level of assurance would make the professional accountant professionally liable for misconduct. Therefore, he will ensure that an assurance engagement is carried out properly, including all the processes necessary to issue an appropriate level of assurance.

Higher risk

An assurance service sometimes involves more risk when it is difficult to identify appropriate criteria for measuring the subject matter. For example, identification of appropriate KPIs (key performance indicators) under an assurance engagement of performance measurement may be difficult. If wrong criteria are chosen, the assurance provided will be incorrect, resulting in a bad name for the audit firm. Therefore, the accountant must spend more time and effort deciding the criteria.

In addition to the above, assurance services, unlike traditional auditing, do not have fixed work processes. The processes involved depend upon the nature of the assurance service. Newer procedures may require more work and time.

Drafting a suitable report

Although there are various guidelines on what must be included in an assurance report, there is no fixed format for an assurance report. Unlike the audit report of financial statements, which has a more or less similar format and content, an assurance report will vary according to the nature of the engagement. Appropriate wording in the report is important in order to convey the auditor's opinion correctly. Often, the nature of the engagement is complex and hence drafting a suitable report is a tedious task.

Assurance services involve more money

Level of work

The level of fees would mostly depend on the complexity and level of work involved. It would be incorrect to say that assurance services involve more money and less work. No client would pay more for less work done by the auditor. Therefore, Henry must reconsider and reanalyse why he feels that assurance services involve more money but less work.

Technical expertise

Assurance services cover many areas of work. For example,

- A trust may require submitting a report certified by an accountant comprising donations received and expenses made during each month to the regulatory authority.
- A listed company may require submitting a report of compliance with the stock exchange regulations.
- A client may require submitting historical accounts which are reviewed and certified by an accountant to a financial institution.
- An organisation may require a certified inventory valuation report or a non-current assets' valuation report for an acquisition deal.
- A company may require a certified report showing the appropriation of R&D expenses to the shareholders.
- A client may hire an accountant to provide assurance on its internal controls or IT systems.

Assurance work may require additional technical knowledge relating to the subject matter and not just accounting knowledge. The audit firm has to ensure that it has appropriate staff with requisite skills and technical knowledge. It has to conduct training and seminars to prepare a team which would be capable of carrying out various assurance engagements. Therefore, the firm has to spend more.

Conclusion

Whether an assurance service involves less work or more money depends on the type of assurance service. It would be incorrect to say that assurance services generally involve less work or more money.

SECTION C

PLANNING AND UNDERTAKING AUDIT WORK

C7

STUDY GUIDE C7: DEVELOPING AUDIT PLANS

Get Through Intro

An audit involves systematically analysing and evaluating the risks faced by an organisation, so an auditor must have a well-thought-out and methodical plan in place before commencing his work. However, the various facets of planning an audit i.e. materiality, internal control assessment, reliance on specialists etc, differ for various assurance engagement.

For example, materiality in the context of VFM work has to be seen as the significance of a departure from the laid down processes, policies and procedures that would mean a significant failure to deliver a fit-for-purpose service in compliance with regulations. However, materiality in the context of group audit would mean the group auditor understanding the materiality decisions taken by component auditors and how these have affected the nature and extent of testing and assurance gained.

This Study Guide discusses the various facets of planning assurance engagements like group audits, value for money audit, public sector audits, review of interim financial information, due diligence audit etc.

As an accountant, you will probably be involved in an audit at some point in your career. Either you will have your work checked by an auditor or be on the “other side of the fence” and audit the work of others. Therefore, it is important that you understand what goes into both planning and performing an audit.

Learning Outcomes

a) **Develop a proposed audit plan with justifications of judgements made based on a business scenario for an audit or assurance engagement including considerations relating to:**
   - **i. Materiality decisions**
   - **Ii. Internal control assessments including IT controls**
   - **iii. Reliance on internal audit, specialists and the work of other auditors**
   - **iv. Use of client generated data, information and reports**
   - **v. Tests of control, substantive procedures including analytical procedures**
   - **vi. Visits to locations, branches and departments**

b) **Develop and coordinate audit plans for group audits, joint audits and value for money audits as well as public sector audits, special engagements and investigations.**

1. Develop a proposed audit plan with justifications of judgements made based on a business scenario for an audit or assurance engagement including considerations relating to:
i. Materiality decisions
ii. Internal control assessments including IT controls
iii. Reliance on internal audit, specialists and the work of other auditors
iv. Use of client generated data, information and reports
vi. Tests of control, substantive procedures including analytical procedures
vii. **Visits to locations, branches and departments**
Develop and coordinate audit plans for group audits, joint audits and value for money audits as well as public sector audits, special engagements and investigations.
[Learning Outcomes a and b]

1.1 Planning group audits – judgements and justifications in audit strategy

1. Materiality

In carrying out a group audit with respect to the opinion on consolidated financial statements, judgements need to be made on an appropriate level of materiality for the group accounts or financial statements.

This judgement will be based on the perspective of shareholders, investors and some creditors who regard the entity as a single entity in terms of control.

The auditor needs to consider the significance of potential financial misstatements on the economic and governance decisions made by those who hold shares, those who consider investing and those who are doing business or considering doing business with the combined entity.

Consolidated financial statements and supporting notes include key headline figures such as revenue, cost of sales and expenses, gross profit, bottom line earnings, cash flow components, the make-up of gearing, the components of liquidity and single line asset, liability and equity numbers etc.

The group auditor must consider how users will make use of disclosures individually, in combination with other numbers as ratios of comparisons and as trend data. Disclosures include descriptive words, explanations and financial values.

Group materiality values may be set for the combined entity as a whole and with respect to individual disclosures.

Study Guide C8, Learning Outcome 2 explains the methodology to be followed to determine materiality for group audits.

2. Internal control assessments

Internal controls have to be seen in the context of their objective in giving reasonable assurance regarding the achievement of corporate objectives in business efficiency and effectiveness, reliable reporting and compliance with law and regulations.

From an audit perspective, internal controls relate to business risks and related reporting risks of material misstatement and have to be assessed in that context.

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**.**

Therefore, the group auditor needs to understand the audit strategy decisions taken by component auditors and the extent to which particular approaches may be required or additional work may be necessary to give sufficient assurance regarding material misstatement at a group level.

3. Reliance on internal audit

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

Internal audit is a management tool. It involves a thorough examination of the operations and records of an organisation. It includes testing the effectiveness and efficiency of an organisation's internal accounting and reporting systems (i.e. determining if the information being reported is accurate and timely).

Reliance on internal audit means that some confidence is gained from the effectiveness of internal audit as a component of internal controls such that reduced substantive testing can be carried out if tests of control based on review and tests of internal audit are sufficient.

Reliance on internal audit may also allow the external auditor to use internal audit work as evidence of procedures already carried out or carried out as a joint work programme in the areas of documenting and testing systems and controls and in routine transactions tests that would support substantive tests.

Using external audit work for more judgemental matters in providing evidence has to be used with considerable caution.

4. Use of specialists

Considerations regarding the use of specialists are really no different in a group audit except that other audit firms are involved in audits of subsidiary companies. This is discussed in detail in Study Guide C2.

5. Use of the work of other auditors

Planning involves coordinating with other auditors to ensure as group auditor that audit strategies are sufficient for the purposes. This is discussed in detail in Study Guide C8, Learning Outcome 7.

6. Use of client-generated data and reports

There are no specific audit considerations on this area.

However, the following matters must be considered by an auditor before relying on client-generated data and reports:

- Internal evidence (evidence generated within an entity) is more reliable when the related controls are effective.
- Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles.

Therefore, when planning an audit, the auditor needs to be sceptical regarding internally generated reports relating to operations, costs or payments and revenues or receipts. Tests may need to incorporate tests to establish the reliability of systems that produce such reports and data.

7. Testing

This is already discussed in para 2 and 3 above. Furthermore, it is also discussed in Study Guide C8.

8. Site visits and similar processes

Auditors provide a reasonable assurance that the financial statements do not contain material misstatements. For this, the auditor needs to carry out various audit procedures which include visiting client premises to carry out inventory counts, cash counts, tests of control, etc. More frequent visits of the auditor would minimise the chance of committing fraud.

Hence, this helps the auditor to give an opinion on the true and fair nature of the transactions. However, the **cost** of visits by the auditor can be high. Therefore, the auditor generally visits those locations where the value or volume of inventory is substantial, and where controls are weak.

A schedule of site visits may adopt a sampling approach with rolling testing over a period of time.

1.2 The various facets of joint audit are discussed in Study Guide C8.

1.3 Planning VFM audits – judgements and justifications in audit strategy

Value for money work is generally undertaken in the public sector and is designed to achieve the classic three-fold objectives of giving management and governing boards both assurance and advice for remediation and improvement relating to three key issues:

- **Effectiveness** in terms of the entity operating in support of central and local government agreed policy, laws and regulations. Effectiveness also means delivering a fit-for-purpose or quality service provision.
- **Economy** in terms of operating in such a way as to focus attention on achieving appropriately competitive prices for all forms of input.
- **Efficiency** in terms of achieving appropriate targets for use of resources in delivering effective services.

VFM work is generally undertaken by focusing on particular service delivery processes or activities in the service value chain.

Example

Parts 'n Pieces (PNP) is an organisation that manufactures coffee tables. It has the following value chain.

- **Inbound logistics:** PNP sources pre-ordered coffee table parts (e.g. table legs, top) directly from other organisations that when assembled will create the final product.
- **Operations:** these parts are then placed into a single package along with an instruction sheet on how they should be assembled.
- **Outbound logistics:** these packages are then shipped out to various retail outlets where they are sold.
- **Marketing and sales:** PNP's sales force are constantly contacting retail outlets to obtain further orders.
- **Service:** each of PNP's tables comes with a customer complaint form. A service department goes through all returned forms and passes their feedback onto the operations department.

PNP creates value by taking its raw material (coffee table parts) and transforming into a package where they can be easily assembled into the final product by the consumer. Further value is then added by shipping these packages to outlets where they can be easily purchased by its end user (the customer). However, since the assembly of the coffee table is done by the consumer, PNP's tables sell at a discount (Tshs60) for a table). If a VFM audit needs to be carried out in PNP, it could be on any of its activities like 'inbound logistics', 'operations' etc.

Testing is undertaken using a systems based approach but with considerable analytical procedures of process handling activities being traced through the system wholly or partly.

1. Materiality

Materiality in the context of VFM work has to be seen as the significance of a departure from the laid down processes, policies and procedures that would mean a significant failure to:

- Deliver a fit-for-purpose service in compliance with regulations
- Achieve appropriate economy in operation
- Achieve appropriate efficiency in operation

Materiality decisions are likely to be used to determine the overall confidence and precision required in assertions relating to effectiveness, economy and efficiency. When sampling is undertaken, testing may use set levels of precision and confidence and materiality is the basis for deciding on these factors such as achieving 95% confidence with a precision plus or minus a percentage deviation rate.

The materiality level set will reflect the significance of budget negative variances with respect to economy and efficiency and in relating to deviations from key performance indicators for effectiveness. The acceptable deviations will be a matter of judgement. The three aspects of VFM need to be related in materiality decisions since their achievement is inter-dependent.

The deviations are likely to be set as a percentage deviation that is then converted to monetary terms based on entity budgets. The auditor takes decisions relating to materiality while selecting samples of revenue and income streams which are to be tested.

2. Internal control assessments

In VFM work, planning will involve making initial assessments regarding the quality and effectiveness of controls implemented by management to achieve effectiveness with regards to both economy and efficiency. Internal controls will be tested at the same time as testing other aspects of achievement of effectiveness, economy and efficiency objectives.

3. Reliance on internal audit

Much of VFM work is undertaken by internal audit as part of a rolling strategy to test different processes on a rolling basis.

4. Use of specialists

Specialists are not generally required for VFM work.

5. Use of the work of other auditors

VFM work does not require reliance on the work of other auditors.

6. Use of client generated data and reports

When planning a VFM audit, the auditor needs to be sceptical regarding internally generated reports relating to operations, costs or payments and revenues or receipts. Tests may need to incorporate checks to establish the reliability of systems that produce such reports and data.

7. Testing

To make VFM audits efficient, tests will generally be planned to combine tests of control and substantive tests.

8. Site visits and similar processes

Site visits will be particularly important to establish the effectiveness of controls over tangible assets, stores and cash. A schedule of site visits may adopt a sampling approach with rolling testing over a period of time.

1.4 Planning public sector audits – judgements and justifications in audit strategy

1. Materiality

Materiality decisions for public sector audits are not significantly different with the exception that profit is not an important input since materiality is largely based on revenue and expenditure, or where more applicable, receipts and payments.

2. Other aspects of planning

All other aspects of planning (i.e. internal control assessments, reliance on internal audit, use of specialists, use of the work of other auditors, use of client generated data and reports, testing, site visits and similar processes) are quite similar to those discussed in para 1.1 and 1.2.above.

1.5 Review engagement

Tip

The scope of ISRE 2410, Review of Interim Financial Information Performed by the Independent Auditor of the Entity, is limited to a review of interim financial information performed by the independent auditor of the financial statements of the entity and, therefore, the standard uses the word ‘auditor’ for the accountant performing such a review.

However, an accountant who is not an auditor of the entity can also perform this kind of review. Such reviews are covered by ISRE 2400, Engagement to Review Financial Statements. ISRE 2400 uses the word ‘practitioner’ for the person performing the review.

ISRE 2400, Engagement to Review Financial Statements, states that the practitioner should plan the work so that an engagement can be performed effectively.

In order to plan the work, the accountant should obtain or update business knowledge by considering the following:

- Entity's organisational structure e.g. Who is reporting to whom
- Accounting systems e.g. accepted accounting policies and principles
- Operating characteristics
- the nature of its assets, liabilities, revenues and expenses
- a knowledge of the entity's production and distribution methods
- product lines
- Operating locations
- related parties

The terms of engagement should be agreed between the client and the practitioner and included in the engagement letter.

1. The review of interim financial information

Definition

Interim financial information is financial information that is prepared and presented in accordance with an applicable financial reporting framework and comprises either a complete or a condensed set of financial statements for a period that is shorter than the entity's financial year.

ISRE 2410

In many countries, listed companies are required to publish quarterly or half-yearly interim financial information which has been reviewed by a professional accountant. In order to comply with this, companies may appoint professional accountants (who may or may not be the company's auditors) to review the interim financial information.

The review of interim financial information enables the accountant to express a conclusion on whether, based on the review, anything has come to his attention that causes him to believe that the interim financial information has not been prepared, in all material respects, in accordance with an applicable financial reporting framework.

If, during the review, the accountant comes across matters that require modification in order for the information to be presented in conformity with the international financial reporting framework, he should communicate with the engaging party about the modifications required.

2. Plan for a review of interim financial information

ISRE 2410, Review of Interim Financial Information Performed by the Independent Auditor of the Entity, states that the **auditor should plan and perform the review with an attitude of professional scepticism**, recognising that circumstances may exist that cause the interim financial information to require a material adjustment so that it can be prepared, in all material respects, in accordance with the applicable financial reporting framework.

While planning a review of interim financial information, the accountant should consider the following:

scope of the work and other terms of the engagement

The scope of the review of interim financial information will be different from the scope of the audit of financial statements. This is because in a review engagement the reviewer expresses only limited (and negative) assurance. In addition, the scope will be limited to the interim financial information and not related to the financial information of a full year. The accountant should consider this while planning for the review of interim financial information.

Responsibilities of the accountant

The accountant should clearly mention his responsibilities in the letter of engagement. He should also mention specifically that the review report will be restricted to the interim financial information.

He should plan his engagement accordingly.

- The **client's accounting policies** including the deviations from the accounting policies followed by the client in the past
- The **effect of new accounting or auditing** (and related services) **standards**, both national and international, on the engagement
- Identifying **significant areas**
- Setting **materiality levels**
- **Conditions requiring special attention**, such as the possibility of material error or fraud
- The **involvement of other accountants and experts** in the assignment
- **Establishing the expected degree of reliance** that should be placed on internal control
- Determining and programming the **nature, timing and extent of the procedures** (i.e. Enquiry and analytical procedures) to be performed
- **Co-ordinating the work** to be performed

Tip

Even if a statutory auditor is conducting the review of interim financial information, while planning he should update his understanding of the entity, its business and internal control system. In addition, the auditor should obtain a sufficient understanding of the internal control relating to the preparation of interim financial information, as this may differ from the internal control relating to annual financial information

The review plan is more or less same as the audit plan, except for the procedures that have to be carried out. Therefore, one can refer to the audit plan. **The scope of work and its deadline should be included in the plan.** The accountant should decide on team members and estimate the time required for the assignment.

The accountant should **plan in advance the time, nature and extent of the procedures** (enquiry and analytical procedures) that the team needs to implement for the review of interim financial information i.e. which person should be consulted for which area (for instance, for confirming the inventory valuation in a manufacturing company, a person from the costing department should be consulted).

If **significant changes** have occurred in the nature of the business, the framework applicable to the entity, the laws and regulations which are fundamental for the entity (as they have an impact on the financial statements) etc., then these areas **should be checked thoroughly**.

Generally, while obtaining / updating an understanding of the entity, the reviewers identify the events, transactions or assertions, to which enquiry, analytical procedures or other review procedures can be applied. The accountant should include all of these in the review plan.

The accountant should **decide the materiality with reference to the applicable financial reporting framework** for interim financial information, so that it can assist in determining the nature and extent of the required procedures and in evaluating the effect of misstatements.

Tip

A review focuses on using analytical procedures and enquiry of personnel as the main methods of obtaining review evidence. Generally, detailed testing is not carried out at any stage during a review.

Tip

Planning aspects relating to internal control assessments, reliance on internal audit, use of specialists, use of the work of other auditors, use of client generated data and reports, testing, site visits and similar to what has been discussed in paras 1.1 and 1.2 above.

1.6 Due diligence assignment

1. Meaning and explanation

Definition

Due diligence review is a review where a person performing it **systematically obtains** and **assesses information** in order **to identify and reduce the risks** associated with a transaction to an acceptable level.

This is conducted in order to decide the worthiness of the proposal.

Example

An accountant may be asked to perform a due diligence review of the company, unit or other assets, as the case may be acquired in mergers and acquisitions. The accountant is supposed to identify risks such as the risk of non-disclosure of any relevant information and non-disclosure of any liability. The accountant can review target companies and comment on whether it is worth investing into these companies.

In addition, due diligence may be required in the cases of venture capital financing, lending, disinvestment etc.

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2. The need for a due diligence assignment

While acquiring a company, business or other assets, if adequate information is not obtained by the acquiring company, it may lead to a significant financial loss to the acquiring company. Due diligence is implemented in order to avoid this. **The due diligence provides assurance to the acquiring company that the given information presents a true and fair view of the situation,** based on which the proposal can be negotiated.

Example

Seymour Co is a producer of readymade clothes. Seymour has acquired Benson Co which deals in raw materials that Seymour requires. The valuation of Benson was decided at Tshs5 million (a contingent liability was determined at Tshs50,000). Benson's management has stated that all the contingent liabilities have been disclosed.

Six months after the merger, Seymour receives a notice from the customs department for a payment of Tshs10,000 towards customs duty. On investigation, it is found that Benson has pending final assessments for customs duty and only a provisional assessment has been done. This was not disclosed to Seymour (neither as a contingent liability nor in the financial statements as a hidden liability).

Seymour now suspects that there may be more hidden liabilities and feels that Benson has been overvalued. This

kind of situation can be avoided by asking a professional to conduct a due diligence assignment.

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3. Matters to be considered before accepting a due diligence assignment

Competency of firm: the audit firm should have the experience and skill to perform the review
Independence issues: as required in any assurance assignment, the accountant should be independent of both the parties
Sufficiency of resources: whether the firm has adequate manpower to perform the engagement
Degree of confidentiality: who the assignment will be performed for and who will see the results
Scope of work: what areas are to be concentrated on
Purpose of the acquisition e.g. whether the acquiring company is interested in acquiring the company (i.e. the share capital) or its trading assets. This is because the auditor will accordingly concentrate his work on that particular area, if any.

Example

Pretty Women Ltd is a company which manufactures readymade clothing. About 80% of its raw material is supplied by Richwell. Pretty Women Ltd is considering a proposal to acquire Richwell. Katrina, a professional accountant appointed to perform a due diligence review for Pretty Women Ltd, asked about the objective of such an acquisition. This is because, if Pretty Women Ltd is interested in the business of Richwell, then Katrina has to obtain information to determine Richwell's financial position.

However if the objective is not to run the business of Richwell but to ensure quality, quantity, timely delivery etc. of the raw material, the subject of the review engagement will change. In that case, Katrina will obtain information about the raw material and will concentrate less on Richwell's overall operations.

Time available for review: i.e. the period between the appointment date and the report date and whether it is possible for the firm to complete the assignment within the available timeframe.

4. Planning due diligence assignments

In due diligence assignments, the scope of the work should be written down in the engagement letter and agreed to by both the accountant and the client. The engagement letter should also include the following:

- Scope of work
- A clear demarcation of the responsibilities of the management and the accountant
- A clarification of interim report requirements
- Confidentiality

Apart from the usual considerations of the audit / review plan, **a due diligence plan should include** the following:

Preparing a list of required information and the people to be interviewed

In due diligence, the accountant analyses the information supplied by the target company and interviews a member of the management of the target company. In order to do this more effectively, the required information and interviewees should be identified well in advance and included in the plan.

The target company needs to be informed well in advance about the required information and the interviewees required so that the company can make these resources available.

Using the work of other people performing financial due diligence

A due diligence exercise can be classified as follows (the list is not exhaustive):

- Financial due diligence
- Commercial or operational due diligence
- Tax due diligence
- Information system due diligence
- Legal due diligence

Not all of the due diligences mentioned above are carried out by the accountant. For example, financial and tax due diligence can be performed by the accountant and legal due diligence may be performed by a lawyer or a company secretary. However, these are interrelated and the professional accountant responsible for carrying out financial due diligence should consider the implications of all the due diligence exercises.

Using the work of another person performing due diligence may reduce the accountant's work and therefore help him to decide the scope of the work and establish responsibilities.

Test Yourself 1

List the matters that could be checked by the accountant as part of due diligence assignment.

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5. Importance of enquiry and analytical procedures in the review

In an audit, the auditor carries out various procedures, such as inspections, observations, enquiry, confirmation, recalculation and analysis. However, **in review engagements the accountant performs limited procedures, such as enquiry and analysis.**

(a) Enquiry

Definition

Enquiry consists of **seeking information of knowledgeable persons**, both financial and non-financial, within the entity or outside the entity.

IFAC Glossary of terms

Advantages

- It provides a direct interface with the client's personnel and facilitates a better understanding of the business.
- It is interactive and doubts can be cleared on the spot.
- Non-verbal communication supports verbal communication.
- Evidence obtained from enquiry can be used to test any assertion.

(b) Analytical procedures

Analytical procedures consist of studies of the relationships either between the figures of financial statements or between financial and non-financial information

Analytical procedures may include ratio analysis and statistical techniques such as trend analyses or regression analyses, and may be performed manually or with the use of computer-assisted techniques.

Advantages

- Provides a sound basis for determining the reasonableness of data
- Helps in assessing the need for further tests
- Provides a good planning tool since it enables the auditor to decide the relative importance and priorities of different items

In review engagements, an accountant gives limited assurance and negative assurance that **nothing has come to his notice** that causes him to believe that the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework. This means that there can be matters which affect his opinion, but have not been noticed by him. Providing limited and negative assurance decreases the audit risk. **Due to limited and negative assurance, and low audit risk, even if an accountant does not perform any other audit procedures, an enquiry and analytical procedure are sufficient for forming an opinion**.

Review work is preferred by entities which do not require an audit by law, but in which the management wants some assurance on the financial statements. This is because a review is often more cost-effective. In a review, accountants only carry out enquiries and analytical procedures. These procedures help them to gather evidence directly related to risk areas from which it is easy to draw a conclusion. As a result, the review becomes cost-effective.

3. Application of enquiry and analytical procedures in review

The following example explains how enquiry and analytical procedures can be used in review of interim financial information

Example

Kat has been auditing Huge Co for the last 5 years. Last year Huge was listed on the London stock exchange. In the UK, listed companied are required to publish quarterly or half-yearly interim financial information that has been reviewed by a professional accountant. Accordingly, Huge asked Kat to perform an interim review of its financial information on 31 December 20Y0.

Enquiry

In order to plan the engagement, Kat should have an awareness of Huge's business. Since she has been auditing Huge for the last five years, she must have a detailed understanding of the company. Even then, she should consult the management regarding the following, in order to assess the impact of these on the interim financial information:

- Changes to the entity's accounting principles and practices
- Changes in the entity's procedures for recording financial information and preparing financial statements
- Other relevant information e.g. a change in the nature of business or in ownership
- The results of the management's assessment of the risk that the interim financial information may be materially misstated as a result of fraud

This information will help Kat to assess the changes and the impact of such changes on the interim financial information and accordingly to decide the scope of the work required.

Kat should ask members of the management who are responsible for financial and accounting matters, and others as appropriate, about the following:

- Whether the interim financial information has been prepared and presented in accordance with the applicable financial reporting framework.

- Whether the interim financial information contains any known uncorrected misstatements.

- Whether any unusual or complex situation has arisen, which have affected the interim financial information (such as a business combination, disposal of a segment of the business and reorganisation).

- Whether the management has made any significant assumptions relevant to the fair value measurement or disclosures.

- Are there any significant changes in commitments and contractual obligations?

- Are there any significant changes in contingent liabilities including litigation or claims?

- Enquire into the significant transactions occurring in the last few days of the interim period or the first few days of the next interim period.

- Whether related party transactions have been appropriately accounted for and disclosed in the interim financial information.

- Whether Huge has complied with debt covenants or if there are any unresolved disputes relating to debt, which has an impact on the interim financial information.

- Whether there is any fraud or suspected fraud affecting the entity involving the management, employees who have significant roles in internal control or others where the fraud could have a material effect on the interim financial information.

- Whether there are any allegations of fraud, or suspected fraud, affecting the entity's interim financial information communicated by employees, former employees, analysts, regulators, or others.

All these matters affect the interim financial information and, therefore, Kat should assess the impact of these on the financial information. For example, if after performing the analytical procedure, the accountant notices that the depreciation charged in the interim financial information is significantly different from what it should have been, a suspicion may not arise if he knows that Huge has changed the accounting policy related to depreciation and given reasons for the change.

Question the management about the current status of any prior year audit issues or management report points that would have an impact on the half-year financial statements. To consider subsequent events, the accountant should ask whether the management has identified all events up until the date of the review report that may require adjustment or disclosure in the interim financial information.

While assessing the going concern status of the client entity, the accountant should make sure of the following:

Whether the management has changed its assessment of the entity's ability to continue as a going concern.

If there are any indications that the going concern is in danger, he should ask the management about its plans for future actions based on its going concern assessment, the feasibility of these plans, and whether the management believes that the outcome of these plans will improve the situation.

Analytical procedures

It is necessary to perform analytical procedures to identify relationships and individual items that appear unusual.

The accountant should compare the interim financial information with the following:

Interim financial information of 31 December 20X9
The expected interim financial information for 31 March 20Y1
The most recent audited annual financial statements

The accountant needs to follow the steps below:

Compare current interim financial information with anticipated results, such as budgets (for example, comparing tax balances and the relationship between the provision for income taxes to pre-tax income in the current interim financial information with corresponding information in budgets, using expected rates, and with financial information for prior periods).

Compare current interim financial information with relevant non-financial information, for example number of employees and average salary.

Compare ratios and indicators for 31 December 20X9 with those of entities in the same industry e.g. the acid test ratio between the company and the average for the industry.

Compare ratios and indicators for 31 December 20X9 with the close competitors for example compare receivable days with that of competitors.

Compare relationships among elements in the current interim financial information with corresponding relationships in the interim financial information of 31 December 20X9, for example, expense by type as a percentage of sales, assets by type as a percentage of total assets, and percentage of change in sales to percentage of change in receivables.

Compare the expectations of the accountant with the actual amounts and ratios calculated from recorded amounts. This means that, from previous records, the auditor should build up a relationship and should apply this relationship to the interim financial information and assess whether the results match the expectations.

For example, if he determines the consumption patterns of raw material, i.e. for one unit of output, ten units of raw materials are required (i.e. 10%), then he should apply this rule to the units of raw material consumed in the current interim period and calculate the units produced during that period. He should then compare these results with the actual units produced and calculate the variance.

Example

Pigeon is a company that makes toys. Toys are sold all over Asia through 12 retail outlets. After its success in Asian countries, Pigeon is now expanding its business to the rest of the world. Pigeon has decided to purchase Green Co.

Green has been supplying raw material to Pigeon for the last six years. Andrew is the CEO of GMR, a firm of Chartered Certified Accountants. Mack, Pigeon's finance manager, has approached Andrew for advice on the purchase of Green Co. Mack has given Andrew the following information.

Green's business is spread all over the world. It has two segments – local and international. The local business comprises ten branches and the audited financial statements show revenue of Tshs8.5 million for the year ended 31 March 20Y0. Its International business comprises four branches and the revenue comes to Tshs2.4 million for the year ended 31 March 20Y0.

Required:

(a) Define 'due diligence' and describe the nature and purpose of a due diligence review.

(b) List the enquiry and analytical procedures Andrew will need to perform as part of a due diligence review of Green Co.

Answers to Test Yourself

Answer to TY 1

The matters the accountant will check in the due diligence include the following:

- True and fair view presented by the financial statements
- Efficiency and effectiveness of the company's controls and systems
- Uniformity and consistency of accounting policies
- Availability of records, information and proper explanation
- Quality of record keeping and information systems
- Physical existence of non-current assets and title of those assets
- net realisable value of business / net assets
- Undisclosed liabilities such as no provision or less provision of compensation to be paid to employees if they are made redundant after the merger
- Liabilities arising from non-compliance with various laws and regulations applicable to the entity

Answer to TY 2

(a) Meaning, nature and purpose of a due diligence review

A due diligence review is the process of systematically obtaining and assessing information in order to identify and reduce the risks associated with a transaction to an acceptable level.

Due diligence is a review process and relates to the following:

(i) An investigation: in this case, Andrew will investigate Green, the target company
(ii) Disclosure of findings: Andrew will disclose the Pigeon the findings of the investigation of Green

In a review, an auditor is required make evaluations from a commercial, strategic and operational perspective and look at accounting policies, recent changes, if any, overall scope, profitability and correctness, as well as any material changes in accounting policies.

Andrew will only carry out enquiries and analytical procedures in Pigeon's due diligence assignment.

The main purpose of due diligence is to identify all the related facts that would materially affect the buyer. This does not mean that if a factor has not been covered, the accountant is responsible for it. However, the accountant should have conducted the review with due diligence.

(b)

(i) Enquiry procedure

In an enquiry, an accountant obtains all the relevant information by interviewing the managerial personnel of the client entity. He should identify the facts which are not covered by the financial statements (e.g. off balance sheet finance, contingencies, commitments and contracts).

Andrew should find out about the following:

- Will the ownership pattern change as a result of the merger?
- Would any member of management (of both the companies) benefit from such merger e.g. perhaps Green will benefit and the managing director of Pigeon has significant shares in Green?
- Whether Green has any undisclosed / hidden liabilities e.g. warranty liabilities not provided in the financial statements, lease liabilities if the terms of lease have not been complied with and tax issues are still pending.
- Whether Green has disclosed all the contingent liabilities e.g. liability for a suit pending in a court.
- Whether Green has complied with all the applicable laws and regulations to identify any hidden liability e.g. if Green has not complied with the environmental laws and as a result, Green needs to pay a heavy penalty.
- Whether, as a result of the merger, Green will lose a major existing client.
- Whether Green has any purchase commitments or other contracts which will be affected as a result of the merger.
- The financial consequences of the termination of such contracts and commitments.
- Whether this merger will result in the redundancy of employees.
- Financial consequences (compensation etc.) of the retrenchment of employees
- The events that made a significant impact on Green's assets, liabilities, operating capabilities, cash flows, etc., since the financial statements were audited on 31 March 20Y0 e.g. tsunami, fire, exchange rate fluctuations or the insolvency of a major customer who owed a significant amount.
- Impact on loan covenants e.g. whether the loan will be taken over by the new company or need to be repaid immediately.

(ii) Analytical procedures

The following are the points that Andrew needs to consider in an analytical procedure:

- Analyse the trend of Green's profit, earning per share etc.
- Comparing the following for, say, five years:
  - Revenue
  - Profits (both gross and net)

The comparison should be performed for both local as well as international businesses AND should be done for the business as a whole as well as for individual units.

- Compare the following ratios for, say, the last three years
  - Return on assets
  - Assets turnover
  - Return on investments
  - Earnings per share
  - Average payable period
  - Average receivable period
  - Current ratio

- Analyse the overall industry trend
- Compare the financial information with the budget, such as with cash
- Analyse the variations from budgets for the last few years and accordingly analyse the chances and extent of variations in the forecasted financial information
- Compare the financial results with those of close competitors
- Compare borrowings against borrowings on 31 March 20Y0
- Review the overall projected future profits against Green's profits as on 31 March 20Y0
- Compare key performance indicators for the year up to 31 March 20Y0 e.g. number of corporate clients, number of delegates, and average revenue per delegate, etc.

Quick Quiz

1. State true or false for the following:

    (a) A person performing a review of the interim financial information does not need to be independent

    (b) An analytical procedure is performed to identify unusual items in the financial statements

2. Explain which audit related services are relevant to the following circumstances:

    (a) Pearl Ltd has decided to take over Emerald. Pearl has appointed John to provide a report of due diligence on Emerald's financial statement.

    (b) Invest-Assure is an insurance company. One of its clients has recently claimed a high amount for the loss incurred by him due to a fire in the factory. Kitty has been appointed to verify the insurance claims.

    (c) Happy Ltd is a partnership firm. It has appointed Ally to prepare income tax returns and act as an agent for tax matters.

Answers to Quick Quiz

1.

    (a) False. A person performing a review of interim financial information should be independent.

    (b) True. An analytical procedure is preformed to identify relationships and individual items that appear unusual.

2.
    (a) This is due diligence work in which John will systematically obtain and assess information in order to identify and contain the risks associated with a transaction to an acceptable level.

    (b) Kitty has been appointed to verify the insurance claim. She does not need to provide an opinion but she need to communicate her factual findings. Therefore, this is an agreed-upon procedures engagement.

    (c) Ally has been appointed to compile income tax information and prepare tax returns. This is a compilation engagement in which an accountant just puts data into a readable, given format.

Self-Examination Questions

Question 1

Royal Ltd which deals in cosmetics and accessories for women has decided to expand its business and to sell imitation jewellery. In order to fulfil the requirement for additional capital, it has approached Rich Bank for a loan.

The bank has asked Royal to submit its financial statements, attested by a professional accountant. However, being small in size, Royal is exempt from a statutory audit.

One of its directors has said that, instead of going for a voluntary audit which may cost more, Royal can ask a professional accountant to review its financial statements. Therefore, Royal has appointed you to perform a review of it financial statements.

Required:

(a) Explain why only enquiries and analytical procedures are performed in a review engagement.

(b) Explain the procedure you will perform in reviewing inventory and accounts receivables (which the bank would be more interested in).

Question 2

Decoration Biotech is a new company. It sells decoration plants (of high quality) prepared in the laboratory. The company is very small, with three directors and shareholders. For the first financial year it recorded a profit of Tshs80,000. Due to the first year's performance analysis, the stakeholders of the company are expecting good future business and have decided to export plants.

For this, they have decided to take loan from a bank. However, the bank wants financial statements certified by a professional accountant. Being a small company, Decoration is not subjected to annual external audit. Therefore, the directors have decided to ask for a review of the financial statements. The directors of Decoration have approached you for a review.

Required:

List the enquiry and analytical procedures you would undertake for the review of financial statements on 31 December 20Y0.

Answers to Self Examination Questions

Answer to SEQ 1

1. In a review engagement I would mostly carry out enquiries and analytical procedures.

This is because, in review engagements an accountant gives **limited assurance and negative assurance** that **nothing has come to my notice** that causes me to believe that the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework. This means that there could be matters which would affect my opinion, but they have not been noticed by me.

Due to the limited and negative assurance, audit risk is low and, therefore, enquiry and analytical procedures are sufficient to form an opinion.

Enquiry and analytical procedures help the reviewer to obtain evidence directly for risk areas and allow the review service to become cost-effective.

2. The following are the procedures I would follow for a review of Royal's inventory and accounts receivable.

(a) Procedure for inventory review:

For inventory, I would:

(i) Acquire a list of the inventory and trial balance.

(ii) Match the amount given in the inventory with the balance in trial balance.

(iii) Find out if inventory counting has been performed on the financial statements' date.

(iv) If yes, compare the list of inventory provided with the list of physical counting of inventory.

(v) enquire about the procedures applied for counting inventory in order to ensure that there are no irregularities in the procedure and therefore verify the completeness, accuracy etc. of assertions made in the inventory.

(vi) Enquire about the control procedures for the movement of inventory during inventory counting to ensure the cut-off i.e. whatever has been received during the counting process is included in the count and whatever is sold is not included. The movement of inventory during counting should not be allowed but sometimes the counting takes a long time and therefore it may not be possible to stop the movement. In this case, if movement is allowed, a proper procedure should be put in place to record the movement.

(vii) Enquire about any adjustments made as a result of the physical count of inventory e.g. if a lot of inventory items are present in the entity and counted as a part of inventory. However, later on the reviewer may find that all the items do not belong to the entity. The items have been sold but not yet delivered. In this case, an adjustment is required to the results of the physical count of inventory.

(viii) Enquire about the procedure applied for cut-off in order to ensure the completeness and accurate valuation etc. of the inventory.

(ix) Enquire about inter-division transfers, if any; if yes, enquire about the valuation of such items (whether inter-division profit has been adjusted).

(x) Enquire about the method of valuation i.e. whether the method is in accordance with the standard on inventory.

(xi) Enquire whether there is any deviation from the previous year or from requirements of accounting standards on inventory.

(xii) Enquire about the method for identifying slow-moving and obsolete inventory and its valuation (this should be valued at net realisable value).

(xiii) Enquire about misappropriation of inventory, if any, and the measures taken by Royal against this. (xiv)

Compare:

Inventory as on the date of the financial statements, with the previous year's data

Inventory turnover with the previous year

Amounts of major inventory categories with those of prior periods, and with those anticipated for the current year

This will help in identifying any significant increase / decrease in inventory. This will provide evidence about assertions relating to valuation, completeness, cut-off and accuracy.

(xv) if, as a result of the above comparison, significant variations are noticed, I would enquire about such variations.

(b) Procedure for accounts receivables:

For reviewing receivables, I would:

(i) Obtain a list of receivables and compare whether the total agrees with the trial balance.

(ii) Compare receivables with the previous year and anticipated results, and investigate about significant variations.

(iii) Obtain an age-wise analysis of accounts receivables and ascertain whether old balances are collectible or if there is any allowance on such balances.

(iv) Enquire about the method for setting allowances for doubtful accounts and consider it for reasonableness. For this, I would consider prior experience i.e. percentage of allowance made in the prior period and actual bad debts.

(v) Obtain classification of receivables such as those related to directors, related parties and others. (vi) Enquire

about the procedure adopted for ensuring proper cut-off of sales and sales return.

(vii) Compare receivables with the previous year and with anticipated receivables.

(viii) Compare allowance created on receivables / bad debts written off with the prior period and those that are anticipated.

(ix) Enquire about significant variations, if any, in the above comparison.

Answer to SEQ 2

A review of financial statements provides a limited assurance. It generally includes an enquiry procedure and an analytical procedure. But before conducting any procedure, an auditor should gather some general information about Decoration's business and its internal and external environment.

1. Enquiry

This is necessary in order to obtain knowledge of Decoration's business and the industry in which it operates. For

this, I would enquire about the following:

- The accounting principles, policies and practices adopted by Decoration.
- Decoration's procedure for recording, classifying and summarising transactions etc., and also the procedure for gathering information for disclosure in the financial statements.
- Whether the financial statements are prepared in accordance with the required financial framework.
- All material assertions in the financial statements.
- The operations of Decoration's internal control system. In addition, I would enquire about the following:

- Whether all the applicable laws and regulations have been identified by the management.
- Whether all transactions have been recorded.
- Whether the financial statements have been prepared in accordance with the basis of accounting indicated.
- Changes in the entity's business activities and accounting principles and practices, such as diversification, changes in the depreciation method and changes in revenue recognition.

Decoration's new commitments and contracts.

- Review changes in contingent liabilities and find out if any litigations or claims are filed against Decoration.
- The compliance of debt covenants, if any.
- Whether related party transactions have been appropriately accounted.
- major decisions taken at meetings between shareholders, the board of directors, committees of the board of directors, and their effect on Decoration's financial statements e.g. business combinations.

2. Analytical procedure

Analytical procedure is a component of the substantive examination of the financial statements. It is often a major component in a review engagement. The requirements of an analytical procedure are as follows:

- Compare:
  - The financial statements with the financial statements of the previous year.
  - The financial statements with anticipated results.
  - Ratios and indicators for 31 December 20Y0 with those of other entities in the same industry, such as gross profit ratio, asset turnover, ROI etc.
  - Ratios and indicators for 31 December 20Y0 with those of close competitors.
  - Current financial information with relevant non-financial information.

This will enable the reviewer to obtain evidence about the assertions made for the account balances and the class of transactions such as completeness, accuracy, valuation and classification. For any significant variation noticed by performing analytical procedures the reviewer must investigate the reasons for such variations. If there is no significant variance, the reviewer may assume that there is no understatement or overstatement. For example, if the reviewer has analysed the gross profit trend for the last five years and also compared with the industry norms and does not find anything abnormal, it shows that there is no overstatement / understatement of revenue and direct expenses. We can assume there is significant variation in the gross profit ratio of the current year as compared to the prior periods.

However, after investigation and enquiry it is found that the reasons for such variance include a change in the product mix and a disproportionate increase in the cost of material. This dispels the reviewer's suspicion about the misstatement in the revenue or direct expenses. This is how analytical procedures can be applied to all the account balances and class of transactions such as revenue, expenses, non-current assets and liabilities in review assignments.

- Study relationships between elements of the financial statements that would be expected to conform to a predictable pattern, based on the entity's experience or industry norms.
- Compare the ratios and amounts recorded in the financial statements so that they reflect the understanding and the experience of an auditor of Decoration's business, within the context of the industry in which Decoration operates.
- compare disaggregated data, such as sources of revenue, the product line, the location, the period, etc.

SECTION C

PLANNING AND UNDERTAKING AUDIT WORK

C8

STUDY GUIDE C8: GROUP AUDITS

Get Through Intro

A group audit is an audit of the consolidated financial statements of a group. Group audits can be relatively easy if:

- The auditor for all group companies is the same
- All group companies have uniform accounting policies
- All group companies follow the same accounting standards
- All group companies have co-terminus year ends

However, this kind of situation is the exception rather than the rule.

This Study Guide discusses the specific issues faced by the principal auditor of a group. It also discusses the matters that need to be considered while relying on the work of other auditors. Remember that the principal auditor has to walk a tight rope, especially where his opinion requires him to modify (for consolidation purposes) the individual financial statements of a subsidiary audited by another auditor.

The importance of group audits is increasing every day!

The snowball effect of this is that the importance of this Study Guide is also increasing everyday!

Learning Outcomes

a) **Identify the matters from a given situation which must be taken into account prior to accepting appointment as principal auditor to a group.**
b) Discuss the matters relevant to planning an audit of group financial statements.
c) Validate the circumstances under which a joint audit would be appropriate.
d) Discuss the audit areas along with the audit procedures relevant to a business combination.
e) Discuss the audit risks, along with audit procedures relevant to the consolidation process.
f) Discuss the matters to be taken into account, along with the procedures to be performed at the planning stage, when a principal auditor considers the use of the work of component auditors.
g) Discuss the methodology to be adopted by the principal auditor to evaluate the audit work performed by a component auditor.
h) Discuss the reporting implications in a given situation where the opinion on a component is modified.

1. Identify the matters from a given situation which must be taken into account prior to accepting appointment as principal auditor to a group.

[Learning Outcome a]

1.1 Group audits are audits of the consolidated financial statements of the group. A group audit report will carry information specific to the financial statements of the individual parent company as well as on the group financial statements.

Group audits are carried out in the same manner as regular audits of single companies, the only difference being that certain transactions which are peculiar to groups need to have additional, peculiar audit procedures carried out. Some of these peculiar transactions could be:

1. **Subsidiaries in foreign countries** may **follow accounting standards applicable to their own country**. These accounting standards would require assets and liabilities to be measured and recorded according to rules different from the parent.

2. **Year ending dates** followed by the subsidiary would **differ** from the parent

3. Again coming back to the topic of foreign subsidiaries, the **foreign subsidiary would report its finances in currencies different from the currencies of the parent.** Also, while translating these currencies into one common functional currency, several issues may crop up.

4. **Adjustments made while consolidating** the financial statements of the group may **give rise to** several **typical transactions**.

5. **Subsidiaries** may be audited by an **auditor different from the parent's auditor.**

6. **Related party transactions** would have to be **audited separately**. As a result, when auditing groups, two

situations could arise:

Situation one

One auditing firm audits the entire group, including all of its subsidiaries.

Example

Maximillian an international auditing firm with affiliates, branches and member firms in 94 countries, may audit the financial statements of the entire group, with offices in Asia, Europe and the America.

Situation two

One auditing firm carries the responsibility of presenting an opinion on the consolidated financial statements, while different auditing firms audit different subsidiaries. This usually happens when the subsidiaries are located in different countries in which the principal auditing firm does not have any branches. It could also be because subsidiaries in foreign countries would pose a number of issues, such as different languages, and political and cultural problems which local accounting firms would be able to handle in a better way. In such cases, the firm auditing the consolidated financial statements is called the **principal auditor** while the firms auditing the subsidiaries are called the **component auditors**. This situation could bring its own share of administrative and support issues, as the principal auditors have to gather enough information from the component auditors to form an opinion on the financial statements.

IFRS

When auditing for groups, an auditor would need to have expert knowledge of accounting, finance and the industry within which the client operates. However, additionally, the following accounting standards would need special consideration:

IFRS 3 Business Combinations
IAS 24 Related Party Transactions
IAS 27 Consolidated and Separate Financial statements
IAS 28 Accounting for Investments in Associates
IAS 31 Accounting for Joint Ventures
IAS 32 Financial instruments: Presentation
IAS 39 Financial instruments: Recognition and measurement

Objectives of the group auditor

According to **ISA 600, Special Considerations - Audits of Group Financial Statements (including the Work of Component Auditors)**, the **objectives of the auditor** are:

to determine whether to act as the auditor of the group financial statements; and

if acting as the auditor of the group financial statements:

to communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings; and

to obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

1.2 Important terms in group audits

The definition of some of the important terms **according to ISA 600** which are used frequently while auditing group consolidated financial statements are as follows:

1. Component

Definition

A component is **an entity or business activity** for which group or component management prepares financial information that should be **included in the group financial statements**.

2. Group

Definition

A group **comprises all the components** whose financial information is included in the group financial statements. A group always has more than one component.

3. Component auditor

Definition

A component auditor is an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

4. Group audit

Definition

The audit of group financial statements is referred to as a group audit. The audit opinion on the group financial statements is thus referred to as group audit opinion.

5. Component materiality

Definition

Component materiality is the materiality for a component determined by the group engagement team.

6. Significant component

Definition

A **significant component** is a **component identified by the group engagement team**

That is of **individual financial significance** to the group, or

That, due to its **specific nature or circumstances**, is **likely to include significant risks of material misstatement** of the group financial statements.

Responsibilities

The group auditor's responsibility includes reporting and presenting an opinion on the group's consolidated accounts, even if subsidiaries / components of the group have been audited by other audit firms. They can, however, in addition to rights usually enjoyed by auditors, request information from the component auditors in the course of their audit.

Thus, the **group auditor is responsible for the audit opinion on the group's financial statements**, irrespective of whether or not the group's subsidiaries have been audited by other auditors. As a result, the **group auditor's report should not include any reference to the component auditors except if there is a legal compulsion to do so.** Even if a reference is made, the group auditor should state in his report that the reference to the component auditor's work does not in any way diminish his responsibility.

1.3 Accepting appointment as auditor to a group

Most audit partners use a **client accept-reject model** to help them accept or reject a new audit client. This model takes into consideration several factors such as:

The financial condition of the client
The audit firm's risk of loss on the engagement
Any possibility of litigation
The level of audit risk undertaken

Matters to be considered

1. Understanding the auditor's own competencies

Firstly, when approached with an audit client, the audit firm should make an assessment of its own capabilities. The auditor must ascertain whether he has the **required skills, expertise, knowledge and resources** to competently and diligently carry out the audit. In addition, the auditor must be sure that taking on the new audit client would **not** induce him to **violate any of the five main ethical principles**. The audit team should also make a **cost benefit analysis** to ensure that the benefits included in the audit outweigh the costs. However, the benefits should not outweigh the costs to the extent that they impair or cast doubts on the **auditor's independence**.

2. Understanding the audit client

According to ISA 600, when faced with a new client, the audit engagement partner should determine the auditability of the new client. This means the audit partner should determine whether sufficient audit evidence can be obtained from the new client by applying appropriate audit procedures on the consolidated financial statements.

In order to do this, the group auditor should obtain an understanding of the parent company, its subsidiaries and the environment that it operates in by checking with the group's management as well as the group's previous auditors. The new auditors will specifically look for the following information:

(a) **The legal and reporting structure of the group:** to ensure it looks legitimate and the principle auditor understands the size and scope of work involved.

(b) **Identifying the group's significant components as well as information about the economic, political and social environment within which they operate:** to ensure that relevant information can be gained when needed.

(c) **Service organisations used by the client** along with shared service centres, if any.

(d) The group's internal control system: to see how much reliability can be placed on it and also whether it is the same system throughout the group (easier to audit) or not (more time consuming).

(e) The consolidation process of the group's accounts: who performs this, their level of expertise and the extent of complexity of the process.

(f) The extent to which the group's component auditors would audit the financial statements: if a subsidiary is extremely material to the group, the principle auditor may want to be involved with their audit.

(g) The group's motive behind appointing more than one auditor: especially if one audit firm is available in all locations: why would the client want to use multiple auditors; professional scepticism may come in.

(h) The level of access to the group's accounts and internal documentation: the principle auditor would want full access.

(i) Any pending litigation against the group: to decide whether the group is a going concern.

3. Communicating with the client's previous auditors

In order to allow the new auditors **to enquire and obtain information** from the group's previous auditor, the newly appointed group auditors would need to obtain the potential client's permission to make enquiries of the previous auditor. The next step is actually communicating with the previous auditors and informing them of their intention to audit the new client. They must also **find** out from the **previous auditors** the **reason for their dismissal or resignation**. Only if favourable replies are obtained should the new group auditor proceed with the engagement; in all other cases the engagement must be refused.

4. Taking an audit decision

If all of the tasks mentioned above return favourable results and the auditor is convinced that he can carry out the audit satisfactorily, the auditor accepts the audit client. The auditor then sends out an engagement letter to the client. The engagement letter outlines all of the points discussed and agreed to by the auditor as well as the audit client in order to avoid misunderstandings at a later stage in the audit. The engagement letter is discussed in detail in Study Guide B1 of this Study Text.

After his assessment, the group engagement partner may conclude that:

(a) It will **not be possible** for the group engagement team **to obtain sufficient appropriate audit evidence** due to restrictions imposed by group management; and
(b) The possible effect of this inability will **result in a disclaimer of opinion** on the group financial statements.

Then the group engagement partner would **not accept the engagement** if the audit client is a new client. If the audit client is an existing client, then the partner would withdraw from the engagement if it is possible according to applicable laws and regulations. However, if the applicable laws and regulations do not allow the engagement partner to do so, then he can audit the financial statements to the extent possible, which can result in a disclaimer of opinion on the group financial statements.

1.4 Scope of work to be performed on components

After accepting an audit assignment, the group auditor has to decide the extent and scope of work to be performed on the financial information relating to each component of the group. To determine this, ISA 600 segregates the components into significant and non-significant components.

1. Significant components

(a) If a component is financially significant to the group, the group engagement partner or a component auditor on his behalf will perform a complete audit of the financial statements of the component on the basis of its materiality level.

(b) If a component is significant to the group financial statements because of its probability of risk of material misstatement due to its specific nature or circumstances, then the auditor or a component auditor should perform any one of the following procedures:

(i) A complete audit of the financial statements of the component on the basis of its materiality level.
(ii) An audit of some specific account balances, transactions or disclosures that are expected to carry a risk of material misstatement.
(iii) Specified audit procedures which are related to the expected significant risks of material misstatement.

2. Non-significant Components

Analytical procedures will be performed at group level for the components which are not significant.

Test Yourself 1

What are the primary responsibilities of?

A a group auditor
B a component auditor

Test Yourself 2

Alligator Appliances Ltd is engaged in the manufacture of electronic appliances for commercial as well as domestic purposes. Its headquarters are in Australia. It has recently acquired all of the share capital of Hi Voltage, a manufacturer of electrical switches in Japan.

Alligator's intention for this acquisition was to be able to step into the Asian market and finally into the world market through a trusted brand such as Hi Voltage. Alligator's electronics will now be sold through Hi Voltage's stores while Hi Voltage's products will be sold in Australia through Alligator's distributors.

The parent company's management wants its auditors, Priestly & Copper, Chartered Accountants, to audit the financial statements of the newly acquired company. According to the terms of the new agreement, P&C's new audit fee should not exceed more than 150% of the current year's audit fees.

Required:

What are the matters that should be considered by P&C before accepting Hi Voltage's audit?

---

2. Discuss the matters relevant to planning an audit of group financial statements. [Learning Outcome b]

The group engagement team shall establish an overall group audit strategy and shall develop a group audit plan in accordance with ISA 300. This Learning Outcome discusses matters specific to audit of group financial statements.

Matters specific to planning an audit of group financial statements

1. Identifying the group structure

The first step in planning an audit of group financial statements would relate to identifying the group structure as the accounting of group financial statements depends on the identity of the components of the group. The various components of a group could be a subsidiary, an associate or joint operations or joint ventures.

Definition

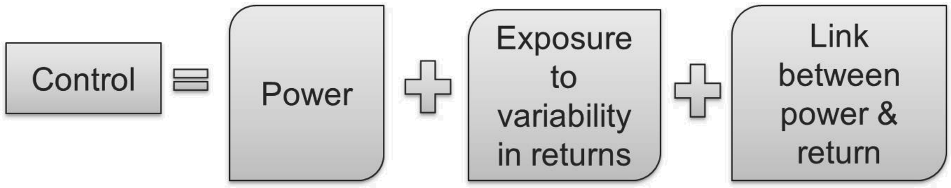
Group is a parent and all its subsidiaries.

Parent is an entity that has one or more subsidiaries.

A subsidiary is an entity, including an unincorporated entity such as a partnership that is controlled by another entity (known as the parent).

IFRS 10 Appendix A

Under IFRS 10, an investor controls an investee if and only if the investor has ALL the following: Diagram 1: Control



Changes in any of the three elements will require a reassessment of the existence of control.

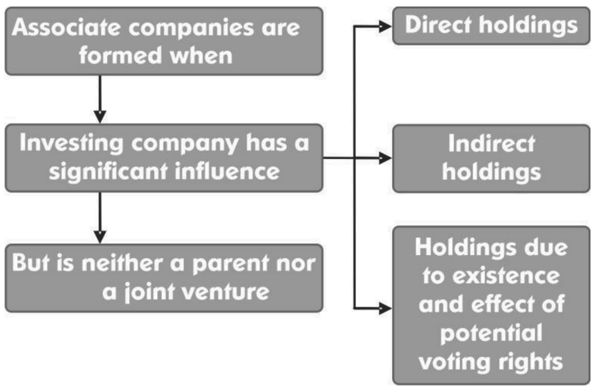
Definition

An **associate** is an entity over which the investor has significant influence.

Significant influence is the power to participate in the financial and operating policy decisions of the investee, but is not control or joint control over those policies.

IAS 28 Para 3

Diagram 2: Formation of associate companies



For example, **IAS 28** states that **investments in associates and joint ventures** shall be accounted for using the **equity method.** Therefore, the first step for planning an audit involves the identification of the group structure.

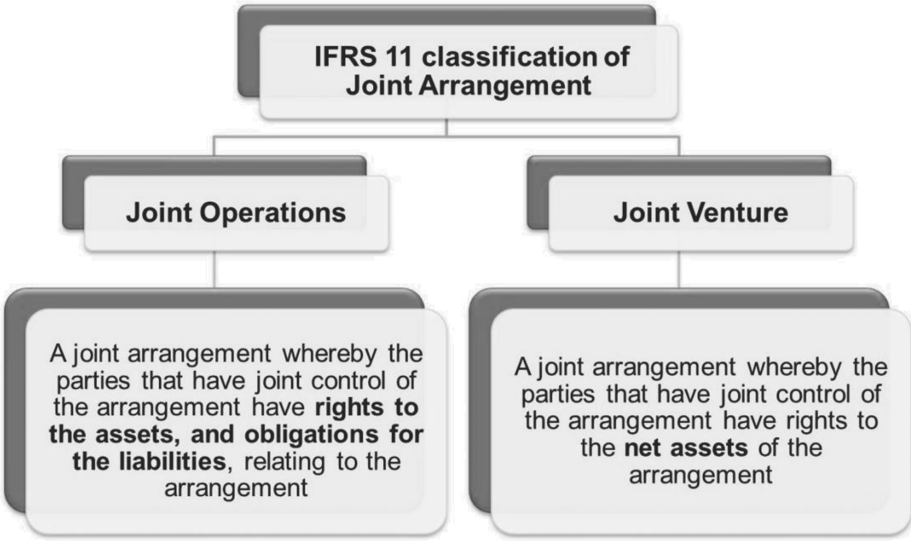
Definition

Joint arrangement is an arrangement of which two or more parties have joint control.

(IFRS 11 appendix A)

IFRS 11 identifies two different types of joint arrangements:

Diagram 3: Joint arrangements



A joint venture arrangement gives rise to a separate entity, which requires to be consolidated with the group. However, a joint operations arrangement is accounted for in the investor's books as it does not give rise to a separate entity.

Accounting treatment of the above joint arrangement

Joint operations: a joint operator accounts for the assets, liabilities, revenues and expenses relating to its involvement in a joint operation in accordance with the relevant IFRSs.

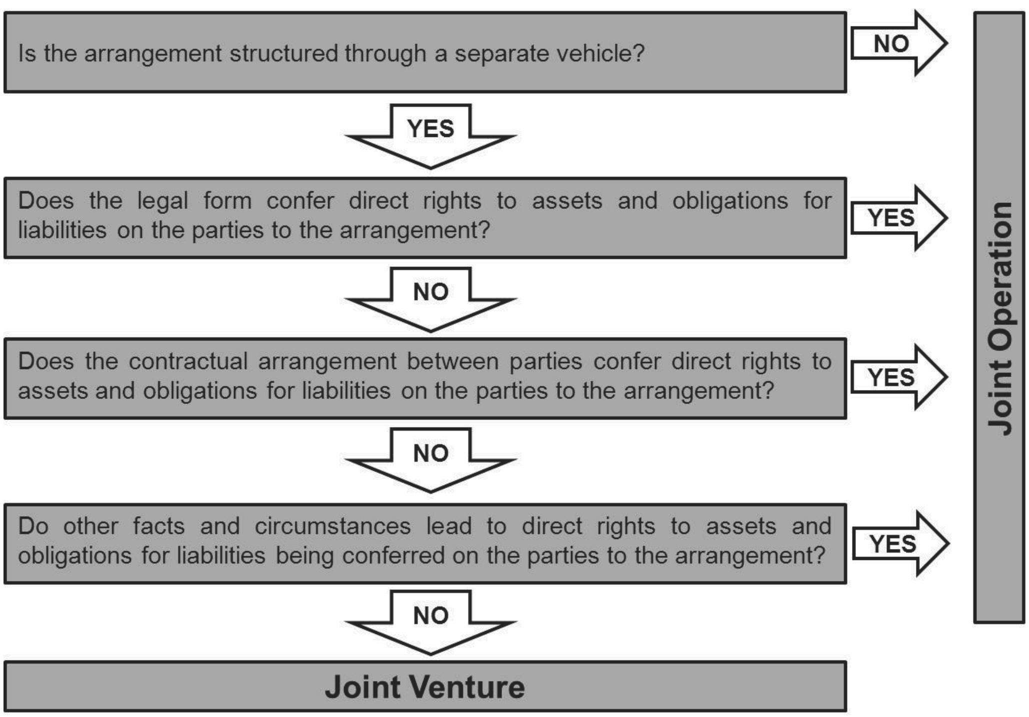
Joint venture: a venturer should recognise its interest in a joint venture using the equity method (discussed in associates).

Guidance on classification of joint arrangements

A joint arrangement which is not in the form of a separate vehicle (generally, a separate legal entity) will be compulsorily classified as a joint operation.

If the joint arrangement is in the form of a separate vehicle, following criteria are to be assessed: Diagram

4: Determine the classification of joint arrangements



Always remember, if the joint arrangement is not a joint operation, it is a joint venture.

2. Understanding the group, its components, and their environments

The auditor is required to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment.

The group engagement team shall:

(a) Enhance its understanding of the group, its components, and their environments, including group-wide controls obtained during the acceptance or continuance stage (discussed in paragraph 1.3)

Group-wide controls may include a combination of the following:

(i) Regular meetings between the group and component management to discuss business developments and review performance

(ii) Monitoring of components' operations and their financial results, including regular reporting routines, which enable group management to monitor components' performance against budgets, and take appropriate action

(iii) Group management's risk assessment process, that is, the process for identifying, analysing and managing business risks, including the risk of fraud that may result in material misstatement of the group financial statements

(iv) Monitoring, controlling, reconciling and eliminating intra-group transactions, unrealised profits and intra-group account balances at group level

(v) A process for monitoring the timeliness and assessing the accuracy and completeness of financial information received from components

(vi) A central it system controlled by the same general it controls for all or part of the group

(vii) Control activities within an it system that is common for all or some it components

(viii) Monitoring of controls, including activities of internal audit and self-assessment programmes

(ix) consistent policies and procedures, including a group financial reporting procedures manual

(x) group-wide programmes, such as codes of conduct and fraud prevention programmes

(xi) Arrangements for assigning authority and responsibility to component management

(b) Obtain an understanding of the consolidation process, including the instructions issued by group management to components

(i) Understanding the consolidation process (discussed in paragraph 5.2) (ii) Instructions **issued by group**

management to components

To achieve uniformity and comparability of financial information, group management ordinarily issues instructions to components. Such instructions specify the requirements for financial information of the components to be included in the group financial statements and often include financial reporting procedures manuals and a reporting package.

The instructions ordinarily cover:

The accounting policies to be applied;
Statutory and other disclosure requirements applicable to the group financial statements, including:
The identification and reporting of segments
Related party relationships and transactions
Intra-group transactions and unrealised profits
Intra-group account balances; and
A reporting timetable.

3. Materiality

Materiality for the group financial statements is quite similar to standalone financial statements.

The group engagement team shall determine the following:

(a) Materiality for the group financial statements as a whole when establishing the overall group audit strategy

(b) If required, it is also set for particular classes of transactions, account balances or disclosures in the group financial statements (for which misstatements of less amounts are expected to affect the economic decisions of users of financial statements

(c) Component materiality is also set for those components for which component auditors will perform an audit or a review for the purposes of a group audit. Component materiality is set at a level lower than the materiality for the group financial statements as a whole. This will reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds the materiality for the group financial statements as a whole. Furthermore, it can be set at different levels for different components.

Component materiality need not be an arithmetical portion of the materiality for the group financial statements as a whole!

(d) The threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements, i.e. the threshold for misstatements is determined in addition to component materiality. Misstatements identified in the financial information of the component that are above the threshold for misstatements are communicated to the group engagement team.

Example

The financial information of Esteem Group Co for the year ended 31 March 20X9 is as follows:

	Tshs m
Revenue	1400.0
Profit before taxation	16.4
Total assets	900.0

Step 1

Materiality for the group as a whole can be calculated as follows:

Revenue		Profit before taxation		Total assets	
Benchmark	Tshs m	Benchmark	Tshs m	Benchmark	Tshs m
0.5%	7.00	5.0%	0.82	1.0%	9.00
1.0%	14.00	10.0%	1.64	2.0%	18.00

Materiality cannot 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 Tshs9.00 m and Tshs14.00 m. Furthermore, materiality must also take into account the qualitative factors (discussed below). Materiality is based on the auditor's judgement so different auditors may set different materiality limits on the same data. Therefore, the auditor sets the materiality at Tshs10 m.

Step 2

The group can also set materiality for particular classes of transactions, account balances or disclosures in the group financial statements if appropriate. For example, materiality level for payroll expenses is set at Tshs4m as there was fraud during the previous year in the area of payroll.

Step 3

Esteem Co has 5 components of similar size. Therefore, the auditor sets the materiality at Tshs2m for each component. However, in reality, components often vary in size. At such times it may not be appropriate to set materiality as discussed above. This is because if the auditor decides to set the materiality at Tshs2m for each component, it can result in over-auditing as the audit risk at the group level would be extremely low. On the other hand, the auditor may decide to set the materiality level at the overall group materiality level i.e. Tshs10m. This is again inappropriate as it would cause a very high level of audit risk at the group level.

The materiality discussed above are extremes and therefore inappropriate. Hence, ISA 600 suggests that materiality should be reasonable and justifiable, and therefore should be set between these two extremes.

(e) Where component auditors will perform an audit for the purposes of a group audit, the group engagement team shall evaluate the appropriateness of performance materiality determined at the component level.

(f) If a component is subject to audit by statute, regulation or other reason, and the group engagement team decides to use that audit to provide audit evidence for the group audit, the group engagement team shall determine whether the following meet the requirements of this ISA:

(i) Materiality for the component financial statements as a whole; and
(ii) Performance materiality at the component level.

(g) **Additional guidelines for setting materiality levels**

(i) Group materiality decisions influence:
The nature and extent of testing,
The key enquiries that must be made,
The significant areas for discussion and
The significance at a group level of what may be significant accounting estimates and accounting policies.

(ii) The group auditor needs to communicate his audit strategy with respect to group matters to his own firm and the component auditors at the individual entity levels.

(iii) The group auditor needs to be satisfied that the nature and extent of testing at an individual entity level will be sufficient to ensure that after consolidation of the financial statements, there is reasonable assurance regarding:
the consolidated figures,
related disclosures and
all group accounting matters including adjustments made during consolidation relating to inter and intra group transactions and events.

(iv) The group auditor must also consider how segmental data disclosures may be used by users.

(v) The group auditor will need to understand the materiality decisions taken by component auditors and how these have affected the nature and extent of testing and assurance gained.

(vi) Sometimes additional work (i.e. audit procedures) may need to be requested where individual entities contribute significantly to group level reporting data and disclosures.

(vii) The materiality decisions at a group level will be affected by the group auditor's understanding of the operations of the group in terms of influence from the top (relating to strategies) operations reporting and compliance issues.

(viii) In order to assess group materiality levels, prior year consolidated financial statements and budgeted figures are also taken into account.

4. Coterminous year ends or accounting periods (discussed in detail in paragraph 4.2)

5. Change in group structure

Changes in group structures could occur on account of acquisitions, disposals, change in composition of acquisitions, etc. Furthermore, changes in group structures are complex and also hidden at times. Therefore identification of correct group structures may sometimes be difficult.

(a) Impact of change in group structures on financial reporting

The accounting of consolidated financial statements is different for different group structures.

Example

Acquisition of a subsidiary requires full or partial method of consolidation.

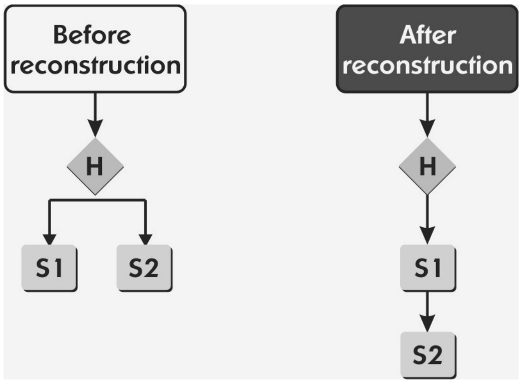
Acquisition of an associate requires equity method of consolidation.

Acquisition in the middle of the year involves splitting profits for the year into pre and post-acquisition profits; acquisition of a partly owned subsidiary involves computation of non-controlling interest.

Continued on the next page

When a subsidiary is moved down in the group as demonstrated in the diagram below, there **would not be any outflow / inflow of assets or liabilities into or out of the group**. Only shareholdings and investments would change from one company to another within the group.

Diagram 5: Moving a subsidiary down



The accounting entries to record this restructuring would be as follows:

In H Co's books:

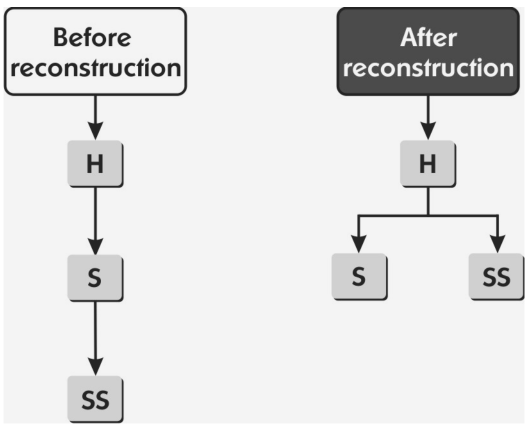
Dr	Investment in S1 shares / cash	X	
Cr	Investment in S2 Co		X

In S1 Co's books:

Dr	Investment in S2	X	
Cr	Share Capital / Cash / Asset		X

When a subsidiary is moved up in a group as demonstrated in the diagram below, before reconstruction, the parent company H, owned a wholly owned subsidiary, S. S has invested in 100% of the share capital of SS. On reconstruction, S transfers its investment in SS to H.

Diagram 6: Moving a subsidiary up



On restructuring, H would make the following accounting entries:

Dr	Investment in SS	X	
Cr	Reserves		X
Cr	Cash		X

At the same time, S would make the following accounting entry:

Dr	Reserves	X	
Cr	Investment in SS Co		X

(b) Impact of the change in structure on audit

Change in group structure can increase the extent of audit risks as:

(i) The auditor may have to obtain audit evidence relating to assessment of fair values in accordance with IFRS 3, which involves exercise of judgements.

(ii) The auditor may not identify the correct group structure due to which the financial statements may be misstated and inappropriate audit procedures may be obtained which in turn could affect the audit opinion provided. For example, when complex changes in group structures take place (like part disposal of subsidiary), the auditor would have to obtain evidence relating to actual transactions as well as the extent to which control is present.

Change in group structure will affect the extent, nature and timing of audit procedures. Therefore the auditor should take care to identify the nature of the change and also understand the audit implications of the change carefully. For example if the group structure changes from non-significant components to significant components; audit procedures will have to be extensive audit procedures (i.e. tests of control as well as substantive audit procedures) rather than just substantive audit procedures. Discussed in point 1.4 above.

If the firm is involved in auditing the individual financial statements along with the consolidated financial statements, the auditor's risk assessment procedures and planned responses to risks at the individual financial statement level will be relevant to the audit of the consolidated financial statements. Furthermore the auditor would have to plan to obtain evidence in respect of inter-company transactions and balances as they would be considered relevant to consolidation.

Change in group structure may mean additional staff in the audit team as the auditors may be expected to visit the various premises of the significant components, perform audit procedures relating to acquisition like goodwill, fair values of assets acquired, contingent consideration, etc. Furthermore, the firm would have to include senior and experienced auditors in the team, as audit of groups is complex.

Test Yourself 3

Explain the need for a first time group auditor to analyse the group structure.

---

3. Validate the circumstances under which a joint audit would be appropriate.

[Learning Outcome c]

3.1 What is a Joint audit?

Definition

A joint audit is the audit of an entity by more than one auditing firm in order to present a single audit opinion to the audit committee, investors, government or a third party. As a result, **all of the auditors** on the audited client **share the responsibility** for the client.

In a joint audit, the **audit planning is done jointly**, with parts of the audit work allocated to each of the auditors.

The main point of **difference** between a joint audit and a group's financial statements audited by component auditors and the opinion issued by a group auditor is that **in a joint audit, the responsibility for the audit opinion is shared jointly by both the auditors while in a group audit, the group auditor takes full responsibility for the audit opinion, irrespective of which auditor actually performs the work.**

Example

Aryabhatta Motors, India's largest motor and energy services group, acquired Cabot Motors, an American motor company in the previous year in one of the largest corporate takeovers in the international motor industry. Aryabhatta's auditors, Chopra and Ramanujan (Chartered Accountants) would have to audit the financial statements for the entire group. In order that the group auditor builds up knowledge on the subsidiary, the financial statements of Cabot Motors were audited by both the group auditor and the new subsidiaries auditors, Campbell and Goldman, Certified Public Accountants.

Continued on the next page

Both the firms worked together while planning the audit, allocating parts of the audit fieldwork to each auditing firm at the gathering evidence stage and the review stage and jointly issuing an opinion on Cabot Motors' financial statements.

Joint Audits involving two or more audit firms would be appropriate in following situations:

1. As discussed in above example, at the post acquisition stage the new holding company may insist that the group's auditors conduct a joint audit in association with the subsidiary's auditors. Joint Audit would be appropriate as, it will allow the group's auditors to get a feel of newly acquired subsidiary so that they would have an **idea of the operations and internal functioning of the subsidiary** when they issue the group's audit report.

2. In case of foreign subsidiaries the financial statements of **subsidiaries** may be prepared using the **local laws and accounting standards** which may be different from those applicable to holding company and at the same time the local laws may require that the group employ local auditors to audit the accounts of the subsidiary to satisfy local law requirements. In such case appointing joint auditors can be the only option available,

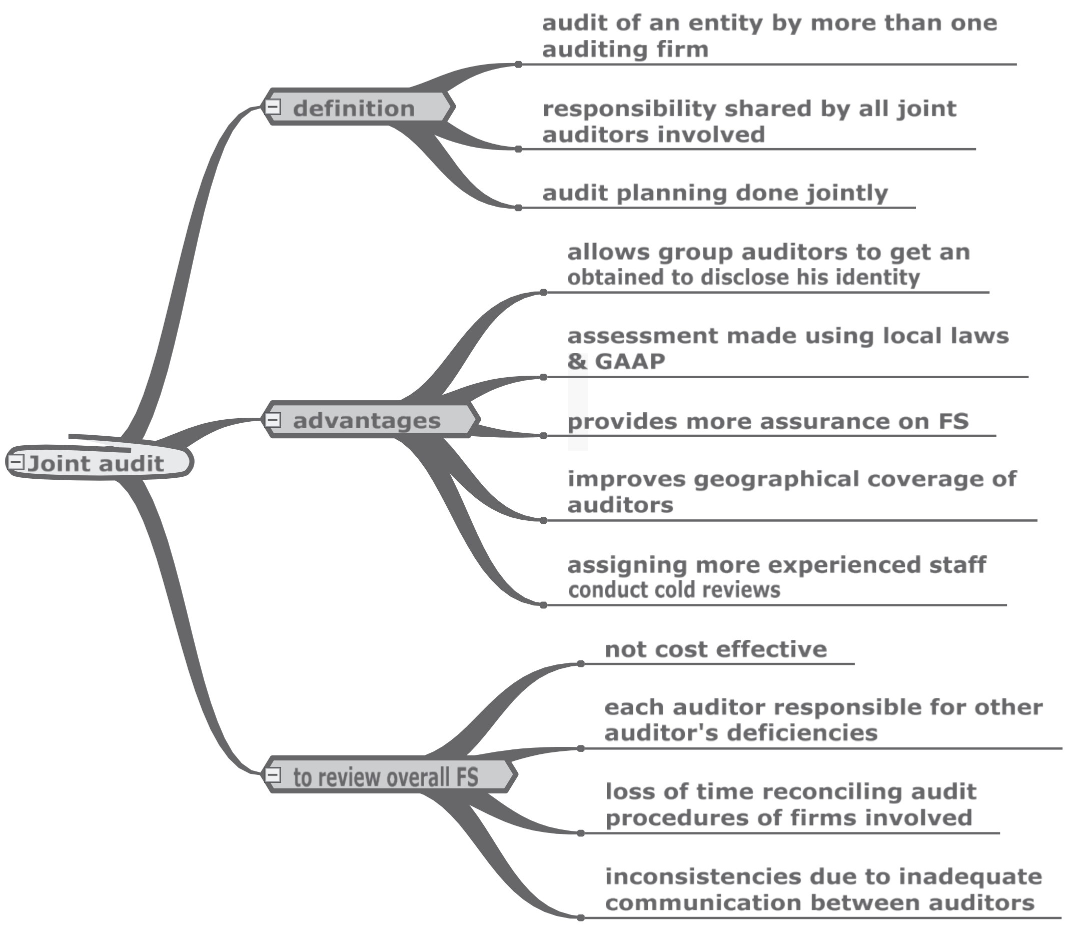
3. If the entity is of the opinion that having two auditors to issue an opinion on the entity's financial statements gives **more assurance** than one auditor providing assurance **on the financial statements, it may appoint joint auditors**.

4. In case of groups with components widely dispersed joint audit would **improve** the **geographical coverage** of the auditors and enhance the effectiveness of the opinion.

5. If considering the volumes of its business the entity thinks that a single firm shall not be in a position to effectively complete the assignment, it may appoint joint auditors.

6. In case of organisations having number of branches and where the reports are to be submitted in very short time span like in case of banking companies' joint audits is the only solution for timely and proper completion of the audits.

SUMMARY



Test Yourself 4

Webber & Associates, Chartered Certified Accountants & Registered Auditors, and Monroe & Michelson, Chartered Accountants & Registered Auditors, were engaged in auditing the financial statements of Axel Electrical Appliances plc. Monroe & Michelson were the company's previous auditors while Webber & Associates was the company's newly appointed auditor. For statutory reasons, it was required that both auditing firms conduct a joint audit and issue a single audit report based on the findings of both audit firms.

Required:

In light of the given situation, draft a note on the responsibilities of joint auditors.

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4. Discuss the audit areas along with the audit procedures relevant to a business combination.

[Learning Outcome d]

Audit procedures can vary from one entity to the next and even in different entities within a group. In most cases, when auditing a group, the same audit procedures are followed as in the case of individual companies, in addition to a few additional procedures carried out in group audits.

While applying the following procedures, each of them must be modified in order to meet the specific requirements of the group.

4.1 Goodwill

Goodwill is generated as a result of a business acquisition. According to IFRS 3 Business Combinations:

- **Goodwill** is the **excess of the cost over acquirer's interest in the net assets** of the acquired entity
- It should be **recognised as an asset** when acquired as part of a business combination
- **It should not be amortised** but should be tested regularly for impairment

The auditor should go through the legal documents and **verify the accuracy of goodwill calculations.** The auditor has to ensure that the assets and liabilities of parents and subsidiaries are combined on a line-by-line basis by adding together like items and the balance figure, if any, is recognised as goodwill. Significant non-current assets such as land and building should have been valued by an expert valuer prior to the acquisition. Additionally, the auditor should check that goodwill has not been amortised, but, in fact, been tested regularly for impairment. For this, he should review impairment calculations and test them for reasonableness.

Example

BlackJack, a popular restaurant and casino located in Lisbon, has witnessed a serious turn of events during the current year. In April 20X9, the restaurant was penalised for not following regular health procedures. Besides fines and penalties levied by the authorities, the owner of the restaurant, Marc, was caught bribing county health officials. In August 20X9, there was an argument between the two patrons of the casino, in which one of the patrons was shot dead.

Due to these events there has been a sudden drop in the restaurant's customers in the past year and a subsequent loss of revenue due to its loss of reputation. BlackJack's goodwill will now be tested for impairment. The previous year's number of customers during a particular period needs to be compared with the average number of customers that the restaurant now attracts. The fall in customers would indicate the impairment in the value of the restaurant's goodwill.

For this the auditor would have to verify the number of customers from the restaurant's bank statements to ascertain the number of transactions. Additionally, the restaurant's customers' register could also be checked. He would also have to consider local events which could have contributed to the fall in the restaurant's value.

The auditor needs to ensure that the goodwill **does not include non-purchased goodwill**. Where negative goodwill arises, the auditor should make sure that it is recognised immediately in the income statement. For loss making subsidiaries, the auditors should pay particular attention which may need write downs in both the subsidiary's and the group's accounts.

Test Yourself 5

On 1 July 20X9 Apricot Co acquires control over Kiwi Co by investing Tshs25 millions. At that time the identifiable assets and liabilities of Kiwi Co are:

	Tshs'000
Tangible assets Inventories	15,000
Receivables Cash at bank **Total**	5,000
assets Ordinary shares	2,500
Retained earnings	2,000
Payables	**24,500**
Total liabilities	15,000
	3,500
	6,000
	24,500

Apricot Co shows the amount of goodwill to be Tshs6.5 millions according to calculations shown below.

Tshs'000

Goodwill	**FV of net assets**	
Amount invested by Apricot Co		25,000
Less: Net assets represented by:		
Share capital	15,000	
Pre-acquisition reserves	3,500	(18,500)
Goodwill		**6,500**

Required:

What audit work should an auditor perform to verify the amount of goodwill in the financial statements?

4.2 Accounting policies

The auditor should ensure that all the entities within the group follow:

1. Consistent accounting policies

Definition

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

IAS 8

Group consolidated financial statements are prepared by combining the financial statements of all the group entities, in order to determine the financial status of the group as if it were one single entity. **IAS 27** requires that **consolidated financial statements** shall be prepared using **uniform accounting policies for like transaction and other events in similar circumstances**. If all the entities in the group do not follow uniform accounting policies, then the consolidated financial statements **will not** reflect a correct picture of the financial status of the group.

Hence, the group engagement team needs to ensure that uniform and consistent accounting policies for like transactions and other events are followed by each component in the group. If this requirement is not fulfilled, then the group engagement team has to ensure that the necessary adjustments are made to bring consistency in the group accounts.

2. Coterminous year ends or accounting periods

Definition

Coterminous year ends' means that the financial year ends of two or more entities are the same.

IAS 27 requires that the financial statements of the parent and its components (subsidiaries) used in the preparation of the consolidated financial statements shall be prepared as of the same date to reflect a correct picture of the financial status of the group.

Tip

IAS 27 requirement

Where a subsidiary's accounts used for consolidation purposes are drawn up to a different year end, **then adjustments should be made** for the effects of significant transactions or events that occur between the reporting dates of the subsidiary and the parent.

Where a subsidiary uses different accounting policies, for like transactions and other events in similar circumstances, **then adjustments should be made** to make its accounts suitable for consolidation.

Hence, the auditor has to ensure that the parent and all its components in the group have the same year end. Where the auditor finds that the parent and its subsidiaries do not have coterminous year ends and **the subsidiary entity's accounts are used for consolidation,** then he needs to ensure that:

- it was impractical to prepare additional financial statements of the group (as mentioned above).
- **Adjustments are made** for the effects of significant transactions or events that occur between the reporting dates of the subsidiary and parent.
- The gap between the reporting date of the parent and the subsidiary is not more than three months.

This means that an auditor has to ensure that the subsidiary's year end is within 3 months of the parent (or vice-versa); in such a case, no further adjustments need to be made (unless material). If the year ends are more than 3 months apart, the auditor has to ensure that the subsidiary prepares full financial statements at the parent's year end date, to be used for the consolidation. The auditor needs to ensure that the length of the reporting periods and any difference in the reporting days is the same from period to period.

If either of the above requirements is **not fulfilled**, the auditor has to ensure that **necessary adjustments** are made to bring consistency to the group accounts. If it is not possible to make adjustments to satisfy these requirements, the auditor has to ensure that **adequate disclosures** have been made.

SUMMARY

4.3 Intra-company trading

These transactions are an area of particular importance to group auditors as they differentiate auditing for groups from auditing for individual entities. For these transactions, the auditor needs to gauge the adequacy of the group's accounting systems to identify inter-company transactions and adjustments.

1. The auditor would have to **obtain** from the client the **names of all the entities** (including associates) **within the group**.

2. The auditor should ensure, by referring to the list of all the entities within the group, that **all the intra-group balances and transactions**, including income and expenses, **are eliminated in full**.

3. The auditor should ensure that **these items** are **part of the monthly or quarterly statements** that are **reconciled** with the group's figures.

4. The auditor should **review** the **lists of receivables and payables for evidence** of other items that have not been removed.

5. The auditor should ensure that **any unrealised profits and losses on transactions** are **eliminated from inventory** as well as from the **profit** in the consolidated statement of financial position.

6. If there is any **mismatch** between the amount sold by one group company and the amount purchased by another group company, then the group auditor has to **check** if there are any **goods in transit** which are added to the consolidated SOCI.

7. The auditor has to **ensure** that **a provision is made for the deferred tax liability / asset** when any unrealised losses / profits resulting from intra-group transactions are eliminated from the carrying amount of assets, (such as inventory or property, plant and equipment), but no equivalent adjustment is made for tax purposes.

Test Yourself 6

Gold Group has eight subsidiaries operating within the country. These subsidiaries are all audited by their own auditing firms in order to comply with certain legal requirements. During the year, Gold's group auditors received reports from the component auditors. As the audit manager of the Gold group engagement, you have to ensure that intra-company balances and transactions are correctly recorded in the group accounts.

Required:

How would you, as an auditor, ensure that intra-company profit from inventory has been correctly eliminated in the group accounts?

4.4 Classification of investments

In the case of group audit, it is very important that the parent's investment in other companies is correctly classified as:

1. Subsidiary,
2. Associate,
3. Joint arrangement according to IFRS 11 (i.e. Joint operations or joint venture), or
4. Normal investment (IFRS 9)

The information about the number and type of shares held would be stated in the share register maintained by the company. The auditor has to **match the amount of holding by the parent company to the share register**. Moreover, he should also ensure that the **responsibility of maintaining the shares ledger** should be **separate from** that of **making entries** in the general ledger. Any concealment of a misappropriation can be revealed by reconciliation of the subsidiary records with the general ledger control accounts.

Similarly, the responsibility for **custody of investments** should be **separate from** that of **accounting** for the securities to detect theft of investments, if any. Along with this, the auditor also needs to take into consideration other factors such as various arrangements among the parties, the existence of a dominant influence etc., as this could have a significant impact on the correct classification of investment. With this, the auditor would correctly be able to identify whether or not the parent's investments are classified correctly.

The auditor should also check whether the division responsible for acquisition of investments is separate from the one responsible for observing the value of the investments in the market. This will help to ensure that the investment values are reported accurately to the management and recorded properly in the financial statements.

Test Yourself 7

Entities A, B, C and D each hold a 25% interest in Alpha Inc. Decisions in Alpha Inc need to be approved by a 75% vote of the parties. Pioneer's accountant treated Alpha as jointly controlled.

Required:

What are your views on the classification of investment in the above case?

4.5 Equity accounting for associates:

Definition

An **associate** is an entity, including an unincorporated entity such as partnership, over which **the investor has significant influence** and that is **neither a subsidiary nor** an interest in **a joint venture.**

Significant influence is the power to participate in the financial and operating policy decisions of the investee, but is not control or joint control over those policies.

IAS 28

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1. Equity accounting

IAS 28 states that **investments in associates** shall be accounted for using the **equity method.** The equity method of accounting is used because an investor in an associate company is actually the non-controlling interest of the associate company.

Full / partial consolidation (explained below) is not suitable because the investor does **not have control/ joint control** over the assets and liabilities of the associate company. It can only exert significant influence. Hence consolidation would depict a misleading picture of the assets and liabilities of the group.

2. Principles of equity accounting

Under this method:

(a) In the consolidated SOFP

On date of acquisition: the **investment** in the associate company is **stated at cost.**

After acquisition: every year, the investment in the associate company will be reflected in the consolidated SOFP after making the following adjustments:

If the associate makes a profit: g**roup share** of **profit** will be **added** to the **investment.**
If the associate makes a loss: g**roup share** of **loss** will be **deducted** from the **investment.**

The procedures used for determining the profit/loss under the **equity method** are similar to those used for determining profit/loss under the **full consolidation method.**

(b) In the consolidated SOCI

The **group's share** in the **pre-acquisition profits** of the associate company:

On the date of acquisition, the pre-acquisition profits have to be revised in order to incorporate all fair value adjustments. The group's share in this revised profit will be **deducted from the consideration** in arriving at **goodwill.**

The **group's share** in the **post-acquisition profits** of the associate company is included in the consolidated SOCI.

3. Audit procedures:

Verify the calculation of goodwill to ascertain whether the value is calculated according to IAS 28.
Check whether all the required disclosures are made properly.
Verify that the impact of unrealised profits arising as a result of transactions between the associate and the entity has been properly accounted for.
Ascertain the correctness of balances appearing in the statement of financial position.

4.6 Change in group structure

Audit procedures relating to:

Acquisitions during the year

Recalculate the value of purchased goodwill after confirming the fair values of assets and liabilities procured through acquisition. Fair values should agree with valuer's reports after the auditor satisfies himself that the work of the expert (i.e. the valuer) can be relied upon. Furthermore, if there exists any contingent assets and liabilities acquired in the business combination, confirm that it is in accordance with the recognition criteria mentioned in the framework.

If the acquisition contains deferred consideration as part payments, the auditor must confirm that the cost of acquisition includes this amount of deferred consideration at the discounted present value, using the current pre-tax cost of capital as the discount rate. Errors in this calculation will affect goodwill calculations, so this needs to be checked carefully. If the acquisition contains a possible contingent consideration as part payments, the purchase consideration should include the amount of deferred consideration at the discounted present value. However, the auditor should also confirm the reasonableness of this assumption.

Disposals during the year

Agree the amount of sale proceeds from the bank statement with the sale deed and the board resolutions. Recalculate the amount of gain / loss on disposal.

Verify the accounting treatment

Confirm that the accounting entries relating to acquisitions which appear in the group financial statements are in accordance with the provisions of IFRS 3.

4.7 Accounting for foreign subsidiary

The problem that would arise when auditing groups with subsidiaries located in foreign countries is that all the countries do not comply with international accounting standards. If this is the case, where the deviation from international accounting standards is material, the auditor may **request the management of the subsidiary to adjust the financial statements in accordance with international accounting standards**, or may themselves **perform additional audit tests and procedures**. Audit procedures involve the principal auditor sending a checklist of standards to the subsidiary, which need to be completed to ensure that the subsidiary has complied with IFRS. The component auditor will need to ensure that the adjustments (relating to consistent accounting policies for all entities within the group) have been incorporated.

Audit procedures

- Verify whether the consolidation process has been correctly performed and all the intra-group balances are eliminated.
- Verify the appropriateness of the functional currency used and that the balances and transactions with the subsidiary are correctly translated to the group`s reporting currency.
- Check the calculation and presentation of the non-controlling interests and goodwill.
- Check whether the disclosures are made according to IAS 21.
- Except for this, all audit procedures applied in the case of domestic subsidiaries are also applicable in the case of foreign subsidiaries.

Exam Focus

This is a very important Learning Outcome. Questions on this learning Outcome could be scenario based questions on matters to be considered in group audit planning or planning of audit of consolidated financial statements.

Questions may require you to explain the effect of the following aspects on audit planning in a given scenario:

- Impact of acquisition on audit planning
- Ascertaining group structure
- Materiality assessment
- Auditing the amount of goodwill arising on the acquisition
- Group (related party) transactions and balances
- Accounting policies

5. Discuss the audit risks, along with audit procedures relevant to the consolidation process. [Learning Outcome e]

Similar to the other areas of accounting, there are risks of material misstatement in the process of consolidation of the financial statements too. The international standard on auditing - 600 'Special Considerations—Audits of Group Financial Statements (including the work of component auditors) provides guidance on audit procedures related to the consolidation process.

5.1. The audit risks relevant to the consolidation process

Study Guides C1 and C3 discuss in detail the general audit risks faced by an auditor while auditing the financial statements of an entity.

Apart from the usual audit risks, the consolidation process itself has certain audit risks, which are:

1. Errors regarding the components to be consolidated: the component may be determined incorrectly, for example, a component that should be consolidated is ignored.

A component is defined as an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.

Example

Norton is a company based in London and prepares its financial stalemates under IFRS. One of the entities it controls is Fairbrother, a partnership firm. Under IFRS, Norton needs to consolidate the firm in its group financial statements under IAS 27, Consolidated and Separate Financial Statements. The group engagement team would have to be alert for such possibilities.

On the other hand, there is a possibility that an entity that should not be consolidated is, in fact, consolidated.

2. Inappropriate, incomplete and inaccurate consolidation adjustments and reclassifications: for example, the transactions / balances that ought to be eliminated may not be eliminated. This may be done, for example, in order to inflate the group turnover.

3. Errors in initial measurement and recording of assets and liabilities of the acquiree and the resultant errors in goodwill calculations

Example

Jenteel Co acquired Minora Co on 1 January 20Y1. While recording the assets and liabilities of Minora, Jenteel did not consider the brand name (fair value: Tshs2m) and the customer lists (fair value: Tshs1m). As a result, goodwill was calculated at Tshs6m. If these two assets were recorded, goodwill would have been reduced to Tshs3m.

Jenteel did not follow the principles laid down in IFRS 3, Business Combinations, and therefore the consolidated statement of financial position was not true and fair.

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4. Inconsistency between the accounting policies followed by different components of the group: for example, two components using different accounting policies relating to valuation of non-current assets i.e. the cost model and the revaluation model, indicates inconsistent accounting policies. The consolidation process must include adjustments to bring the accounting policies at par with each other. Not making the requisite adjustments would cause an audit risk as this may lead to consolidation of figures prepared on different basis.

5. Financial information that is incorporated in the group financial statements being different from that identified in the component auditor's communication.

6. Lack of appropriate adjustments to the financial statements where the year-ends of the group companies are different.

7. Other misstatements resulting from the financial reporting framework not being followed.

5.2. Indicators of risk of material misstatement

The following are some of the indicators pointing towards the risk of material misstatement stated in ISA 600:

A complex group structure, especially where there are frequent acquisitions, disposals or reorganisations.

Poor corporate governance structures, including decision-making processes that are not transparent.

Non-existent or ineffective group-wide controls, including inadequate group management information on monitoring of components' operations and their results.

Components operating in foreign jurisdictions that may be exposed to factors like unusual government intervention in areas such as trade and fiscal policy, restrictions on currency and dividend movements and fluctuations in exchange rates.

Business activities of components that involve a high risk, such as long-term contracts or trading in innovative or complex financial instruments.

Uncertainties regarding which components' financial information require incorporation in the group financial statements in accordance with the applicable financial reporting framework, for example, whether any special-purpose entities or non-trading entities exist and require incorporation.

Unusual related party relationships and transactions.

Prior occurrences of intra-group account balances that did not balance or reconcile on consolidation.

The existence of complex transactions that are accounted for in more than one component.

Components' application of accounting policies that differ from those applied to the group financial statements.

Components with different financial year-ends, which may be used to manipulate the timing of transactions.

Prior occurrences of unauthorised or incomplete consolidation adjustments.

Aggressive tax planning within the group, or large cash transactions with entities in tax havens.

Frequent changes of auditors engaged to audit the financial statements of components.

Audit Procedures

1. Understanding of the consolidation process:

Audit planning has to start with the understanding of the consolidation process being followed at the entity that is to be audited. This would include the following:

(a) Matters relating to the applicable financial reporting framework

(i) Component management's understanding of the applicable financial reporting framework
(ii) The process for identifying and accounting for components
(iii) The process for identifying reportable segments
(iv) The process for identifying related party relationships and related party transactions
(v) The accounting policies applied to the group financial statements
(vi) The procedures for dealing with components having financial year-ends different from the group's year-end.

(b) Matters relating to the consolidation process

(i) Group management's process for ensuring that uniform accounting policies are used and differences in accounting policies are identified, and adjusted where required.
(ii) Group management's process for ensuring complete, accurate and timely financial reporting by the components for the consolidation.
(iii) The process for translating the financial information of foreign components into the currency of the group financial statements.
(iv) How IT is organised for the consolidation, including the manual and automated stages of the process, and the manual and programmed controls in place at various stages of the consolidation process
(v) Group management's process for obtaining information on subsequent events

(c) Matters relating to consolidation adjustments

(i) The process for recording consolidation adjustments, including the preparation, authorisation and processing of related journal entries and the experience of the personnel responsible for the consolidation
(ii) The consolidation adjustments required by the applicable financial reporting framework
(iii) Frequency, nature and size of transactions between components
(iv) Procedures for monitoring, controlling, reconciling and eliminating intragroup transactions, unrealised profits and intra-group account balances
(v) Steps taken to arrive at the fair value of acquired assets and liabilities, procedures for amortising goodwill (where applicable), and impairment testing of goodwill, in accordance with the applicable financial reporting framework
(vi) Arrangements with a majority owner or minority interests regarding losses incurred by a component (for example, an obligation of the minority interest to make good such losses)

Example

Tallmart has several subsidiaries. It follows IFRS for preparing its financial statements. In the case of one of its subsidiaries, the goodwill calculations resulted into negative goodwill which the accountant presented on the liability side of the statement of financial position as capital reserve.

Once the auditor knows that IFRS are applicable, he would be in a position to apply the correct provisions. He can advise the client that the proposed accounting treatment is wrong and that the correct treatment is to take the amount to the income statement after rechecking the correctness of the measurements and calculations.

2. Assessing the operating effectiveness of the controls

The group engagement team shall test, or request a component auditor to test, the operating effectiveness of the controls if:

(a) The nature, timing and extent of the work to be performed on the consolidation process are based on an expectation that group-wide controls are operating effectively; or
(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

Evaluation of controls will help in deciding the extent of substantive procedures to be applied.

3. Substantive audit procedures

The consolidation process may require adjustments that do not pass through the usual transaction processing systems, and may not be subject to the same internal controls that are applied to other financial information.

In general, one needs to evaluate whether significant adjustments:

Appropriately reflect the events and transactions underlying them;
Have been correctly calculated, processed and authorised by group /component management; and
Are properly supported and sufficiently documented.

The following are instances of specific substantive procedures.

(a) Obtain copies of the entity's consolidation working papers and verify the following: (i) arithmetic accuracy of

the consolidation calculations
(ii) whether the financial information included in the consolidation for each component matches the component's financial statements

(b) For the first consolidation after acquisition:

(i) Recalculate the pre acquisition and post acquisition profits and the valuation of non controlling interests at the date of acquisition
(ii) Verify the calculation of goodwill, if any

(c) Verify subsequent impairment / amortisation (where applicable) of goodwill, e.g. trace the calculations of value in use and the related cash flows for the cash generating units with the management’s estimates. If required, obtain expert opinion.

(d) Verify if the post acquisition profits are correctly apportioned between the owners of the parent and the non-controlling interests.

(e) Identify applicable exchange rates for each foreign subsidiary and agree them to an independent source e.g. quotes given by a leading bank of the land. Check the translations of foreign currency amounts to the presentation currency, if required.

(f) Where the equity method is used for consolidation, verify that the investment is initially recorded at cost and the carrying amount is increased or decreased to recognise the investor's share of the profits or losses of the component after the date of acquisition.

(g) If any component is consolidated proportionally, check whether shares of the assets, equity, liabilities, income and expenses are appropriate.

(h) Check the reconciliation and elimination of intra-group transactions and unrealised profits, as well as intra-group account balances.

(i) Verify the consolidation journal entries.

Test Yourself 8

Slovak Minerals Ltd is a parent company located in Rome and follows IFRS. It acquired two subsidiaries located in India. Slovak's auditors, Novak & Co, assigned the audit to Samuel.

Required:

Briefly explain any two precautions that Samuel should take in this situation.

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6. Discuss the matters to be taken into account, along with the procedures to be performed at the planning stage, when a principal auditor considers the use of the work of component auditors.

[Learning Outcome f]

The group engagement team should set up an audit strategy for the group as a whole and accordingly develop a group audit plan.

However, sometimes it is not possible for the group engagement partner to audit the financial statements of a group's subsidiaries due to the following reasons:

For statutory reasons, other auditors would need to audit the component's financial statements
A group could have **subsidiaries that are located in far-off places**
Foreign subsidiaries would follow local accounting customs and measurement norms, which would be **easier for local auditors to audit**
It would be **more cost effective** to have local auditors audit a subsidiary's financial statements
in some cases, the **parent may insist** that component auditors audit a subsidiary's financial statements

Example

The parent may insist that the component auditors, who are actually the subsidiary's old auditors, audit the subsidiary's accounts in the year of acquisition.

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or **any other reason** such as political reasons or current events

Example

After 9/11, several restrictions were placed on international travel, and there was a general fear of international travel, which meant that auditing firms found it more feasible to have local auditors audit the subsidiary's financial statements.

Due to the above mentioned reasons, the group engagement team can sometimes request the component auditor to work on the financial statements of a component.

However, while using the work of a component auditor, the group engagement team should consider the following points during the planning stage:

1. Obtain an understanding of the component auditor

If the group's principal auditors intend to use the component auditor's work on the subsidiary's financial statements, the principal should first be able to understand and assess the component auditors on the following points:

(a) The component auditor's professional competence and reputation

For this, the group engagement team would have to contact professional associations and make local enquiries regarding the audit firm's reputation.

(b) The other auditor's competence and capability

This would include assessing whether the component auditors have the necessary resources to audit the subsidiary's financial statements, whether they can comply with the group's ethical requirements, and whether or not they are independent of the group and its subsidiaries.

(c) The local environment

The group engagement team would also have to assess the external political, social and legal environment and ascertain whether or not the other auditors operate in an environment with enough regulatory controls to oversee auditors. In addition, the group engagement team would also have to assess the degree of involvement they have in the audit of the component's financial statements.

In cases where the group engagement team has serious concerns regarding any of the above points, they would have to gather appropriate audit evidence regarding the subsidiary's accounts without relying on the audit of the subsidiary's financial statements carried out by the component auditors.

Example

Mercury Sporting Gear and Apparel, an international sporting brand, acquired Gaia Golfing Gear in January 20X9. For an audit of the financial statements ending December 20X9, the Mercury group's auditors, Stanton and Machado, Chartered Certified Accountants and Registered Auditors, conducted an assessment of Gaia's auditors, J.S. Kane & Associates, Registered Auditors. The component auditors were found to have a good professional reputation and were considered to have all the necessary resources to conduct the audit.

However, in the course of the assessment, it was discovered that the audit manager in Gaia owned a considerable amount of Mercury's stock. This could impair the independence of Gaia's auditors. Therefore, Stanton and Machado, the principal auditors, need to obtain the necessary audit evidence on Gaia's financial statements on their own without relying on the audit conclusions presented by the component auditors, J.S.Kane & Associates. In order to do this, the group auditors would have to confirm Gaia's receivables on their own or have their own staff physically verify the assets, or observe inventory on their own.

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2. Communication with the component auditors

In order to ensure smooth work flow, the component auditor should co-operate effectively with the group engagement team with regard to the information that they needs in terms of queries and questionnaires. The group engagement team usually sends out a questionnaire to the component auditor which covers all the matters that need to be included in the group's audit. The component auditor can answer these queries in the form of a report or a memorandum.

The questionnaire would cover all of the following areas:

(a) Planning the audit

(i) Amount and level of work to be performed e.g. the amount of materiality, the major risk areas. (ii) How the work would be used by the group engagement team.
(iii) Form and content of the communication of the component auditor with the group engagement team.

(b) Confirmations that the component auditor

(i) Knows of the purpose of his audit opinion on the subsidiary's financial statements. (ii) Would extend full co-operation to the group engagement team.
(iii) Understands the ethical requirements that are relevant to the group and has complied with the group's. ethical requirements
(iv) Has complied with the group's other (accounting, procedural, etc) requirements

(c) Judgement of materiality levels

(i) Identification of the component's financial information with regard to the group.
(ii) Materiality of the component and its financial statements with regard to the group as a whole. (iii) The amounts lower than the materiality level for a particular class of transactions.
(iv) The threshold below which the misstatements cannot be regarded as trivial to the firm and a list of those uncorrected misstatements that are above the threshold limit.

(d) Risks of material misstatement

(i) Identify significant risks of material misstatement relevant to the component auditor.
(ii) Request for timely communication of any other significant, material risks of misstatement.
(iii) Information on any instances of non-compliance with statutes or accounting standards that could give rise to a material misstatement in the accounts.

(e) Related party issues

(i) An understanding of the group's related parties, which the group engagement team is aware of.
(ii) Any other related parties that are not mentioned in the communication, that the component auditor may be aware of.

(f) Other issues

(i) Management bias against a possible issue.
(ii) Description of any material weakness in the component's internal control system.
(iii) Any other significant matters that the component auditor wishes to draw to the group engagement team's attention or to the attention of those charged with governance of the component (such as fraud, internal control issues, etc.).
(iv) The component auditor's overall findings and audit conclusions.

Test Yourself 9

Don Merino, a Clothing & Accessories group, and its subsidiaries, were having their annual audit. The principal auditor, Max Hart, sent all of its component auditors a standard questionnaire as a means of gathering information on the subsidiary, so as to express an opinion on the group's consolidated financial statements.

Required:

In light of the above situation, how effective are these standardised questionnaires that have been sent to the other auditors in a group audit.

7. Discuss the methodology to be adopted by the principal auditor to evaluate the audit work performed by a component auditor.

[Learning Outcome g]

The group auditors need to be convinced about the component auditor's professional competence and independence before they can rely on his work or evaluate the work.

If the group engagement team is satisfied with the professional competence and independence of the component auditor, it may decide to evaluate his work to a lesser extent.

Evaluation of the component auditor's work is important because if the group engagement team concludes that the work of the component auditor is insufficient, it has to determine what additional procedures need to be performed.

The evaluation could be done in the following ways:

Evaluation of the component auditor's communication
Involvement in the work of the component auditor
Review of the component auditor's audit documentation

1. **Component auditor's communication**: the group engagement team needs to obtain the component auditor's communication, which usually contains the following information:

(a) Whether the component auditor has complied with ethical requirements that are relevant to the group audit, including independence and professional competence.

(b) Whether the component auditor has complied with the group engagement team's requirements.

(c) Identification of the financial information of the component on which the component auditor is reporting.

(d) Information on instances of non-compliance with laws or regulations that could give rise to material misstatement in the group financial statements.

(e) A list of uncorrected misstatements of the financial information of the component. (f) Indicators of possible

management bias.

(g) Description of any identified significant deficiencies in internal control at the component level.

(h) Other significant matters that the component auditor communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud.

(i) Any other matters that may be relevant to the group audit, or that the component auditor wishes to draw to the attention of the group engagement team, including exceptions noted in the written representations that the component auditor requested from component management.

(ii) The component auditor's overall findings, conclusions or opinion. After evaluation, the group engagement

team shall:

discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate; and

determine whether it is necessary to review other relevant parts of the component auditor's audit documentation.

2. **Involvement in the work of the component auditor:** the group engagement team may be involved in the work of the component auditor in respect of one or more of the following:

(a) Meeting with component management or the component auditor to obtain an understanding of the component and its environment.

(b) Reviewing the component auditor's overall audit strategy and audit plan.

(c) Performing risk assessment procedures to identify and assess the risks of material misstatement at the component level: these may be performed with the component auditor, or by the group engagement team.

(d) Designing and performing further audit procedures: these may be designed and performed with the component auditors, or by the group engagement team.

Example

Gold Ltd is the parent company and Silver Ltd is a subsidiary in the group.

During the planning and review stage, it was found that the risk of material misstatement is higher in the case of trade receivables. The group engagement team may decide to do the confirmations exercise jointly with the auditors of Silver.

(e) Participating in the closing and other key meetings between the component auditor and component management

(f) Reviewing other relevant parts of the component auditor's audit documentation

To the extent the group engagement team is involved, the need for a separate review of documentation of the component auditor's work would be less.

3. Reviewing the component auditor's audit documentation

What parts of the audit documentation of the component auditor will be relevant to the group audit may vary depending on the circumstances, as discussed above. Often the focus is on the audit documentation that is relevant to the significant risks of material misstatement of the group financial statements.

Example

Jackson Ltd has a subsidiary, Samson Ltd. The auditors of Samson identified that the internal controls on inventory were weak. Jackson's auditors may like to closely review the working papers related to inventory, for example, inventory count, valuation, cut off procedures and so on. This may enable them to evaluate whether the risk of material misstatement of inventory has been reduced.

The group engagement team may review the audit checklists and the related comments and documents of the component auditor related to the significant items in the financial statements, for example, property, plant and equipment.

The extent of the review may be affected by the fact that the component auditor's audit documentation has been subject to the component auditor firm's review procedures. Thus, if an effective peer review has been conducted, the extent of additional review would be less.

Sufficiency and appropriateness of audit evidence

If the group engagement team concludes that sufficient appropriate audit evidence on which to base the group audit opinion has not been obtained, the group engagement team may request the component auditor to perform additional procedures. If this is not feasible, the group engagement team may perform its own procedures on the financial information of the component.

The group engagement partner's evaluation of the aggregate effect of any misstatements (either identified by the group engagement team or communicated by the component auditors) allows the group engagement partner to determine whether the group financial statements as a whole are materially misstated.

Example

Continuing the example of Jackson Ltd, if Jackson's auditors conclude that the evidence obtained regarding inventory is insufficient, they may request the auditor of Samson to apply further audit procedures, for example, reconcile the movements in inventory and their valuations, verify the raw material consumption trends related to quantity and amount for last several years etc.

Test Yourself 10

Morris Minerals Ltd is a newly acquired subsidiary of Harris Ltd. After the acquisition, Steven & Co are appointed as auditors of Morris. GHFC Associates are the auditors of Harris.

Required:

As a partner in charge of the group audit at GHFC, explain how you will evaluate the work of Steven & Co.

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8. Discuss the reporting implications in a given situation where the opinion on a component is modified.

[Learning Outcome h]

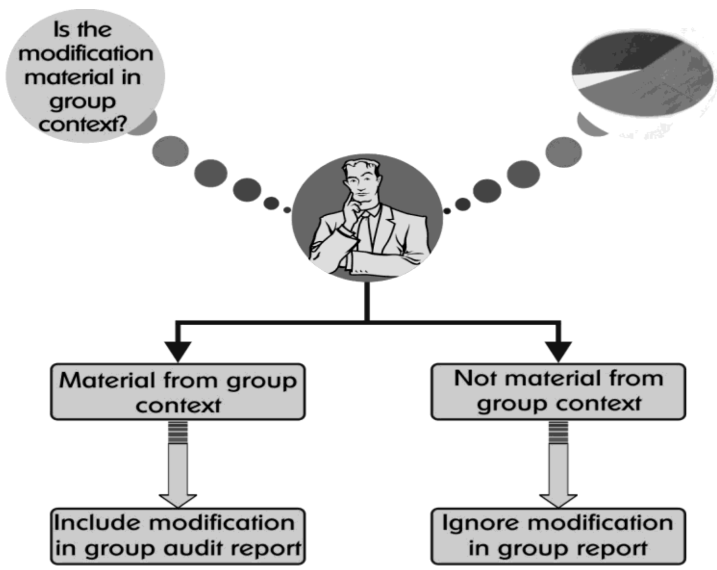
When a component auditor presents a modified audit report on the financial statements of the subsidiary, the principal auditor has to first **assess whether the modification is material when viewed from the point of view of the group as a whole.** If the qualification is material to the group's accounts, the modification should be carried forward to the auditor's report on the group's financial statements.

Example

Zylo Fluids is a wholly owned subsidiary of Maximum Food Processing & Distribution. Zylo forms 11% of the group's net assets and 4% of the group's net revenue. For the year ended 31 December 20X9, the auditor was not able to observe Zylo's inventory counting (which took place at a warehouse in another state) as at the year end because of a national emergency declared by the government, which banned inter-state travel.

Since the auditor was also not able to apply alternative procedures to confirm the amount, the auditor provided a qualified (except for) audit opinion in the 20X9 audit report, on account of inability to obtain sufficient appropriate audit evidence. Furthermore Zylo forms a material part of the group's net assets and revenue. Therefore the auditor's report on the group's financial statements would also be qualified based on inability to obtain sufficient appropriate audit evidence.

Diagram 7: Impact of component's modified opinion on group opinion



When principal auditors are satisfied that the work of other auditors is adequate, they will make no reference to them in their audit report. However, if the principal has **not been able to obtain** from other auditors or group members **all the evidence sufficient to draw a conclusion**, then this could lead to a modification in the group **audit report**.

Answers to Test Yourself

Answer to TY 1

The responsibilities of each auditor:

A **Group auditors** have sole responsibility for **expressing an opinion on group accounts** even if the subsidiaries / components of the group have been audited by other audit firms.

B **Component auditors** have sole responsibility for their **audit opinion on the financial statements of the components they audit.**

Answer to TY 2

While is it usual for a group to retain its principal auditor for the audit of a newly acquired subsidiary, P&C should make arrangements to communicate with Hi Voltage's former auditors and find out why the auditor was replaced. This would include obtaining written permission from Alligator in order to communicate with Hi Voltage's previous auditors to ask if there is any reason that they should not accept this audit engagement.

However, before this is done, P&C should assess whether they are competent enough to audit Hi Voltage's accounts. This includes assessing the new company's business systems, procedures and technical competence. Apart from assessing these points, P&C needs to have knowledge on conducting business in Japan, including Japanese social, cultural, legal and accounting systems and rules. P&C would also need to assess whether they have sufficient resources (such as representative or associated offices in Japan) to carry out a full-fledged audit on financial statements in Japan.

Additionally, P&C would have to consider any factors that would impair its objectivity in expressing an audit opinion on Hi Voltage's financial statements. It would not be able to accept the audit of Hi Voltage if it feels that a limitation imposed by the group or by the subsidiary's management would cause it to issue a disclaimer of opinion. Another factor that would have to be considered before P&C can accept the audit of Hi Voltage is whether the restriction in audit fees are enough for the audit firm to compromise on their audit opinion for any reason. The increase in fees should be enough to cover the audit of Hi Voltage and the incremental costs associated with auditing Alligator's consolidated financial statements.

Answer to TY 3

A certain amount of analysis of the group structure will be undertaken before an auditor accepts the role of group auditor, particularly if the auditor is not directly responsible for the whole group.

An analysis of the group structure is necessary to:

Ensure that particular attention is given to the more unusual aspects of corporate structures (e.g. partnership arrangements that may be a joint venture, components in tax havens, shell companies and horizontal groups);

Arrange access to information relating to all 'significant' components (i.e. those representing 20% or more of group assets, liabilities, cash flows, profit or revenue), on a timely basis;

Identify the applicable financial reporting framework for each component and any local statutory reporting requirements;

Plan work to deal with different accounting frameworks/policies applied throughout the group and differences between International Auditing Standards (ISAs) and national standards;

Integrate the group audit process effectively with local statutory audit requirements;

Identify related parties and effectively audit the completeness of disclosures in the group accounts in accordance with **IAS 24 Related Party Disclosures**

Any doubts about the group structure will need to be clarified against publicly available information as soon as possible to ensure an effective audit of the relevant components (i.e. subsidiaries, associates and joint ventures). The auditor can then plan the level of assurance required on each component well in advance of the year end

Having established the group structure comprehensively right from the outset, the auditor will then need to only update the structure for changes year-on-year.

Answer to TY 4

While the responsibility of joint auditors is no different from the responsibility of individual auditors, there are a few additional points that arise in case of joint auditors.

(a) Work allocation at the planning stage

When joint auditors are appointed, they should first discuss and plan the work that needs to be done. This work should then be split into specific work areas consisting of audit procedures. Each of these work areas would then be allocated to each auditing firm on the joint audit. Certain areas of the work are not divided among the auditors, but performed by all the auditors on the engagement. These are very important areas of the audit engagement. This kind of division of work needs to be properly documented and communicated to the other auditor as well as to the client.

(b) Coordination with the other auditor

Each joint auditor on a joint audit engagement is responsible for the work allocated to him, irrespective of whether or not he has made a separate report on specific issues that have not been allocated to him. Nevertheless, joint auditors are jointly responsible for the work performed by them in respect to the audit work that has not been specifically allocated to a particular auditor and that has been performed by both auditors. The financial statements that were audited in the joint audit report must comply with the disclosure requirements of the relevant accounting standard or legal requirement.

Answer to TY 5

The auditor will need to follow the following procedure to ensure that the value of goodwill calculated is correct:

(a) Goodwill is the **difference** between the **amount a company pays** to purchase another company and the **fair value of the net assets it acquires at the date of acquisition.** Thus, the fair value determination has a direct impact on the amount of goodwill to be calculated.

Therefore, the auditor should **review and ensure that the methods used to determine the fair values** of the net assets acquired at the date of acquisition are appropriate. For doing this, the auditor should obtain the valuation certificate issued by the certified valuer. The auditor should, according to his general knowledge of the relevant industry, carefully assessed whether the valuation is done using scientific analysis and using current market research. A valuation certificate usually contains a full description of the asset and a statement explaining the reason for the valuation and the intended market.

The auditor should ensure that **those who perform the valuations are adequately qualified and independent.** If necessary, the auditor should **consult other valuation experts** and get a second opinion.

(b) The auditor needs to verify whether the consideration paid is recorded correctly because otherwise it will affect the goodwill calculation. To ensure the amount of consideration, he should go through Apricot's bank statements. He also needs to verify the related documentation to verify whether any consideration is paid in the form other than money for example issue of shares of Apricot. In that case, he needs to study the stock exchange position of Apricot's shares to verify whether the market value of Apricots shares is correctly determined.

(c) The auditor should ensure that **proper disclosures** as required by IFRS 3 are made wherever required.

Some of the disclosures required are:

Acquisitions of subsidiaries and businesses are accounted for using the acquisition method.

The cost of the acquisition is measured at the aggregate of the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued in exchange for control of the acquiree.

Goodwill arising on the acquisition of a subsidiary is recognised as an asset at the date that control is acquired (the acquisition date).

Goodwill is not amortised, but is reviewed for impairment at least annually. Any impairment loss is recognised immediately in profit or loss and is not subsequently reversed.

Answer to TY 6

Unrealised profit arises because of transactions in which one company supplies goods to another company in the same group. These goods remain in the purchasing company's inventory as at the end of the year. Since the financial statements of the group are consolidated, recording this amount of profit would amount to the group trading with itself.

As a result, the auditor should ensure that this amount of intra-company profit is eliminated by the implementing the following procedure:

Understand the group's procedures to identify this class of inventory, and confirm whether or not the component has notified the parent of this inventory and requested that a provision be made in respect to this kind of inventory in both past as well as current years.
Verify whether or not this inventory has been included in the group's closing entry. In order to do this the auditor would have to select a sample and check how it has been recorded as well as obtain confirmations from component auditors.
The auditors would also have to check the inventory sheets to verify whether the inventory level is comparable to previous years.
Check the calculation of unrealised profit on inventory for reasonableness, consistency and accuracy.
Review transactions of the parent with subsidiaries and transactions between subsidiaries.
Check whether goods and/or services sold within the group are sold at market prices or at lowered prices.
Verify if the profit of the subsidiary before acquisition has been adjusted between the acquired subsidiary and the parent.

Answer to TY 7

Alpha Inc is not jointly controlled. For there to be joint control, the voting arrangements would have to require unanimous agreement between those sharing joint control of Alpha Inc. The voting arrangements of Alpha Inc allow agreement of any combination of three of the four investors to make decisions. The standard refers to this as collective control.

Each investor should account for its interest in Alpha Inc as an associate since each entity is presumed to have significant influence, but they do not have joint control.

Answer to TY 8

Samuel should take, inter alia, the following two precautions:

1. He should ensure that if the same accounting policies are not followed by all the group companies, then all the differences are identified, and adjusted where required.

He should instruct the audit staff to carefully study the accounting policies of the subsidiary companies, compare them with the IFRS requirements, and identify the differences and the impact and submit a report. If the subsidiaries are audited by component auditors then Samuel may take their help. If the impact of the differences in policies is material, Samuel should request the accountant to adjust the financial statements of the subsidiary companies to bring them in line with IFRS before they are consolidated in the group financial statements.

2. As this is the first audit after the acquisitions, Samuel should check the identification and valuation of all assets and liabilities. He should also review the valuation of non-controlling interest, split-up of profits into pre and post acquisition amounts and the calculation of goodwill.

Answer to TY 9

Standardised questionnaires are used by the group engagement team to gather information from component auditors about the auditing components of a group. These can take the form of "yes / no" questions or can include questions which would require a detailed explanation.

These questionnaires are widely used since they can be easily filled and it does not require too much time to prepare a new one for every component auditor. Moreover, the auditor can quickly summarise and analyse the required data from the responses obtained. However, a major drawback of these kinds of standard questionnaires is that they are less effective than a personalised enquiry from the component auditor: they are more likely to include unnecessary questions that would take a lot of time to answer. The component auditor may end up answering most questions as 'not applicable'. Therefore, a questionnaire is more a form filling exercise rather than something which provides the component auditor with essential information that will be useful.

On the other hand, standardised questionnaires tend to omit some crucial queries that may be useful and at the same time specific to one component of the group that is being audited. As a result, the component auditor may overlook the importance of alerting the group auditor of a potential risk area.

In conclusion, there has to be a balance while requesting enough information from the component auditor to enable him to make and express an opinion on the consolidated financial statements. The auditor should also keep in mind the local accounting and auditing standards, applicable laws, and industry being audited when he drafts the questionnaire. The group auditor should, while drafting a questionnaire, emphasise the quality of the information requested and should not request duplicate information.

Answer to TY 10

Mining is a highly specialised industry. The operating procedures are quite distinct compared to other manufacturing or service industries. Consequently, there is a separate accounting standard (IFRS 6, Exploration for and Evaluation of Mineral Resources) to deal with the accounting of this industry. Our evaluation of the work of Steven & Co would depend upon whether or not Steven & Co have audit experience in the mining field.

If Steven & Co does not have any prior experience in the audit of mines, then we will:

be involved in the planning of audit of Morris

implement joint procedures where our staff would work jointly with Steven & Co's staff for critical areas For example, for recognition, measurement, and impairment of exploration and evaluation of assets

obtain Steven & Co's communication about the audit, specifying inter alia, the description of any identified significant deficiencies in internal control at the component level, whether the component auditor has complied with ethical requirements and the group engagement team's requirements, a list of uncorrected misstatements of the financial information of the component, etc.

evaluate their work more closely and regularly, and also review their audit documentation for important areas. For example, internal controls review and testing, revenue recognition etc.

If Steven & Co have prior experience in the audit of mines, then:

We would obtain Steven & Co's communication about the audit, as stated above.

Based on the review of the communication, we would plan the review of the audit documentation of Steven & Co, for example, if the controls over purchases are weak, then the audit documentation of the area will be reviewed in detail. If required, we may request for additional procedures.

For certain critical audit areas, Steven & Co's audit procedures would be evaluated in detail. For example, for recognition, measurement, and impairment of exploration and evaluation assets.

We may not plan any joint audit work with Steven & Co.

For other areas, the audit working papers of Steven & Co will be reviewed.

Quick Quiz

1. Name the four types of transactions that are peculiar to groups.

2. Define the role of a component auditor.

3. Briefly explain what is a joint audit?

4. What are the procedures that need to be followed by a group engagement team before it can rely on the work of the component auditor?

5. If the audit opinion on a subsidiary is material from the point of view of the group's financial statements, what is the impact of a qualified opinion on the component's financial statements from the point of view of the group's financial statements?

Answers to Quick Quiz

1. Transactions that may specifically be carried out in groups are as follows:

   (a) Foreign subsidiaries may follow their own local accounting policies and standards
   (b) Foreign subsidiaries would report transactions in their own local currency
   (c) Subsidiaries within the same group may follow different year ending dates
   (d) Subsidiaries may be audited by auditors different from the parent company's auditors

2. An auditor who performs an audit for a particular operation or business activity of a group is called a component auditor.

3. A joint audit is an audit of the financial statement of a particular entity undertaken by two auditors who jointly present a single audit opinion on the entity's financial statements.

4. Before relying on the work of the component auditor, the group engagement team should assess the component auditor's competence, reputation and independence, as well as the local environment.

5. When the audit opinion on an entity is material from the point of view of the group statements and the component expresses a qualified opinion on the component's financial statements, the group auditor would request that the group's management adjust the reason for qualification in its own accounts and issue an unmodified opinion, or issue a qualified audit report if the group's management refuses to adjust the reason for the qualification.

Self-Examination Questions

Question 1

Canoe Systems has been taken over by the Ocean Software Group. Canoe System's current auditors are John Cloud & Associates, Certified Chartered Accountants, while the auditors of the Ocean Group are Tye & Cobo, Chartered Accountants.

The group's management asks John Cloud whether they would be able conduct a joint audit in cooperation with Tye & Cobo. This would enable John Cloud to improve its group audit efficiency while at the same time build on the experience that Tye & Cobo have gained from auditing Canoe.

Required:

Explain what a joint audit is, and its merits and drawbacks.

Question 2

Myra Cook & Associates (Cook), Chartered Certified Accountants, is currently auditing Apex Corp for the year ended 31 December 20X9.

During the year, Apex Corp acquired all the equity of another competing company, Mango Corp, as part of a strategic plan to gather a major market share. Mango's assets and equity form a substantial portion of the group's net assets and its accounts are material from the group's point of view.

Mango's accounts for the year 20X9 were audited by its own auditors, Williams & Greene (W&G), Accountants and Registered Auditors. William & Greene sent their draft audit report to Cook.

An extract of the opinion paragraph of Mango's audit report reads as follows:

"Mango has, in its financial statements, not recognised the impairment losses on non-current assets in profit or losses, since the directors are not able to quantify the amounts related to this issue. This matter has been explained in Notes 5 and 6 of the financial statements.

According to IAS 36 Impairment of Assets, there should be a provision recognised with respect to the impairment of the non-current assets. This would have resulted in an increase in the before and after tax loss for the year by Tshs50,000 and a reduction in the value of the non-current assets of Tshs50,000. As the directors are unable to quantify the amounts, we are not able to indicate the financial effects of such omissions in the financial statements.

In light of the inability to make a provision for the impairments referred to in the paragraphs above, in our opinion, the financial statements do not present fairly in all material respects the financial position of Mango Corp, as on 30 December 20X9 and its losses and cash flows for the year then ended with the International Financial Reporting Standards."

After further enquiry, it was discovered that the audit opinion for the year ended 31 December 20X8 was also worded in a similar manner.

Required:

Discuss the implications of W&G's audit opinion on Mango's financial statements for the year ended 31 December 20X9.

Question 3

Aurora Corp is an auto manufacturing group headquartered in Tokyo, Japan and audited by Taro & Co, a firm of Chartered Certified Accountants. During the year ended 31 December 20X9, the group acquired the following companies, as a result of which Taro & Co expects that significant costs will be incurred:

1. Tokyo based Andromeda Autos in October 20X9, Aurora's largest competitor in the Asia-Pacific region. This takeover was a strategic move to capture a large portion of the market and become one of the top five auto manufacturers in the world. The acquisition is expected to result in material effects on the revenue and expenditure of both companies.

2. Detroit based Cassiopiea Cars in December 20X9. Taro & Co has no representation in the USA, due to which Cassiopiea's financial statements will continue to be audited by their local auditors Mitchell & Co, Chartered Certified Accountants.

Required:

(a) Explain the impact these acquisitions have on Taro's planning of the audit for the group's financial statements.
(b) Discuss how the non-consolidated entities operating under common control affect the scope of the audit of a group's consolidated financial statements.

Question 4

Humpty Inc is a subsidiary of Miss Muffet Co. During the year, due to the loss of a major market, there were serious doubts cast on Humpty's ability to continue as a going concern or continue trading in the foreseeable future, unless it received a substantial amount of financial support from its parent company. The group auditor has been provided with a letter of support from Miss Muffet Co, a successful company in the toy making business. However, in light of the situation, Humpty's component auditor feels that a qualified report should be issued to make matters clearer to the users of the group's financial information.

Required:

Explain with reasons whether the auditor's opinion is suitable.

Answers to Self-Examination Questions

Answer to SEQ 1

A joint audit is an audit conducted by two or more auditors in order to present a single audit report to the users of financial statements with all of the auditors on the engagement taking shared responsibility for the audit opinion presented in the financial statements.

The **merits of joint audits** are as follows:

- In the case of newly acquired subsidiaries, it allows the group auditor to get acquainted with the operations and internal functioning of the subsidiary.
- Allows local auditors to audit financial statements and to become accustomed to local laws / accounting standards while at the same time enjoying the benefits of a large firm.
- It provides a higher level of assurance to the company's users of financial information.
- Improves on the auditor's geographical coverage.

The **drawbacks of joint audits** are as follows:

- Waste of resources as double the number of people are often involved in a joint audit
- Would result in one auditor taking responsibility for the other auditor's actions
- Reconciling internal policies and procedures can take up too much time and resources
- Inconsistencies may arise due to differences in ideology

Answer to SEQ 2

Non-compliance with matters that are material and consequential must be investigated by the auditor. In the case of non-compliance with the relevant accounting standard, the auditor should either communicate any doubts to the management or obtain sufficient appropriate evidence to clear his doubts.

If the auditor's concerns are not resolved after reporting the matter to the senior management, non-compliance should be reported to the next highest level of authority in the entity's reporting structure, such as the entity's audit committee or supervisory board. If there is no higher authority in the entity and the auditor believes that the non-compliance may not be acted upon, the auditor should consider seeking legal advice or consider qualifying his audit report, or issuing a disclaimer of opinion if the management has prevented him from obtaining sufficient audit evidence.

A group auditor has to first check that the material non-compliance which causes a modification in the component's report is material when viewed from the point of view of the group's financial statement. Mango is material to Apex and the modification appears to be material. Therefore, this would affect the group audit opinion.

Since Apex holds all Mango's share capital, Apex can request Mango's management to adjust Mango's financial statements to bring it into accordance with IAS 36. This would result in an unmodified audit report reissued by W&G. Alternatively, the impairment losses can be adjusted as part of the consolidating adjustments of Mango's financial statements with those of Apex. This would also result in an unmodified audit opinion on Mango.

If in any case, the group management also refuses to adjust asset values, then the audit report would carry an "except for" audit opinion.

Answer to SEQ 3

(a) When planning the audit of the Aurora group, its principal auditor, Taro & Co, should consider certain matters relating to the acquisitions made during the year by the group.

All the entities that are under the group's control should be identified. Out of these entities, the entities whose accounts would be consolidated with Aurora's financial statements should be recognised, and an assessment of how material each component is in relation to the group should be made.

A component would be material if it contributes more that 10% of the group's total revenue and total assets. This procedure is carried out so that the auditor can assess the components which the principal can plan to visit for, if necessary, and the implementation of additional analytical procedures for the audit can be discussed. As a result, if Cassiopiea is material from the group's point of view, then Taro may plan to perform additional analytical procedures or discuss Cassiopiea's audit with its own auditors.

However, Cassiopiea was acquired at the end of Aurora's accounting year. As a result, Taro would have to assess whether Cassiopiea's post-acquisition results are significant to the group. Additionally, Cassiopiea operates in another jurisdiction, so its accounting policies and control procedures may not comply with those of the group. Therefore, Taro would have to ask Mitchell to report the effect of any deviation from the group financial statements.

Taro would have to be aware that with the acquisition of a competing company, the operations and audit procedures for Andromeda would be similar to those of Aurora. This can allow increased audit efficiency and better control procedures. During the planning stage, Taro should also confirm that Aurora's accounting systems provide for identifying the inter-company accounting systems of all the companies within the group and also provide for reconciling inter-company balances, especially in the case of foreign subsidiaries where exchange differences are expected to arise

On consolidation, the assets and liabilities of both the acquired companies would be combined on a line-by-line basis and any goodwill recognised on the acquisition would be recognised. Goodwill would be calculated as the cost of the purchase consideration over the fair value of each acquired entity's net assets, as on the date of acquisition. Taro would have to plan for the goodwill arising on acquisition, especially in the case of assets which have to be valued by independent valuers.

During the course of the group audit, the auditor will have to assess whether or not to rely on the component auditor Mitchell's report. If Taro intends to use Mitchell's report, he should evaluate Mitchell's independence and competence by analysing questionnaires and by analysing its work.

(b) Non-consolidated entities under common control or horizontal groups do not require inclusion in the preparation of group accounts because they receive off-balance sheet finance. These kinds of entities were a significant feature of Enron and Parmalat, two entities which were involved in major accounting scandals.

These kinds of businesses require group auditors to fully understand the group structure as well as the economic purpose of these parallel entities, in order to avoid an increased audit risk and fraud concealed through a maze of complicated group structures.

With these entities excluded from the consolidated financial statements, the users of financial information in these entities would have to rely on disclosures on related party issues. As a custodian of public information, the auditor would face several difficulties such as failing to detect parties related to the group, lack of access to complete financial information, relying on reports made by other auditors. These kinds of group structures also give rise to creative tax planning with a number of implications on transfer pricing.

Situations like these can give rise to dubious transactions and arrangements which have to be assessed by group auditors.

Answer to SEQ 4

Letters of support are letters from the parent to the auditor of a component experiencing going concern issues. These letters provide reassurance to the component auditor that the parent would provide the component with all the necessary support to allow it to function as a going concern.

In this case, had Miss Muffet not provided Humpty's auditor with a letter of support, the qualified opinion on the grounds of the entity not being able to continue as a going concern would be justified. However, Miss Muffet has, by way of a support letter, agreed to provide the necessary financial support that would enable Humpty to continue trading.

If Humpty's auditor feels that this letter of support is enough evidence from management representations to support Humpty's going concern assumption, then a qualified opinion is not necessary provided that Humpty's financial statements appropriately disclose the support the financial support received from Miss Muffet. If the disclosure was not sufficient enough, in spite of evidence being available, a qualified opinion would still be expressed on the component.

If the auditor feels that the letter of support does not provide the necessary evidence, then any uncertainty arising from going concern doubts would have to be disclosed in an 'emphasis of the matter' paragraph in a qualified audit report.

In view of Humpty's situation, assuming that the letter of support is enough audit evidence to ascertain that Humpty can continue to trade in the foreseeable future, Humpty's auditor should issue an unqualified audit opinion on Humpty's financial statements.

SECTION D

ASSESSMENT OF RISKS, INTERNAL CONTROLS, AND INTERNAL FINANCIAL CONTROLS

D1

STUDY GUIDE D1: ASSESSMENT OF RISKS, INTERNAL CONTROLS AND INTERNAL FINANCIAL CONTROLS

Get Through Intro

An audit involves systematically analysing and evaluating the risks faced by an organisation, so an auditor must have a well thought out and methodical plan in place before commencing his work.

The first step in this direction involves identifying the various kinds of risks faced by the organisation i.e. business risk, compliance risk and reporting risk, as each risk will have to be tackled differently by the auditor.

Business risks are related to the uncertainties of what happens day by day as natural events unfold, the weather changes, customers, suppliers and employees interact with a company and competitors and new technologies pose changing threats and opportunities. At the most fundamental level, people and processes fail, giving rise to errors, mistakes, service disruptions, or worse still, injury and death. Sadly, people (externally and internally) also exhibit dishonesty, lack of integrity, mischief or deeper antagonism that can result in fraud, theft, attack, malicious damage and destruction.

This Study Guide discusses the categories of risk and how to classify and describe risk, which is an essential task and one where accountants play a key role.

Learning Outcomes

a) **Identify and assess based on a given business and a given scenario the business, reporting and compliance risks in the context of an assurance or audit engagement in the public or private sector.**

b) Communicate advice or a report based on the assessment above.

c) Discuss the implications of the results of tests of control on the audit strategy and audit plan.

d) Evaluate the implementation of a previously suggested control measure and its effectiveness.

1. Identify and assess based on a given business and a given scenario the business, reporting and compliance risks in the context of an assurance or audit engagement in the public or private sector.
Communicate advice or a report based on the assessment above.
[Learning Outcomes a and b]

1.1 Business risks

Certain risks are business specific risks which businesses face due to the inherent nature of their business. These risks could relate to entities in both private as well as public sector.

These are known as **sector specific risks**. The general risks mentioned in the previous Learning Outcome can also affect different businesses in different ways. E.g. banks and finance companies will face higher market risks since the nature of their business requires them to invest large amounts of money in the market. They also face very high credit risks.

The sector specific risks can be best understood with the help of examples. The following table discusses specific risks in relation to various industries:

Industry	Type of risk			
Oil company	**Market risk** The risk that the prices of crude oil will increase	**Legal risk** The risk that the government may not allow the digging of new oil wells and political instability will affect operations	**Environmental risk** The oil wells may pollute the environment and hence there might be a ban on the operations	**Liquidity risk** The company may face a risk since it exports oil and if the currency rates fluctuate then it may face a liquidity crunch
Finance company	**Market risk** The risk of the market instrument prices fluctuating against and adversely affecting the company's performance	**Liquidity risk** The bank may face a liquidity crunch if the investors back out	**Reputation risk** The risk that customers might not invest in them any more if they do not give them returns	**Credit risk** The risk that the borrowers will default and hence they will face insolvency
Chemical company	**Environmental risk** The risk that the emissions from the factory may pollute the environment, giving the company a bad reputation since it is not socially responsible.	**Legal risk** The political environment may lead to demand fluctuations e.g. production of certain chemicals such as uranium requires permission from the government	**Market risk** The market risk is the risk that the raw materials prices may fluctuate and increase the production costs.	**Health and safety risk** Harmful emissions from the factory may have an adverse impact on the health of the employees and the community at large. The waste management may fail.
Retailing company	**Technological risk** The computer and billing systems may not work and hence the customer service will be affected	**Reputation risk** Any bad publicity of the products may lead to a reduction in the number of customers	**Business probity risk** Dishonest and fraudulent employees may report wrong sales to the company and make personal profits	**Credit risk** Customers may default and the business will suffer

Tip

All risks mentioned above have been explained in detail in Study Guide C3.

1.2 Reporting risk

Reporting risks are generally caused due to poor internal controls and internal financial controls. This would cause a risk of material misstatements at the assertion level or at the financial statement level (discussed in Study Guide C2).

We now discuss the reporting risks faced by entities while carrying out the following major activities:

Purchases and trade payables
Sales and trade receivables
Wages and salaries

1. Reporting risk in the area of procurement would arise due to:

(a) Purchases made by persons who are not authorised (this can also cause liquidity risk)
(b) The procedure for purchase may not be in accordance with the company's policies
(c) Purchases made at higher than optimum prices (can also cause liquidity risk)
(d) Unnecessary purchases made (can also cause liquidity risk)
(e) Purchases made by unauthorised persons
(f) Goods received not supported by a PO
(g) Quantity specified on the GRN not received (can also cause liquidity risk)
(h) Rejected materials used for production (can also cause reputation risk)
(i) Amount paid is higher than the purchase order terms (can also cause liquidity risk)
(j) Payments made before the due date and discount for early payment not received (can also cause liquidity risk)
(k) All purchases, debit notes and credit notes may not be recorded
(l) Amount paid not correct (can also cause liquidity risk)
(m) Payments made to the wrong vendors (can also cause reputation risk)
(n) Payments made before the due date and discount for early payment not received (can also cause liquidity risk)
(o) Poor quality materials consistently received from vendors (can also cause reputation risk)

2. Reporting risk in the area of sales would arise due to:

(a) All orders and enquiries received may not be executed (may also cause reputation risk)
(b) Credit limits allowed to new customers without assessing their credit worthiness; or credit limits not authorised (can also cause liquidity as well as credit risk)
(c) Order may not be executed on time and delivery terms committed may not be met (can also cause reputation risk)
(d) More than the required inventory held at the regional sales offices
(e) Requisition for materials to sales office may not be authorised
(f) Goods dispatched without authorisation and of a quantity other than that mentioned in the sales order (can also cause reputation risk)
(g) Items invoiced are of poor quality or not in accordance with the sales order (can also cause reputation risk)
(h) Sales price fixed is less than the rates specified in the standard price list (can also cause liquidity risk)
(i) Sales invoices may not be recorded
(j) There may be theft in transit (can also cause liquidity risk)
(k) Invoices may not be recorded for the correct amount or in the correct accounting period
(l) Bad debts due to insufficient follow-up for dues (can also cause liquidity and credit risk)
(m) Bad debts not authorised (can also cause liquidity and credit risk)

3. Reporting risk in the area of wages and salaries would arise due to:

Lack of segregation of duties between the persons authorising the attendance, overtime etc., calculating salary, checking payroll calculations, making payments and retaining unpaid salary and wages

Reporting risk, reputation risk, business probity risk and liquidity risk in the area of payroll would arise due to:

(a) Employees recording dummy attendance
(b) Incorrect attendance time being recorded
(c) Salary paid to persons who are not employees
(d) Overtime paid to unauthorised persons and employees who have not actually worked overtime
(e) Salary calculated incorrectly
(f) Changes in pay rates, overtime and holiday pay made by unauthorised persons
(g) Unauthorised changes made to the payroll data in computer systems

1.3 Compliance Risk

Compliance risk is faced by entities in the following situations:

(a) When entities do not adhere to the regulatory requirements relating to minimum wages payable to employees
(b) When entities do not follow health and safety norms within their manufacturing and office premises like:
(i) not having fire extinguishing systems
(ii) not providing safety shoes to employees engaged in manufacturing activities
(iii) not providing safety uniforms to employees engaged in hazardous operations
(c) When entities manufacture / trade in products such as arms and ammunitions, drugs, etc. which are not authorised by the government
(d) When entities indulge in illegal activities like smuggling, money laundering, etc.

1.4 Communication and Advice

There are no prescribed formats for preparing reports, through which accountants communicate risks. However, a standard report format can be used for this purpose.

A format of a report which can be used for this purpose is as follows:

Report on business risks faced by Winson Plc

Report to: The audit committee, Winson Plc
From: A professional accountant
Date: XXXX

Business risks

The mining industry faces environmental risks, health and safety risks and technological risks that are inherent to the business of mining. Winson Plc's research and development department has identified that the cuprite reserves in its mines have decreased. This is an environmental risk since the natural resources of the mineral have declined.

The research department has identified another area for the mine. However the area is located near to a river and it is dangerous to dig in the area for the mineral. If Winson decides to mine in the area in order to maintain the turnover of the company there is a safety risk that water might flood the mines and the workers' lives will be at risk.

Winson Plc earned a turnover of $4 billion in the last financial year. The research department's reports have shown that the cuprite reserves have decreased. This indicates that it is probable that the company will not achieve the same level of turnover in the current year. Therefore there is a business risk since a drastically reduced turnover will not attract investors.

Other general risks

Other general risks that the business will normally face include technological risk. Technological risk is the risk that new technology will render the current machinery useless. In other words, competitors might use better research and development techniques and mining equipment that may render the machinery used by Winson obsolete. It may also lose revenue if competitors make use of advanced technology to extract more minerals.

The mining industry also faces a political risk in that the government may put restrictions on the mining of certain minerals such as coal. Similarly the state authorities in Mexico may impose restrictions on the mining of certain minerals that Winson extracts.

There is also an operational risk that the safety equipment installed for the workers may not operate properly and hence the work might be disrupted.

Test Yourself 1

Vista Professionals has been appointed by Flora and Fauna to identify and assess the business, reporting and compliance risks faced by Flora in the context of an assurance or audit engagement.

You are the senior manager of Vista and have been entrusted with the responsibility of preparing the report desired by the client.

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:

Using the information provided above, prepare the report,

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2. Discuss the implications of the results of tests of control on the audit strategy and audit plan.

[Learning Outcome c]

2.1 Meanings

1. Tests of control

Tests of control and how they are performed by the auditor have already been examined in Book B3. Tests of

control are performed to obtain audit evidence of the effectiveness of the:

Design of the internal control system
Operation of the controls

2. Audit plan and audit strategy

The terms audit plan and audit strategy have been explained in detail in the Study Guide C2.

According to ISA 330, in designing and performing tests of control, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. Furthermore, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of control.

2.2 Modifications to audit plan and strategies

Definition

The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit.

ISA 300

Example

Until 30 June 20X9, Harry & Co recorded all its accounting data manually. From July 20Y0, the company started recording its transactions through the new accounting software it purchased. The auditors planned the audit to suit the manual system of audit for the period up to 30 June 20X9. The audit plan for transactions from 1 July 20X9 was modified by the auditors to suit the new system of recording transactions.

The auditor may need to **modify the overall audit strategy and audit plan** under any of the following situations:

Unexpected events e.g. discontinuation of a major operation of an entity.
Changes in conditions e.g. recording of attendance of employees through swipe cards introduced by an organisation in the middle of an accounting period.
Change in the audit evidence obtained from the results of audit procedures e.g. audit testing showed that a **number** of purchase orders were not authorised.

2.3 Effect of results of tests of control on the audit plan

1. The nature, timing and extent of the audit procedures depend on the **risk assessed** by the auditor and the **effectiveness of the internal control system**. The **auditor conducts tests of control** to test the **effectiveness of the internal control systems**.

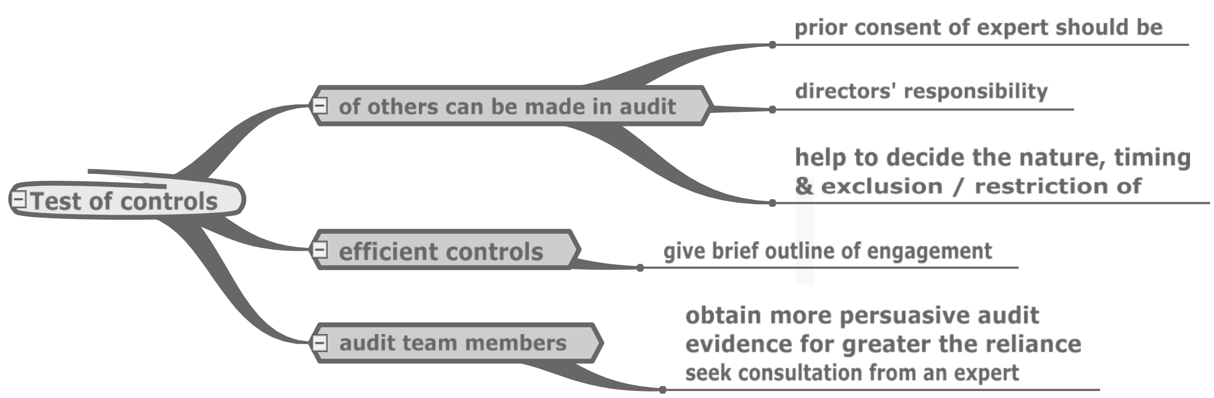
2. According to ISA 330, if deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

(a) The **tests of control that have been performed provide an appropriate basis for reliance on the controls**; or

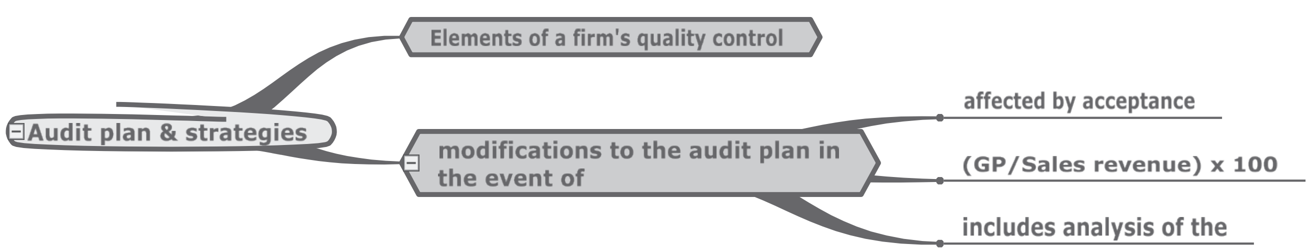
(b) **Additional tests of control are necessary**; or

(c) The **potential risks of misstatement need to be addressed using substantive procedures**

SUMMARY



SUMMARY



Test Yourself 2

Samson Ltd manufactures refrigerators. It has 225 employees. The total wage bill was approximately $550,000.The auditors prepared an audit plan to test the internal control systems. The plan included a verification

of:

the attendance report from the swipe machine for 25 days with the payroll records.

the annual increment list for authorisation, recalculation of the increment amounts for 20% of the employees.
performance and recalculation of salary paid to 5% of the employees each month.

The auditors made the following observations:

All the employees were required to swipe their cards at the time of entering and leaving the premises. Out of 225 employees, at least 100 employees each day did not follow this practice. The reasons for not swiping the cards were also not substantiated by management.

The annual increment list was not authorised.

The annual increments were also not updated according to the list made available to the auditors.

Required:

Explain the effect of the results of the tests of control on the audit strategy and audit plan.

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3. Evaluate the implementation of a previously suggested control measure and its effectiveness.

[Learning Outcome d]

According to ISA 265, Communicating Deficiencies in Internal Control to those Charged with Governance and Management, if the auditor **has previously communicated the significant deficiencies to the client but the management did not take suitable remedial action, it will be considered a significant deficiency.**

Let us briefly understand the meanings of deficiency in internal controls and significant deficiency in internal controls and then understand the implication of these issues to the audit.

3.1 Meaning of deficiency and significant deficiency in internal controls

Deficiency in internal control

Definition

This exists when:

(a) 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
(b) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

IFAC, Glossary of terms

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. 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**.

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. 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. This is a deficiency in the internal control system of the bank

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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:

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.

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.

3.2 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 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.

Test Yourself 2

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.

Test Yourself 3

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.

During the audit of the previous year, the auditor had carried out tests of control in the area of payroll and noticed deficiency in the design and implementation of the internal controls in the area of payment of wages to temporary staff. The supervisor who hires temporary staff, is given the pay packets of the temporary staff. This was not just a deficiency in the design of the control, the auditor also got evidence of fraud in this area. Therefore the auditor had recommended a change in the change in the design of the controls to the management.

Required:

During the current year what should be the auditor’s strategy while testing payroll.

3.3 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.

1. Method of communication

Deficiencies can be communicated either in writing or orally. The points below explain the circumstances under which they are appropriate:

(a) 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:

(i) 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.

(ii) 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.

(iii) 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 Tshs500,000 and payments above Tshs500,000 should be authorised by Fox, the CEO. The person who is paying the invoices should check whether the authorised person has approved the payments.

(iv) 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.

(b) 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.

2. Time of communication

According to ISA, the deficiencies should be communicated on timely basis. However, no fixed timing is mentioned.

(a) 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.

(b) 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.

3. 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 Tshs5 million. Payments of Tshs5 million and above are to be authorised by, Gorge, the finance director and Mandy. If it is discovered that even payments above Tshs5 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.

3.4 Examples of communication of deficiencies

Payroll system

Example

Nasco is a manufacturing company which has branches in different parts of the country. In its new factory in Birmingham, 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

Answers to Test Yourself

Answer to TY 1

Report on business risks faced by Flora and Fauna

Report to: Flora and Fauna From: Vista Professionals Date:

Business risks faced by Flora & Fauna

(a) Credit risk

Credit risk is the risk that accounts receivables will not meet their obligations on time. Flora sells goods on credit so it will face this risk. Credit risk may adversely affect cash flow and may require additional financing. Since credit risk may involve customers, there may be a risk that revenue streams may be lost and that operational overcapacity may result. There are immediate risks to operating profit and, in the longer term, to gross margin and contribution.

(b) Liquidity risk

Liquidity refers to the non-availability of cash or cash equivalents in the business. **Liquidity risk refers** to the risk that the business will **not have enough liquidity to fulfil its current liabilities**. As Flora offers credit to its customers, it faces liquidity risk if creditors do not make payments in accordance with sales order terms. Liquidity risk is more likely to mean that working capital will require an injection of funds from the sale of an asset or the raising of longer term finance. If short-term facilities such as an emergency overdraft are required these may come at a high price, and being payable on demand, create additional risks for the future.

Liquidity risk may affect credit ratings and the ability to raise future finance.

(c) Business probity risk

Probity is about honesty and integrity and ultimately the risk here is the risk of fraud. Lack of integrity or perceived lack of integrity in business dealings can lead to damage to reputation.

The possibility of business probity risk could occur if Flora experiences:

- Theft by customers or staff
- Theft by management
- Illegal transactions
- Bribes
- Deception
- Aggressive earnings management and window dressing
- Misleading statements to auditors and regulators
- False accounting

Compliance risk could arise in Flora if:

- It does not adhere to the regulatory requirements relating to minimum wages payable to employees
- It indulges in illegal activities like smuggling, money laundering, etc.

Reporting risk could occur if:

- It does not execute all orders and enquiries / it does not execute its orders on time (this may also cause reputation risk)
- The new customers to whom credit limits were allowed by the credit controller do not make payment of dues in accordance with sale terms (can also cause liquidity as well as credit risk)
- Flora holds more than the required inventory (this can also cause liquidity risk as the nature of the Flora's Goods is perishable hence the excess inventory will have to be written off)
- Items invoiced are of poor quality or not in accordance with the sales order (can also cause reputation risk)
- Flora faces theft in transit (can also cause liquidity risk)
- Invoices are not recorded at the correct amount or in the correct accounting period
- Flora faces the risk of bad debts due to insufficient follow-up of dues (can also cause liquidity and credit risk)

Answer to TY 2

Payroll expense is generally a significant element of the financial statements. The audit evidence from tests of control revealed that the risk of misstatement on account of discrepancy in wages was very high i.e. the auditors would have assessed the control risk as high. The auditor's observations clearly indicate that there is an increased risk of material misstatement (relating to payroll expenses) in the financial statements on account of **change in the audit evidence** obtained from the results of the audit procedures. Therefore the auditor will **need to modify the overall audit strategy and audit plan.**

According to ISA 530, the greater the reliance the auditor places on the operating effectiveness of controls in risk assessment, the greater is the extent of the auditor's tests of control. Therefore the revised **audit strategy and plan must include performance of the following additional tests of control and substantive procedures:**

- Obtaining the authentic list of employees that qualify for an increment from the management, and a recalculation of the increments for 20% of the employees.
- Asking that the payroll software be rerun with the appropriate annual increments and monthly loan deductions from the salary. The auditors should then recalculate the calculations for 5% of the employees.
- Scrutiny of the rectification entries made on the payroll.
- Asking the client for time sheets of employees (if available) and determining whether they were present on the days when they had not swiped their attendance.

Furthermore, if the auditor performed an interim audit and executed some tests of control during such an interim audit, they should not rely on the results of these tests. This is because they need to confirm the effectiveness of the controls throughout the audit period. They should therefore perform tests of control for the remaining period.

They also have to check whether the internal controls function throughout the year. If they observe that the controls change at different times during the period, then they should test the controls during different periods separately, and decide the nature, timing and extent of the audit procedures to be applied, considering each period separately.

Answer to TY 3

The company has 150 temporary staff, therefore if a fraud was noticed in their salary payments the deficiency will most probably be a 'significant deficiency' in the internal control. During the current year, if remedial action was not taken by the management, the deficiency can be considered a 'significant deficiency'. This is suggested by ISA 265. **Significant deficiency in internal control** is 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.

First of all, the auditor will have to discuss with the client how the suggestions given in the earlier audit were implemented. The auditor will confirm whether the design of the control is changed so that pay packets are not given to the supervisor. Furthermore, the auditor will also carry out tests of control in the area of wages to temporary staff to determine whether the controls can now be relied upon. If the controls can be relied upon, the auditor will perform less extensive substantive procedures.

However, 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 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.

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 Questions

Question 1

Doll Co is a company which buys dolls from a supplier in China. Doll Co is situated in Hong Kong. The dolls come to Hong Kong and they are repackaged for different markets, e.g. the UK, the USA and Asia.

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. Chin receives these orders and checks whether they are within the credit limit. If the order is within the credit limit, Chin will raise the sales order.

The sales order is then sent to the inventory department. Chan 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.

Choo from the accounts department prepares sales invoices then enters sales in the books. In the case of cash sales, Lee 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, Lee fills in both the sales receipt as well as the counterfoil at the same time. The director, Wu, checks the credit limits every six months.

Required:

As an auditor of Doll Co, identify the deficiencies in the system and report them to the management of Doll Co. Also, make suggestions on how to eliminate these deficiencies.

Question 2

(a) Explain the procedures relating to communication of control deficiencies to management.
(b) Explain the extent of the auditors' responsibility relating to detection and reporting internal control deficiencies.

Answers to Self-Examination Questions

Answer to SEQ 1

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.

Continued on the next page

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 Chin 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. Chan), receives the order, checks the limit and prepares the sales order there is a possibility that Chan 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. Chan 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.
Use of perforated sales receipts.	**Fraud in cash sales** Cash sales are recorded on perforated sequentially numbered sales receipts. Lee, 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** Lee, 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.

Continued on the next page

Deficiencies	Implications	Recommendations
Low frequency of reviewing credit limits.	Wu reviews the credit limits every 6 months. This interval is large and it may happen that a customer with a limit of, say, Tshs100 million, has defaulted twice for a total amount of Tshs45 million (Tshs20 million and Tshs25 million). Having defaulted twice, he should not be allowed further credit but will be given credit of Tshs55 million (Tshs100 million - Tshs45 million) since he has balance in his credit limit.	To avoid this, Wu 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 Tshs100 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

Answer to SEQ 2

(a) Communication of deficiencies

(v) Timeliness

Generally, the deficiencies are reported after the audit has been completed. When the assessment of the control risk is made during the interim visits, the auditor should communicate the deficiencies at the end of the each visit. If the deficiencies are of such a nature that the corrective action should be taken immediately, the auditor should communicate them immediately on their discovery.

(vi) Method

There is no specific method of communicating the deficiencies. Generally, communication is made in writing by way of a management letter. Oral communication can also be made in the case of serious deficiencies, but the auditor should mention this fact in their working papers and also the responses of management. Even if oral communication is made, it should also be mentioned in the management letter.

(vii) Level of Management

The auditing standard says that the deficiencies should be communicated to the appropriate level of management but does not mention the exact level. It is advisable that the auditor should discuss the matters with the line management which is actually responsible for those controls. The auditor should also communicate the deficiencies to those charged with governance.

(b) The auditor's responsibility to detect and communicate deficiencies in the internal control system

The external auditor is not responsible for assessing the effectiveness of the internal control system. They are only responsible for those controls which they intend to use for their audit. If any deficiency is found in any internal control that does not come under the audit, the auditor is not responsible for detecting and communicating such deficiencies. However, if, during the course of the audit, they find any deficiency in the system they should report it. The auditor is responsible for reporting of the deficiencies to the management / those charged with governance only and not to the third party. The management letter should state that the letter is for communicating deficiencies to the management and not for the use of the third party.

SECTION E

EVALUATION OF ACCOUNTING TREATMENTS AND OTHER AUDIT CONSIDERATIONS

E1

STUDY GUIDE E1: EVALUATION OF ACCOUNTING TREATMENTS

Get Through Intro

The main aim of the entire audit exercise is to help the auditor form and express his opinion about the truth and fairness of the financial statements he audits. An auditor is a professional and his opinion matters to the various users of financial statements. Any mistake on his part (whether accidental or incidental) can cause thousands of investors to lose their hard earned money.

A thorough review of the audit procedure is very important in order to arrive at proper conclusions. Even the most well laid plans and procedures will be of no use if the people who execute the plan do not follow them. Checklists are a good tool for ensuring compliance with set procedures.

This Study Guide discusses the importance of evaluation and review in the audit process. It also discusses matters like materiality, risk, relevant accounting standards and audit evidence relating to important financial items in the financial statements. These are important areas which may be questioned in the examination and this knowledge also provides practical guidance for conducting an audit!

Learning Outcomes

a) **Analyse and evaluate, drawing conclusions on the appropriateness of stated accounting treatments in the context of a given business and a given scenario in the public or private sector in an audit assignment based on corporate and other relevant law and generally accepted accounting practice.**

b) Propose alternative accounting treatment in accordance with financial reporting standards where the applied treatment is inappropriate.

1. Analyse and evaluate, drawing conclusions on the appropriateness of stated accounting treatments in the context of a given business and a given scenario in the public or private sector in an audit assignment based on corporate and other relevant law and generally accepted accounting practice.

[Learning Outcome a]

While auditing the financial statements of an entity, certain findings may crop up that would have an impact on the audit opinion. Each of these findings may have a different impact on the overall audit opinion. In these cases, it is up to the auditor to apply his skill, experience, expert knowledge and common sense in order to decide how to respond to this information.

Usually, the auditor has to obtain evidence to satisfy himself about the nine assertions that you have studied in Paper B3. (i.e. completeness, cut off, classification, occurrence, valuation and allocation, understandability, accuracy, rights and obligations and existence).

What follows are a few of the issues that an auditor may encounter in the course of his audit and certain broad guidelines on the matters an auditor would need to consider when auditing those issues. Note that each of these issues would be handled differently by different audit firms working at different times, locations and in different industries.

We now discuss the issues on the following areas:

- Inventory and construction contracts
- Standard costing systems
- Statement of cash flows
- Changes in accounting policy
- Taxation (including deferred tax)
- Segment reporting
- Non-current assets
- Fair value
- Leases
- Revenue recognition
- Employee benefits
- Government grants
- Related parties
- Earnings per share
- Impairment
- Provisions, contingent liabilities and contingent assets
- Intangible assets
- Financial instruments
- Investment properties
- Share-based payment transactions
- Business combinations
- Assets held for sale and discontinued operations
- Events after the end of the reporting period
- The effects of foreign exchange rates
- Borrowing costs.

1.1 Inventory and construction contracts

1. Inventory

Inventory **consists of** raw materials, consumables in the production process, finished goods, work in progress and inventory held for re-sale.

Determining materiality is largely a matter of judgement. Inventory is **regarded as an important and high risk area** of an audit because:

- It usually has a substantial effect on the entity's profits
- It is usually subject to an element of estimation
- It may be complex

The valuation and recording of inventory is governed by **IAS 2 Inventories**. The accounting standard states that inventories should be **measured at a lower of cost or net realisable value.** Costs include all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

The auditor has to **obtain sufficient audit evidence to ensure** that:

- All inventories are recorded
- All inventories that are recorded and relate to the entity
- Valuation is proper (at lower of cost or net realisable value); allowance is made for slow moving or obsolete inventories
- Inventories exist physically

Audit evidence

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 **attending** physical inventory counting, unless this is impracticable. **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.

ISA 501 requires the auditor to **review the instructions issued by the management** for physical verification, focussing particularly on the following:

(a) **Control activities:** count and recount procedures and control over used and unused stationery that is used to record inventory during the inventory count. The instructions should be simple and clear. They should lay down the responsibilities of different persons and state which location will be covered by which persons. They should also specify the procedure to be followed and the identification marks to be made.

The intention should be to count each item and count it only once.

(b) **Accurate identification** of slow moving / damaged items, inventory owned by third party, for example, goods received on consignment, stage of completion of WIP.

(c) **Arrangements regarding the movement of inventory:** dispatch and receipt of inventory before and after cut-off date, movement of inventory between areas during the process of counting.

(d) Subsequent arrangements to check the accounting of movements mentioned above.

2. Construction contracts

According to **IAS 11 Construction Contracts**, a construction contract is negotiated specifically in order to construct an asset or a group of assets which would be independent in terms of design, technology and function.

Activity under a construction contract usually begins in one accounting period but ends in another. This creates a necessity to **allocate the costs and revenues to different periods.** Also, **the revenues recognised have to be matched to the relevant costs.**

Income is recognised in the SOCI (income statement) when an increase in future economic benefits related to an increase in an asset or a decrease in a liability has arisen that can be measured reliably. Expenses are recognised in the SOCI (income statement) when a decrease in future economic benefits related to a decrease in an asset or an increase in a liability has arisen that can be measured reliably.

Recognition of profits will be the result of recognising the **contract revenues and costs.**

The **rules of recognition** are as follows:

- Contract **revenue** is recognised in the **period in which the work is done.**
- Contract **revenue is matched with the contract costs** incurred in reaching that stage.
- The expected **excess of contract cost over contract revenue** is recognised as an expense immediately.
- The contractor may incur costs related to **future activity;** these costs are recognised as an asset to the extent it is probable that the costs will be recovered.
- That part of the collection from the customer which is received **before** the work is performed is known as an **advance.** This amount is a liability for the contractor.
- If any part of the amount recognised as revenue becomes **uncollectible (i.e. a bad debt),** it should be **recognised as an expense** rather than as an adjustment to the amount of contract revenue.

Audit procedures

The procedures involved in auditing for construction contracts are as follows:

(a) Confirm that revenue is recognised based on certificate of completion of work obtained from experts

Auditors should ascertain whether the entity has a system of recognising revenue after obtaining certificates from 'experts' who certify the stage of completion of the contract. Furthermore the provisions of ISA 620 'Using the work of an auditor's expert' provides guidance on the matters which need to be considered by the auditor, before the work of an expert is used as audit evidence:

Refer to Study Guide C7 of Paper F8!

(i) Independence and objectivity: the risk of impairment of independence will be greater when the expert is employed by the entity or is related to the entity in any other manner.

(ii) Skill and competency of the expert: the external auditor should take into account the expert's professional certifications, licences or memberships of appropriate bodies and his experience and reputation in his field.

(iii) Terms of engagement of the expert: an external auditor should review the following matters:

Scope of the work: the auditor should obtain sufficient appropriate audit evidence for determining the adequacy of the work for audit purpose.

General guidelines for specific items in the expert's report: these matters include:

The nature and complexity of the item
The issues related to the item
The materiality of that item in relation to the audit work etc.

The intended use of the expert's work: the auditor must verify the contract with the expert to confirm that the contract contained information about the intended use of his work. Such information will ensure that the expert will work accordingly.

The **expert's access to appropriate records and files:** the auditor will enquire with the expert and also verify the contract with the expert to ascertain this matter. Such information will ensure that there were no restrictions imposed on the scope of work of the expert.

(iv) Evaluation of the work of an expert: evaluation of the work of an expert will provide the auditor with reasonable assurance that he has obtained appropriate and sufficient audit evidence in support of the financial statements. The following matters would need to be considered in this connection:

(i) Adequacy and appropriateness of source data: the auditor can make enquiries with the expert and also test the data used by him to confirm that adequate and appropriate source data was available with the expert, based on which the expert has prepared the certificate.

(ii) The assumptions and methods used: the auditor should satisfy themselves that the assumptions and methods used by the experts are relevant, reliable, neutral (unbiased), understandable and complete. If the assumptions and methods have changed during the current period in relation to the earlier period, the auditor should enquire the reason for the change.

(b) The auditor should verify invoices on a sample basis (relating to costs incurred on the contracts). While reviewing the invoices relating to various costs the following matters must also be verified:

(i) The **invoices relate to the current period**: this will ensure that contract costs relate to the current period.

(ii) The **evidence relating to costs is appropriate**: for this the auditor should trace the various costs incurred during the current period to the material cost and expense invoices. The auditor must agree the amounts in the account with the invoices. Furthermore the invoices with the client on the cut-off dates should also be verified to confirm that all invoices relating to the current period have been recorded. The labour costs incurred should also be traced to the payroll sheet.

(iii) The costs do not relate to **future activity (e.g. advance payment made to vendors). If the costs relate to future activity, then** these costs are to be recognised as an asset.

(c) The auditor should trace the various invoices raised during the current period to the revenue recorded on the contract. Furthermore while reviewing the invoices relating to revenue the following matters must also be verified:

(i) The amount in the revenue account must agree with the amount in the invoices. Furthermore the invoices raised should be in accordance with the terms of the contract.

(ii) If collection from the customer is received **before** the work is performed, it is recorded as an **advance i.e.** a liability for the contractor.

(iii) If any part of the revenue becomes **uncollectible (i.e. a bad debt),** it is **recognised as an expense.**

(d) The auditor should scrutinise the contract and other documents raised by the client to estimate the cost of the contract. From this the auditor must confirm that **the contract makes a profit (i.e. total revenue less estimated total cost). If the contract makes a loss, the entity should provide for full anticipated loss.**

1.2 Standard costing systems

1. IAS 2, Inventories permits valuation of inventories based on standard costing when prices fluctuate. Therefore, while auditing standard costing systems, the auditor needs to **ensure that standard costing is a valid basis** for valuing inventory and that the **standard cost has been reasonably calculated**.

2. Audit procedures

(a) Review the purchase invoices and price index and enquire with management, to establish whether or not the prices have fluctuated. The source documents should also be reviewed in order to verify the standard cost calculations.

(b) Discuss with management, whether or not standard costing is a valid costing system to use for the company's inventory.

(c) Consider if the inventory is still comparable with the previous year's inventory due to a change in accounting policies, with appropriate disclosures of changes in accounting policies.

(d) Check the reasonableness and accuracy of the standard cost calculation sheet by:

(i) Tracing the costs relating to purchases with the purchase invoices, wages with the wage sheets and personnel records and overheads with the expense invoices
(ii) Verifying the invoices mentioned above and checking whether the calculations are reasonable
(iii) Casting the calculation sheet
(iv) Verifying the standard cost calculations, including arithmetical calculations with the account totals in the income statement.

Standard cost can also be verified by using analytical procedures such as comparison with the total related expense in the income statement. For example the proportion of total overhead expenses (in the income statement) to the total production during the year, would be the standard overhead cost.

1.3 Statement of cash flows

1. A statement of cash flows is accounted for under the provisions of IAS 7 Cash Flow Statements.

A statement of cash flows presents the details of flows of cash and cash equivalents. Cash equivalents enable the entity to meet **short term cash commitments.**

An investment can be treated as a cash equivalent, if:

It is readily convertible to cash;
It has a short maturity period; and
There exists no significant risk of change in value to be realised.

Equity / share instruments are generally excluded from cash equivalents unless they are, in substance, cash equivalents. **Bank borrowings** are **generally excluded** from cash equivalents, unless they are repayable on demand.

An entity has to **disclose** the **components of cash and cash equivalents**. It also has to present a reconciliation of this amount with the cash balance disclosed in the statement of financial position. The statement of cash flow is also a **reconciliation** of the cash movements in the items of the SOFP and the items in the SOCI.

The statement of cash flows shows the movement of cash under three distinct sections of the cash flow cycle and allows users to assess the cash flows and their sources.

(a) Cash flow from operating activity: Operating cash flows are cash flows from the **principal revenue-earning** activities and other activities other than investing and financing activities.

Cash flows from operating activities include:

Cash receipts from the sale of goods and the rendering of services, royalties, fees, commissions and other revenue and refunds of income taxes.
Cash payments to suppliers for goods and services, payments to and on behalf of employees.

These cash flows can be reported by using either the **direct or indirect method.**

Under the **direct method**, major classes of gross cash receipts and gross cash payments are disclosed. The

information under major classes of **gross receipts and payments of cash** may be obtained either:

Directly from the accounting records; or
By taking the statement of comprehensive income as the basis and adjusting the figures for sales, cost of sales and other items for:
Changes during the period in inventories and operating receivables and payables;
Other non-cash items; and
Which the cash effects relate to investing or financing activities.

Under the **indirect method**, the net profit or loss from the statement of comprehensive income is taken as a starting figure.

Adjustments are made for the effects of:

Non-cash items such as depreciation, provisions and deferred taxes (depreciation will be added to the net profit to arrive at the cash from operating activities).
Gains or losses on account of investing and financing activities, as the net profit includes them.

(b) Cash flow from investing activity: investing activities are the acquisition and disposal of long term assets and other investments not included in cash equivalents.

The following cash payments or receipts (i.e. acquisition or disposals) are treated as cash flows from investing activities:

(i) Property, plant and equipment, intangibles and other long term assets.
(ii) Equity or debt instruments of other entities and interests in joint ventures (excluding those forming part of cash equivalents or held for trading).
(iii) Cash advances and loans made to other parties (other than if made by a financial institution).

(c) Cash flow from financing activity: financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. This includes the following cash receipts and payments relating to:

(i) Issue or redemption of shares.
(ii) Borrowing and repayment of debentures, loans, notes, bonds, mortgages and other short or long term borrowings.
(iii) Cash payments towards the principal portion by the lessee of a financial lease.

Relevance of SOFP to auditors

The disclosure of the cash flows from operating activities will enable users to judge whether the entity is fulfilling the main purpose for which it exists, i.e. to earn sufficient money from the principal revenue producing activities so as to maintain operating capability, pay dividends, repay loans and make new investments.

The statement of cash flows can be used by the auditors to ascertain **the liquidity position** of the entity e.g. whether the entity has sufficient funds to meet its short term needs such as working capital needs. This may bring any going concern issues to the auditor's notice, as it would highlight cash shortages, lock up of working capital, as well as over-gearing.

Analytical procedures such as computation of current ratio, quick ratio and gearing ratios are performed on the financial statements to determine the liquidity position, gearing position, etc. Furthermore a comparison of significant ratios is also made between two accounting periods and also between the entity and the industry.

The audit evidence required for the statement of cash flows is taken from the already audited accounting records used to prepare the financial statements. The statement of cash flows can also be used to provide additional evidence for cross checking figures in the accounts. This would also ensure **consistency** of the evidence collected.

Audit evidence

Audited financial statements include the statement of cash flows (SOCF). Therefore auditors need to assess whether the entity's SOCF is true and fair and prepared in accordance with the provisions of IAS 7.

2. The statements of cash flows can be audited in two ways:

(a) By reconciling each item with the financial statements. This includes:

(i) Tracing the items to the source documents (e.g. tracing the loan document and bank statement to the entry on the SOCF relating to repayment of loans).

(ii) Recalculating each reconciliation e.g. recalculating the interest paid on loans with the loan document).

(iii) Agreeing the prior year items in the SOCF (of the current period) with the corresponding amounts in the audited SOCF of the earlier period.

(iv) Agreeing schedules of cash receipts (prepared based on the analysis of cash book receipts) to the receivables ledger control account.

(v) Agreeing schedules of cash payments to suppliers and employees (prepared based on the analysis of cash book payments) to the payables ledger and payroll control accounts (respectively).

(vi) analytical procedures such as various liquidity ratios and gearing ratios, comparison of trade receivable (and payable) days (i.e. average credit periods given to customers and received from suppliers) with prior years, are performed on the current period and also on the previous period. This will enable assessment of the ratios with reference to previous years as well as with the industry.

(b) By drawing up a statement of cash flow from the audited financial statements. The use of computers has made this task very quick and easy.

Test Yourself 1

Book Universe is a publishing house listed on a national stock exchange. The company's cash flow statements over the last seven years indicate a falling cash flow position.

However, interestingly, during the previous year the company was able to make significant investments in capital expenditure. On further investigation by the auditor, it came to light that the company was financing these capital expenditures through term loans and bank overdrafts.

Required:

What are the implications of this situation on the entity's audit?

1.4 Changes in accounting policy

Accounting policies are the **specific principles, bases, conventions, rules and practices** applied by an entity in preparing and presenting financial statements. After having selected an appropriate policy, **entities are required to follow the same accounting policies consistently for similar transactions.**

The application of the same accounting policies within each period and from one period to the next allows the users of financial statements to compare the financial statements of the entity year after year and study the trends in financial position.

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, allows for a change in accounting policies only if:

- They are **required by statute**
- The change in accounting policy would **result in a more reliable presentation** of the financial statements

A change in accounting policy is treated as a retrospective adjustment to the opening balances of the relevant accounts with appropriate disclosure being made in the accounts. If a particular standard allows for two or more alternative treatments of a particular item in the accounts, the method of treatment should be consistently applied and the accounting policy chosen should be adequately disclosed.

Audit evidence

Auditors should review the appropriateness of accounting policies in particular and whether they have been consistently applied, particularly where changes have been made. It is essential to confirm this fact to ensure that the financial statements are not misstated or misleading.

(i) For this the auditor must first enquire with the management of the client about the changes made to accounting policies, during the current period.

(ii) The auditor must then determine the reason for the change i.e. by statute or for a more reliable presentation. The auditor must confirm the accuracy of the entity's reason for change in accounting policies. For example if it is the requirement of the statute, the matter must be confirmed by studying the statute which prescribes the change. On the other hand, if the change amounts to a more reliable presentation of financial statements, the fact must be ascertained by calculations.

(iii) The auditor will then re-perform calculations on recognition and measurement of elements of financial statements for which change in accounting policies took place. Furthermore, if the change in the accounting policies is material, the auditor will recalculate the impact of the change on the entity's accounting policies.

For example, if there is a change in the useful life of an asset which has caused a change in the accounting policy, the auditor will:

- Obtain details of the accounting policy from the notes to the financial statements.
- Confirm against last year's financial statements the assets where there is a change to the policies.
- Obtain the copy of the report of expert relating to useful life.
- Evaluate the work of the expert based on the expert's qualifications, experience, independence, etc.
- Re-perform the depreciation calculation for the year.
- Re-perform the retrospective calculation of depreciation.

(iv) Any change in the accounting policy requires a disclosure of the effects of the change in the policy on the amounts in the financial statements (IAS 1). The auditor will confirm that appropriate disclosures are made after performing recalculations.

Effect on audit report

The auditor **should express disagreement** (an 'except for' clause or an adverse opinion as appropriate) in his report, if the current period's accounting policies have not been consistently applied in relation to opening balances and if the change has not been properly accounted for and adequately presented and disclosed.

Test Yourself 2

When auditing the financial statements for Bull's Eye, a beverage company, you notice that the company has changed its accounting policy of measuring inventory from FIFO to the weighted average method.

Required:

What are the matters that you, as an auditor, would consider when auditing the financial statements of Bull's Eye?

1.5 Taxation (including deferred tax)

1. Accounting treatment

IAS 12 Income Taxes covers accounting for taxes and deferred taxes.

(a) Current tax

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Current taxes are to be **treated as an expense**. However, if the tax relates to **items that are credited or charged** directly **to equity, then this** current tax and deferred tax shall **also be charged or credited directly to equity.**

If the tax **expense and the provision at the end of the year are greater** than the payment, the **shortfall in the payment will be disclosed as a current tax liability.**

If the tax **expense and the provision at the end of the year are lower** than the payment, the **excess payment will be disclosed as a current tax asset.**

(b) Deferred taxation refers to income tax amounts arising from taxable temporary differences that would be payable over future accounting periods. Deferred tax is provided for in the statement of financial position.

Recognition of deferred tax is based on the principle that when an asset or liability is recognised, it is obvious that the entity will recover or settle the carrying amount of that asset or liability. If, as a result of such recovery or settlement of the carrying amount future tax payments get affected, IAS 12 requires that in order to ensure the matching principle, the entity should recognise a deferred tax liability / deferred tax asset when the related asset or liability is recognised.

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:
- Deductible temporary differences
- The carry forward of unused tax losses
- The carry forward of unused tax credits

Temporary differences are differences between the carrying amount of an asset or liability in the SOFP and its tax base.

The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

(a) Temporary differences may be of two types:

(i) Taxable temporary differences are temporary differences that will result in **taxable amounts** in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

A taxable temporary difference occurs when:

Depreciation or amortisation is accelerated for tax purposes.

Example

The cost of an asset is Tshs200 million. For the first year, accounting depreciation is Tshs32 million while tax base (i.e. tax depreciation is Tshs50 million. The accounting profit will be Tshs18 million (Tshs50 million–Tshs32 million) higher than the taxable profit.

The carrying amount of an asset is Tshs168 million. **In future,** the entity will **earn taxable income and recover this carrying amount.** When it does so, for tax purposes it can deduct only Tshs150 million (Tshs200 million – Tshs50 million), the tax base, on which depreciation is yet to be allowed. On the difference of Tshs18 million, it will have to pay tax, i.e. it is a taxable difference.

A particular liability has already been allowed as a deduction for tax purposes but has not been deducted in the accounts, for example when the development cost is capitalised in the books but is deducted from the taxable profit in the period it is incurred.

Income received in advance: the tax base will be the carrying amount, less any amount of revenue that will **not be taxable** against that item in future. The temporary difference is equivalent to the carrying amount of the income accrued on the date of SOFP as the tax base of the accrued income is nil.

Fair value adjustments: when fair value adjustments are made to the financial assets or investment property where the carrying amount is different from carrying value, no equivalent adjustment is made for tax purposes. The loss will be recognised on sale of investments for tax purposes and the tax profit on sale will be lower than the accounting profit. Therefore, a temporary difference would arise when such a fair value adjustment is made.

Deferred tax on impairment: if the net realisable value of inventory or the recoverable amount of property, plant and equipment falls below the previous carrying amount, the entity reduces the carrying amount. These adjustments are ignored for tax purposes until the asset is sold. As a result, temporary difference will arise until the carrying value is realised.

(ii) **Deductible temporary differences** are temporary differences that will result in **amounts that are deductible** in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Deferred tax liabilities are closely related to taxable temporary differences and deferred tax assets are linked to deductible temporary differences.

Deferred tax accounting is required when the identifiable assets acquired (excluding goodwill) and liabilities assumed in a business combination are recognised at their fair values in accordance with IFRS 3 Business Combinations, but no equivalent adjustment is made for tax purposes.

However, a deferred tax asset (DTA) shall be recognised for all deductible temporary differences **to the extent it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.**

Types of deductible temporary differences

Provisions, accrued product warranty costs for which the taxation laws do not permit the deduction until the company actually pays the claims. This is **a deductible difference as its** taxable profits for the current period will be higher than those in future, when they will be lower.

The carry forward of unused tax losses and the carry forward of unused tax credits: the DTA should be recognised only to the extent it is probable that taxable profit will be available against which the above losses or credits can be utilised.

(b) Fair value adjustments

Liabilities are recognised on business combinations although the expenditure is deductible for tax purposes in a future period.

Unrealised profits on intra group trading

In intra group transactions the unrealised profit will be eliminated in the consolidated financial statements. However, tax authorities would not make such adjustments. This creates a deductible difference.

Measurement of deferred tax assets and liabilities

(i) Measurement shall be **at the tax rates expected to apply** to the period when the asset is realised or liability is settled.
(ii) The rates used shall be those **enacted or substantially enacted by the end of the reporting period.**
(iii) Measurement **depends upon the expectations about the manner** in which the recovery of tax asset or settlement of tax liability will take place.
(iv) **In the case of deferred tax assets and liabilities, the values are not to be discounted**.

A deferred tax asset is recognised, giving rise to a corresponding effect of deferred tax income. This deferred tax income will nullify the extra amount in the current tax expense. In future, when the related profit is recognised, this deferred tax asset should be transferred to expense.

When planning the audit engagement, the auditor should check with its tax services arm about the entity's future tax planning measures so that the auditor can evaluate when a deferred tax liability may arise and in turn, assist in the analytical reviews carried out with respect to deferred tax.

Tip

The deferred tax entry in the financial statements has an effect on the profit / loss before dividends and on the SOFP. However it does not affect the current taxes which are paid to "Tanzania Revenue Authority" (TRA). Therefore any manipulation in the amount of deferred tax will not affect the actual tax position.

2. Audit procedures

The auditor would carry out the following procedures when auditing for deferred tax:

(a) Obtain a copy of the deferred tax calculation sheet and perform the following audit procedures:

(b) Confirm that the rates used for the calculation of current tax and deferred tax have been **enacted or substantially enacted by the end of the reporting period**.

(c) Verify that current tax expenses are properly calculated.

(d) Check the accounting for and disclosures related to current tax expenses, asset, and liability.

(e) Check the arithmetical accuracy **of the deferred tax calculations**. This would include checking the opening balances of the deferred tax account against the previous year's financial statements.

(f) Carry out a numerical reconciliation between tax expense and accounting profit multiplied by the applicable tax rate.

(g) Evaluate the **reasonableness of the assumptions** made while calculating deferred tax. For example, consider the assumptions regarding the growth rate of taxable profit.

Match the figures used to calculate the temporary differences to those on the financial statements. For example, trace the schedule of carrying amount (i.e. cost or revalued amounts net of accumulated depreciation) of non-current assets to the general account balances and agree these to tax computations and the asset register.

(a) **Inspect** the invoices relating to additions to assets and agree the depreciation rates to the previous year's accounting policies.

(b) Enquire with management and verify that the tax computations include all differences which need to be adjusted.

(c) **Review the provision** to make sure that it is in accordance with IAS 12.

(d) Ensure that all **necessary disclosures** have been made e.g. the rate, the items on which deferred tax has been calculated etc.

(e) Ensure the **consistency of the deferred tax computation** from one year to the next e.g. the method of calculation and the disclosure is the same year on year.

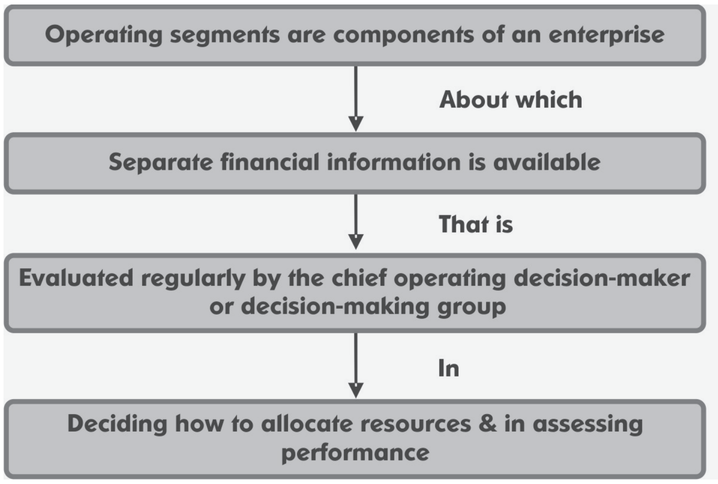
(f) Determine the time period required to generate sufficient profits to utilise the tax losses. The recognition of the asset should be restricted, if it is going to take a number of years to generate such profits.

(g) Review correspondence relating to tax, to confirm that there is no restriction on the ability of the entity to carry the losses forward and to use the losses against future taxable profits.

1.6 Segmental reporting

1. **IFRS 8 Operating Segments** governs the accounting and disclosure of segmental information

Diagram 1: Operating segments



The numerical thresholds in the case of segmental information (i.e. specific criteria that a reporting segment would meet):

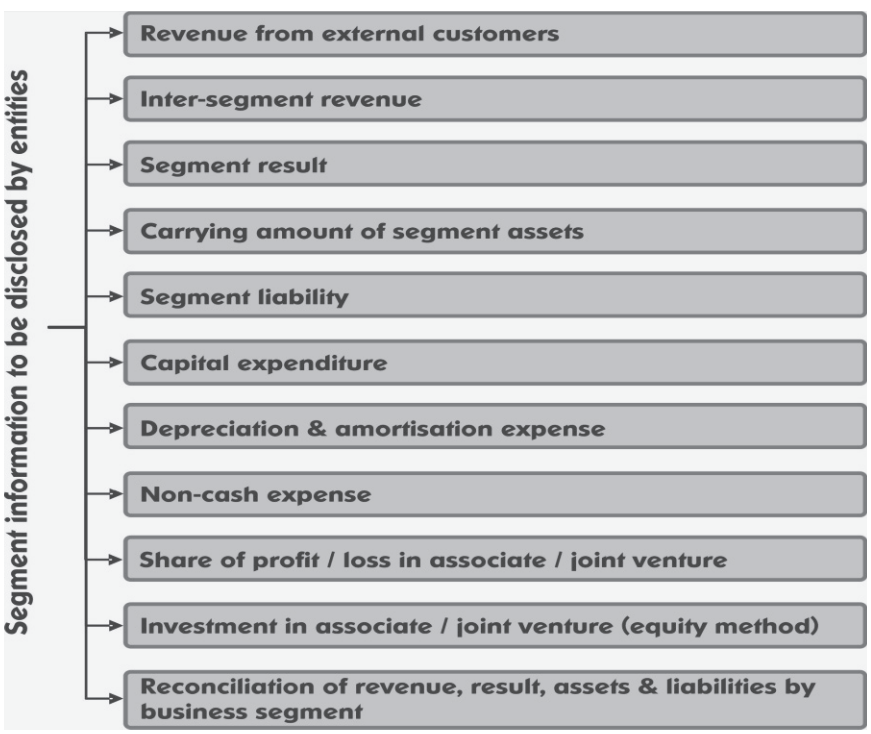
(a) Reported revenues (internal and external) are more than 10% of the combined revenues (internal and external) of all the segments.

(b) The absolute amount of an entity's reported profit or loss is 10% or more of the greater, in absolute amount, of:
(i) the combined reported profit of all the operating segments that did not report a loss, and
(ii) the combined reported loss of all the operating segments that reported a loss.

(c) Assets are more than 10% of the combined assets of all the segments.

However, if the total external revenue consists of less than 75% of the entity's revenue, then additional reporting segments must be identified, as reportable segments up to at least 75% of the reportable profit is included in segmental information. These segments may not meet the numerical threshold.

Diagram 2: Reporting related to profit and loss and assets and liabilities



2. Audit procedures

The audit objective relating to segment information is that if the information is material, the information must be disclosed in accordance with the provisions of IAS 14 Segment Reporting. Furthermore the auditor must obtain sufficient and appropriate evidence relating to segment information.

Detailed audit procedures

(a) The identification of the operating segments and the amounts related to prior period that are included in segment information must agree with the segment information included in the financial statements of the earlier year.

(b) The totals of the segment information disclosure must be cast.

(c) The turnover and operating profit totals must be agreed with the amounts shown on the face of the income statement.

(d) The segment results (i.e. segment revenue less segment expense) must be agreed with the internal MIS reports of the entity.

(e) The appropriateness of the geographic segments identified for the primary reporting format must be confirmed. For this:

(i) The auditor must review the MIS information of the entity to ascertain whether it indicates that the **chief operating decision maker (like the board)** of the entity reviews the performance of the operating segments and also takes decisions relating to allocation of resources based on this information. The auditor will confirm that operating results include segment information.

(ii) The entity must have a system of recording segment information in its accounting systems e.g. cost centre wise information. This will provide assurance that discrete financial information relating to operating segments is available.

(iii) The numerical thresholds mentioned above must be recalculated.

(iv) The auditor would also discuss the basis of allocation with the entity. Furthermore on a sample basis the information must be verified with source data such as segment revenue with invoices.

(v) The auditor would also look at segments which were slightly too small and double check to see if they need to be included.

(f) The appropriateness of secondary information must be verified i.e. the information for either industry or geographical segments (which is part of secondary information) needs to be at par with the information given for the primary segments.

(g) Revenue expenses that arise at the enterprise level on behalf of segments (e.g. head office costs) which are not directly attributable to a segment need to be allocated between the different segments on a reasonable basis. However, the IFRS has not explained how this is to be done. Furthermore the basis for allocation which is chosen can have a material effect on the segment result. Therefore the auditor needs to review the basis on which such expenses are attributed to segments and confirm that it is reasonable (i.e. whether it is in agreement with prior year basis).

1.7 Non-current assets

1. Non-current assets are **valued at cost or at their revalued amounts**.

When assets are **revalued**, the **certificate** obtained after revaluing the asset is used to verify the value of the tangible non-current asset.

The auditor should ensure that the asset's revalued amount does not deviate too far from its fair value by comparing the revalued amount with the current fair market values.

If the asset is revalued at cost, then the asset can be valued by verifying its original purchase invoices. In the case of **depreciated assets**, the useful life of assets is determined by scrutinising the management's estimates of how long they expect the assets to be used in the business by referring to minutes of meetings in which the purchase of the asset is discussed, capital budgeting reports, etc. The depreciation amount on the revalued asset / asset recorded at cost is verified by re-performing depreciation calculations.

Test Yourself 3

Glider Travels is a car rental company that rents out cars to corporates for conferences and seminars. Furthermore, the company also leases out cars for short term periods. The company owns a fleet of 10 SUVs, 5 limousines and two buses. All of these cars were purchased in 20X9 when the company started expanding and capturing market share. The cars have an estimated useful life of four to eight years depending on the type and make of the car, current trends and client requirements. The auditors have started planning their audit for the year ended 31 December 20Y2.

Required:

What are the procedures that the auditor needs to follow and the matters that he would consider during the audit of the financial statements for the year ended 31 December 20Y2?

The purpose of substantive procedures is to test the following assertions:

(a) All non-current assets purchased and disposed of during the year are recorded. (Completeness) (b) All non-current assets relate to the entity. (Rights and obligations)
(c) Valuation is proper; impairment (reduction in value) and revaluation (in case the revaluation model is adopted) has been done where appropriate. (Valuation and allocation)
(d) All non-current assets procured and disposed of are correctly recorded. (Valuation and allocation) (e) Assets exist physically. (Existence)
(f) Entity has a right to dispose of or use the assets. (Rights and obligations)
(g) Information is recorded and classified under appropriate headings. (Classification)
(h) The disclosures relating to cost, useful life of assets, depreciation policies, procurements and disposals are understandable. (Understandability)
(i) Recorded non-current assets are in use at the year end. (Occurrence)

2. Audit procedures

(a) Appropriate classification

Non-current assets should be correctly classified as tangible or intangible assets. In addition, an auditor should know the difference between non-current assets and current assets and ensure that no current assets have been classified as non-current assets and vice versa. Also, non-current assets not covered by IAS 16 should not be included as non-current assets. These assets would be:

(i) Property, plant and equipment, classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations**;**
(ii) Biological assets related to agricultural activity (see IAS 41 Agriculture);
(iii) The recognition and measurement of exploration and evaluation assets (see IFRS 6 Exploration for and evaluation of Mineral Resources); or
(iv) Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

Assets purchased during the year should be correctly classified under their own account headings. In the case of additions and disposals to the assets made during the year the auditor should inspect ledger accounts to ensure that the additions and disposals are not recorded as purchases and sales revenue.

(b) Appropriate Cut off

This means that transactions and events have been recorded in the correct accounting period. In this case, when auditing non-current assets, the auditor has to ensure that all additions and disposals to the non-current assets account that have occurred during the year are recorded and that no transactions occurring in prior years have been recorded in the current year's accounts.

(c) Valuation and allocation

An auditor would have to ensure that all the valuations are made according to company policy and amounts are valued correctly in accordance with the conducted valuation. The auditor will also have to check whether any adjustments on valuation have been made correctly. According to IAS 16 Property Plant and Equipment, an entity can choose between the two methods of subsequent recognition of non-current tangible assets.

(i) Assets revalued by a valuer

The auditor would need the certificate from the valuer as proof to verify the value of the asset. However before accepting the work of an expert, the auditor must evaluate the experts' work (independence, objectivity, scope of work, assumptions used) and confirm the reasonableness of the valuation. Additionally, the auditor would have to check that the valued amount does not deviate too far from its fair value. While revaluing the asset, the value of the asset may increase or it may decrease.

Situation one: increase in the value of the asset

When the increase in the value of the asset is recognised in the statement of comprehensive income, the auditor should ensure that there is no balance remaining in the revaluation reserve account and that the correct amount has been charged to the statement of comprehensive income.

Situation two: decrease in the value of the asset

The auditor should ensure that if there is a decrease recognised in the statement of comprehensive income, there is no balance in the revaluation reserve account and that the correct amount is debited from the revaluation reserve account.

(ii) Assets measured at cost

For assets that are measured at cost, the auditor would have to verify the cost from the asset's purchase invoice. The amount of depreciation could be calculated by ascertaining the asset's useful life from management estimates and verify subsequent depreciation calculations.

Accuracy

The auditor should refer to the purchase invoices and the valuation certificate (to ensure that the asset has been correctly recorded). In addition, the auditor would have to recheck the depreciation calculations to ensure that the correct amount has been included in the accumulated depreciation account.

Rights and obligations

This means that the entity has the right to use and dispose of the asset. Any liability arising from the asset has to be paid by the entity. Only when the rights of ownership are in the hands of the entity can it record the asset in its accounts. For property purchased during the year, the auditor would have to look at any legal documentation that would indicate ownership of the asset e.g. title deed documents.

Existence

By existence, it means that the non-current asset does really exist at the end of the reporting period. The auditor would have to visit the site of the assets and physically verify that the asset exists as at the end of the reporting period. If the auditor is not able to physically verify the assets the auditor can make a surprise physical check of significant assets. Furthermore the auditor will confirm whether physical verification of non-current assets was carried out by the entity.

Overall, the auditor uses a number of techniques to ensure that the figures are not materially misstated. Existence will ensure that the items exist, but will not confirm the valuation. Hence valuation methods need to be used to confirm the valuation e.g. looking at the purchase invoices and confirming the original cost and then estimating depreciation based on past experience with the entity etc.

1.8 Fair value

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Auditing for fair values is covered by **ISA 540** Auditing accounting estimates, including fair value accounting estimates, and related disclosures.

1. Accounting estimates

According to ISA 540, an **accounting estimate** is an approximation of a monetary amount in the absence of a precise means of measurement. Approximations are often made in conditions of uncertainty regarding the outcome of events. Therefore there is greater risk of material misstatement.

The auditor has to design and perform **further audit procedures** to obtain sufficient appropriate audit evidence so as to ensure that the accounting estimates are appropriate and appropriately disclosed in the financial statements.

Risk assessment procedures to assess the risks of material misstatement in relation to accounting estimates, enables the auditor to understand the nature and types of estimates which the entity has. **This procedure includes:**

(a) The requirements of the applicable financial reporting framework

(b) The management's means of identifying those transactions, events and conditions that may give rise to accounting estimates

(c) The management's method of making accounting estimates

(d) Evaluation by the auditor of the degree of estimation uncertainty associated with an accounting estimate and assessment regarding whether it gives rise to significant risk of material misstatement

(e) 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.
(ii) Test how management made the accounting estimate and the data on which it is based.
(iii) Test the operating effectiveness of the controls over how management made the accounting estimate together with appropriate substantive procedures.
(iv) Develop a point estimate or a range to evaluate management's point estimate.

(f) Further Substantive Procedures to Respond to Significant Risks

The **auditor shall evaluate the following**:

(i) How management has considered alternative assumptions or outcomes and why it has rejected them, (ii) whether the significant assumptions used by management are reasonable, and
(iii) Management's intention to carry out specific courses of action and its ability to do so.

(g) Disclosures Related to Accounting Estimates

(h) Indicators of Possible Management Bias

(i) Written Representations

Fair value

Accounting for statement of financial position items at fair value is advocated in many accounting standards, including **IAS 16 Property Plant and Equipment.** When assets and liabilities are measured at historical cost, verifying the value of the asset becomes easy, as all the auditor has to do is check the purchase invoice of the asset and re-perform the calculations to account for depreciation.

However, when fair value accounting is used, the fair value of assets and liabilities would fluctuate between one accounting period and the next. As a result, at the end of every accounting period, the fair value of the asset would have to be vouched.

The auditor should **assess the entity's systems for determining fair value and its related disclosures**. Some entities may have systems that are too complex to measure fair value while other entities may have no systems to determine fair value. According to the **risks involved,** in the auditor should determine the extent of his audit procedures.

2. Audit procedures

When the asset's fair value equals its market value, the auditor has to check the current market value and verify the asset's fair value. The fair value of assets would be verified by using work of experts, like valuers, lawyers, etc. referring to published price quotations for marketable securities.

However, in other cases, where the fair value is calculated using assumptions, the auditor would have to consider whether the management would be able to and or intend to carry out these procedures in reality. This includes assessment of:

- The entity's past history in carrying out its stated intentions relating to assets and liabilities.
- The entity's reasons for choosing a particular course of action.
- The entity's ability to pursue a specific course of action

As the above points are difficult to corroborate, the auditor must obtain management representation from the management of the entity.

In addition, the auditor has to consider whether or not the **method adopted** by the entity to calculate fair value **is consistent** with the applicable accounting standards. If the fair value measurement uses alternative methods which are not prescribed by the auditing standards, the auditor must confirm that the method used is applied consistently for other fair value measurements in the financial statements as well as applied consistently during the earlier periods too.

1.9 Leases

Leases are accounted for in accordance with **IAS 17 Leases**. According to IAS 17, a lease is an agreement in which the lessor conveys to the lessee the right to use an asset for a particular period of time, in return for a payment of a series of payments.

Leases are classified into **finance leases and operating leases**. Finance leases are those in which all the risks and rewards of ownership are substantially transferred from the lessor to the lessee and are recorded as assets in the SOFP of the lessee at the fair value of the leased asset.

A lease is normally classified as a finance lease when any one or all of the following situations arise:

- The lease transfers ownership of the asset to the lessee by the end of the lease term.
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value of the asset, at the date the option becomes exercisable.
- The lease term is for the major part of the economic life of the asset, even if the title is not transferred.
- At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
- The leased assets are of such a specialised nature that only the lessee can use them without major modifications.

The amount to be recorded is the **lower** of the **fair value of the asset** and the **present value** of the **minimum lease payments.**

All other leases are operating leases. Lease rentals under operating leases are written off as expenses on a straight line basis over the term of the lease.

Method of classifying leases of land and buildings

For classifying a lease involving land and buildings, land and buildings elements are required to be separated. The minimum lease payments are allocated between the land and buildings elements in proportion to their relative fair values. The land element of lease is normally classified as an operating lease however, when the title of land passes to the lessee at the end of the lease term it is classified as finance lease.

However, according to the amendment made to IAS 17 in April 20W9, a long term lease of land should be classified on the basis of its substance and not only based on its legal form. In the case of long term land agreements, the risks and rewards would be automatically transferred to the lessee, even though the title is not transferred. In such a case, the lease for the land should be treated as a finance lease. The buildings element is classified as an operating or finance lease by applying the classification criteria in IAS 17.

Sale and lease back arrangements

A sale and leaseback transaction is one where a company sells an asset and then immediately takes the asset back on lease. When goods / assets are sold on the condition that they will be taken back on lease, the **legal form** says that a **sale** has been **made,** as generally the title to the goods is transferred to the buyer at the time of sale.

However, the **substance of the transaction** could be different:

> The buyer could have advanced a loan to the seller, with the goods acting as security for the transaction, or the lease rentals paid by the seller to the buyer, in fact could be loan repaid along with interest.

A sale and leaseback transaction may be accounted for as either an operating or a finance lease. The classification of the lease arrangement is determined by the same criteria discussed above.

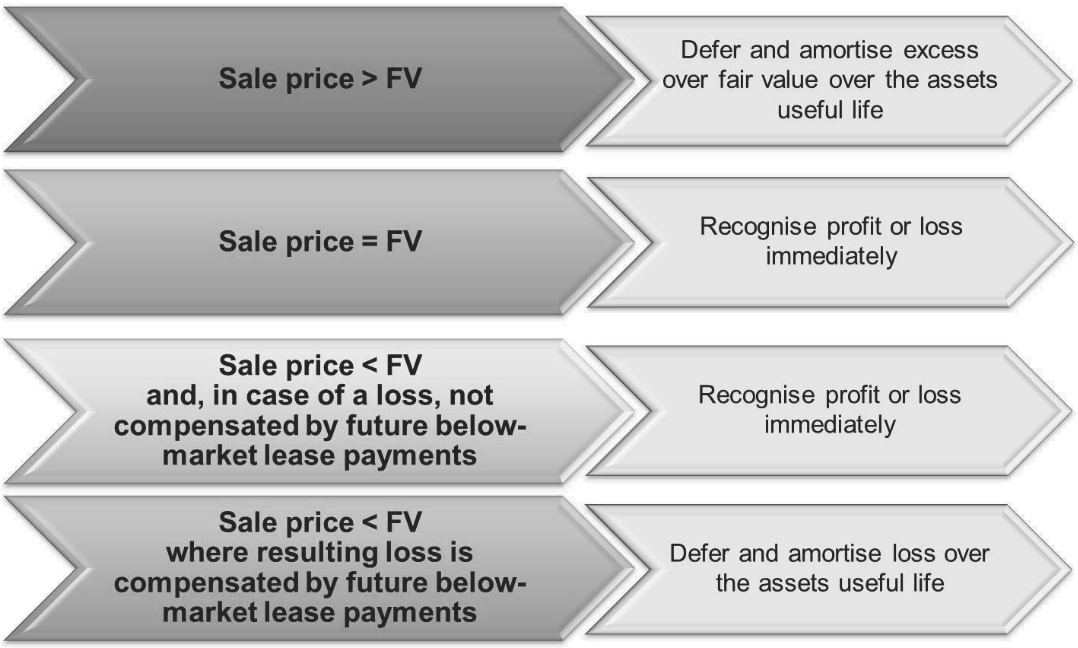
1. **The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.**

(a) If a sale and leaseback transaction results in a finance lease

In such a case, the transaction is a means by which the lessor provides finance to the lessee, with the asset as security. Therefore, any apparent profit (i.e. **excess of sales proceeds over the carrying amount)** shall be deferred and amortised over the lease term.

(b) If a sale and leaseback transaction results in an operating lease

Diagram 3: Sale and leaseback transaction results in an operating lease



2. **Audit procedures**

From the above discussion, it is clear that improper classification of a lease is likely to cause material misstatement. Therefore the auditor needs to primarily ascertain the appropriateness of the classification. For this the auditor needs to read the contract in order to establish its legal form (whether an operating lease or a finance lease) and interpret its economic substance. The auditor must also look for indicators mentioned above under which a lease is normally classified as a finance lease.

After the classification of the lease is identified, the auditor must confirm that the accounting treatment is appropriate (accounting treatment is discussed above). The auditor must verify the physical existence of the leased asset, to have assurance about its existence.

The auditor needs to re-perform the calculations of the values related to the lease such as present value of minimum lease payment, lease rentals, interest, depreciation, asset account, lessee account, etc. (the calculations must be in accordance with the provisions of IAS 17 discussed above). These values must be agreed with the values measured in the financial statements.

In case of a property lease involving land and building component, verify whether both the components are classified separately and accounted for according to their respective classification.

A finance lease gives rise to a depreciation expense. The entity's depreciation policy (e.g. straight line) should be consistent with equivalent owned assets. The lease rentals must be traced to the bank statements. The other elements of the lease such as amortisation charge for the year, lease rent, depreciation, asset account, etc. must be traced to the financial statements. The auditor must confirm that the financial statements include disclosures related to leases in accordance with the provisions of IAS 17 e.g. disclosures relating to minimum lease payments.

Test Yourself 4

Farrow is an eleven year old limited liability company that is engaged in the manufacture of small gift articles. These articles are sold across the world in gift stores at affordable prices. During the year the company took on a non-cancellable ten-year lease for an office suite in an upcoming commercial area. According to the terms of the lease, Farrow was to pay Tshs65 million as annual lease payments at the beginning of the year. The present value of the total lease payments is Tshs385 million, which has been recognised as a lease asset and a lease liability in Farrow's accounts. The lease asset would be depreciated over the life of the lease on a straight line basis.

Required:

Discuss the matters that the auditor must consider during the audit of Farrow and explain the audit evidence that the auditor should obtain.

1.10 Revenue recognition

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Sales revenue includes revenue arising from the following transactions and events:

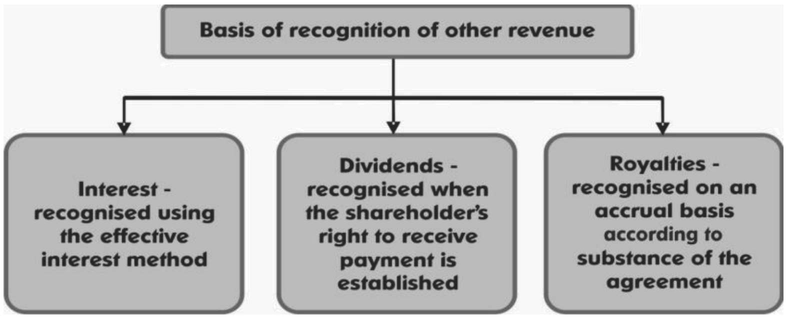
The sale of goods;
The rendering of services; or
The use by others of entity assets yielding interest, royalties and dividends.

Conditions to be fulfilled for recognition of revenue	Sale of goods	Provision of services
Transfer of significant risks and rewards relating to ownership		X
No continuing managerial involvement over goods		X
Reliable measurement of revenue		
Probable that economic benefits will flow to the entity		
Cost incurred, can be reliably measured		
Stage of completion at SOFP date, can be measured reliably	X	
If all above conditions are fulfilled	**Recognise** revenue	**Recognise** revenue using **stage of completion** method
If any of the above conditions are not fulfilled	**Do not** recognise revenue	**Recognise** revenue **to the extent of the expenses** recognised **that are recoverable**

Revenue received on account of **use of entity assets** (yielding **interest, royalties and dividends)** are r**ecognised** when **all** the following conditions are satisfied:

it is probable that the **economic benefits associated with the transaction will flow to the entity;** and
the amount of the revenue can be **measured reliably.**

Diagram 4: Basis of recognition of revenue



Audit procedures

Analytical procedures are commonly used to audit revenue. This is because revenue recognition, apart from those transactions which are complex in nature such as construction contracts, etc., has a logical relationship with available information like inventory and receivables. Furthermore even trend analysis of actual turnover, budgeted turnover, on a monthly basis is also useful to determine the reasonableness of the revenue for the current period. When recognising revenue, the auditor has to consider:

- Whether a **reasonable basis** for the recognition of revenue has been applied.
- if revenue has been **correctly recorded** by verifying the amounts recorded to its applicable source documents like despatch documents, sales order, sales rates approved by an authorised official, etc.

Test Yourself 5

During the last year, the auditor of Shylo Corporation, a listed auto manufacturer, noticed some revenue recognition issues in its financial statements. Revenue on sales was recognised immediately during sales negotiations and before the sale agreement was completed, sometimes even before the product was delivered to the customer. In addition, the company had also been intentionally dishonouring local GAAP to make the company's accounts look attractive for a possible merger with an overseas auto manufacturing giant.

Required:

Discuss how the auditor should deal with these issues when auditing the financial statements of Shylo Corporation.

1.11 Employee benefits

1. Post-employment benefits include pensions, post-employment death benefits to a previous employee's next-of-kin, or post-employment retirement benefits, or any other benefits that an employee is entitled to receive after his employment, in cash or in kind. Guidance on accounting for post-employment benefits is provided in **IAS 19 Employee Benefits**. According to IAS 19, there are two types of post-employment benefit plans:

(a) Defined contribution plan

Defined contribution plans simply match payments made into a plan as the employee works for the organisation. So if a company has agreed to pay Tshs1,000,000 into a pension each year the employee works, the company will show an expense of Tshs1,000,000 each year.

A defined contribution plan has the following features:

(i) The **obligation** for defined benefit plans **is determined by the contribution made at the beginning** of each period.
(ii) The **contribution** to a defined contribution plan is **recognised as an expense** in the period that it is payable.
(iii) Excess **contributions** made are **recognised as assets**.
(iv) Liability for **unpaid contributions** as at the end of the period is **recognised as a liability.**
(v) In addition, for defined contribution plans, a description of the plan as well as the amount recognised as an expense should be disclosed.

Tip

Defined contribution plans do not make use of actuarial assumptions. Furthermore, when the obligation is settled within the current period there is no need for discounting.

(b) Defined benefit plans

A defined benefit plan seeks to give the employee a defined benefit when he retires, e.g. the company will pay him a pension of 50% of his final salary.

At present the company may not know what the final salary will be, therefore uses actuaries to help predict this.

The features of a defined benefit plan are as follows:

(i) The employer's future obligations (with respect to the future benefits employees may earn from past and current service) are calculated using actuarial methods and assumptions. These obligations should be attributed to the services performed by employees in the current and prior periods and valued by discounting them to their present value.

(ii) The fair values of the plan assets are established and the size of actuarial gains and losses are determined.

(iii) The benefits payable under the plan should be determined. If they have improved, the extra cost arising from past service should be determined and recognised. If those benefits have decreased, the gain should be determined and recognised.

(iv) The employer's contribution to the plan is immediately recognised as a liability.

Diagram 5: Accounting for Defined benefit plan (DBP)

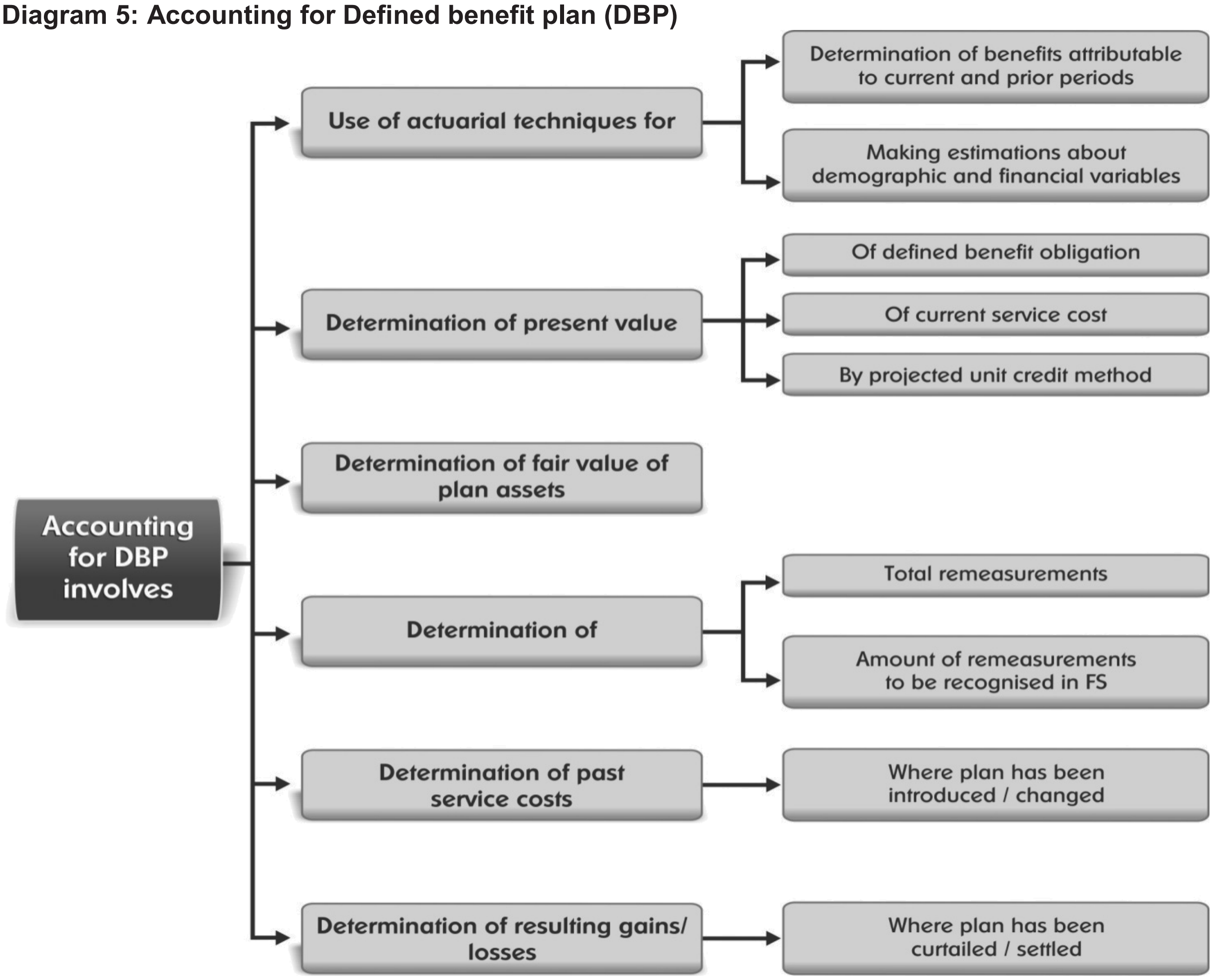
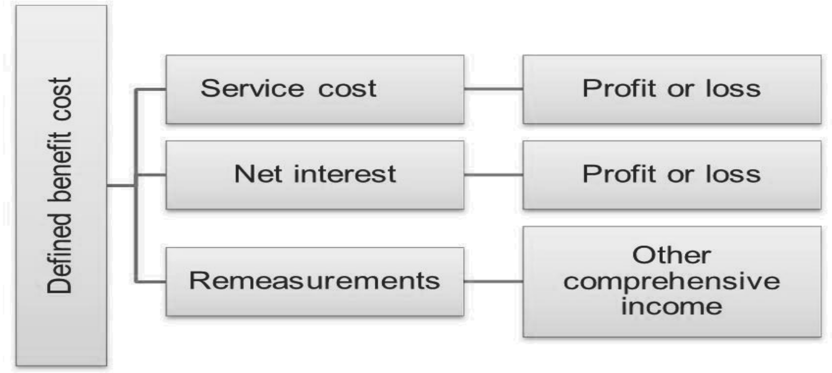


Diagram 6: Summary of provisions under revised IAS 19



Cause of movement in net defined benefit liability (asset)	Provisions under IAS 19
Service cost	Profit or loss
Interest cost on obligation and expected return on plan assets	Net interest income or expense on the net liability (asset) recognised in profit or loss
Past service cost	Profit or loss (including unvested past service cost), as part of service cost
Actuarial gains and losses/ re-measurements	Immediate recognition in OCI
Effect of asset ceiling,	Immediate recognition, partly in net interest and the remainder in OCI as part of re-measurement

2. Presentation in the financial statements

(a) Disclosure in the statement of financial position

An entity shall recognise the net defined benefit liability (asset) in the statement of financial position

(b) Disclosure in the income statement

Paragraph 120 requires an entity to recognise service cost and net interest on the net defined benefit liability (asset) in profit or loss. This Standard does not specify how an entity should present service cost and net interest on the net defined benefit liability (asset). An entity presents those components in accordance with IAS1.

(c) Disclosure in the notes to the accounts

An entity shall disclose information that:

Explains the characteristics of its defined benefit plans and risks associated with them);
Identifies and explains the amounts in its financial statements arising from its defined benefit plans and
Describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows

3. Audit procedures

The audit evidence and audit procedures that an auditor would look for while auditing post-employment benefits are as follows:

(a) Actuarial assumptions such as termination rates, retirement age, mortality rates:

Discuss with the actuaries the basis used to calculate assumptions and review whether or not the assumptions appear to be reasonable based on their knowledge of the entity's financial information.
Compare the assumptions used in the current year with those used in the previous years, for consistency.
Obtain written representations from the entity's management regarding the appropriateness of the assumptions in relation to their knowledge of business.
Auditors should determine whether the assumptions used by the entity are similar to the assumptions used by other entities in the industry.

(b) Accounting treatment in accordance with the provisions of IAS 19:

The auditors should confirm that the accounting treatment of the various aspects of the plan (discussed above) is recorded in the financial statements in accordance with the provisions of IAS 19.

Furthermore the auditor must trace some of the items recorded in the financial statements with the source documents. For example interest cost with the loan documents, bank statements; current service costs with payroll records, personnel records, etc.

(c) Scheme assets

Obtain direct confirmations of scheme assets from the investment professional in charge of the plan assets. Obtain reconciliations from the company's management of the valuation as at the scheme year end date with the entity's reporting date.

(d) Scheme liabilities

Work done by the actuary can be relied upon after evaluating his work in accordance with the provisions of ISA 620 Using the Work of an Auditor's Expert.

1.12 Government grants

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance governs accounting for assistance received from the government.

Government grants represent government assistance by a transfer of resources provided in return for past or future compliances with certain conditions.

Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income are government grants other than those related to assets.

Accounting treatment

According to IAS 20, government grants and forgivable loans are recognised once the attached conditions are complied with and receipt of the loan is guaranteed.

For grants related to assets, two alternative methods are available for presentation of these grants:

1. **Deferred income:** government grants are recognised as deferred income, recognised as income over the useful life of the assets. The balance of income not yet recognised is presented in the statement of financial position as deferred income.

2. **Deduction from asset value:** grants related to **depreciable assets** are usually recognised as income over **the periods and in proportions in which depreciation is charged** on the assets.

IAS 20 also advocates recognising non-depreciable assets over the period in which the cost of meeting the obligation is incurred.

Government grants are deducted from the carrying amount of the asset.

Non-monetary assets received and recognised as grants should be valued at fair value or nominal value.

For grants related to income:

Government grants are recognised in profit and loss on a systematic basis so as to match them with the related costs.

Grants may be presented either as income or as a deduction from the related expense.

Repayment of government grants are accounted for as a revision of an account estimate.

Audit procedures

When auditing for government grants, the auditor should cover the following necessary tasks:

Verify the **classification of the government grant** as revenue by checking the documentation relating to the government grant such as a contract with the government wherein the terms of the grant (conditions which need to be fulfilled) are clearly specified.

Verify the **value of the government grant** by checking supporting documentation.

Check the **receipt of the grant** from the related bank statements.

In the case of non-monetary assets accounted at fair value received as government grants, the auditor should check whether the grant is accounted for consistently with changes in the method of accounting disclosed separately.

Grants that are capitalised require the following audit procedures to be conducted:

Discuss the matter relating to the basis of accounting with the directors of the entity.

Compare the basis of accounting during the current year and confirm whether the basis is consistent with the earlier years.

Disclosures relating to change in accounting policies must be disclosed in accordance with the provisions of IAS 23.

1.13 Related parties

This topic is explained in detail in Study Guide E2.

1.14 Earnings per share

IAS 33 Earnings Per Share (EPS) governs the accounting and disclosure of earnings per share. It requires that companies which fulfil certain criteria disclose their earnings per share. EPS is the amount which an entity has earned per share in the given period.

Basic earnings per share shall be calculated by dividing **profit or loss attributable to ordinary equity holders of the parent entity** (the numerator) by **the weighted average number of ordinary shares outstanding** (the denominator) during the period.

Diluted EPS means an EPS that is reduced or diluted due to increase in the number of shares (the denominator) without a proportionate increase in the earnings (the numerator).

When auditing earnings per share, the auditor should perform the following procedures:

Check whether or not the **calculation of EPS** is performed consistently with the previous year's calculation and accurately. For this the workings relating to calculation of EPS must be obtained by the auditors and the computations must be recalculated and verified for arithmetical accuracy.

Verify from the financial statements, the values included in the calculations.

Confirm that the disclosures are made on a comparable basis with the prior year.

If there is a **change in the EPS calculation:**

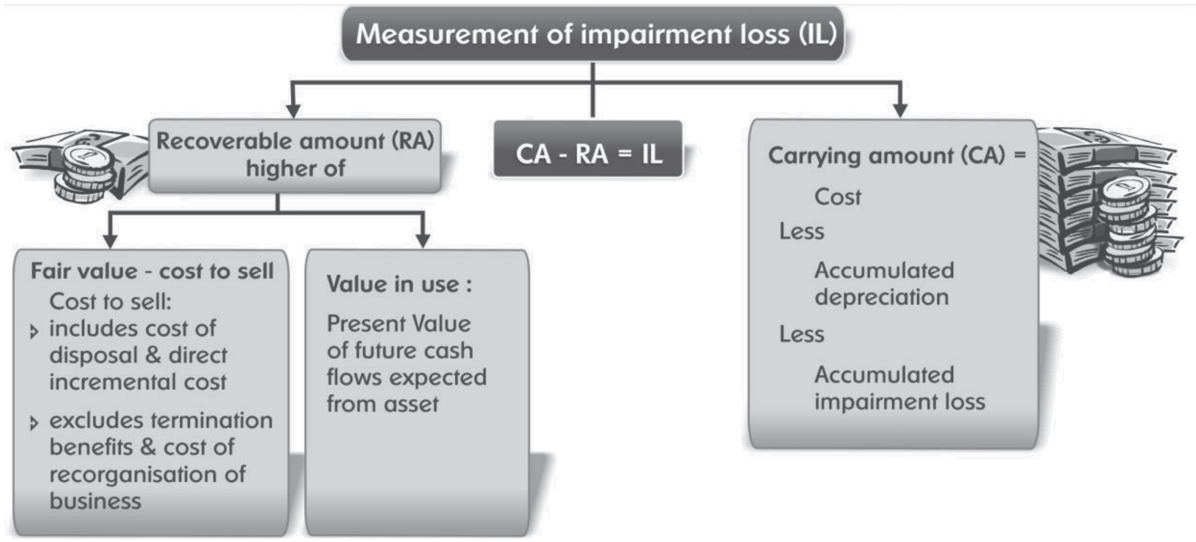
Confirm that adequate disclosure is made.

Discuss the reason for the change of method with the directors and confirm that it is appropriate.

1.15 Impairment

An auditor needs to check whether or not cash generating units have been annually tested for impairment.

Diagram 7: Measurement of impairment loss (IL)



A **cash generating** unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. When auditing an entity's non-current assets, the auditor would, use the same criteria as set out by the management in accordance with **IAS 36 Impairment of Assets**, check for indicators that may suggest a possibility for impairment on assets.

If there is an indication of impairment on an asset, the auditors should request the management for a copy of the impairment review. If the management has carried out an impairment review, that impairment review should be audited.

Assets will not be impaired if the recoverable amount exceeds the carrying amount. Furthermore, if the fair value less cost to sell or the value in use exceeds the carrying amount, the asset is not impaired. Therefore if fair value less cost to sell or the value in use exceeds the carrying amount then the management need not determine the other matter.

Therefore the matters to be audited would be: **Recoverable amount**: this depends on the fair value, cost to sell and value in use.

Fair value and cost to sell: both are subject to estimations. Therefore they need to be reviewed carefully. The risk assessment procedures to assess the risks of material misstatement in relation to accounting estimates and fair values, which were discussed in paragraph 10.9 would have to be carried out. Additionally while reviewing cost to sell the items which can be included and excluded must be in accordance with the provisions of IAS 36.

Cost to sell should be checked for arithmetical accuracy. Furthermore, cost of delivery can be verified from the rates published by delivery companies. Cost to sell includes transaction taxes. These can be recalculated by applying the applicable tax rate to the fair value. Stamp duty can be recalculated based on the regulatory requirements.

Value in use

If the management has used the asset's value in use, the auditor must conduct the following audit procedures.

Physically inspect the asset; this provides evidence of existence and condition of asset as on the reporting date.

Obtain the document containing value in use (along with the working papers) from the entity.

Trace the projected cash flows in the workings with budgets and projections, to ensure that they are approved by the board and are reasonable (e.g. asset days available and average daily utilisation per asset).

Check the arithmetical accuracy of the document.

Cash flows need to be discounted to present values. Confirm that the present values used for discounting should be in accordance with the published market rates expected by the market.

The growth rates used in the calculation of value in use should be at par with the long term average growth rates for the product. For this the auditor should review production records and sales orders for the year, as compared to the prior period.

Recalculate:

On a sample basis, the make up of the cash flows included in the forecast;

The entity's weighted average cost of capital.

The auditor must also confirm that the financial statements include disclosures which are applicable, in accordance with the provisions of IAS 36.

If the management has not conducted an impairment review, then the auditors should propose an impairment review and qualify their report depending on whether or not the management agrees to carry out the impairment review.

1.16 Provisions, contingent liabilities and contingent assets

IAS 37 Provisions, Contingent Liabilities and Contingent Assets is used to account for provisions.

1. **Some important features of IAS 37 are as follows: 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.

An **obligating event** is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

A **legal obligation** is an obligation that a company derives because of a contract (through its explicit or implicit terms) or legislation or other operation of law.

A **constructive obligation** is an obligation that a company derives because of an entity's actions, where:

by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

A **contingent liability** is:

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

A present obligation that arises from past events but is not recognised because:

It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

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.

Restructuring provisions

Restructuring provisions were used by some companies to manipulate their results; therefore IAS 37 specifically lays down the accounting requirements in this area.

A **restructuring** is a programme that is planned and controlled by management, and materially changes either:

The scope of a business undertaken by an entity; or

The manner in which that business is conducted.

The following are examples of events that may fall under the definition of restructuring, as specified in the IAS:

- Sale or termination of a line of business
- The closure of business locations in a country or region or the relocation of business activities from one country or region to another
- Changes in management structure, for example, eliminating a layer of management
- Fundamental reorganisations that have a material effect on the nature and focus of the entity's operations

An entity is required to recognise the constructive obligations for restructuring if the following conditions are satisfied:

- A formal plan exists
- A valid expectation that it will carry out the restructuring exists

A restructuring provision **shall include** only the direct expenditures arising from the restructuring.

Onerous contracts

An **onerous contract** is a contract in which the **unavoidable costs of meeting the obligations** under the contract **exceed the economic benefit expected to be received** under the contract. **The liabilities** derived from **onerous contracts have to be provided for** as onerous contracts **fulfil all the three conditions of the recognition criteria.** According to IAS 37, contingent assets and contingent liabilities should not be recognised until they become probable outflows of future economic benefits; after this they are recognised as provisions. A contingent asset should not be recognised unless it becomes certain that the economic benefits would flow to the entity.

2. Audit procedures

The audit procedures that would be carried out on provisions, contingent liabilities and contingent assets are as follows:

- 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.

- The auditor would 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 and
  - Discussing the matter

The matters considered are whether the entity has raised a valid expectation to the affected stakeholders e.g. announcing the main features of a restructuring plan to those affected by it.

- 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

- 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.

The auditor would trace the amounts of provisions to the financial statements and confirm that they agree.

- Checking whether there are **adequate disclosures** (in accordance with the provisions of IAS 37) for provisions, contingent assets and contingent liabilities in the accounts.

- Considering the nature of the entity's business the auditor must consider whether appropriate provisions are made. For example the auditor of a mining company would verify whether provisions for site restoration are made on mines.

If provisions are not made due to non-availability of best estimate amounts, the auditor would check whether they are is 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, contingent liabilities and contingent assets in the financial statements.

ISA 501 Audit evidence – additional considerations for specific items

ISA 501 includes contingencies arising as a result of litigation. Litigation and legal claims against the entity may have a material effect on the financial statements. Due to this, the auditor should carry out appropriate audit procedures to identify litigation legal claims against the client.

Audit procedures

These procedures would include enquiring from management, reviewing board meetings and legal expense accounts, among other tasks. 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:

Identification of potentially material litigation

Claims

Management's estimates of the financial implications, including costs and whether they are reasonable.

This communication after the client's management provides the auditor with a letter requesting its legal counsel to directly communicate with its auditors. If it is perceived that the external legal counsel would not respond to a general letter of enquiry, a letter of specific inquiry would have to be sent. This letter would include:

A list of legal claims against the company,

The management's assessment of the outcome (if available) of each of the identified litigation and claims and its estimate of the financial implications, including costs involved,

A request to the lawyers to confirm or disaffirm the reasonableness of the management's assessment of the outcome of the claims brought up against the company. Furthermore a request for further information, if the list is considered by the entity's external legal counsels to be incomplete or incorrect.

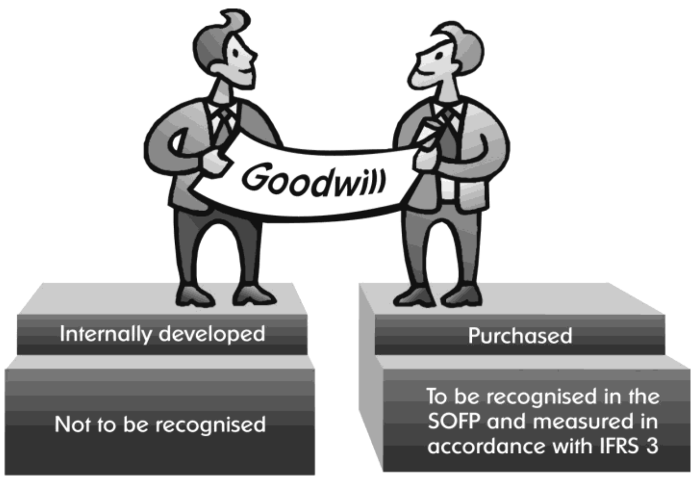
In addition, the auditor would also hold meetings with the client's lawyers in order to discuss if there is a very serious matter or where there is a disagreement between any of the parties. Written representations from the management must include completeness of all the potential litigation and claims being disclosed to the auditors. Refusal by the management to provide the auditor with permission to communicate with the legal counsel would result in a modified opinion in the audit report.

1.17 Intangible Assets

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 annually tested for impairment.

Diagram 8: Accounting treatment of Goodwill



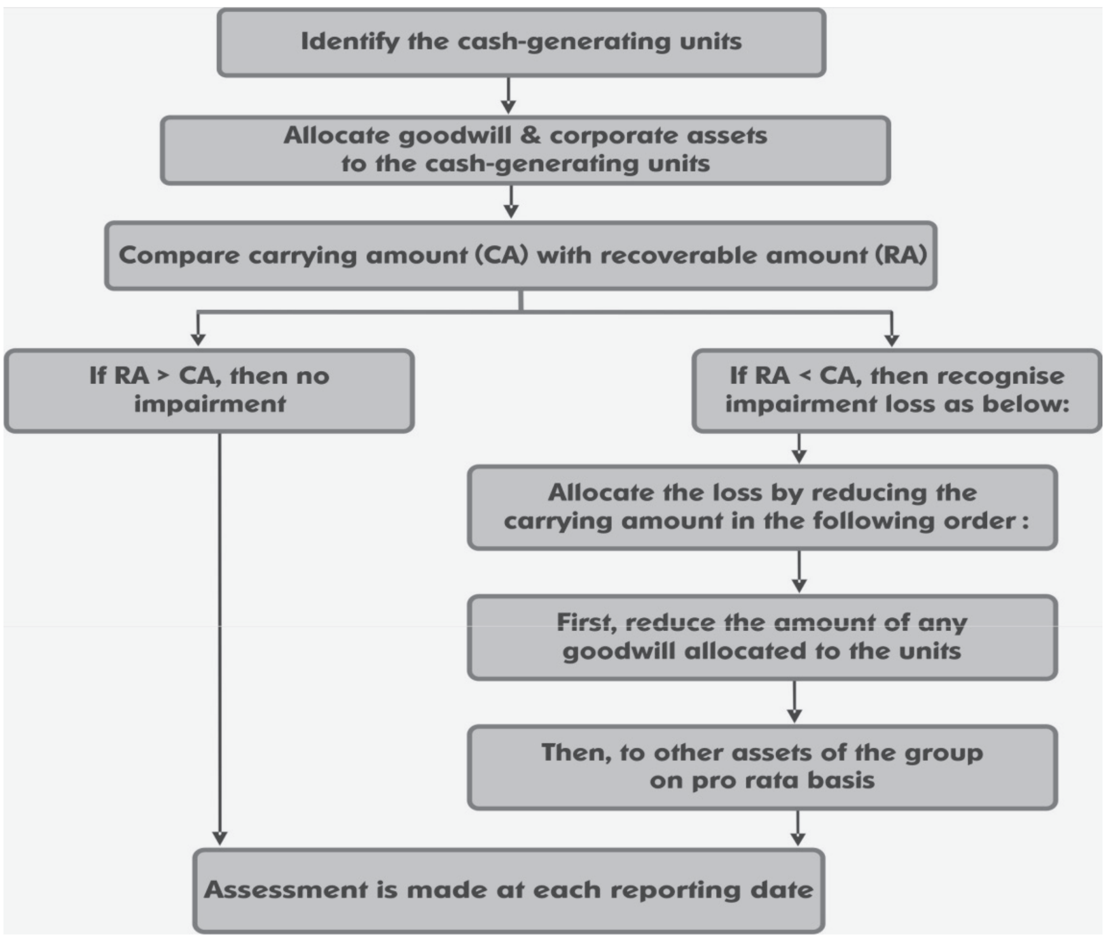
The following points are necessary when auditing for goodwill:

1. **verifying the amount of goodwill** calculated by matching the purchase consideration to the acquisition agreement.
2. confirming that the fair value of the assets are acquired by conducting audit procedures discussed earlier, relating to fair values.
3. recalculating the amount of goodwill and agreeing it with the amount recognised in the financial statements.
4. ensuring that the goodwill calculation does not include **internally generated goodwill.**
5. ensuring **that goodwill is not amortised as it** is not permitted by IFRS 3.
6. reviewing the **calculations relating to impairment of goodwill** for accuracy and reasonableness. Refer to the audit procedures relating to testing impairment discussed in paragraph 10.17.

7. Goodwill impairment test

Goodwill has an existence 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 9: Process of impairment testing

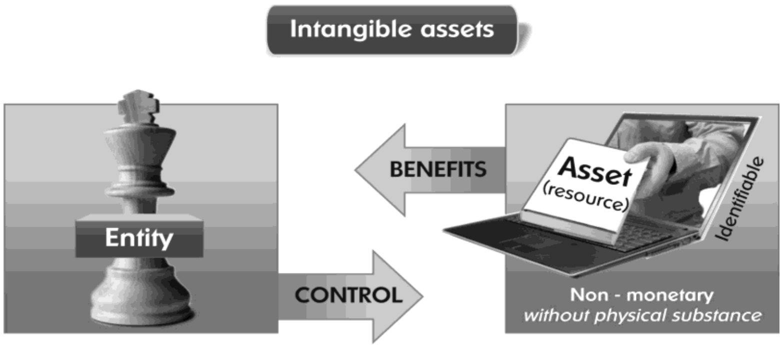


Brands

An **intangible asset** is an identifiable non-monetary asset without physical substance.

IAS 38 **Intangible Assets** specifies the following conditions to be satisfied by an item for it to be called an intangible asset:

Diagram 10: Conditions to be fulfilled to classify an asset as an intangible asset



IAS 38 Intangible Assets, which includes guidance on intangible assets, disallows internally generated assets to be capitalised.

Diagram 11: Subsequent measurement of intangible assets

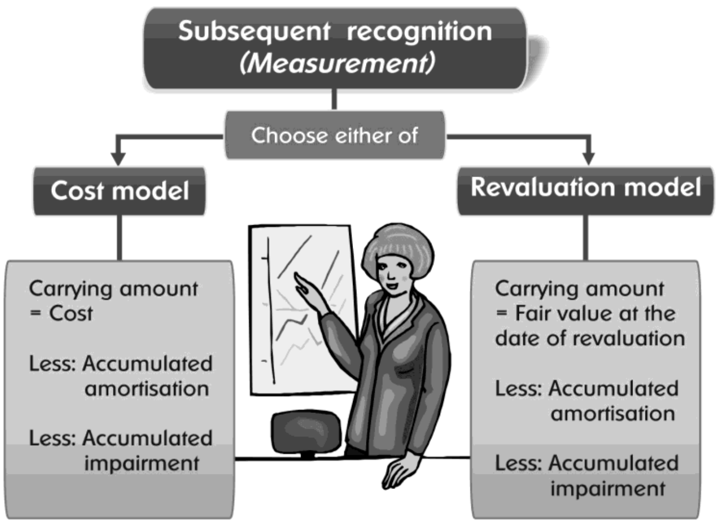
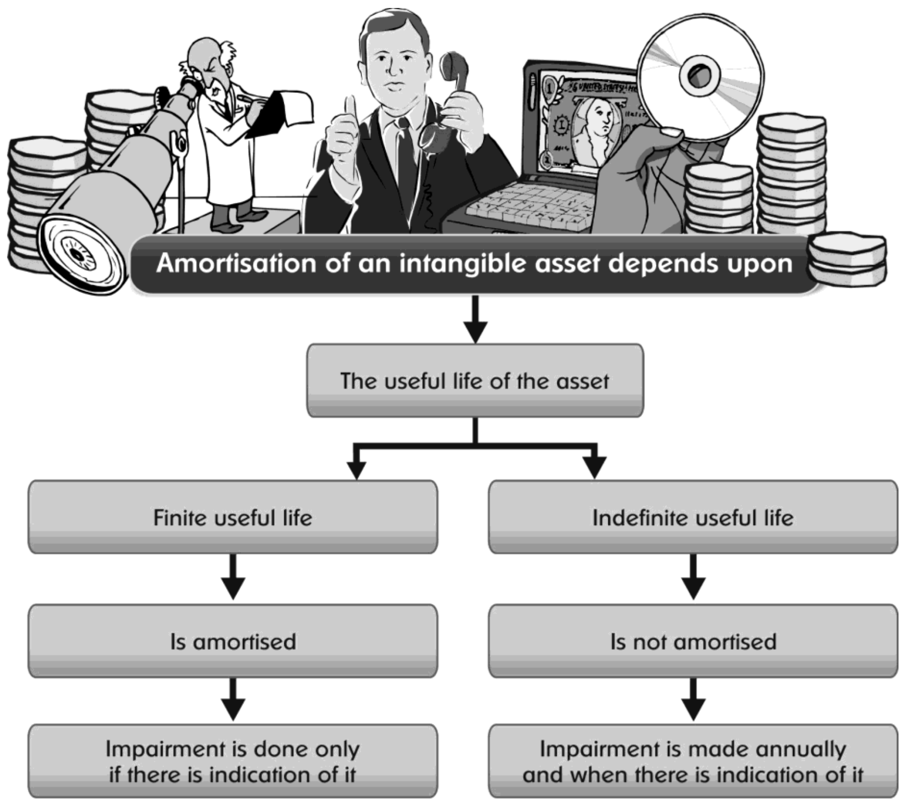


Diagram 12: Amortisation of an intangible asset



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 enable 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 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.

Test Yourself 6

Green Bay Clothing purchased a clothing brand called Colors Inc in the past year. Colors is currently a market leader in textile manufacturing. The clothes manufactured by Colors would be used by Green Bay in its manufacturing process. The management does not want to quantify the life of this intangible asset and as a result has not amortised this asset.

Required:

Discuss the audit work the auditor will carry out when auditing Colors for inclusion in the current year's financial statements.

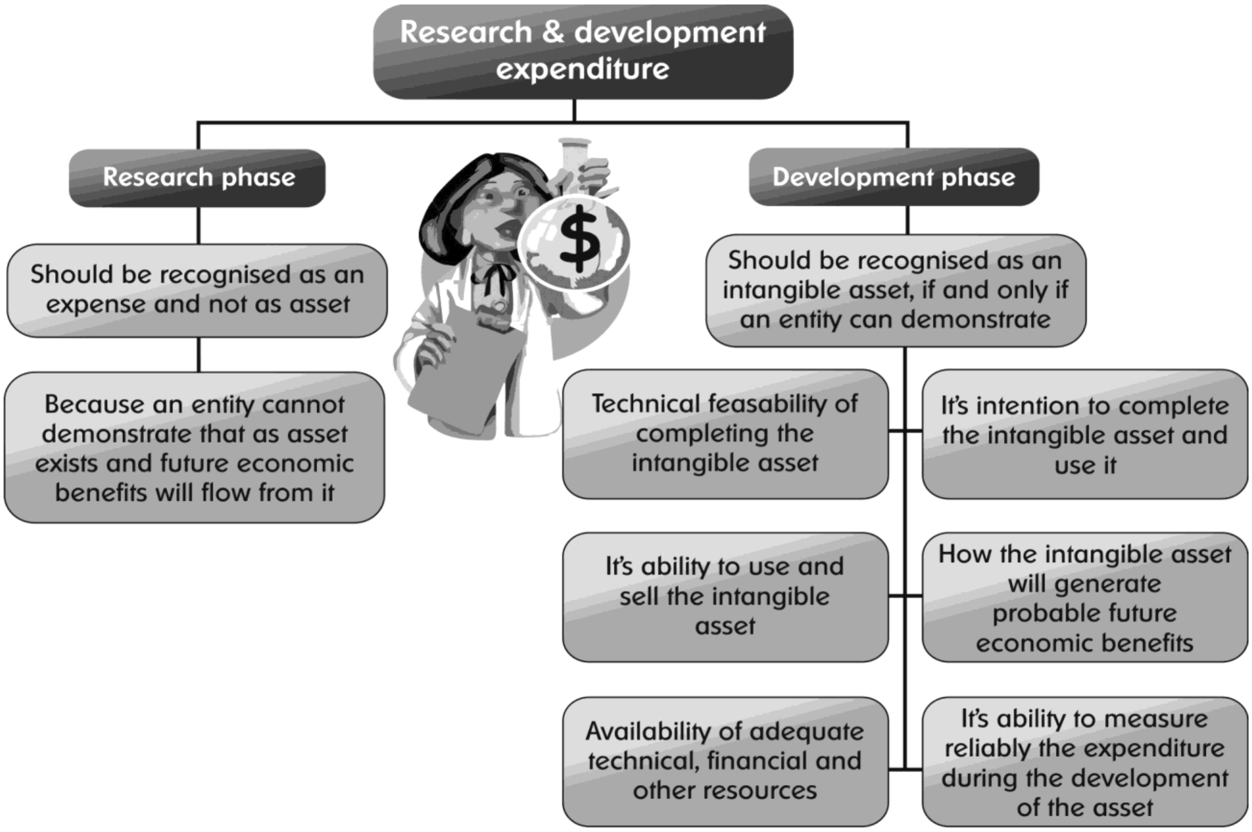
Research and development expenditure

IAS 38 Intangible Assets also covers the accounting guidance on research and development costs.

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development is the **application of research findings or other knowledge** to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services **before the start of commercial production or use.**

Diagram 13: Expenditure during the research and development phase



According to IAS 38, the expenditure incurred by the entity on research and development is to be written off by the entity in the year that it is incurred. Only certain development costs that fulfil certain criteria should be capitalised. The criteria for capitalising development costs are listed in the diagram above.

When auditing research and development expenditure, the auditor should ensure that the amount charge to the statement of comprehensive income with respect to research expenditure is accurate and reasonable. In order to do this the auditor can carry out the following audit procedures:

Check project reports (from the management as well as experts) to ensure that the expenditure relating to the research and development project can be separately identified and feasible to be completed.

Confirm that all the conditions relating to development cost are completed before the development expenses are capitalised. For this confirm:

The technical feasibility and viability by verifying reports from technical experts, results of test runs, etc.
The market research documents, budgets, forecasts to conclude whether the entity believes that a market for the internally developed asset exists.
that the various significant expenses are supported with valid invoices in order to confirm that expenditure that would be incurred from developing the asset and can be reliably measured.

Review the budgeted revenues and costs and calculations for future cash flows to ensure that resources required to fulfil the budgets actually exist.

Check the appropriateness of amortisation i.e. the asset should be amortised over its useful life. Therefore the auditor should verify the expert's report relating to useful life of the development costs.

The auditor should also verify the accounting entries to confirm that the financial statements are correctly drawn up.

Other intangible assets

All other intangible assets such as patents, trademarks, licences, software and franchises are covered by IAS 38 Intangible Assets. **Internally generated intangible assets are not recognised as assets.**

Expenditure on an intangible item shall be recognised as an expense, except where the expenditure is part of the cost of an intangible asset that meets the recognition criteria or the expenditure on an item acquired in a business combination.

For example start up expenditure, training expenditure, advertising and promotional expenditure, business relocation or reorganisation expenditure.

The audit procedures are similar to the ones discussed under the topic of 'Brands' above.

1.18 Financial instruments

1. Meaning

Financial instruments are governed by **IAS 32 Financial instruments: Presentation, IAS 39 Financial instruments: Recognition and Measurement, IFRS 9 Financial Instruments and IFRS 7 Financial Instruments:** They are contracts that give rise to a right to receive an asset on one hand (called financial assets) and an obligation to discharge an obligation on the other hand (called financial liabilities).

Some common examples of financial assets and corresponding financial liabilities representing a contractual right / obligation to receive / deliver cash in the future are:

Trade accounts receivable and payable
Loans receivable and payable
Bonds receivable and payable

2. Classification

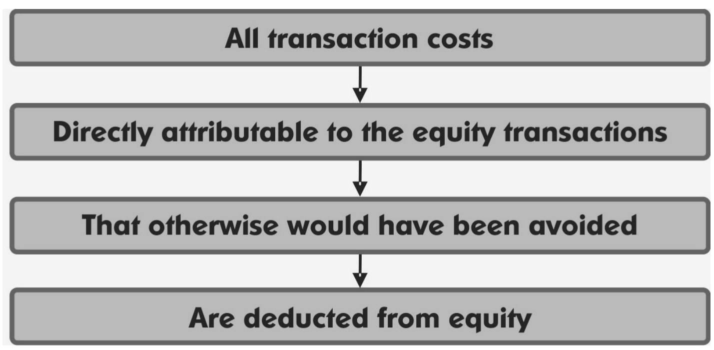
IFRS 9 requires all financial assets to be classified into one of the two categories given below:

Financial asset at fair value through profit or loss:
Financial assets measured at amortised cost.

In the case of an equity instrument not held for trading, an entity has additional choice as follows:

At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in **an equity instrument within the scope of this IFRS that is not held for trading.**

Diagram 14: Accounting of transaction costs



When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability except for a financial asset or financial liability classified as 'at fair value through profit or loss'.

3. Measurement of financial instruments

Financial Instrument	IFRS 9 classification	Initial Measurement	Subsequent Measurement	Value changes
Debt instruments	Amortised cost	Amortised cost	Amortised cost	Not relevant - unless impaired
Debt instruments	Fair value through profit and loss	Fair value	Fair value	Through income statement
Equity investments	FVTOCI – if irrevocable election made on initial recognition	Fair value	Fair value	Through OCI
Equity investments	Fair value through profit and loss	Fair value	Fair value	Through income statement
Financial liabilities	Fair value through profit and loss	Fair value	Fair value	Through income statement
		Amortised cost	Amortised cost	Not relevant

4. Compound financial instruments

Compound financial instruments are instruments that contain both a debt element and an equity element. A convertible bond is an example of a compound instrument, since it has a debt element and a potential equity element (on conversion).

Recognition of such instruments

The **carrying amount of the liability component** is determined **first**. This is equal to the fair value of a **similar liability that does not have an associated equity component.**

The **carrying amount of the equity instrument** represented by the **option to convert the instrument into ordinary shares** is then determined in the following manner:

Diagram 15: Compound financial instruments

5. Audit procedures

(a) Classification: inaccurate classification of financial instruments can cause material misstatements in the financial statements as they will reflect incorrect gearing ratios and hence the risk profile of the entity. Therefore the auditor will:

Understand the classification by making enquiries with the management.

Read the terms of contracts related to the financial instruments to determine the substance of the transaction.

(b) Existence: the first point an auditor has to verify when auditing financial instruments is the existence of the financial instrument. Whether the company actually exists or not can be verified through confirmations from the company registry or enquiry at the stock exchange. Furthermore, the auditor can examine the share certificates with the client to check for the existence of financial instruments.

(c) Valuation and allocation

Initial valuation

Confirm that all the financial assets and liabilities are valued at fair values. Compare the values recorded in the books with the fair values.

Conduct audit procedures relating to fair values, discussed earlier.

Verify the transaction price by tracing the transaction costs from the purchase documents.

For financial assets ensure that the classification is based on the business model test and cash flow characteristics.

If an entity at initial recognition, designates a financial asset as measured at fair value through profit or loss, confirm whether this classification eliminates or significantly reduces an 'accounting mismatch'.

Confirm that equity instruments and derivatives are always be measured at fair value as they cannot be classified under the category of amortised cost.

Subsequent valuation: while financial instruments are measured initially at fair value, how a financial asset is valued subsequently in the accounts of an entity depends upon the level of control in the entity whose shares it holds. This classification can be verified by making enquiries of the management about their intention to keep the financial instrument.

Financial asset / Financial liability	Basis for measurement	Audit procedure
Financial asset / liability at fair value through profit / loss	Fair value	Market price from stock exchange listings
Financial asset / liability at amortised costs	Amortised cost	Verifying purchase invoices and checking amortisation schedule

Recalculate the amortised cost in accordance with the provisions of IFRS 9 (i.e. measured at initial recognition less principal repayments, plus or minus the cumulative amortisation).

Confirm that the amortisation is calculated using the effective interest method.

(d) Rights and obligations: this assertion can be substantiated by confirming that the entity has the share certificates in the name of the entity.

6. IAPN 1000, Special considerations in auditing financial instruments

IAPN 1000 covers the significant issues that auditors are most likely to encounter in practice when auditing financial instruments. It focuses specifically on issues around risk, assertions, controls and other matters that are of particular importance to the audit of these instruments.

(a) Scope of IAPN 1000

(i) The guidance on valuation in this IAPN is likely to be more relevant for financial instruments measured or disclosed at fair value.
(ii) The guidance on areas other than valuation applies equally to financial instruments either measured at fair value or amortised cost.
(iii) This IAPN is also applicable to both financial assets and financial liabilities.

(b) IAPN 1000 does not address:

(i) The simplest financial instruments (such as cash or trade accounts receivable or payable) and the most complex ones
(ii) Investments in unlisted equity instruments
(iii) Insurance contracts
(iv) Specific accounting requirements relevant to financial instruments, such as those relating to hedge accounting, offsetting or impairment, amongst others

(c) Risks associated with financial instruments

Management's failure to fully understand the risks inherent to a financial instrument can have a direct effect on management's ability to manage these risks appropriately, and may ultimately threaten the viability of the entity**.**

The principal types of risk applicable to financial instruments are listed below:

(i) Credit (or counterparty) risk is the risk that one party to a financial instrument will cause a financial loss to another party by failing to discharge an obligation, and is often associated with default.

(ii) Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. For example, currency risk, interest rate risk, commodity and equity price risk etc.

(iii) Liquidity risk includes the risk of not being able to buy or sell a financial instrument at an appropriate price in a timely manner due to a lack of marketability for that financial instrument.

(iv) Operational risk relates to the specific processing required for financial instruments.

Operational risk includes:

The risks that there is **inappropriate documentation of transactions** and insufficient monitoring of these transactions.

The risk that **transactions are incorrectly recorded, processed or risk managed** and, therefore, do not reflect the economics of the overall trade.

The risk that **undue reliance is placed by staff on the accuracy of valuation techniques**, without adequate review, and transactions are therefore incorrectly valued or their risk is improperly measured.

The risk that **the use of financial instruments is not adequately incorporated into the entity's risk management policies and procedures**.

The risk of **loss resulting from inadequate or failed internal processes and systems**, or from external events, including the risk of fraud from both internal and external sources.

Legal risk that relates to **losses resulting from a legal or regulatory action that invalidates or otherwise precludes performance by the end user** or its counterparty under the terms of the contract or related netting arrangements. For example, legal risk could arise from insufficient or incorrect documentation for the contract.

(d) Controls Relating to Financial Instruments

Management and those charged with governance are also responsible for designing and implementing a system of internal control to enable the preparation of financial statements in accordance with the applicable financial reporting framework.

Factors causing effective controls over financial instruments

An entity's internal control over financial instruments is more likely to be effective when management and those charged with governance have:

(i) Established an appropriate control environment, i.e.:
active participation by those charged with governance in controlling the use of financial instruments;
A logical organisational structure with clear assignment of authority and responsibility, and appropriate human resource policies and procedures; and
clear rules on the extent to which those responsible for financial instrument activities are permitted to act. For example, certain public sector entities may not have the power to conduct business using derivatives.

(ii) Established a risk management process relative to the size of the entity and the complexity of its financial instruments (for example, some entities have a risk committee which handles the risk management function)

(iii) Established information systems that provide those charged with governance with an understanding of the nature of the financial instrument activities and the associated risks, including adequate documentation of transactions

Audit Considerations Relating to Financial Instruments

Certain factors may make auditing financial instruments particularly challenging. For example, it may be difficult for both management and the auditor to understand the nature of financial instruments, determine what they are used for, and realise the risks to which the entity is exposed.

Professional Scepticism

Professional scepticism is necessary for the critical assessment of audit evidence and assists the auditor in remaining alert for possible indications of management bias. This includes questioning contradictory audit evidence and the reliability of documents, responses to inquiries and other information obtained from management and those charged with governance.

Application of professional scepticism is required in all circumstances; however, the need for professional scepticism increases with the complexity of financial instruments. The areas of challenge for auditors could relate to evaluation of sufficient appropriate audit evidence when models are used or in determining if markets are inactive.

Planning considerations

The auditor's focus in planning the audit is particularly on **understanding the accounting and disclosure requirements, understanding the financial instruments to which the entity is exposed, and their purpose and risks.**

Substantive Procedures

Designing substantive procedures includes consideration of the following:

The use of analytical procedures

Generally, analytical procedures are considered effective risk assessment procedures to provide the auditor with information about an entity's business. However, due to the complexities involved in their valuation, it may not be possible to accurately determine any unusual trends in their valuation. Therefore, substantive procedures relating to financial instruments must include analytical procedures as well as tests of details and tests of account balances.

Non-routine transactions

For entities which do not regularly deal with financial instruments, auditors should adopt a substantive audit approach, i.e. the auditor's responses to assessed risk should include designing and performing audit procedures, having regard to the entity's possible lack of experience in this area.

Availability of evidence

When entities value their financial instruments using a third party pricing source, evidence relating to assertions like 'valuation', 'completeness' may not be available from the entity.

Procedures performed in other audit areas

Evidence relating to 'completeness' of financial instrument transactions would require the performance of tests of subsequent cash receipts and payments, and the search for unrecorded liabilities.

Selection of items for testing

When the financial instrument portfolio comprises instruments with varying complexity and risk, auditors are required to use judgmental sampling.

Example

While auditing an asset-backed security, the auditor may consider performing some of the following audit procedures:

- Examining contractual documentation to understand the terms of the security, the underlying collateral and the rights of each class of security holder
- Inquiring about management's process of estimating cash flows
- Evaluating the reasonableness of assumptions, such as prepayment rates, default rates and loss severities
- Comparing the results of the fair value measurement with the valuations of other securities with similar underlying collateral and terms
- Re-performing calculations

1.19 Investment properties

Guidance on accounting for investment properties is provided in **IAS 40 Investment Property.** According to IAS 40 Investment Property, property is property (land or building or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation, or for both, rather than for use in the production or supply of goods or services, or for administrative purposes, or for sale in the ordinary course of business. In order to be classified as an investment property, it can not be used by a related party or by the company itself.

1. The accounting treatment is either to:

(a) Hold an investment property at cost and depreciate it, or
(b) Hold it at fair value, with any changes going into the SOCI and no depreciation is charged.

2. Audit procedures

Auditing investment property involves looking at the agreements to ensure that the tenant is not a related party.

The auditor should verify the cost from the original purchase document or the fair value of the investment property from the expert's certificates depending on how the investment property is valued.

Additionally, the auditor should ensure that the disclosures made are in accordance with what is required in IAS 40.

1.20 Share-based payment transactions

Share-based plans and schemes are accounted for in accordance with **IFRS 2 Share-based Payments**.

1. Accounting treatment

Share-based payments are payments for continuing employee service. According to IFRS 2, there are two types of share-based payment transactions:

(a) share-based payment transaction settled through equity in which the entity receives goods and services in exchange for equity instruments.

(b) share-based payment transactions through which the entity receives goods or services in exchange or equity instruments payable in cash.

Alternatively, share-based payment transactions could be a combination of the above.

Goods or services received in a share-based transaction should be recognised as expenses or assets at fair value immediately on receipt. The goods or services received should be charged to equity or to cash.

2. Audit procedures

(a) Auditing share-based payments requires the auditor to ask and obtain written representations from the management that all the share-based payment plans in operation in the entity have been disclosed to the auditors. Furthermore the representation must affirm the reasonableness of assumptions used for measuring expenses.

(b) In addition, the management's **assumptions and forecasts are examined for their reasonableness**.

(c) The auditors should also examine the contract with the employee for any share-based payment details. (d)

While verifying the fair value of the of share-based payments, the auditor should:

Check that all calculations are in accordance with IFRS 2 such as the model used to calculate fair value (e.g. the Black-Scholes Model) and
Confirm that the fair value has been correctly measured at the correct dates i.e. for an equity-settled share based payment it would be the grant date; the use of fair value at any other date is incorrect.

(e) The auditor must verify the workings sheet relating to such transactions and trace information such as number of employees, length of vesting period, number of employees expected to benefit, etc. from source documents e.g. employees' personnel records. Furthermore some information will be obtained after enquiries with directors.

1.21 Business combinations

IFRS 3 Business Combination defines a business combination as the bringing together of separate entities or businesses into one reporting entity. This is covered more in Group Audits covered in Study Guide C8.

Audit procedures

While auditing the business combination, the auditor has to check the following aspects:

Whether the business combinations are accounted for by applying the **purchase method** as required by IFRS 3.

Whether the **acquirer** has been identified correctly. (The acquirer is the combining entity that obtains control of the other combining entities or businesses.)

Whether the **cost of the business combination** has been measured correctly. IFRS 3 requires measuring the cost of a business combination as the aggregate of the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree, plus any costs directly attributable to the combination.

IFRS 3 requires an acquirer to **recognise separately**, at the acquisition date, the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria at that date, regardless of whether they have been previously recognised in the acquiree's financial statements. The auditor needs to ensure that this has been done correctly.

Whether the **goodwill** acquired in a business combination is **recognised by the acquirer as an asset** from the acquisition date. Goodwill is measured as the excess of the cost of the business combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities

The auditor needs to ensure that the **goodwill** acquired in a business combination is **not amortised but is instead tested for impairment** annually, or more frequently as required by IFRS 3.

1.22 Assets held-for-sale and discontinued operations

An entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

Discontinued operations are covered under **IFRS 5 Non-Current Assets Held For Sale And Discontinued Operations.**

Discontinued operations and operations held for sale must be disclosed separately in the statement of financial position at the lower of their carrying value less costs to sell.

A discontinued operation includes the following criteria:
Is a separately identifiable components
Must represent a major line of the entity's business
Is part of a plan to dispose of a major line of business or a geographical area
Is a subsidiary acquired with a view to resell

Audit procedures

Discuss with the management the existence of discontinued operations.

Verify the board minutes to confirm the existence of this class of assets.

The auditor must go through the entity's accounting records and other company documentation (e.g. MIS records, production records of the current year and previous year) to confirm that the discontinued operations represent a major line of the entity's business or is a subsidiary acquired with a view to resell). This will ensure that the assets meet the definition of discontinued operations.

Carry out the audit procedures discussed earlier to assess the reasonableness of the fair vales and cost to sell.

Compare the opening balance of the carrying value of the asset from the previous year's financial statements. Recalculate the depreciation for the current year (up to the date of classification as discontinued operations).

Non-Current Assets Held For Sale

According to IFRS 5, held for sale assets are those assets that fulfil the following criteria:

An appropriate level of management must be committed to sell the asset or the disposal group.

An active programme to locate a buyer and complete the plan must have been initiated.
The sale should be expected to qualify for recognition as a completed **sale within 1 year.**
The asset must be available for immediate sale in its present location and condition.
The sale must be highly probable.
The management has committed to a plan to sell the asset.
The asset's sale price can be reasonably compared with its current fair value.

The results of the held for sale operations must be disclosed separately in the statement of comprehensive income.

Auditing procedures

Discuss with the management about the existence of assets held for sale.
Confirm that the assets meet the definition of assets held for sale. When auditing held for sale components, the auditor should look out for appropriate audit evidence that would support each of the above contentions. For example auditors should review documentation such as written representations from the management regarding its intention to sell and appointment of agents to sell the assets, etc.
Review minutes of the board meetings, about management's intention to sell and the action plan for the sale and so on.
Verify the basis of deciding the sale price e.g. availability of market values.
Compare sale value with fair value.
Discuss with management if there are changes in the plans relating to assets held for sale.

General procedures applicable to all assets classified as non-current assets held for sale and discontinued operations.

Verify the workings relating to depreciation and confirm that the assets are not depreciated.
Check the disclosures made in the financial statements and agree them with the disclosures required by IFRS 5.

1.23 Events after the end of the reporting period

Before going into detail as to what an auditor is supposed to do when subsequent events that require adjustment are discovered, we need to understand a few terms first.

Definition

Date of the financial statements: The date of the end of the latest period covered by the financial statements.

Date of approval of the financial statements: the date on which all the statements that comprise the financial statements, including the related notes, have been prepared (which is later than the date of the financial statements) and those with the recognised authority have asserted that they have taken responsibility for those financial statements. The directors literally sign the financial statement to approve them.

Date of the auditor's report: the date the auditor dates the report on the financial statements in accordance with ISA 700.

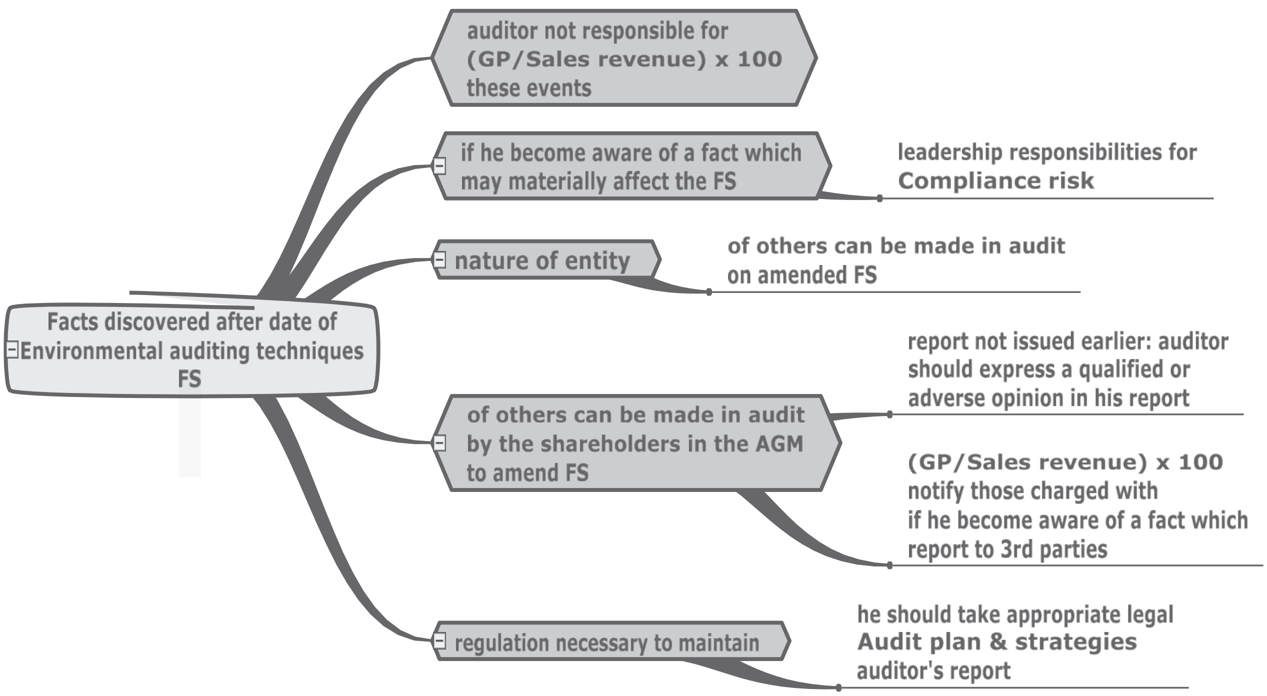
Date the financial statements are issued: the date that the auditor's report and audited financial statements are made available to third parties.

Subsequent events: events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

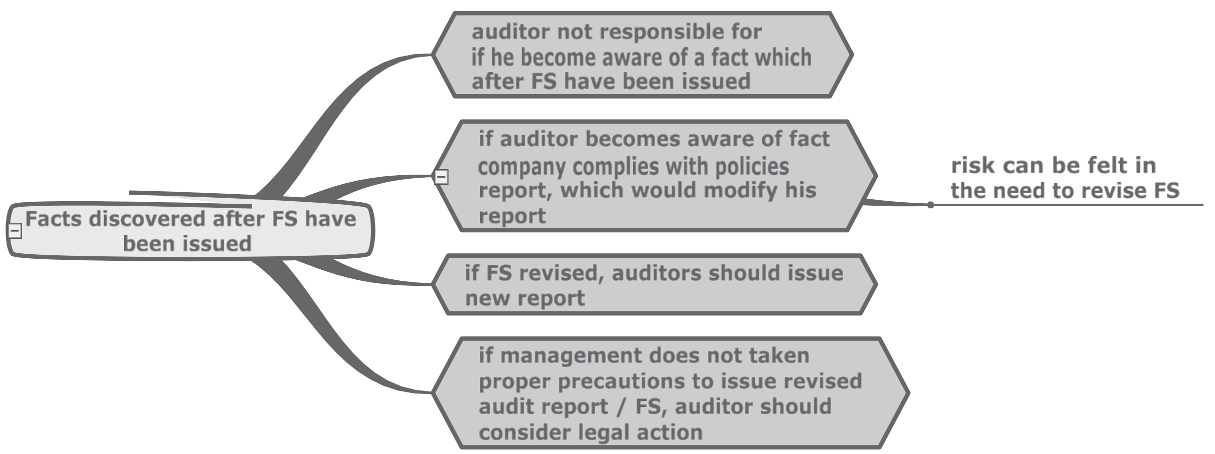
ISA 560

ISA 560 requires the auditor to consider the effects of subsequent events on the financial statements and on the auditor's report. The audit implications relating to subsequent events can be understood from the following summaries:

SUMMARY



SUMMARY



1.24 The effects of foreign exchange rates

Foreign exchange market is one of the most volatile markets and hence change in foreign exchange rates can have a great impact on performance of entity carrying foreign activity on large scale , which is now-a- days a normal phenomenon. Any entity will carry on its foreign activities in any of the two ways. It may either have transactions in foreign currencies or may have foreign operations. In addition to this even the entity may prepare its financial statements in foreign currency. IAS 21 prescribes how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

Initial recognition

At the time of initial recognition, an entity first has to determine the carrying amount of the transaction in the foreign currency by applying the relevant accounting standard. For example, the carrying amount of a machine acquired in foreign currency should be measured under the cost model or revaluation model in accordance with IAS 16 Property, Plant and Equipment.

This carrying amount is then translated into the functional currency at the **spot exchange rate at the date of the transaction.**

Recognised in FS = Foreign currency amount x Spot exchange rate between the functional currency and the foreign currency as on the date of the transaction

Subsequent translation

The subsequent translation depends on the category of the item to be translated. There are broadly two categories monetary items which include cash, receivables and non-monetary items which include non-current assets. The monetary and non-monetary items are recognised in the statement of financial position in the following manner:

Item	Rate used for subsequent translation
Monetary items	Spot exchange rate as on the date of the statement of financial position or date of settlement, if earlier

Item	Rate used for subsequent translation
Non-monetary items recognised at cost	Rate of exchange as on the date of the original transaction i.e. on the date of purchase / acquisition of the non-monetary item

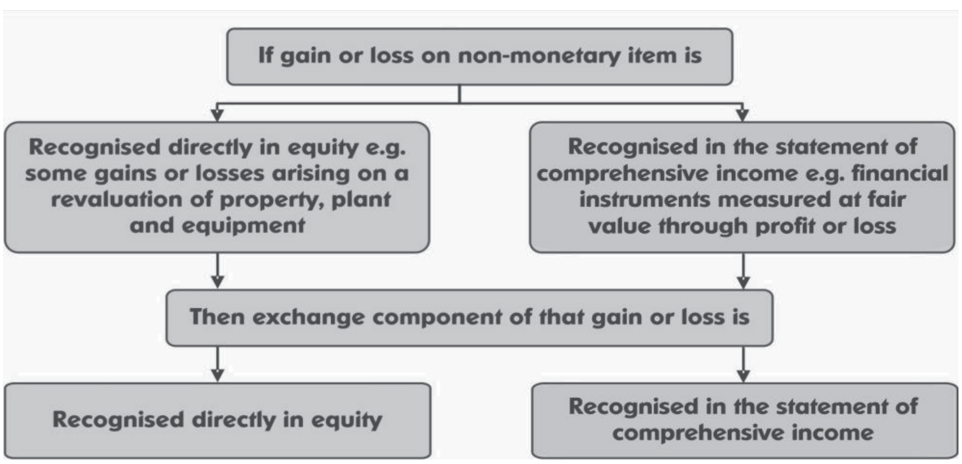
Treatment of exchange differences

Monetary items

The exchange difference is recognised in the statement of comprehensive **income in the period in which the exchange difference arises.** However IAS 21 does not specify where this exchange difference should be presented in the statement of comprehensive income.

Non-monetary items

Diagram 16: Loss or gain on non-monetary items



Audit procedures

- Ensure that regulatory provisions related to foreign exchange transactions have been complied with.
- Discuss with management and verify the appropriateness of the functional currency used while recording transactions and preparing financial statements.
- Verify for the samples selected whether the transactions are recorded correctly using appropriate exchange rates.
- Discuss with management about foreign operations of the company and obtain a list of all branches, subsidiaries and associates situated in foreign countries along with their domestic currencies.
- Determine whether the hedging provisions are sufficient and appropriate for foreign exchange risks.
- Verify whether the account balances have been properly classified into monetary and non-monetary items.
- For a few transactions selected on a random basis, verify that the effect of the foreign exchange rate has been correctly taken in financial statements in accordance with IAS 21.
- Perform audit trail for a few transactions or carry out a walk through analysis to verify the efficiency of the accounting system from the inception to presentation of foreign exchange transactions.

1.25 Borrowing costs

IAS 23 Borrowing Costs deals with the treatment of borrowing costs that are associated with the construction of self-constructed assets or assets purchased which take substantial time to be ready for use / sale. These costs are incurred by the entity and are associated with borrowing funds associated with these assets.

1. Accounting treatment

Generally, borrowing costs are recognised as expenses in the period that they are incurred. If the borrowing costs are directly attributable to the cost of the asset, they can be capitalised as part of the cost of the asset until the physical construction of the asset is complete. The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying assets had not been incurred. Borrowings eligible for capitalisation: borrowing costs less any investment income on the temporary investment of those borrowings.

The capitalisation rate to be applied on borrowing costs shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. An entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

An entity shall disclose:

- The amount of borrowing costs capitalised during the period; and
- The capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

2. Audit procedures

Interest can be verified by performing analytical reviews as the relationship of various loans and the interest amounts is predictable. The auditor should review the list of amounts capitalised to ensure that revenue items have not been capitalised by mistake (e.g. staff training costs are operating expenses that should not be capitalised). Furthermore the provisions of IAS 23 relating to capitalisation of borrowing costs (discussed above) should be complied with. The calculation of any amount capitalised should be recomputed to confirm accuracy.

Borrowing costs associated with the investments relating to qualifying assets should be agreed with the finance terms mentioned in the loan contracts. Furthermore the accounting treatment must be verified with the books of accounts and it must be confirmed that they comply with the provisions of IAS 23. The payments made towards borrowing costs must be agreed with the bank statements. The basis of capitalisation, if any, should be agreed to comply with IAS 23 'Borrowing Costs' (e.g. interest accruing during any suspension of building work should not be capitalised).

When borrowing costs are capitalised, the auditor should value the amounts by matching the figures with the payments made to and from the lender and verify that the amounts that are attributable to the constructed asset. Furthermore the auditor must confirm that all disclosures to financial statements relating to borrowing costs should be made in accordance with the provisions of IAS 23.

Exam Focus

This is a very important Study Guide. The exams can contain scenario as well as knowledge based questions on the topics covered in this Study Guide.

2. Propose alternative accounting treatment in accordance with financial reporting standards where the applied treatment is inappropriate.

[Learning Outcome b]

In Learning Outcome 1, we have discussed the accounting treatment for the common transactions which entities undertake. We now illustrate how the auditor needs to tackle these issues when the applied accounting treatment is inappropriate.

Example

You are the manager responsible for the audit of Zorro, a limited liability company. Zorro develops products and technologies for the agricultural industry. The draft accounts for the year ended 30 June 20Y0 show profit before taxation of Tshs46 million (20W9 – Tshs42 million) and total assets Tshs463 million (20W9 – Tshs417 million).The following issues are outstanding and have been left for your attention:

(a) A government grant of Tshs8,000,000 was received in May 20Y0 to assist in operating a new pilot plant that will use Zorro's patented technology. The amount of the grant has been deducted from technology development costs that are included in intangible assets with a carrying value of Tshs45 million. In October 20X0, Zorro's order for specialist equipment, which was to have been used in the pilot plant, was cancelled. A recent board minute shows that the company's research activities are to be focused on a new 'more-crop' technology.

(b) Zorro closed and demolished one of its laboratories six years ago. The land on which it stood has not been used since and is carried at a cost of Tshs720,000. Results of tests by the local water authority published in July 20Y0 show that the site is contaminated with effluents, which are known to be toxic. Although there is currently no legislation requiring Zorro to clean up the site, a provision for Tshs10 million has been made in the financial statements for the year ended 30 June 20Y0.

Required:

For each of the above issues:

(i) Comment on the matters that you should consider.
(ii) State the audit evidence that you should expect to find, in undertaking your review of the audit working papers and financial statements of Zorro

Answer

(a) Government grant

(i) Matters

The grant represents 17·4% of profit before tax, 17·8% of intangible assets and 1·7% of total assets and is therefore material. Intangible assets (before deduction of the grant) constitute 9·7% of total assets and are therefore material also. Receipt of a grant does not itself provide conclusive evidence that any conditions attaching to it have or will be fulfilled.

The most appropriate accounting treatment of the grant depends on whether or not it:

Relates to asset(s) or income;
Has been made for past or future expenditure;
Has (or will) become repayable.

If the grant related to assets it should be presented in the balance sheet either as deferred income or by a deduction from the carrying amount of the assets. A grant relating to income should be credited to the income statement (IAS 20' Accounting for Government Grants and Disclosure of Government Assistance'). Zorro's treatment suggests that the grant relates to the asset of development expenditure which has been recognised as an asset and therefore incurred.

However, if it was granted for the future operation of a pilot plant it should be deducted from expenditure not yet incurred (e.g. on the specialist equipment ordered for the pilot plant). Therefore, it should be shown as a deferred credit.

Continued on the next page

The reason for the order for specialist equipment being cancelled – whether it was instigated by Zorro or the supplier. Zorro may incur penalties if the contract was cancelled by them (or be able to claim compensation if cancelled by the supplier). There is evidence to suggest that the pilot plant may not come into operational existence (i.e. the order for specialist equipment has been cancelled and research activities are being directed from one technology to another). If the terms and conditions attaching to the grant which was applied for and received are not met it may be repayable.

To the extent that the grant has become repayable (assuming it relates to an asset) the carrying amount of technology development costs should be increased and a liability recognised. Zorro's plans for using the patented technology appear to have changed and the carrying amount included in intangible assets may be impaired. The recoverable amount of the intangible asset arising from the development of the technology should be assessed (IAS 36 'Impairment of Assets').

If Zorro now has plans to sell rather than use this technology it may be possible to determine a net selling price. If the intangible asset is not yet available for use it should have been reviewed for impairment at 30 June 20Y0 (IAS38 'Intangible Assets').

(ii) Audit evidence

Receipt of Tshs8,000,000 in May 20Y0 – confirming the amount recognised.

The bank report for audit purposes if the grant is still held (e.g. in a separate bank account) to be expended.

The terms and conditions of the grant set out in the application for the grant or government contract received including:

Pre-conditions (e.g. if Zorro was to have already placed an order or contracted for the specialist equipment before being entitled to receive the grant);

Any 'proofs of purchase' or similar which may be required to be sent to the government agency as and when expenditure is incurred;

Any obligations of Zorro to declare any breach in their undertakings.

Correspondence with the relevant government agency (e.g. if repayment of the loan has been requested).

Any penalties incurred, and by whom, as a result of the order for specialist equipment being cancelled.

The repayment, if any, of part or all of the grant since 30 June 20W2.

Legal advice on the terms and conditions of the grant and whether, for example, repayment can be enforced.

Management representation confirming future plans for Zorro's activities.

(b) Contaminated land

(i) Matters

The cost of the land represents 1·6% of profit before taxation and less than 0·2% of total assets and is therefore not material (e.g. if the value of the land is so impaired that an impairment loss should be recognised amounting to the whole of its cost).The provision represents 21·7% or profit before taxation and 2·2% of total assets and is therefore material.

The reason for the closure and demolition four years ago – whether Zorro knew about or suspected the contamination; the reason for recent testing by the water authority (e.g. whether routine inspection or in response to concerns about public health and safety).

A provision should not be recognised unless there is:

A constructive obligation to clean up the land (because there does not appear to be any legal obligation to do so); and
A reliable estimate of the obligation can be made.

Continued on the next page

There will not be a constructive obligation unless, for example, Zorro has a published policy for cleaning up sites and honouring its published policy (i.e. creating a 'valid expectation'). If Zorro has a published policy and knew or suspected contamination of this site, the fact that it has taken four years to do anything about remedying it may suggest that it does not honour its policy (and therefore that a provision should not be made).

Whether now, more than four months after the findings, any action has been taken by Zorro's management to carry out a clean-up operation (e.g. whether outside waste management contractors have been asked to tender for it).

How Tshs10 million has been estimated (e.g. from tenders or the report of an expert) and how it is to be financed - whether the results or the timing of them had any bearing on the facts of (1) – e.g. if financing the clean-up creates a lack of finance for the pilot plant.

(ii) Audit evidence

The conclusions and recommendations (if any) of the local water authority's report.

A visit to the site – is it wasteland? Has a clean-up operation commenced?

Board minutes documenting the need for and approval of a clean-up (e.g. if the land is to be sold)

Any plans drawn up for permissions to develop the site.

Prior year financial statements – whether the matter (of contamination and potential liability) has previously been disclosed.

Any tenders invited or received or contracts entered into for a clean-up operation.

Published environmental policies and/or costs incurred in past clean-ups (documented in prior year working papers).

Written representations concerning management's intentions to undertake the clean-up.

Test Yourself 7

Refer to the previous example of Zorro

Zorro owns two properties as well as its laboratories, production facilities and head office. One property is a residential apartment block and the other an office block. The apartments are leased out on an annual basis and are currently fully let.

However, many of the offices are vacant and available for let on monthly as well as annual terms. On 30 June 20Y0, the apartment block was valued at an open market value that was Tshs33million in excess of its carrying amount under the benchmark treatment of IAS 16 'Property, Plant and Equipment' (i.e. at cost less accumulated depreciation). This excess has been credited to a revaluation reserve.

Required:

(a) Comment on the matters that you should consider; and
(b) State the audit evidence that you should expect to find, in undertaking your review of the audit working papers and financial statements of Zorro.

Answers to Test Yourself

Answer to TY 1

This is not so much of an audit problem as a management problem, as this could lead to going concern issues in the future. Financing capital expenditures through borrowed capital would lead to an increase in the cost of capital, which would presently be difficult for the company to meet.

An analysis should be made by the auditor to assess whether or not the company can finance the cost of capital from its own operating incomes and profits and whether the benefits derived from its investments in non-current assets outweigh the costs associated with the investment. The auditor would have to enquire with Book Universe’s management on whether or not the company can finance the cost of its capital investment expenditure from its own revenues.

In addition, the auditors would have to analyse cash and bank statements and go through loan agreements which were possibly used to finance these capital expenditures. While performing all of these procedures, the auditor would also have to keep one eye on the general economic trends to analyse whether or not in reality Book Universe would in fact be able to pay off its capital expenditure debts.

Answer to TY 2

Auditing financial statements which contain a change in accounting policy in the current year require some additional matters to be considered. The auditor would have to investigate the reason for the change in accounting policy as well as the impact of the change on the entity’s accounts, by speaking to management and being assured that this gives a truer and fairer picture.

If the change in the accounts is material, then the auditor would have to check if changes from the prior period have been made, in order to ensure that the net effect of the change in accounting policy has been made. In addition, the auditor would have to check whether or not the new accounting policy is consistent with acceptable or international GAAP and the applicable laws governing Bull’s Eye.

Answer to TY 3

When auditing Glider’s fleet of vehicles:

- The auditor would first have to compare and match the opening balances in the vehicles account and the accumulated depreciation with the non-current assets register and the financial statements of the previous year.
- The auditor would also have to physically inspect a sample of the vehicles to ascertain whether or not they are available, and also whether they are in proper condition.
- The repairs and maintenance records should be checked to confirm that no capital expenditure has been expensed.
- The auditor should also review the terms of all lease contracts (rentals) , if any, to ensure that leases are recorded and disclosed in accordance with IAS 17 (for example, if it is an operating lease, yearly depreciation needs to be provided and the rental income needs to be recorded).

Answer to TY 4

According to IAS 17 Leases, a finance lease should be recognised as an asset as well as a liability. An operating lease would have to be expensed over the term of the lease on a straight line basis.

The auditor would have to primarily ascertain the appropriateness of the classification. For this the auditor needs to read the contract in order to establish its legal form (whether an operating lease or a finance lease) and interpret its economic substance. For this the auditor must also look for indicators (e.g. whether lease transfers ownership of the asset to the lessee by the end of the lease term) under which a lease is normally classified as a finance lease. From the scenario it appears less likely that it is a finance lease as ten years lease for an office suite (in an upcoming commercial area) cannot be for the major part of such an asset’s inherently long life. However, other indicators must also be examined before the classification is decided.

After the classification of the lease is identified, the auditor must confirm that the accounting treatment is appropriate (accounting treatment in accordance with IAS 17). In order to determine whether the lease is material from the point of view of the financial statements of Farrow, the auditor would have to verify whether the lease values more than 1.5% of the total assets of the company. (In the absence of value of the total assets, we cannot arrive at a conclusion about its materiality).

The auditor will also have to check that the present values of all the future lease payments are correctly calculated (i.e. whether in accordance with the provisions of IAS 17). The auditor will have to recalculate the discount rate used for accuracy. The extent to which Farrow will bear the risks and rewards of ownership can be determined from the lease contract.

Depreciation on the lease, if it is a finance lease: to confirm that it is correctly calculated (whether the depreciation policy is consistent for other similar assets, whether the depreciation charge is correctly charged to the statement of comprehensive income etc.). In addition, the auditor would have to physically inspect the suite to ensure that the leased asset actually exists.

Answer to TY 5

Recognising revenue before the terms of the sale transaction has been completed is a creative accounting device known as revenue acceleration. It violates the principle that revenue should be recognised as and when it is realised. For revenue to be realised, the risks of ownership should be transferred to the buyer. Recognising revenue in this manner would indicate higher revenue from sales which do not in fact exist. The auditor should perform additional cut off tests to ensure that revenue has been correctly recognised if a doubt arises.

Violation of local GAAP or IFRS could in some ways affect the judgement of a user of financial statements. The auditor should know about the possible violations that could occur due to deviations from GAAP and be able to detect such violations. In order to do so, the auditor should also train his staff and ensure that they get proper experience in detecting such inconsistencies.

In the case of non-conformance with GAAP, the auditor should request that management correct the financial statements. If the management refuses to do so, the auditor could issue a modified (except for) opinion on the grounds of incorrect accounting treatment of revenue (against IAS 18).

Answer to TY 6

Before the auditor actually starts the actual review of the brand name Colors, the auditor would have to go through the history of the Colors and check mostly for issues such as how long the brand has been in existence, the market value of the brand, and so on.

When actually auditing Colors, the auditor should compare the carrying value of the Colors for the current year with that of the previous years. Any marketing or advertising expenditure incurred for the brand should be validated against actual invoices to ensure correctness and accuracy.

The auditor would also have to review the expenditure that the management intends to incur for maintaining the brand at its current level. In doing so, the auditor would also have to verify its indefinite useful life and accounting policies used in similar brands currently used in the market.

Answer to TY 7

Investment properties

(a) Matters

The Tshs33 million 'revaluation surplus' represents 7·1% of total assets (and 71·7% of profit before taxation) and is therefore material.

What has prompted this first time valuation of the apartment block and what is the reason for not having valued the office block at the same time?

Carrying an item of property at a revalued amount with the surplus being credited directly to a revaluation surplus within equity is the allowed alternative treatment under IAS 16 'Property, Plant and Equipment'. IAS 16 requires that all assets within a class be revalued simultaneously in order to avoid selective revaluation of assets (and the reporting of amounts in the financial statements which are a mixture of costs and values at different dates).

If it was management's intention to adopt the allowed alternative treatment, all other land and buildings (including head office, contaminated land, etc) should have been revalued within a short space of time of 30 June 20Y0.

However, the apartment block and office block are not owner-occupied but held to earn rentals and therefore investment properties. Investment properties should be accounted for under IAS 40 'Investment Properties' not IAS 16. (All other properties may, however, be valued under the IAS 16 benchmark treatment and not be revalued.) IAS 40 does not permit selective revaluation and all Zorro's investment properties should be measured under either:

The fair value model; or
The cost model (i.e. the benchmark treatment of IAS 16).

The fair value model cannot be said to be adopted if the office block is not revalued. It is likely/possible that the carrying amount of the office block is impaired (and that a valuation would be lower) given the difficulty which Zorro seems to have in letting out office space.

Under IAS 40 gains and losses arising from a change in fair values should be included in net profit or loss for the year in which they arise. However, assuming that the office block will also be revalued, this is the first year in which IAS 40 is adopted. If Zorro previously disclosed the fair values of these properties (i.e. in the notes to the financial statements as at 30 June 20Y0), then the comparatives can be restated and the opening balance of retained earnings adjusted. If fair values have not previously been disclosed, the comparative information should not be restated (i.e. the net gain/(loss) will be included in net profit of loss for the year to 30 June 20Y0).

(b) Audit evidence

Physical inspection of the location and condition of the apartment and office blocks. Confirm that the office block is not owner-occupied (in the light of low tenancy).

The information in the valuer's report including the date of valuation, bases used (e.g. open-market), assumptions made (e.g. full occupancy), etc.

The qualifications, experience and objectivity of the valuer.

Discussions with management/board minutes to ascertain the reason for the revaluation.

Management's impairment review, if any, of the office block.

Quick Quiz

1. **Which of the following options contains important matters relating to goodwill which need to be considered by an auditor:**

   A Goodwill should not include non-purchased goodwill and negative goodwill should be transferred to retained earnings
   B Goodwill should not include non-purchased goodwill and negative goodwill should be recognised immediately in the income statement
   C Goodwill can include non-purchased goodwill and negative goodwill should be transferred to retained earnings
   D Goodwill can include non-purchased goodwill and negative goodwill should be recognised immediately in the income statement

2. **Which of the following is true about revaluation model?**

   A In the revaluation model starting point is the cost prior to revaluation.
   B Accumulated depreciation and impairment losses from the date of initial recognition are deducted from the revalued amount.
   C Gain on revaluation surplus is recognised in Statement of comprehensive income.
   D Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from fair value.

3. **Which of the following is correct about government grants?**

   A According to IAS 20 Para 12 Government grants should be credited directly to shareholders' interests on a systematic basis.
   B The income approach requires that government grants are recognised as income on a systematic and rational basis so as to match them with the costs.
   C Grants related to depreciable assets are usually credited to shareholders' interests.
   D None of the above

4. **Which of the following statements about the valuation of inventory are correct, according to IAS 2 Inventories?**

   (i) Inventory items are normally to be valued at the higher of cost and net realisable value.
   (ii) The cost of goods manufactured by an enterprise will include only material and labour. Overhead costs cannot be included.
   (iii) The First In First Out or weighted average method may be used to determine the cost of inventory.
   (iv) The selling price less the estimated profit margin may be used to arrive at cost, if this gives a reasonable approximation to actual cost.

   A (i), (iii) and (iv)
   B (i) and (ii)
   C (iii)
   D (iii) and (iv)

5. Goldshine is a manufacturer of jewellery (diamond jewellery and platinum jewellery and only gold jewellery). On an average its yearly sales amount to Tshs300 million. It offers the facility of free repairs on the sale of its diamond jewellery if any defects are found within a period of 1 year from the date of sale. For platinum jewellery it gives full refund of the amount paid if any defects are found within a period of 6 months.

   For the year 20W9, the company expects the sale of Tshs500 million out of which Tshs200 million are estimated for platinum jewellery and Tshs100 million for the diamond. The past experience of the management says that 20% of the platinum jewellery and 30% of the diamond jewellery generally has defects.

   The expenses for repairs are estimated to be Tshs10 million assuming all the diamond jewellery sold has defects.

   Which of the following is the amount of provision required to be made in the books of accounts of Goldshine?

   A 43,000
   B 50,000
   C 63,000
   A 41.000

Answers to Quick Quiz

1. The correct option is **B**.

   The auditor needs to ensure that the goodwill does not include non-purchased goodwill. Where negative goodwill arises, the auditor should make sure that it is recognised immediately in the income statement.

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

   In the revaluation model revalued amount is the starting point. In the revaluation model, accumulated depreciation and losses subsequent to the revaluation date are to be deducted. Gain on revaluation surplus is an unrealised gain and hence it is recognised in other comprehensive income.

   Hence only statement **D** is correct.

3. The correct option is **B.**

   Statement **A** is incorrect. Recognising the grants as income is known as the income approach; crediting them directly to shareholders' interests is the capital approach. IAS 20 requires the income approach to be followed.

   Statement **C** is incorrect. Grants related to depreciable assets are usually recognised as income over the periods and in proportions in which depreciation is charged on the assets.

4. The correct option is **D.**

   Statement (i) is incorrect. Inventory should be valued at the lower of cost or net realisable value.

   Statement (ii) is incorrect. The cost of goods manufactured by an entity will include materials, labour and overheads and all other costs incurred in the development of inventory to the condition it is at the date of valuation.

5. The correct option is **A.**

   In this case, the amount which will be provided for will be:

The amount provided will be:	**Tshs million**
For diamond jewellery 30% x 10 **(W1)**	3
For platinum jewellery 20% x 200	40
Total amount of provision	**43**

Workings

W1

Repairs (assuming all the diamond jewellery has defects: Tshs10 million) In this case 30% of diamond jewellery may have defects i.e.10 * 30%= 3

Self-Examination Questions

Question 1

Mitchell and Holmes, Accountants and Registered Auditors, was auditing the financial statements for the year ended 31 December 20X8 of Aurora Maze, a brewery company.

During the year the tax authorities filed an appeal in the country's Supreme Court against Aurora Maze for the recovery of Tshs800 million in tax on certain peculiar real estate transactions. Aurora had not made any provision for the claim in its financial statements since its legal counsel reported that the outcome was most probably in the company's favour. However, in January 20X9, the Apex Court adjudicated a similar case in favour of the tax authorities. Aurora's management is still of the opinion that since the Apex Court has not yet heard its case, there is no need to make the provision. The management also feels that this event has not yet had any impact on Aurora's financial position as on the reporting date.

Required:

As Mitchell and Holmes' audit manager on the Aurora Maze engagement, draft a memo to Aurora's management detailing the implications of the situation and the action required to be taken by the company.

Question 2

Metcalfe Retailing is a nationwide chain of stores which determines its purchases, pricing and management policies centrally. All store managers report to the central management committee.

The financial statements for the year ended 31 March 20X9 show the following details:

	Tshs million	
	31 March 20X9	**31 March 20X8**
Total assets	124.6	121.1
Sales revenue	212.1	197.4
Profit before tax	6.6	5.1

On 1 May 20X9, Metcalfe announced its plans to downsize one of its stores from a large-scale store to a small scale store due to the negative result of the store's cost-benefit analysis. The management's current plan is to close the store throughout the month of June to refurbish the store's interiors and re-open it in July. When this store was purchased in 20X6, in addition to two other stores, the management recognised goodwill of Tshs3.85 million with the intention to write-off goodwill over the next five years.

On 1 April 20X8, the retail chain announced a reward programme for its customers. The points of the plan included a “star” for every purchase of Tshs1 spent at the store, with extra “stars” for every purchase of the store’s special offers. These “stars” could be converted into cash discounts on further purchases at the rate of Tshs1 for every 100 “stars” collected.

On 1 October 20X8, the company decided to build a store at a popular tourist destination. The tourist destination was also a heritage site and, according to national legislation, local government permission was required to build on and around the site. Government permission was received in April 20X9, on the condition that the construction of the store would not substantially harm the area’s natural ecosystem.

The company made additions to its non-current assets of Tshs3.08 million as the estimated cost of site restoration after completing the construction of the store. This estimate includes a provision of Tshs0.28 million to relocate two 100 year old trees in order to plan for the development of the site. However, in March 20X9, the trees were chopped down to make way for an additional wing of the store. Metcalfe paid a fine of Tshs28,000 for chopping down the trees.

Required:

While reviewing the audit working papers and the financial statements of Metcalfe Retailing, discuss the matters that the auditor should consider and explain the audit evidence the auditor would expect to find in the course of the audit.

Question 3

(a) The following figures are extracted from the draft financial statements of Mwendokasi Ltd, one of your audit clients for the year ended 31st December 2015.

Current assets	**TZS. “000”**
Inventory	140,000
Accounts Receivables	160,000
Non-Current liabilities	
Loan	130,000
Provision for warranty	15,000

In obtaining sufficient appropriate audit evidence, the following information relating to the above figures is obtained:

Inventory

The client deals in high tech equipment such that technological advances move very fast resulting in a high rate of obsolete/outdated equipment. Included in the inventory figure is a cost of TZS.45 million for equipment which was sold in February 2016 for TZS.28 million

Accounts Receivables

Shortly after the year end in the first quarter of 2014 and before finalization of audit a major credit customer of the company has gone into liquidation because of heavy trading losses. It is estimated that this customer will not be able to pay the debt. The amount included in receivable relating to this customer is TZS.54 million and no allowance for receivables has been made at the period end.

Loan

Two weeks after the issuance of the audit report, the financial statements are issued and it is discovered that, the loan figure in the financial statements is materially misstated. Had this fact been known before the issuance of audit report, your firm would have modified the audit opinion. The figure of TZS.130 million is understated by TZS.64 million.

The figure in the draft financial statements relates to warranty provision for the period for year ended December 2014. The policy of the company is that goods are sold with warranties enabling customers to return their goods within one year of purchase if goods are found to be faulty.

After the period end, before finalization of the report, you establish that repair costing TZS.46 million have been incurred relating to goods sold in the year under audit.

REQUIRED:

Discuss the audit issues relating to the above matters and recommend action that management of Mwendokasi Ltd should take in line with IAS 10: *Event after the period end*.

(b) IAS 38 Intangible assets and IFRS 3 *Business combinations* give guidance for intangible assets.

REQUIRED:

State audit procedures for development costs as the requirement of IAS 38 *Intangible Assets*.

(c) ISRE 2400: *Engagements to review financial statements* give guidance on review engagements. Auditors are allowed to carry out other services such as review engagements and due diligence reviews.

REQUIRED:

Discuss the nature of review and due diligence engagements.

Answers to Self Examination Questions

Answer to SEQ 1

From: Mitchell & Holmes, Accountants and Registered Auditors

To: The management of Aurora Maze Ltd

IAS 10 Events Occurring After The Reporting Date considers all favourable and unfavourable events that would arise after the date of the financial statements and would have a material impact on the financial statements on the date of the financial statements. ISA 560 requires the auditor to assess all events occurring after the reporting date and consider the impact they would have on the entity's financial position and the auditor's report.

In this case, the tax authorities have filed a claim of Tshs800 million in the country's Apex court against you in relation to certain peculiar real estate transactions. Your accounts have not yet made a provision in respect of the court even when the country's apex court adjudicated a similar case in favour of the tax authorities. Therefore, your contention that since its own case has not yet been heard, there is no necessity to create any provision is completely flawed.

As a result, if you choose not to make any changes we would have to choose between a qualified opinion (except for) and an adverse opinion (the financial statements do not give a true and fair view) depending on the intensity of the situation, as your financial position is materially affected.

Answer to SEQ 2

Store impairment

The auditor would have to consider the materiality of the goodwill from the point of view of the total assets of the company. The amount of total goodwill is Tshs3.85 million which forms roughly 3% of the company's total assets, which is a material amount. However the carrying value of the goodwill after three years would work out to Tshs1.54 million which would represent only around 1% of the company's total assets, therefore making it immaterial. The impact of annually writing off the goodwill is material as it consists of more than 11% of the total profit before tax. Ideally, according to IFRS 3 Business Combinations, goodwill should not be written off but tested annually for impairment.

This restructuring is announced after the reporting date and is therefore a non-adjusting event for which no provision is required to be made. However, this event does give rise to an impairment of a cash-generating unit, i.e. the store that has to be downsized. As a result, the goodwill assigned to it also has to be tested for impairment. The current carrying amount of the goodwill would be 23% of the retail chain's current profit before tax. As a result, the write-off is material to the profit before tax. If the goodwill of the impaired store cannot be allocated among the stores purchased along with it, the impairment test should be applied to all the three stores purchased together.

The audit evidence that the auditor would gather would include minutes of the board meetings that approve the renovation carried out by the store detailing the negative result of the cost-benefit analysis on the store. Written documentation of all the assets of the store under review and their respective carrying amounts including the carrying amount of goodwill of the store and the current fair value of the store as a whole would also be a part of the audit evidence collected.

The auditor would also look for agreements in the cash flow projections, the reasonableness of the discount rates used and written representations of the assumptions used in the preparation of the financial budgets. The auditor would additionally look for revenue budgets and cash flow projections for the other stores in the retail chain besides making a formal inspection of the store while it is closed for renovation.

“Star” customer rewards scheme

If the auditor were to assume that the entire profit before tax earned by the retail chain would attract reward “stars”, then the cost of the reward scheme would be Tshs2.12 million. This would represent one per cent of the revenue and almost 31% of the before-tax profit. Therefore, the cost of the reward points would be material, from the point of view of both the revenue as well as the before-tax profits.

The auditor should consider that the expenses and liabilities are recognised as and when revenue is earned in accordance with the accrual assumption and IAS 1.

The extent to which the stars have been awarded but not converted into discounts would also be considered as those stars would form a liability on the part of the company.

In addition, any restriction / expiration clause for the stars earned as well as those points earned but not expected to be taken up should also be considered.

The auditor should check that the total balance due to customers account should match the individual customer reward cards.

The valuation of the reward starts whether they are valued at cost or at selling price should also be checked by the auditor.

The audit evidence collected would be as follows:

- a plan explaining the procedure of how the stars are awarded to customers and how cash discounts are allowed on later purchases.
- a report from tests of controls, relied on as audit evidence.
- reports from tests of details conducted on a sample of transactions conducted on the stores.
- analytical procedures performed on the valuation of stars awarded by the store per month with explanations on variations from normal, if any.

Construction of a new store at the heritage site

The provision for the restoration of the site after the construction of the store at the heritage site forms more than 2% of the total assets of the retail chain. The cost of restoring the site as estimated by the chain’s management is recognised as a provision.

The provision would be recognised as a liability only if it arises as a present obligation resulting from past events. As a result, the amount of Tshs280,000 which is attributed to the relocation of the trees is not correctly recorded since the store’s management is not obligated to relocate the trees. However, Metcalfe is obligated to pay the penalty for felling the trees and should recognise the fine as a liability.

Another matter to be reviewed by the auditor is whether any actions carried out by the store conflict with any of the store’s socio-economic policies.

The auditor must gather audit evidence on this matter such as a copy of the application to build on the site as well as the building plans. The bank statement transactions containing the transactions on the payment of the fines as well as the present value calculations relating to the provision and an assessment of the pre-tax discount rate would also form part of the audit evidence to be gathered. Besides this evidence, the auditor would physically inspect the assets at the construction site and look out for any contracts which might confirm or contradict management’s intentions to restore the site.

Answer to SEQ 3

(a) **Inventory – TZS. 140 million**

According to IAS 2 Inventory, inventory held at the period end and included in the financial statements should be valued at the lower of cost and net realizable value.

The sale of the equipment at TZS. 28 million is an event after the period end which gives evidence of conditions that existed at the period end. The inventory was valued at a figure of TZS.45 million and at the time it was not clear what the realizable value was. In accordance with IAS 10 Events after the reporting period any events after the period end and which give additional information of the conditions that existed at the period end should result in the adjustment of the related figures.

The fact that the inventory has been sold for a lower than cost is indicative of the fact that the realizable value is lower than the cost. Since the audit has not yet been finalized and the report issued, the value of inventory at the period end should be reduced by TZS.17 million so that the new inventory figure is TZS.123 million.

Accounts receivable – TZS.54 million

In accordance with IAS 10 Events after the reporting period, this event can be classified as an adjusting event. This is because it gives additional evidence of conditions that existed at the period end. With hindsight, it is clear that most of this debt is irrecoverable and as such the figure of TZS.54 million at the period end is misstated.

The audit procedures will include:

(i) A discussion with management on the irrecoverability of the debt so that an allowance for receivables is made.
(ii) In the event management refuses to make a provision, consider the effect of this on the audit report. This will depend on the materiality and pervasiveness of the amount to the financial statements.

Loan

The auditor do not have any obligations to perform procedures or make enquiries regarding the financial statements after the date of their report. They have a passive duty.

If they come across a matter that would have caused them conclude otherwise their duty then becomes active and they need to:

(i) Discuss the matter of the understated loan amount with management and where appropriate with those charged with governance.
(ii) The auditor should determine whether the financial statements need to be amended and if this is the case.
(iii) Find out with management how they hope to deal with this matter.
(iv) If the financial statements are changed the auditors will need to perform further audit procedures on the amendments. They will also need to extend the period of reviewing events after the period date to the date of the new report that will be issued. If management declines to amend the financial statements, the auditors will consider the effect of this on their opinion.

Provision for warranty

The risk in this situation is that provisions may be misstated at the end of 2015. The risk is high because it is a matter of accounting estimate requiring judgment.

The question states that no provision relating to sales made during 2015 has been made in the financial statements.

The following audit procedures will be undertaken:

(i) Discuss with management and establish their policy regarding warranty provisions.

the accuracy of the management estimates.

(iii) Use the information obtained above to determine/estimate provision for the year 2015

(b) **Key audit tests largely follow the criteria as laid down in IAS 38**

Audit procedure for development costs:

(i) Check accounting records to confirm that the project is clearly defined, related expenditure can be separately identified, and certified to invoices and time sheets.

(ii) Confirmation for feasibility studies and viability. The auditor needs to examine market research reports, feasibility studies, and budgets.

(iii) Review calculations of future cash flows to ensure that resources exist to complete the project.

(iv) Review previous deferred expenditure to ensure IAS 38 criteria are still justified.

(v) Review budget revenues and costs by examining results to date, production forecasts, advance orders and discussion with directors.

(vi) Check amortization from the date of commencement of the project that has been charged on a systematic basis.

(vii) Obtain written representation from management demonstrating how future economic benefits will be generated from the project.

(c) The objective of the **review engagement** is to enable an auditor to state whether on the basis of the procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditors attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an international financial reporting framework. The two types of audit assurance engagement where the accountant declares that a given premise is either correct or not are an attestation and a direct reporting.

In a **due diligence** is where an advisor often (in an audit firm) engaged by one company planning to take over another to perform an assessment of the material risks associated with a transaction (including validating the assumptions underlying the purchase), to ensure that the acquirer has all the necessary facts and that the perceived business opportunities are in fact real. The common types of due diligence are financial, operational, IT and legal as well as people due diligence for key positions in an organization.

In both case a low level assurance in form of a negative assurance is provided which is an assurance in the absence of any evidence arising to the contrary

SECTION E

EVALUATION OF ACCOUNTING TREATMENTS AND OTHER AUDIT CONSIDERATIONS

E2

STUDY GUIDE E2: OTHER AUDIT CONSIDERATIONS

Get Through Intro

The auditor needs to assess whether the financial statements are prepared based on the fundamental assumption of going concern, which is the assumption that the entity will be able to continue in the foreseeable future.

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, we will discuss various issues relating to going concern status and written representations, which need to be assessed carefully by the auditors. Furthermore, we will also look into the auditor's responsibilities relating to corresponding figures, comparative financial statements and 'other information', audit considerations relevant to initial engagements and various issues which need to be considered while auditing related parties.

A careful consideration to the above stated matters will enable the auditors to assess the true and fair status of the entity's financial statements accurately.

Learning Outcomes

a) Discuss the auditor's responsibilities relating to corresponding figures, comparative financial statements and 'other information'.
b) Discuss the audit implications of an inconsistency or misstatement of fact noticed in relation to other information.
c) Describe the additional audit considerations and audit procedures relevant to initial engagements.
d) Describe the indicators when the going concern basis may be in doubt and identify the mitigating factors.
e) Suggest audit procedures and evaluate the appropriateness of the going concern basis in given situations.
f) Discuss what happens after the auditor issues a report that mentions going concern issues.
g) Discuss the use of written representations to support other audit evidence.
h) Discuss the specific audit concerns and procedures with regards to related parties and related party transactions.
i) Identify the circumstances relating to the existence of unidentified related parties and explain appropriate audit procedures.
j) Discuss the impact of outsourced functions on the conduct of an audit.

1. Discuss the auditor's responsibilities relating to corresponding figures, comparative financial statements and 'other information'.
Discuss the audit implications of an inconsistency or misstatement of fact noticed in relation to other information.

[Learning Outcomes a and b]

Definition

Corresponding figures: comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as 'current period figures'). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

Comparative financial statements: comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

Comparative information: refers to the amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

ISA 710

Example

Myson Inc had a closing receivables balance of Tshs450,000 for the year ended 31 December 20X9. When bringing this amount forward for the 20Y0 financial statements, this amount was brought forward as Tshs540,000. This would reflect in receivables being overstated by Tshs90,000. As a result, Myson's statement of financial position would not tally because of the unaccounted Tshs90,000. In addition, the receivables statement in the accounts of Myson would not match with the external confirmations received from the receivables. As a result, a detailed reconciliation would have to be carried out.

Generally the extent of audit procedures that the auditor needs to follow on corresponding figures is significantly less than that for the audit of current period figures.

When auditing financial statements, the auditor's responsibility is to verify that the prior period's corresponding figures have been correctly reported and classified according to the required financial reporting framework. To do this he must obtain appropriate audit evidence.

1.1 Auditor's reporting responsibility regarding corresponding figures

When comparative financial information is presented in the financial statements, the auditor's report need not specifically identify the corresponding figures. This is because the auditor's opinion on the current period financial statements as a whole includes the corresponding figures.

However, **if any of the following situations exist** then the auditor's report must **specifically refer to corresponding figures.**

1. **The auditor has issued a qualified, adverse or disclaimer of opinion in the prior period,** and the reasons for this qualification (or adverse opinion / disclaimer of opinion) has **not yet been resolved** when the new financial statements have been prepared.

In this case, the effects of the prior period's qualification have a material effect on the current year's financial statements. Therefore, the auditor's report on the current period financial statements should be **modified with respect to the corresponding** figures.

Example

John, the auditor of Xylo Corp, was not able to confirm payables directly for the 20X1 financial statements; nor was he able to apply alternative procedures to confirm payables. As a result, John issued a disclaimer of opinion on the financial statements of Xylo Corp for the year ended 31 December 20X1.

The company issued comparative financial statements for the year ended 31 December 20X2. In 20X2 too, the company did not allow its auditors to confirm payables. In this case, although John's responsibility does not extend to reporting on the corresponding figures, John would still have to issue a modified opinion on the current year's financial statements.

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2. As discussed above when a **material misstatement comes to light on corresponding figures which could affect the prior period's** financial statements (an unmodified opinion on these statements was issued previously), and if the previous year's financial statements have not been revised and reissued, the audit report must be modified on the current period financial statements with respect to the corresponding figures included therein.

3. Incoming auditors: additional requirements

(a) When the prior period's financial statements were audited by other auditors

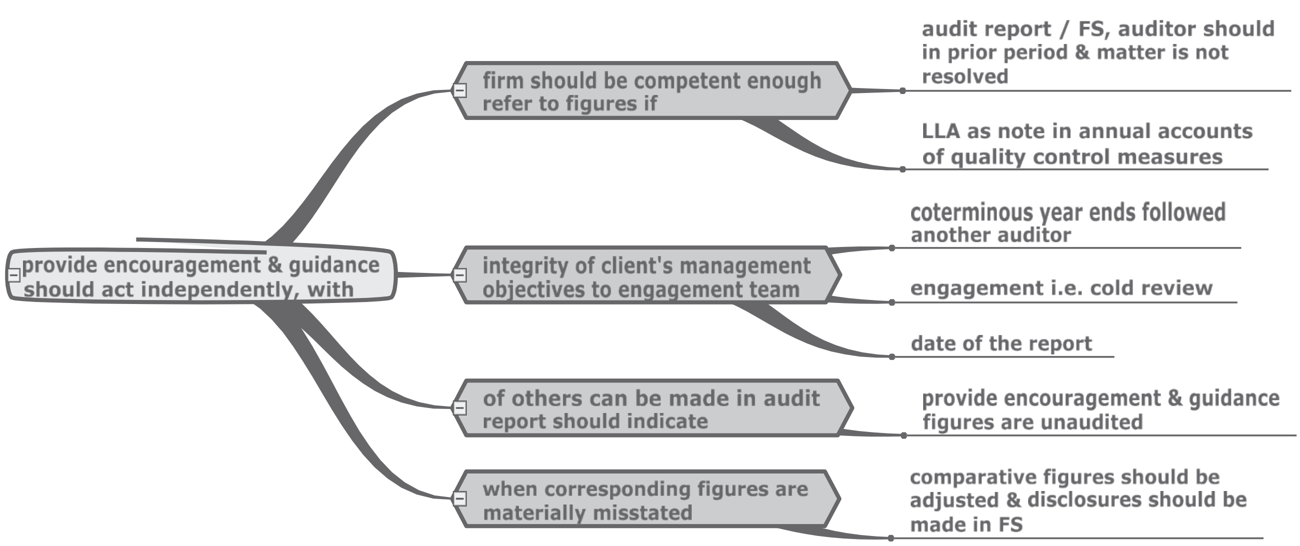
ISA 710 recognises that, in some countries, the incoming auditor is permitted to refer to the previous auditor's report on the corresponding figures in the incoming auditor's report for the current period. In such a case, if the auditor decides to refer to another auditor, the 'other matter' paragraph of the incoming auditor's report should indicate:

(ii) That the financial statements of the prior period were audited by another auditor;
(iii) The type of opinion expressed by the previous auditor and, if the opinion was modified, the reasons for the modification; and
(iv) The date of that report.

(b) When the prior period's financial statements were not audited

If the previous year's financial statements have **not been audited**, the current year's **auditor should state in the other matters paragraph that the previous year's corresponding figures are unaudited**. Such a statement **does not**, however, **relieve the auditor** of the requirement to perform **appropriate audit procedures** regarding the opening balances of the current period. Where the incoming auditor identifies that the corresponding figures are materially misstated, the auditor should **request management to make the adjustment to the comparative figures and also make a disclosure in the notes to financial statements**. If **management refuses** to do so, the auditor should **appropriately modify the report** on the current period financials with respect to the corresponding figures included therein.

SUMMARY



1.2 Auditor's reporting responsibility regarding comparative financial statements

1. Redrafted ISA 710 summarises the auditor's reporting responsibility in the following points:

(a) The auditor has to **state specifically the periods for which financial information is presented and an audit opinion is expressed**.

2. It is possible that the **audit opinion expressed (by the previous auditor) on the prior period's financial statements differs from the auditor's opinion on such prior period financial statements**. The **difference of opinion is described in the 'other matters' paragraph.**

This occurs when (during the course of audit) the auditor becomes aware of circumstances that materially affect the financial statements of a prior period!

3. Incoming auditors: additional requirements

(a) Where the entity's previous year's financial statements were audited by a predecessor

If the auditor is auditing the financial statements of an entity for the first time, in addition to their audit opinion, they must state in the 'other matter' paragraph that:

The prior period's financial statements were audited by the entity's previous auditors
The opinion expressed on them by the previous auditor and the reasons for any modification
The date of the previous auditor's report

If the current auditor discovers a **material misstatement** in the financial statements of prior periods on which the previous auditor had issued an unmodified report, the current year's auditor should report the matter to the appropriate level of management (or those charged with governance) and propose that the previous year's financial statements be **revised** and an audit report on the revised financial statements be issued by the previous auditor.

On the other hand, if the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period.

Example

In 20X2, Bloom & Co resigned as auditors of Orlando Inc after its audit of Orlando's financial statements for the year ended 31 December 20X1. Bloom had issued an unmodified report on the 20X1, financial statements. To audit its financial statements for the year ended 31 December 20X2, Orlando brought in new auditors, Peterpan & Co.

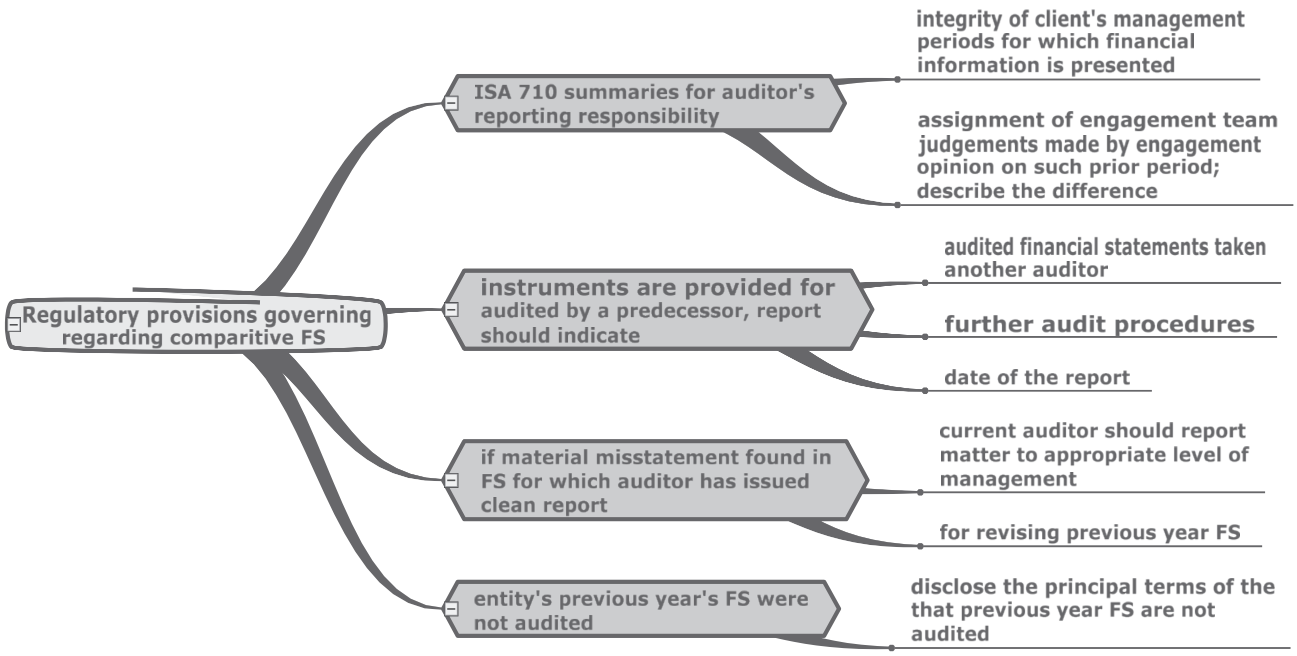
During Peterpan & Co's audit of the 20X2 financial statements, Peter discovered that a supplier of Orlando was suing the company for Tshs2 million, on the grounds of breach of patents rights. There was no provision in this respect as Orlando's legal team believed that the outcome of this case would be in the company's favour. Orlando however, lost the case and had to pay compensation of Tshs2 million.

In this case, Peterpan & Co would request the company to revise the 20X1. Financial statements and have Bloom & Co issue a fresh opinion on the revised financial statements.

(b) Where the entity's previous year's financial statements were not audited

Where the previous year's financial statements were not audited, the current auditor should state in their report that the comparative financial statements are not audited. This declaration, however, does not relieve the current year's auditor of their responsibility to carry out appropriate audit procedures to verify opening account balances.

SUMMARY



Tip

The essential difference in reporting between corresponding figures and comparative financial statements is:

For corresponding figures, the auditor's report only refers to the financial statements of the current period; **whereas**

For comparative financial statements, the auditor's report refers to each period that the financial statements are presented for.

1.3 Auditor's responsibility for other information

ISA 720 Auditor's responsibilities relating to other information in documents containing audited financial statements deals with the auditor's responsibility in relation to other information in documents containing audited financial statements. Furthermore, it refers to matters over which the auditor has no reporting responsibilities.

ISA 720 requires the auditor to **read** the other information and **identify whether any material inconsistencies with the audited financial statements exist**.

The financial statements include:

1. The statement of financial position
2. The statement of comprehensive income
3. The statement of cash flows
4. The statement of changes in equity
5. Explanatory notes

Definition

Other information is financial and non-financial information (other than the financial statements and the auditor's report thereon) which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor's report thereon.

ISA 720

Other information may comprise, for example:

A report by directors or those charged with governance
Financial summaries or highlights
Planned capital expenditure
Employment data
Names of officers and directors
Financial ratios
Financial and operating reviews
Selected quarterly data

1.4 Inconsistency and material inconsistency noticed in relation to other information

Definition

Inconsistency: other information that contradicts information contained in the audited financial statements.

A **material inconsistency** may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.

ISA 720

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1. **Material inconsistencies identified in other information obtained prior to the date of the auditor's report**

If the rectification is necessary in the audited financial statements, (on account of material inconsistencies) the auditor should **request the management of the entity to amend** the audited financial statements. If the management refuses to do so, the auditor should issue a **qualified or adverse opinion** depending upon the materiality of the misstatement.

2. **If the rectification is necessary in the other information** and the management refuses to make the revision, the auditor shall:

(a) Communicate this matter to those charged with governance (unless all of those charged with governance are involved in managing the entity); and
(b) Include a description of the material inconsistency in the 'other matters' paragraph of the audit report, or
(c) Withhold the auditor's report; or
(d) Withdraw from the engagement, if withdrawal is possible under applicable laws or regulation.

Example

The business analysis paragraph in the directors' report states that the "company's sales resulted in a 15% increase in profit from the previous year. A scrutiny of the statement of comprehensive income reveals that the company's profit also included a profit of Tshs450,000 attributed to the disposal of assets from a discontinued operation. If this profit on the sale of the discontinued operation was not present, the company would have reported a profit of Tshs1.75 million for the year, representing a decrease in profit of 30% compared to the previous year.

Except for the matter outlined in the preceding paragraph, in our opinion, the information given in the directors' report is consistent with the financial statements.

1.5 Material misstatement of facts noticed in relation to other information

Definition

A "**material misstatement of fact:** other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

ISA 720

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1. While reading the other information to identify a material inconsistency, the auditor may become aware of an **apparent material misstatement of facts**. In such cases the auditor should:

(a) **Discuss** the matter **with the entity's management**
(b) If necessary, request the management to **consult a qualified third party** such as the entity's legal counsel
(c) **Consider the advice** received

2. If the **management refuses to correct the misstatement**, the auditor should consider taking further action. Accordingly he may decide to:

(a) Notify those responsible for governance of the misstatement
(b) Take further appropriate action such as seeking **legal advice**

Tip

Remember, the auditor cannot qualify his report on grounds of the existence of material misstatements in other information. All he can do is to notify the matter to the management and request them to correct the misstatement.

Example

Gyro Chemicals is currently discussing recruiting Nobel Laureate and pioneer, KL Symmonds as a non-executive director of the company. Having a person of this stature would be very favourable for the market value of the company's shares and sales.

However, the company has mentioned (in its other information to financial statements) that it already has Symmonds on board, when in reality; Symmonds would not be able to join Gyro's board for at least another six months due to some prior commitments. Symmonds is not aware of this statement in the company's other information.

Gyro's auditors would have to discuss this matter with Gyro's management and ask it to rectify this misstatement. If the management refuses to correct this misstatement, its auditors would either have to notify the company's committee in charge of corporate governance, or consider taking legal advice.

3. Availability of other information after the date of the auditor's report

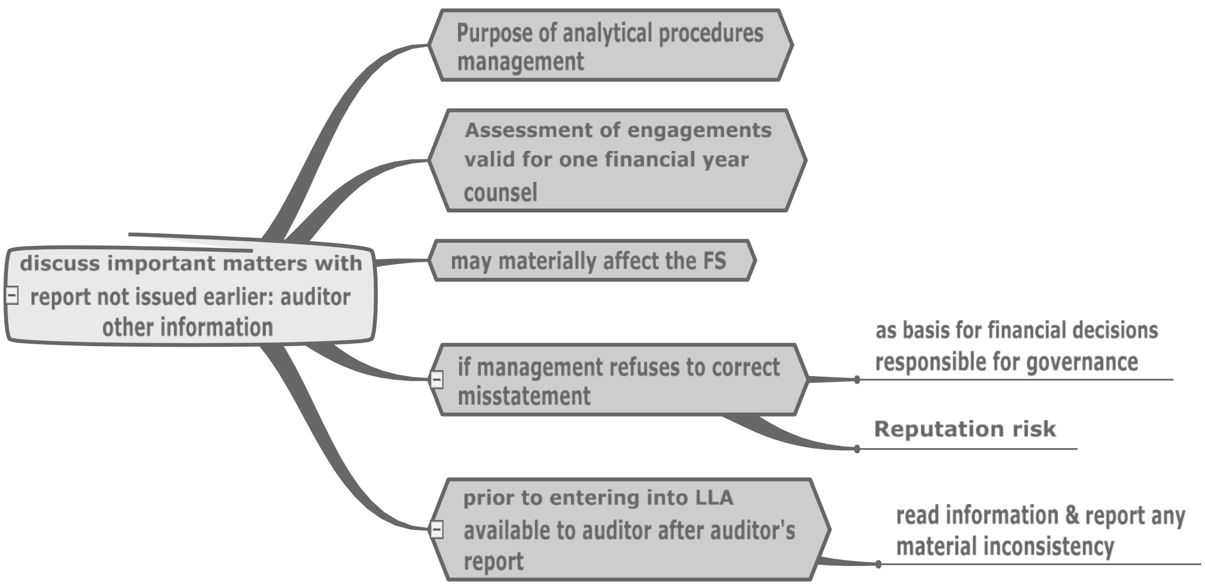
ISA 720 requires the auditor to read the other information and identify material inconsistencies. So it is important that the auditor makes appropriate arrangements with the entity to obtain the other information on a timely basis. If it is not possible to obtain the other information prior to the date of the auditor's report, the auditor should read this information at the earliest possible opportunity.

When the other information is made available to the auditor **after the date of the auditor's report**, and if, on reading the other information, the auditor **identifies a material inconsistency** or becomes aware of an apparent material misstatement of fact, the auditor will determine whether the audited financial statements or the other information need **revision**.

When revision of the audited financial statements is appropriate:

(a) The guidance in ISA 560 Subsequent Events would be followed.
(b) If management agrees to make the revision, the auditor shall carry out the procedures necessary under the circumstances.
(c) if management refuses to make the revision, the auditor shall notify those charged with governance (unless all of those charged with governance are involved in managing the entity) of the auditor's concern regarding the other information, and take further appropriate action such as seeking **legal advice**.

SUMMARY



Test Yourself 1

The directors' report of Violetware, a software company, stated in the paragraph on business analysis that profits had increased over the last year by 40%. An analysis of the company's income statement reveals that the increase in the profits was due to the closure of the software testing division of the company's South Asia operations, due to regulatory and operational problems. This closure resulted in 55,000 employees being made redundant. In the previous year the profits from the South Asia operations constituted 22% of the company's total revenue. The redundancies have not been mentioned in the directors' report.

Required:

How is the auditor's responsibility for material inconsistency different from the responsibility to identify material misstatements of fact in the other information?

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2. Describe the additional audit considerations and audit procedures relevant to initial engagements.

[Learning Outcome c]

2.1 Initial audit engagement means that:

The auditor is engaged to carry out the audit of financial statements of an entity for the first time (i.e. the financial statements for the prior period were not audited); or
The financial statements of the entity for the preceding period were audited by another auditor.

ISA 510 Initial Engagements requires auditors to conduct an **initial audit engagement** to obtain sufficient appropriate audit evidence to ensure that:

The opening balances **do not contain material misstatements** which can affect the current period's financial statements.
Appropriate **accounting policies have been consistently applied** or changes thereto are properly accounted for and adequately disclosed.
The prior period's **closing balances have been correctly brought forward** to the current period or, when appropriate, have been restated.

Definition

Opening balances: those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

IFAC, Glossary of terms

2.2 Audit procedures

The following procedures are to be conducted:

1. Prior period financial statements audited by another auditor

(a) If the prior period's financial statements were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by reviewing the previous auditor's working papers in countries where these can normally be obtained. Usually, the current auditor can rely on the closing balances of the previous year's audited financial statements.

However, he should judge the sufficiency and appropriateness of audit evidence considering the professional competence and independence of the previous auditor.

(b) The auditor also needs to evaluate whether the audit procedures performed in the current year are relevant to the opening balances. For example, for certain items of current assets and liabilities, some audit evidence may be obtained as part of the current period's audit procedures.

Example

The collection of opening accounts receivable during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

(c) However, if the auditor feels that there is a possibility of misstatement in the previous year's closing balances, he has to perform additional procedures to verify the previous year's closing balance indirectly.

Example

In the case of inventories, it is difficult for the auditor to be satisfied as to the inventory on hand at the beginning of the period because the auditor won't have attended the inventory count that took place at the end of the previous reporting period. Therefore, additional audit procedures may be necessary, such as observing a current physical inventory taking and reconciling it to the opening inventory quantities:

Performing audit procedures on the valuation of the opening inventory items

Performing audit procedures on gross profit and cut-off

A combination of these audit procedures may provide sufficient appropriate audit evidence.

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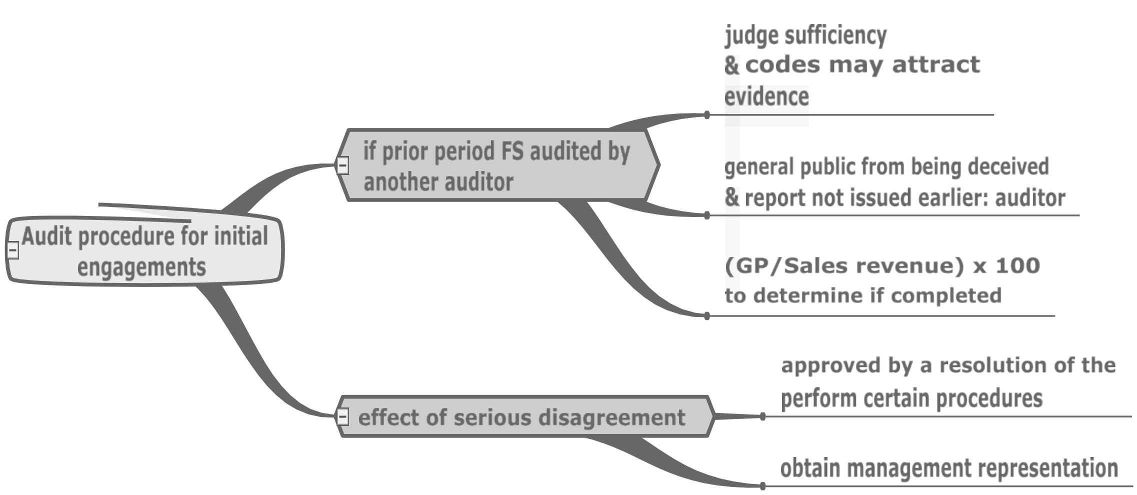
2. Prior period financial statements not audited

When the audit of financial statements is being conducted for the first time, the auditor has to perform auditing procedures to obtain sufficient appropriate audit evidence. In this case, it will not be possible for the auditor to perform certain procedures, e.g., observing physical verification of inventories. Therefore, the auditor may obtain confirmation, etc. and perform suitable procedures in respect of non-current assets, investments, etc. The auditor can also obtain management representation with regard to the opening balances.

SUMMARY



2.3 Audit conclusions and reporting

1. If after performing audit procedures including those set out above the auditor is unable to obtain sufficient appropriate audit evidence concerning opening balances, the auditor's report should express either a qualified opinion or a disclaimer of opinion.

2. If the auditor concludes that:

(a) The opening balances contain a misstatement that materially affects the current period's financial statements, and

(b) The effect of the misstatement is not appropriately accounted for or not adequately presented or disclosed, then the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with ISA 705 (REVISED).

Example

Copper Grey is a large manufacturing firm which manufactures and sells consumer durables. During 20X3, the group's receivables totalled Tshs520 million. The provision for uncollectible receivables is estimated at 20% of the amount of receivables. For the accounts closing on 31 December 20X2, the amount of provision was reflected at Tshs104 million. When carrying the amount of receivables to the next year, the amount was wrongly posted as Tshs250 million. As a result, after making all the necessary adjustments to the receivables accounts, the receivables were closed on 31 December 20X3 at Tshs780 million. This resulted in a wrong provision for uncollectible receivables which was wrongly estimated at Tshs156 million (i.e. 20% of Tshs780)

When the auditor carries out an initial audit engagement, he tries to obtain sufficient audit evidence to ensure that the opening balances do not contain any material misstatement; accounting policies are applied consistently and closing balances are correctly brought forward. In the above case, the opening balance of receivables is understated by Tshs270 million. Furthermore this error has caused an under provision of Tshs54 million in the amount of provision for uncollectible receivables. If this amount is material to the financial statements, and no adjustment is made, then the auditor needs to consider whether a qualified or adverse opinion should be given.

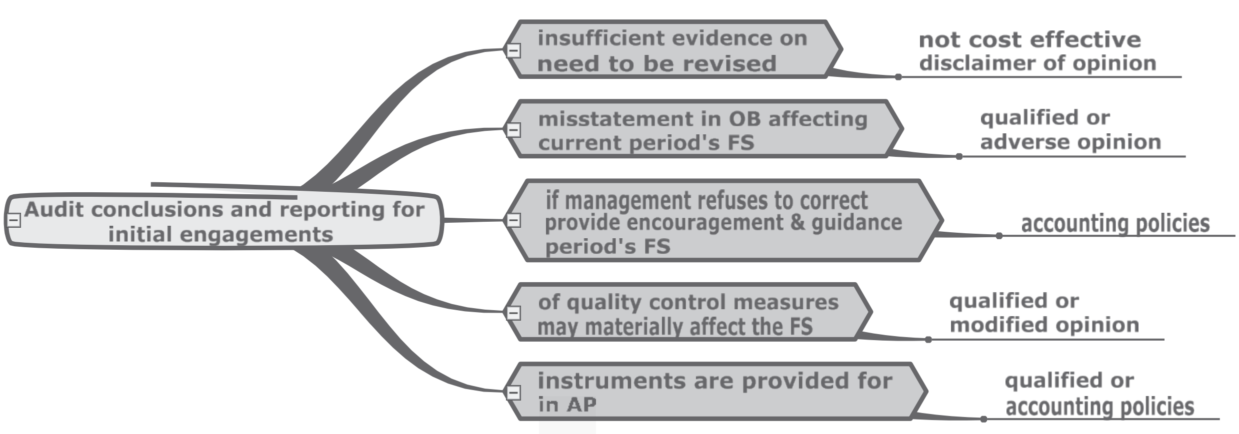
The auditor shall modify the **auditor's opinion on the current period's financial statements** also **if the previous period's audit report contained a modified opinion** and the **matter** (which caused the modified opinion) is **relevant to the current period's financial statements**. In the example of Copper Grey, if the auditor had issued a qualified opinion in 20X3 and the matter is still unresolved in 20X4, the audit report in 20X4 will also be qualified.

The auditor also **issues a qualified opinion or a modified opinion**,

Refer to Study Guide F2 for various audit opinions!

the **application of accounting policies** during the current year are **Inconsistent** with their application in relation to opening balances; or
The **change in accounting policies** is **neither appropriately accounted for nor adequately presented** or **disclosed** in the financial statements.

SUMMARY



Test Yourself 2

B George and Co has been appointed as the auditors of Medix Co, a provider of electronic goods. This is Medix's third year of operation. However, the accounts for the previous two years were not audited. Peter, a junior member of the audit staff of B George and Co, is working on this job. He is very doubtful about the reliability of the opening balances shown in the books of Medix as the opening balances were not audited.

Required:

As a senior member of audit staff, advise Peter on how to confirm the reliability of opening balances.

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3. Describe the indicators when the going concern basis may be in doubt and identify the mitigating factors.

[Learning Outcome d]

3.1 Meaning of Going Concern

Financial statements are prepared based on certain fundamental assumptions, one of which is going concern. Going concern is the fundamental accounting assumption that the entity will be able to continue in the foreseeable future. According to ISA 570, Subsequent events, general purpose financial statements are prepared on a going concern basis, unless:

1. Management intends to liquidate the entity or
2. To cease operations, or
3. Has no realistic alternative but to do so.

It is the responsibility of management to make a specific assessment of the entity's ability to continue as a going concern. When the entity assesses that its going concern status is appropriate, the financial statements will measure assets and liabilities at values at which the entity can realise the assets and discharge the liabilities in the normal course of business.

In simple terms, going concern refers to the ability of the business entity to continue without the threat of liquidation in the foreseeable future i.e. for at least a twelve month period, normally starting from the date that the financial statements are approved by the directors.

Test Yourself 3

The auditors of a company qualified their audit report with the following paragraph:

"Adder Company's leasing agreements expire as on June 20W9 and the amounts outstanding are payable as on 30 September 20W9. Adder Company has been unable to re-negotiate its leasing arrangements or obtain a replacement source of finance. This situation indicates a material uncertainty that would cast doubt on the ability of Adder Company to continue as a going concern.

The financial statements do not disclose this issue. "In our opinion, except for the incomplete disclosure as mentioned in the preceding paragraph, the financial statements of Adder Company present fairly, in all material respects, the financial position of the company as on 31 December 20W9 in accordance with the International Financial Reporting Standards".

Required:

With respect to the above paragraph, explain the significance of the going concern assumption.

3.2 Factors affecting management's assessment of going concern status

Any judgment made about going concern should be based on the available information at the time when the judgment was made. Subsequent events may prove this judgment to be wrong.

The following **factors affect the judgment of management relating to going concern status**:

1. Size, nature and complexity of the entity
2. Availability of the information at the time of judgment making
3. Period under consideration

3.3 The auditor's responsibility relating to going concern

The auditor's responsibility relating to going concern is:

1. To **consider the appropriateness of management's use of the going concern assumption** in the presentation of the financial statements and consider whether there are material uncertainties about the entity's ability to continue as a going concern. In this connection the auditor needs to obtain sufficient appropriate audit evidence.

2. To conclude **whether there exists a material uncertainty** that might affect the going concern status of the entity.

3. To determine the **implication of the going concern status** on the auditor's report.

3.4 Indicators of the going concern basis being in doubt

1. The following examples are indicators of events or transactions which cast doubt about the going concern assumption:

(a) Financial indicators

(i) Adverse key financial ratios

If key financial ratios of the entity are adverse, such as negative net profit ratio, current ratio of less than 1 or debt to equity ratio prompting over dependence on debt fund, the auditor should consider the appropriateness of the going concern assumption. As these indicators are not conclusive in nature, further analysis should be undertaken to ascertain the appropriateness of the assumption.

Example

Amazing Fashions Plc was a retailer of women's clothes. During the audit of the financial statements for the year ended 31 December 20X1, Martha, the auditor, discovered that the company's current liabilities had increased more than its current assets resulting in an adverse current ratio. On further ratio analysis, she discovered that the debt-equity ratio was negative. This meant that the company's debts were higher than its equity resulting in a higher cost of interest. In addition, the net profit to total funds ratio and the return on capital employed ratios had been declining for the last three years.

This reflected a trend of falling profits due to which investors in the business did not get the expected return on their investment. Due to the reduction in profits, the return on capital employed ratio had also declined. On calculating the cash profit margin ratio, operating ratio and gross profit ratios, all of which were unfavourable, Martha concluded that the company's key financial ratios were unfavourable.

The company's key financial ratios revealed a trend of falling profits, rising interest costs, and insufficient liquid assets to meet the company's cash flow needs. Since these adverse key financial ratios affected the going concern assumption of the company, Martha should confirm the facts with management and obtain their opinion on whether or not Amazing Fashions can continue as a going concern.

(ii) Negative operating cash flows as indicated from historical or prospective financial statements

If the operating cash flows for the entity are negative in the historical financial statements or the entity is expected to have negative operating cash flows considering the prospective financial statements, auditors should undertake additional audit procedures to ascertain the validity of the going concern assumption.

Example

During the audit proceedings of Onward Plc, the auditor, Jack, realised that the entity's working capital requirement was consistently greater than the amount of cash generated by the entity in the previous six months. This indicated that the company had negative cash inflows from its operating activities.

Jack will now have to analyse critically the company's cash flow statements to investigate the reasons for the company's negative cash flows and the implications for Onward's businesses. Jack will also have to assess the reliability of Onward Plc's information systems in generating such statements. If they are not reliable, he may disagree with the going concern assumption.

(iii) Inability to pay account payables on due dates

Inability to pay accounts payables on the due dates shows that the liquidity of the entity may be at risk and that the cash flows are not sufficient to pay even the current obligations. In such cases, auditors should perform further audit procedures to ascertain the appropriateness of the going concern assumption. Inability to pay can be deduced from the analytical procedures and from communication with the account payables.

Example

Supreme Electrical Co trades in all types of electrical goods of various companies. It follows the practice of allowing a 90 day credit period. This credit policy is followed for accounts receivable as well as accounts payable.

During an audit of the 20W9 financial statements, the auditor noticed unusually high interest costs incurred by the company of Tshs5 million, Tshs8 million and Tshs15 million during the months of October, November and December 20W9 respectively. On further analysis of these interest costs, the auditor realised that the company had been unable to pay account payables on their due dates because of which the company's vendors had charged them interest.

Inability to pay vendors on their due dates indicates an insufficiency of cash which could raise significant doubt over the company's ability to continue as a going concern. The board decided to adopt methods to increase the working capital or to reduce the credit period of account receivables.

(iv) Change from credit to cash on delivery transactions with suppliers

(v) Inability to comply with loan agreements

Example

Greenfields Designers is an interior designing firm. It took a term loan from Pioneer Bank Ltd to expand its business into custom made furnishings. However, Greenfields has defaulted on the last three monthly instalments.

On enquiring into the interest payment defaults, Greenfields' auditor, David came up with the following reasons:

- Shortage of working capital
- Heavy negative cash flows from two divisions
- Shortage of customers for the extended division
- Shortage of key management to solve the above problems

In the current scenario, David found it difficult for Greenfields to continue in business in the long term. He warned the management to look into the matter seriously, as the going concern assumption might be affected in future.

(vi) Fixed term borrowings approaching maturity without any intention of renewal

(vii)Short term borrowings used to finance tangible assets

Example

During the audit of Rainmakers Inc, the auditor, Daisy, examined the short term borrowings during the year. The company had accepted many short term borrowings for various purposes. Daisy asked about the purpose of each loan and realised that each loan was taken to finance a tangible asset.

Tangible assets are the foundation of any business and they should support the company's debts. As the company is borrowing money for a short period to finance assets, this clearly indicates that the profits earned are not sufficient to finance the assets.

Daisy feels that this is a serious situation which management should focus on as it carries a risk of affecting the company's going concern status in future.

(viii) Large arrears of dividends payable

(ix) Consistent substantial operating losses

(x) Material deterioration in assets used primarily for the purpose of generating cash flows

Example

During the audit proceedings of Cheers, a holiday resort, the auditor, Justine, discovered that an unusually large proportion of assets had been disposed of. On enquiry, the hotel's management explained that the asset had to be sold to overcome the current shortage in working capital. Justine further realised that the asset sold was a sports club which is the prime tangible assets of the hotel industry. This asset generates cash flows and enables the business to operate effectively.

Disposal / deterioration of material assets used for the purpose of generating cash flows is an indication that the going concern status might have been affected. Justine should examine the matter in detail as it affects the basic assumption of going concern.

(xi) Inability to obtain finance to develop key new products

(b) Operating indicators

(i) Loss of key management personnel (and no replacements) (ii) Loss of a major market or franchisee

Example

Galaxy Ltd has been engaged in the manufacture of beauty products for the last five years. It has very few competitors as its products are unique. However, in spite of this, there has been a sudden decline in the current year's sales.

Galaxy's auditor, Tom, asked the directors the reasons for the decline in sales. An analysis of the market revealed that Galaxy is located in a war zone. International organisations have cut trade ties with the country in which Galaxy is located. This has resulted in a major loss of sales as well as a shortage of supplies of raw materials used in the production process. Tom felt that this loss of a major market share in such a short time could affect the going concern status of Galaxy.

(iii) Shortages or loss of key suppliers or customers

(iv) Difficulties with labour unions

(v) Loss of licence or changes in law that may adversely affect the entity

(vi) Management intentions to liquidate the entity or to cease operations. (c) Other indicators

(i) Non-compliance with capital or other statutory legal requirements

(ii) Pending legal proceedings against the entity which, if successful, may result in claims that the entity is unlikely to be able to satisfy.

(iii) Changes in law or regulation or government policy expected to affect the entity adversely.

Example

In the case of a chemical company, if the government issues new legislation that bans the emission of certain chemicals which are essential to the manufacturing process, significant doubts are raised on the ability of the entity to continue as a going concern.

Furthermore, if the company refuses to adhere to these terms, because of which the regulatory authorities initiate legal proceedings against the company, the company's ability to continue as a going concern would be doubtful.

(iv) Uninsured or underinsured catastrophes occur.

3.5 Mitigating factors

When entities face events and conditions that cast a doubt on its going concern status, entities undertake activities which can mitigate the threat to the going concern. Mitigating factors refer to factors that can reduce the effect of identified events / conditions that cast a doubt on the entity's ability to continue as a going concern.

Example

The effect of an entity being unable to make its normal debt repayments may be counter balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, or obtaining additional capital.

The loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Test Yourself 4

Given below are some indicators that the going concern assumption may no longer be appropriate. Give the appropriate mitigating factors.

(a) Reduced net profit ratio

(b) Inability to pay account payables on due dates

(c) Long term borrowings approaching maturity without any intention of renewal

(d) Short term borrowings used to finance tangible assets

(e) Consistent substantial operating losses

(f) Material deterioration in assets used primarily for the purpose of generating cash flows

(g) Inability to obtain finance to develop key new products

(h) Loss of a major market or franchisee

(i) Shortages or loss of key suppliers or customers

(j) Loss of licence or changes in law that may adversely affect the entity

(k) Non-compliance with legal requirements

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4. Suggest audit procedures and evaluate the appropriateness of the going concern basis in given situations.

[Learning Outcome e]

The audit procedure recommended by ISA 570 (REVISED) for the review of going concern by the auditor, include the following:

1. Risk assessment procedures

While obtaining an understanding of the entity and performing risk assessment an auditor should:

(a) Identify whether there are any indicators which suggest that the going concern status of the entity can be affected.

(b) Enquire whether management has made a preliminary assessment of the going concern status.

(i) If it is made: the auditor should confirm whether it has identified any indicators which can affect its going concern status and the mitigating factors to address them.

(ii) If it is not made: the auditor should discuss with the management about the basis for its intended use of the going concern assumption. Furthermore he should make enquiries of the management about indicators that may cast significant doubt on the entity's ability to continue as a going concern.

Furthermore the auditors must be alert throughout the audit for any indicators which suggest that the going concern status of the entity can be affected.

2. Evaluating management's assessment

The auditor should evaluate:

(a) The process followed by management to make its assessment
(b) The assumptions on which the assessment is based
(c) Management's plans for future action and their feasibility
(d) Whether management has taken into consideration all the facts that the auditor is aware of during the course of audit

A detailed analysis of the going concern status is not called for, when the entity has a history of profitable operations and access to finance.

In the assessment by management, the auditor should consider the same period as considered by management but, if that period is less than 12 months, the auditor should ask management to extend the period to 12 months from the date of the SOFP - or, in some cases for example, where the going concern assumption is in doubt, 12 months from the date that the financial statements are approved.

> Remember the auditor needs to maintain professional skepticism i.e. be alert for indications of threats to going concern status of the entity!

If the auditor is aware of certain conditions or events that might significantly affect the going concern assumption he may inquire of management about its knowledge of events or conditions beyond the period of assessment.

3. Additional audit procedures

After events have been identified by the auditor, (which may cast significant doubt on the entity's ability to continue as a going concern) the auditor needs to obtain sufficient and appropriate audit evidence to confirm whether material uncertainty exists. The audit procedures would also have to take into account the mitigating factors. The procedures include:

(a) Request management to perform an assessment of the entity's going concern status: this applies if the management has not yet performed an assessment.

(b) Review management's plan for future actions: this includes the feasibility of the steps included in management's plan to mitigate the impact of those events and conditions.

The general audit procedures performed by the auditor include the following according to ISA 570 (REVISED).

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 of them has 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 unfulfilled 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.

(c) **When analysis of cash flow is a significant factor in considering the future outcome of events or conditions, the auditor considers:**

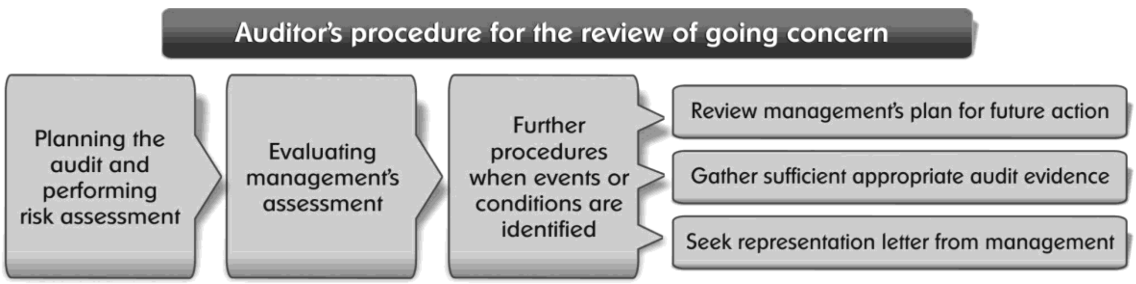
The dependability of the entity's information system for generating the cash flow information.

Whether there is sufficient appropriate supporting evidence for the assumptions underlying the forecast.

(d) **Existence of additional facts or information available since the date on which management made its assessment.**

(e) **Seek written representation from management:** this relates to management's plan for future action and the feasibility of the plans.

Diagram 1: Going concern review by the auditor



Example

Nano Plc appointed Reggie as its auditor in January 20X1. During the audit, Reggie observed that one of Nano Plc's biggest customers had not paid any money for six months. Discussion with management revealed that the customer had not been happy with the services provided by Nano Plc and hence was not interested in continuing his contract with them. The contract was still valid as he had not legally cancelled it. Nano Plc had prepared its financial statements on the going concern assumption without considering the fact that the cancellation of this contract could lead to major losses.

On observing this fact, Reggie should ask management why it did not assess the going concern status of Nano Plc and should now assess whether the entity will be able to operate in the foreseeable future.

Test Yourself 5

Makeyourown.com was an email hosting website created by WebTech Corp that allowed its members to create email accounts on a domain name that was completely made up by them, in return for a small fee.

The company recorded a substantial amount of profits within the first two years of operation and so the founders of WebTech Corp were able to obtain finance from banks and venture capitalists easily. At the peak of the dot-com bubble in November 19W7, the company's stock recorded an all time high of Tshs291 a share.

Around this time the website launched 24X7market.com (financed through a long term bank loan) that allowed registered members to buy and sell items online. This facility was largely appreciated and registered a record number of hits and transactions within the first quarter of its launch.

By the end of 20X2, the dot-com bubble had burst and the company's stock price had fallen to Tshs3 a share. Andy McHolden, one of the company's three co-founders, suffered a severe heart attack and resigned.

The company, which had ventured into several other internet related businesses besides 24X7market.com, was barely able to pay off the instalment on its bank loan due to large cash shortages.

The reason for these cash shortages was the large payments were due from other websites which advertised on makeyourown's homepage. These web based companies were now suffering because of the burst of the dot-com bubble and many were in the process of filing for bankruptcy. The dividend declared for 20Y0 still remained in arrears due to cash flow issues.

In order to salvage its failing business, the company launched a social networking website that allowed people to connect with friends and relatives as well as make new friends. The online social networking market at that time was dominated by a few well known players due to which it was difficult to gather market share.

The directors themselves, after considering the overall internal and external situation, were considering filing for bankruptcy.

Required:

As WebTech's auditors, how would you assess the position of the firm as a going concern for the annual accounts ended on:

(a) 31 December 19W7 (b) 31 December 20X2

Also state the impact of your answer on the audit report.

5. Discuss what happens after the auditor issues a report that mentions going concern issues. [Learning Outcome f]

Based on the audit procedures followed by him, the auditor is of the opinion that a material uncertainty exists relating to conditions or events that might cast a significant doubt on the going concern status of the entity. In this case he should ask management to disclose this uncertainty clearly in the financial statements. The auditor has to **ensure** that the financial statements:

Adequately describe the principal events and conditions that cast significant doubt on the going concern and management's plans to deal with these

State clearly that, because of the above stated uncertainties, the **entity might not be able** to realise its assets and discharge its liabilities in the normal course of business

Diagram 2: Reporting implications in relation to the going concern issues

Appropriate evidence		Disclosure in FS		Effect on Audit Report
✓	+	✓	=	Unmodified opinion & emphasis of matter / disclaimer of opinion
✓	+	✗	=	Qualified / adverse opinion (i.e., modified opinion)
✗	+	✗	=	Adverse opinion (i.e., modified opinion)
No assessment made			=	Qualified / disclaimer of opinion (i.e., modified opinion)

Reporting requirements in relation to the going concern issues when the going concern assumption is appropriate but a material uncertainty exists

The **reporting requirements** of the auditor differ depending on whether the management has made adequate disclosures of the material uncertainties and events that may cast a significant doubt on the going concern status of the entity.

1. Proper disclosure is made in the financial statements

When the financial statements adequately disclose the principal events and conditions that give rise to significant doubt over the entity's ability to continue in future and also management's plan to deal with these events, the auditor should express an unqualified opinion. Furthermore he should add an emphasis of a matter of paragraph stating these matters and drawing attention to the note in the financial statements that discloses the matters set out by management as explained above.

On rare occasions in situations involving multiple material uncertainties significant to the financial statements as a whole, this report will contain a disclaimer of opinion!

He should ensure that the disclosure draws the readers' attention towards these events and conditions and they are aware that the entity might not be able to realise its assets and discharge its liabilities in the normal course of business.

Example

The auditor may include the following paragraph when he is satisfied of the adequacy of the disclosure made by the management in the financial statements.

"Without qualifying our opinion, we draw attention to Note14 in the financial statements which indicates that the Company incurred a net loss of Tshs5,000,000 during the year ended 31 December 20W9 and, as of that date, the Company's current liabilities exceeded its total assets by Tshs2,000,000. These conditions, along with other matters as set forth in Notes 14, indicate the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern."

2. Adequate disclosure is not made in the financial statements

ISA 570 (REVISED) states that, when adequate disclosure is not made in the financial statements, the auditor should express a qualified or adverse opinion as appropriate.

The report should also include specific reference to the fact that there is a material uncertainty that may cast significant doubt over the entity's ability to continue as a going concern.

Example

An example of a relevant paragraph when a qualified opinion is expressed is given here:

Basis for Qualified Opinion

The Company's financing arrangements expire and amounts outstanding are payable on March 19,20X1. The Company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty which may cast doubt on the company's ability to continue as a going concern and that the company may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes to it) do not disclose this fact.

Qualified Opinion

In our opinion, except for the incomplete disclosure of the information referred to 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 the Company as at December 31, 20X0, and of its financial performance and its cash flows for the year then ended in accordance with …

(Example as given in ISA 570, IFAC, 2009 edition)

---

3. Going concern assumption is not appropriate

If, in the opinion of the auditor, the entity will not be able to continue as a going concern, yet the financial statements are prepared on a going concern basis, the auditor should give an adverse opinion regardless of whether the disclosure is made or not.

Example

An example of a relevant paragraph where an adverse opinion is expressed is given below:

Adverse Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, because of the omission of the information mentioned in the *Basis for Adverse Opinion* section of our report, the accompanying financial statements do not present fairly (or *do not give a true and fair view of*), the financial position of the Company as at December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with …………………

Basis for Adverse Opinion

The Company's financing arrangements expired and the amount outstanding was payable on December 31, 20X1. The Company has been unable to conclude re-negotiations or obtain replacement financing and is considering filing for bankruptcy. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this fact.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

(Example as given in ISA 570)

When the entity's management is convinced that the going concern assumption used in the preparation of the financial statements is not appropriate and they should prepare the financial statements on an alternative basis then the auditor's opinion can be different. In this case, based on the additional audit procedures for the revised statements followed by him, he may issue an unqualified opinion if he determines that the alternative basis is appropriate and an adequate disclosure is made. However, he may include an emphasis of a matter paragraph in the auditor's report to draw the readers' attention to this fact.

Example

"On 15 July 20W9, Learning Resources Live closed down its operations in the Northern region because of political instability in the region. The Northern region accounted for 55% of the overall revenue of the company. In our opinion, the company has made adequate disclosures in this respect and has used the revaluation technique of measuring its assets and liabilities, which is appropriate in such a situation. "In our opinion, the financial statements of Learning Resources Live for the year ended 31 December 20W9, in light of the situation explained in the preceding paragraph, present fairly the financial position of the entity as on that date."

---

4. Management is unwilling to make or extend its assessment

If the auditor is of the opinion that the period for which the assessment is made by management is not sufficient, or if management has not made the assessment, the auditor may ask to extend the period of assessment. If management is unwilling to do so, the auditor should express a qualified opinion or a disclaimer of opinion in the audit report, as this is a limitation on the scope of the audit since it may not be possible for the auditor to obtain sufficient appropriate evidence regarding the use of going concern.

Example

An example of a modified audit report where a limitation of scope exists is given below.

"We are concerned that the company does not have enough cash to pay off its short term liabilities. This matter was discussed with management but they are unable to give us any guidance on where additional funding may be coming from. In the absence of this funding the company may not be able to continue as a going concern.

"In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to whether management can provide additional funding, the financial statements give a true and fair view of...."

In such a case, the auditor is in no way responsible for making management carry out the assessment.

Circumstances may also exist where the auditor may still be satisfied about the entity's going concern assumption in the absence of management's assessment, when it has a history of profitable operations and ready access is available to its financial resources. In any other cases the auditor should modify the audit report according to ISA 705 (REVISED) 'Modifications to the Opinion in the Independent Auditor's Report.'

Test Yourself 6

My Fair Lady is a company which manufactures designer clothes. The raw material used is of high quality and expensive. The company uses specialised machinery for production. The company enjoys a monopoly in this line of production. The director of the company is very aggressive and wants to increase the company's profits by expanding its operations. He intends to raise finance for this expansion through a bank loan. The company accordingly manages to take a loan from its bank despite already being heavily in debt and buys the new, advanced machinery required for faster and high quality production.

The directors of the company have not fulfilled the requirements of its workers for a long time and hence the workers have gone on strike. Production has therefore come to a standstill. Finding a replacement for these workers is very difficult for management and hence the strike is adversely affecting business. The entity, being heavily in debt, cannot fulfil the demands of its workers and hence a compromise is also not possible.

Marina has been appointed as the auditor of the company. The financial statements reveal that the payables show a considerable outstanding amount with no matching receivables. There is an increase in liabilities (loans from banks) since the interest and instalments to be paid to the bank are long overdue. Marina feels that the going concern status of the entity is in danger; however management explains to her that they are in the process of reaching a settlement with the workers and soon their production will start which will solve their problem. However, there is no documentation on the settlement process with the workers.

Required:

Describe the different ways in which Marina's audit report might refer to the going concern status of the company.

---

6. Discuss the use of written representations to support other audit evidence. [Learning Outcome g]

6.1 Management's responsibilities

ISA 580 states that the auditor shall request written representations from **management** with appropriate responsibilities for the financial statements and knowledge of the matters concerned**.** The responsibilities mentioned in the ISA are:

1. Preparation of the Financial Statements

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.

2. Information Provided and Completeness of Transactions

The auditor shall request management to provide a written representation that:

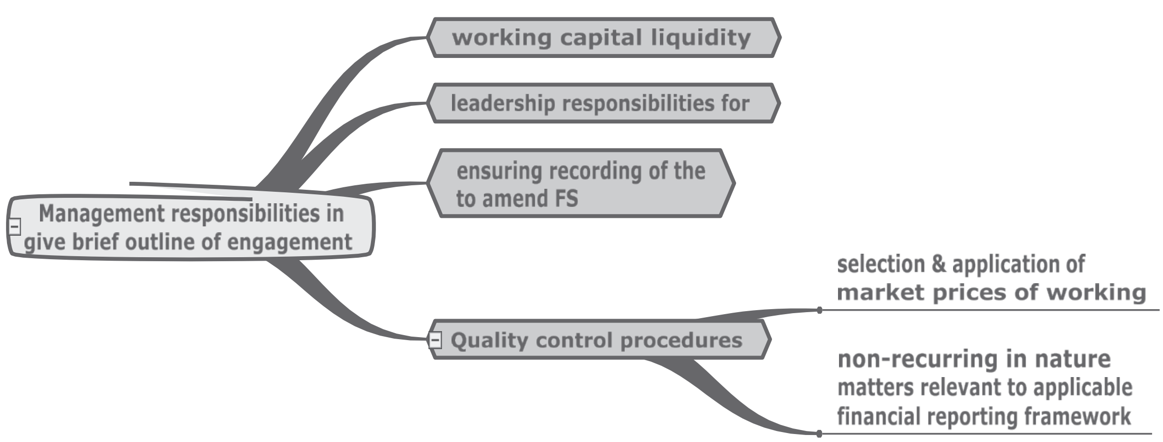
(a) it has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement, and
(b) all transactions have been recorded and are reflected in the financial statements.

Other Written Representations

The provisions of other ISAs (including ISA 240, ISA 550 and ISA 570 (REVISED)) require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. They may include representations about the following:

Whether the selection and application of accounting policies are appropriate; and
Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognised, measured, presented or disclosed in accordance with that framework:
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, the 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 noncompliance.

SUMMARY



In some cases, however, auditor may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialised knowledge relating to the matters about which written representations are requested. Such individuals may include:

An actuary responsible for actuarially determined accounting measurements.
Staff engineers who may have responsibility for and specialised knowledge about environmental liability measurements.
Company's own solicitor who may provide information essential to provisions for legal claims.

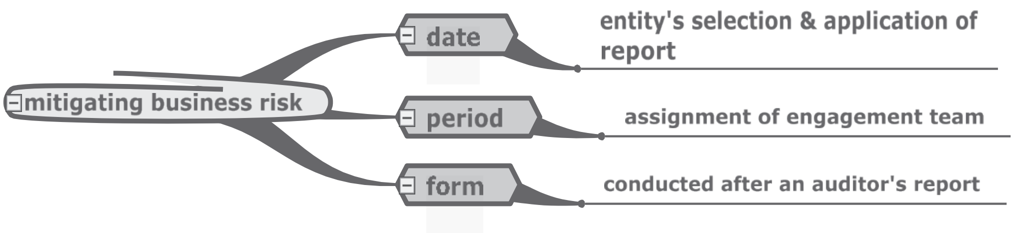
Date of and Period(s) Covered by Written Representations

The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Form of Written Representations

The written representations shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required by Paragraphs 10 or 11 of ISA 580, the relevant matters covered by such statements need not be included in the representation letter.

SUMMARY



Appendix 2 of ISA 580 provides an example of an illustrative representation letter. The letter is reproduced below.

Example

Illustrative Representation Letter

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, 20X9. It is assumed in this illustration that the applicable financial reporting framework is International Financial Reporting Standards; the requirement of ISA 570 (REVISED) 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.

(Entity Letterhead) (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 Financial Statements (to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

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)

Continued on the next page

Any other matters that the auditor may consider appropriate. 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 the fraud could have a material effect on the financial statements. (ISA 240)

We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (ISA 240)

We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (ISA 250)

We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (ISA 550)

Any other matters that the auditor may consider necessary

(Management)

6.2 Doubts as to the reliability of written representations

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 shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general.

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general.

If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report. The auditor shall disclaim an opinion on the financial statements.

6.3 Requested written representations not provided

ISA 580 requires the following course of action to be followed where written representations are not provided:

1. **Discuss the matter with management**,

2. **Re-evaluate the integrity of management** and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

3. **Take appropriate actions**, including determining the possible effect on the opinion in the auditor's report. The auditor shall disclaim an opinion on the financial statements.

Test Yourself 7

(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 Tshs80 million with profit before tax of Tshs3 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 Tshs1million 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 representation letter
(ii) If appropriate, draft the paragraph for inclusion in the representation letter

(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:

(i) Discuss whether the directors' argument is true or false and give reasons for your answer.
(ii) State the steps that an auditor should take under circumstances where an auditor feels that representation is required but management refuses to sign.

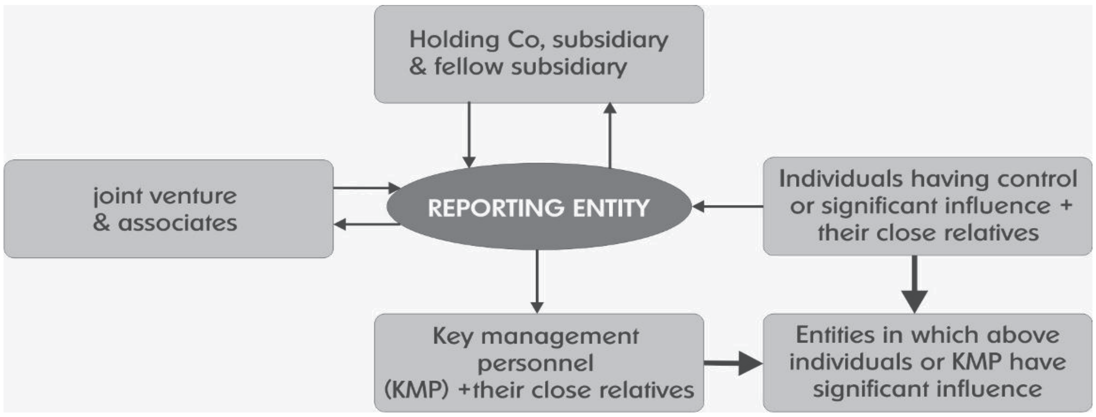
7. Discuss the specific audit concerns and procedures with regards to related parties and related party transactions.
Identify the circumstances relating to the existence of unidentified related parties and explain appropriate audit procedures.
[Learning Outcomes h and i]

Increasing globalisation has resulted in an increase in transactions between group and associated companies. These transactions can have an important effect on income statement and the statement of financial position of the businesses concerned.

7.1 Related parties

Related parties are those parties considered to be related if one party has the ability to control or exercise significant influence over the other party in making financial decisions. In the context of above, a related party could be management, owner or any person who is in a position to influence an entity's operating policies and financial decisions.

Diagram 3: Examples of related parties



According to ISA 550, the objectives of the auditor are:

1. Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:

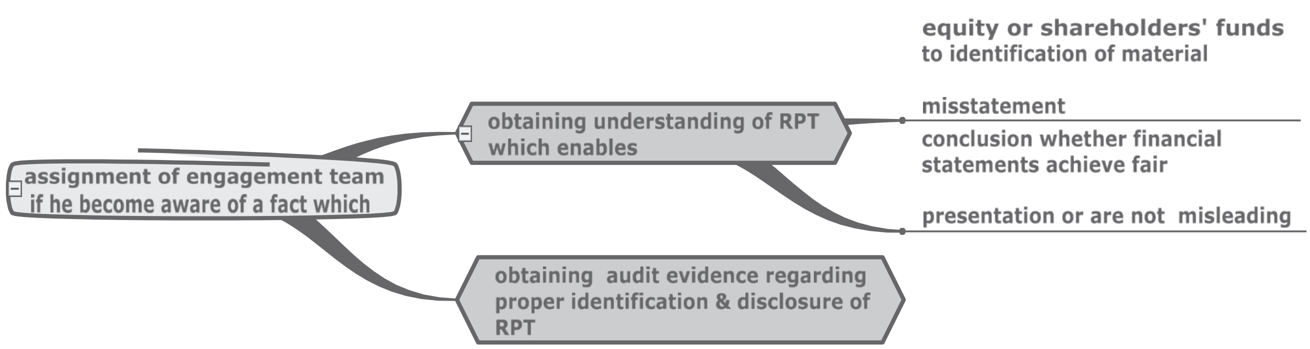
(a) To recognise fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and

(b) To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:

(ii) Achieve fair presentation (for fair presentation frameworks); or
(iii) Are not misleading (for compliance frameworks); and

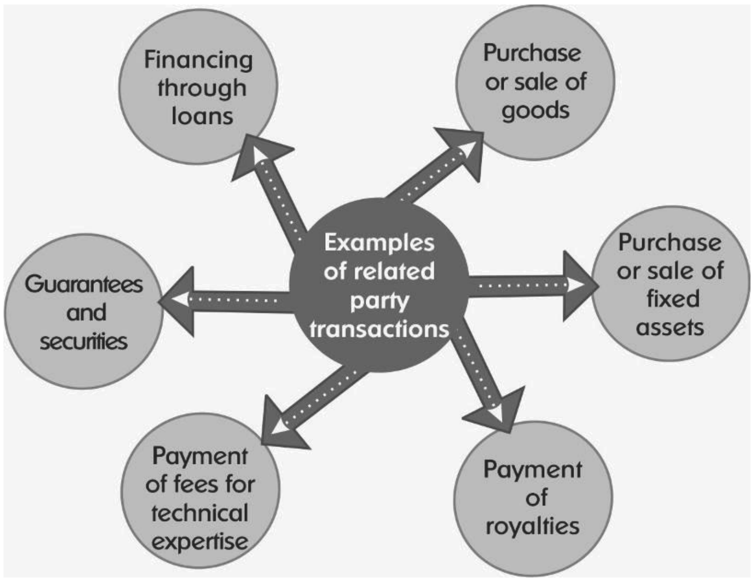
2. In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

SUMMARY



7.2 **Related party transactions** refer to the transfer of resources or obligations between related parties irrespective of the value of these transactions.

Diagram 4: Examples of related party transactions



Sometimes, group companies may not make any transactions between one another during a financial year. All related parties and the transactions between them should be disclosed in the financial statements. This is because the disclosure of related party transactions will allow the users of the financial statements to determine whether the transaction has led to a manipulation of the financial statements.

Example

Healthy Ltd is a holding company of Sick Ltd. Healthy is a fast growing cash rich company. However, Sick has been making operating losses continuously for the last two years. Sick's finished product is used as a major raw material by Healthy.

To show lower profits and thereby pay lower taxes, Healthy has decided to purchase raw materials from Sick at rates which are higher than the market rate for the raw materials.

Here, Healthy and Sick are the related parties as one party, Healthy is in position to influence and control the operating policies and decisions of another party, Sick.

Furthermore, the purchase transaction by Healthy from Sick (and the sale transaction from Sick to Healthy) will be recognised as related party transactions in the books of Healthy (and Sick).

In normal business practice, there are no legal restrictions when dealing with related parties. However, the auditor faces a high risk of material misstatements on transactions relating to related parties. This can be understood from the example above in which transactions were not carried out on normal commercial terms. These transactions may be motivated by a factor other than business considerations. So, related party transactions always carry a risk.

7.3 Audit concerns with related parties and relates party transactions

While auditing related party transactions, the auditor faces the following specific audit problems:

1. **Identification of related party**: the main problem faced by an auditor is the identification of the related parties for the following reasons:

(a) The **definition of related party is complex** and partly **subjective in nature**. Many times, it becomes difficult for management to decide whether a party is related.

(b) Many **accounting and information systems are not designed to identify the related party** from other party. So, it requires extra attention to be paid by the auditor.

(c) **Management is primarily responsible for the identification and disclosure of related parties** and transactions with them. So, the **auditor must rely on management disclosures** to some extent.

(d) **Corporate structure is very complex to identify the related party**.

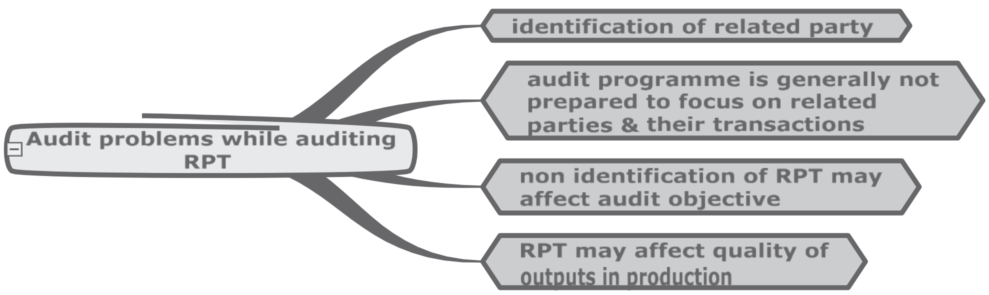
2. An **audit programme is generally not prepared to focus on the related parties and its transactions**. The primary objective of an audit is to give an opinion on how true and fair the financial statements are and to ensure that it is free from material misstatement. An auditor is not expected to detect all the material related party transactions.

3. In case of related party transactions, the risk of material misstatement or fraud is increased. **Non-identification of related party transactions can affect the overriding audit objective of showing a true and fair view.**

4. Related party transactions may affect the quality of information expressed by the financial statement rather than the actual situation.

In order to ensure that all related party transactions which are disclosed in the financial statements do not contain material misstatements, it is important that auditors first identify the related parties. However, identifying the transactions is a complicated process and so the list of related parties is normally provided to the auditors by management and those charged with governance.

SUMMARY



According to ISA 550, the auditor should perform the following audit procedures and related activities in order to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.

7.4 Procedure for identifying related parties

Auditor can follow the following audit procedures for identification of related party and its transaction:

1. Review **prior year's working paper and financial statements** to confirm that the list provided to the auditor includes the related parties which were identified the previous year.
2. Review the **entity's procedure to identify related parties**.
3. Ask for **the copy of minutes of various meetings** i.e. board meeting, annual general meeting and confirm whether there is any reference to related parties.
4. Collect **information about key management personnel.**
5. Review **joint venture agreements** and confirm that joint ventures are included on the list.
6. Verify **secretarial records** for interested parties, register of director's interest, names of principal shareholders and verify whether they fall within the scope of related parties.
7. **Enquire with previous auditors** about related parties and compare the information provided with the list.
8. Ask for **income tax returns and information made available to regulatory authorities** and verify whether the information relating to related parties matches with the list.
9. Review **correspondence with lawyer** for evidence of related parties.
10. Ensure that **all names of pension funds** (established for benefit of employees) and their management are included in the list.

7.5 Audit procedure to determine the value of related party transactions

1. **Verify and inspect the transactions and documented evidence of the transactions made with related parties**. E.g. purchase / sale invoices, executed copies of agreements, contracts and other relevant documents.

2. **Discuss the business purpose** of related party transactions with appropriate person i.e. management or directors.

3. **Confirm that the terms and conditions** of the transactions with related party are at market prices. The auditor should confirm that the terms are the same for similar kinds of transactions with a third party. For example, if a raw material is purchased from a related party, the auditor will verify whether the commercial terms of the transactions are similar to the commercial terms for the same raw material in the open market.

4. **Carry out the audits of inter-company account** balances to cross check the transactions. This will include:

(a) Cross checking the related party's statement of account with the transactions recorded in the entity's books.
(b) Confirmation of other terms such as guarantees and other significant data, with the other party to the transaction.

5. **Verify whether the transaction has been approved by the board of directors or other appropriate authorities.**

6. **Confirm or verify material information with third parties involved such as banks, guarantors or agents to obtain a clearer understanding of the transaction.**

7. **Confirm that the transaction is authentic.** For example, if purchases are made the auditor will verify whether the purchase was a genuine requirement to process a sale order.

8. **Verify the legality and completeness of the disclosed transactions declared by the directors.** For example, if the company has purchased property from a director but the property papers are not transferred to the name of the company.

9. The above point leads to important audit evidence, which is **the ascertainment of ownership rights of all assets purchased from related parties.** This will enable the auditor to make the 'rights and obligations' assertion.

10. **Assess the recoverability of amounts due from directors and other related parties.**

11. **Examine all agreements and contracts involving directors and management personnel and trace the details of those transactions.**

Identification of the related party is the fundamental difficulty faced by the auditor for a number of reasons. However, the auditor must be alert in order to identify them due to the potential risks associated with related parties. Normal accounting and auditing procedures and practices do not cover the detection of related party transactions yet non-detection and verification of related party transactions may lead to a misstatement in the financial statements.

In following routine audit procedures there is always the risk of the non-identification of related parties.

7.6 Circumstances which indicate the existence of a related party

The following are the circumstances that indicate the existence of a related party.

1. Economic substance of the transaction differs from form

In situations where the substance and economic reality of a transaction is different from the legal form, the possibility of a related party exists and it becomes necessary to assess the transaction on its substance and economic reality.

Example

Ben is the auditor for Sharpline Inc, a courier business. Sharpline has recorded revenue of Tshs10,000 from the courier charges received from Rapid Flights Inc, another courier company. Ben noticed that Sharpline has recorded another transaction with Rapid Flights in which Sharpline has given them a loan of Tshs9,700.

In this transaction, Ben identified the legal form i.e. sale from a customer; but in this case, if the two transactions are considered together, the sale may be without any consideration as the same is funded by Sharpline itself by way of loan. So the substance, i.e. the economic reality of the transactions, is in doubt.

Ben realised that possible related party transactions exist.

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2. No logical business reason

The auditor can identify the transaction where there is no logical business reason to effect the particular transaction.

Example

Richfield Ltd is a fast growing cement manufacturing company. It has many branches across the country. The business has expanded at a very fast rate from last year and the company has purchased new land as the new location for the introduction of an advanced product. The company purchased the land from Dixie Plc. Alice, the auditor, had received sufficient evidence of the purchase of land.

However, Alice discovered that Richfield purchased other land from Dixie within one month of the earlier sale. This transaction was not supported with an agreement. Alice felt that there was no logical business reason for the second deal and felt that there was the possibility of a related party transaction.

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3. Not adhering to the set methods of processing transactions

Transactions that are not processed in the routine manner may be on account of related party transactions.

Example

Martin is the auditor of Pole Ltd. According to the internal control manual, the following method is followed by the company for the purchase of assets:

Invitations of minimum of 3 quotations
Vendor selection process
Approval by board
Raising a purchase order
Actual delivery

Martin verified all the transactions relating to purchase of assets made during 20W7. All the transactions were processed according to the procedures mentioned in the internal control manual, except for two transactions. This related to the purchase of office furniture amounting to Tshs50,000.

For the purchase of furniture, there was no board approval. Further, there was only one quotation which was invited from the vendor. This indicates that the set process was not followed for the vendor selection.

Martin was alerted to these transactions which were not processed in the routine manner and so there is the possibility of a related party transaction.

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4. Terms of trade different from normal

If the terms of trade are different and not according to routine business transactions, there can be a related party transaction.

Example

Brown Bank's management has given a car loan to two customers at an interest rate of 11.5% p.a. as opposed to the normal rate of 13% p.a. Ralf, the auditor, noticed the risk of unidentified related party transaction and asked for the audit evidence to support the lower interest rate.

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5. High volume with one customer / supplier

An extraordinary high volume of sales or purchases with one customer or vendor is also a risky area as this can be construed as a related party transaction.

Example

Enrich Ltd manufactures tools and had a turnover of over Tshs200,000 in 20W7. On the verification of the sales register, auditor Ronnie found that sales amounting to Tshs130,000 were given to Inde Ltd. 65% out of the total sale. Ronnie felt that the situation was risky and asked for an explanation from management. He suspected that a related party transaction existed.

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6. Unrecorded transaction

If there are any unrecorded transactions, the auditor can assess whether there is a genuine error or whether the mistake had been made on purpose.

Example

During the course of the audit of Tall Inc, Sam discovered that the cash account showed cash deposits in the supplier's account. On inquiring, Sam found that they are against the routine purchase invoices which were not recorded in the account books.

Sam verified the account in detail to determine the possibility of a related party transaction.

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7. Transactions not having adequate evidence

An auditor always asks for the audit evidence which is sufficient and reasonable to cover the risk. If any particular transaction is effected without adequate documentary evidence, there is a probability of the transaction being a related party transaction e.g. absence of documentary evidence to support an investment made in the shares of a company.

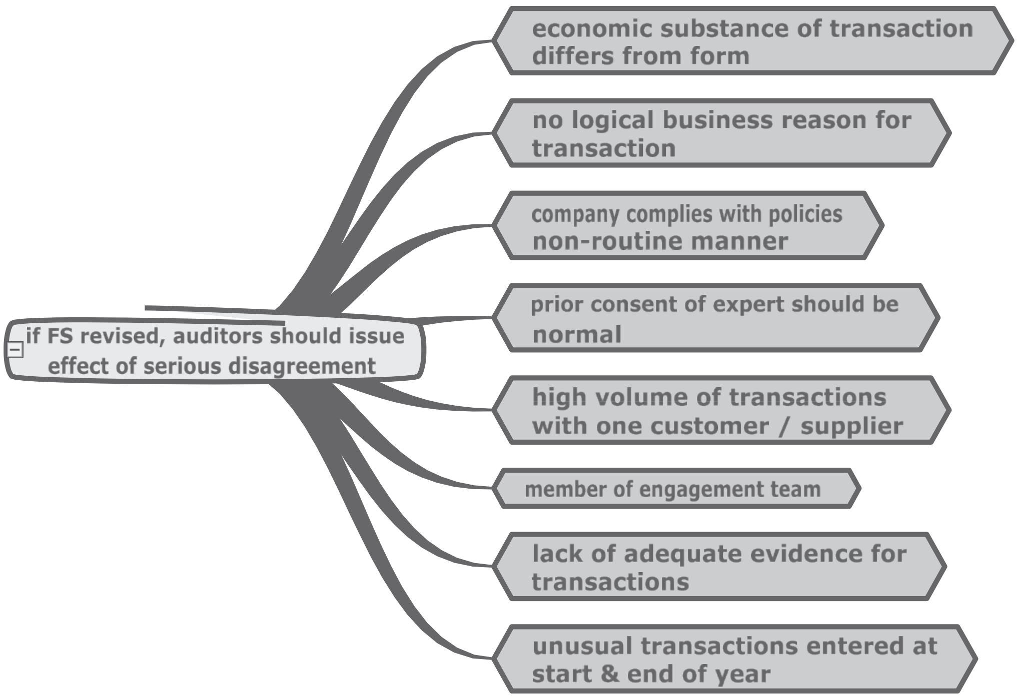
8. Unusual transactions entered at the start and end of year

Example

Tom is the auditor of Reliable Inc. During the course of the audit, he discovered that there are many entries in one customer's account for giving and receiving back the short term loan. The entries were made at the beginning and end of the year. The loan taken was repaid within 10-15 days of acceptance.

Tom wanted to verify all those transactions and collect adequate evidence for the possibility of a related party transaction.

SUMMARY



Test Yourself 8

Tufstyle Leathers Ltd is a producer of leather garments and other accessories like belts, bags etc. The company is a significant competitor for its rivals in both domestic and international markets and has well-known brands. Amy is an audit manager responsible for the audit work for the year 20X7.

While reviewing the financial statements and related documents, Amy noticed that the company had purchased a new machine costing Tshs35 million at its factory, from Vesta Technologies. The purchases made were not supported by a price comparative sheet (i.e. a sheet showing different quotes from different companies) and did not include three alternative quotations from vendors of the machine which Tufstyle purchased.

Therefore, this was not in accordance with the internal controls of the company even though the other capital purchases made by the company were in accordance with the internal controls set out in the company's internal control manual.

Required:

Discuss the audit procedures which Amy must carry out in order to ensure that the financial statements do not contain material misstatements.

8. Discuss the impact of outsourced functions on the conduct of an audit.

[Learning Outcome j]

8.1 Extent to which work is outsourced (including accountability)

In today's age of e-commerce core competencies are outsourced as well as non-core competencies. The following case study of British Airways is an example of a business which outsources both critical and non-critical activities are outsourced.

Case Study

Although customers may not be aware of this fact, British Airways (BA) is an example of an entirely outsourced model.

Tickets for BA flights are booked through a call centre i.e. the booking function is outsourced. The aircraft, crew and cabin staff are provided by Maersk and the on-flight meals are provided by Gate Gourmet.

In the above scenario, who should be held responsible for any inconvenience caused? What should the auditor of BA do if there are some manipulations carried out by the staff or Maersk or Gourmet?

To answer the above questions, the auditor of BA should first find out the extent to which the work is outsourced as this will determine whether BA is able to rely completely on the policies and procedures of the service organisation or whether it remains accountable.

If the auditor concludes that the service organisation only provides the cabin crew while BA is responsible for training them, then BA is responsible for implementing effective policies and procedures for the crew with respect to training, appraisal, health care etc.

However, if the service organisation maintains accountability for the crew members, then BA may have decided to rely on the policies and procedures of the service organisation. **Note that the outsourcing of cabin crew will not have direct impact on the financial statements.**

8.2 Audit Considerations Relating To Entities Using Service Organisations

In accordance with ISA 402, Audit Considerations Relating To Entities Using Service Organisations, the auditor should determine the significance of the service organisation's activities to the entity and the relevance to the audit. Under the Clarity Project, this ISA is updated in view of rapid increase in the use of service organisations. The updated ISA, provides clarity on issues which resulted into the complexity of relationships between the auditor and service organisation.

Definition

A service organisation is a third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

A service auditor is an auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.

A user entity is an entity that uses a service organisation and whose financial statements are being audited. A

user auditor is an auditor who audits and reports on the financial statements of a user entity.

IFAC Glossary of terms

ISA 402 Audit Considerations Relating to Entities Using Service Organisations has identified the following activities (not exhaustive) which will help the auditor of the outsourcing organisation to determine the significance of the service organisation's activity to the outsourcing organisation and relevance to the audit.

- Maintenance of accounting records
- Management of assets
- Other finance functions
- Authorisation and accountability

ISA 402, Audit considerations relating to an entity using a service organization, provides guidance on how the user auditor:

Obtains an understanding of the user entity,
Including internal control relevant to the audit
Sufficient to identify and assess the risks of material misstatement; and

Designs and performs further audit procedures responsive to the risk of material misstatement due to use of work of service organizations (refer to the example on Enrich discussed above).

The auditor of the entity should take into account the following considerations to understand and assess the impact, significance and related risk of using a service organisation:

1. The nature of the services provided by the service organization and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;

When any work is outsourced to the service organisation**, the auditor should consider its impact on the internal control of the entity**. If the auditor concludes that outsourcing to service organisation significantly affects the accounting and / or internal control system of the entity, they should obtain sufficient understanding of the entity and its environment, including the internal control. This will help him in assessing the risk of material misstatement and designing and performing further audit procedures.

Example

The auditor should determine the function outsourced e.g. payroll preparation, collection of debts, calculation of tax etc. and also the nature and extent of the function outsourced i.e. **whether all** activities, from authorisation to maintenance of accountability are outsourced **or only** the recording and processing of data is outsourced.

Suppose the client has outsourced the entire work related to the preparation of the payroll. The service organisation has an effective internal control system to meet all payroll control objectives, except to check the authenticity of the employees on the payroll.

The external auditor will then have to assess the risk of material misstatement as high and will perform audit procedures to check the authenticity of the employees on the payroll, e.g. physically verifying the employees when they receive their pay packets.

The auditor should obtain an understanding of the **nature of the services provided** by the service organisation, **terms of contract** etc. through the agreement between the client and the service organisation.

From the agreement, the auditor will come to know what services are outsourced, to what extent the services are outsourced, how the responsibilities are fixed and other details of the agreement.

2. The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation

In certain situations, the transactions processed and the accounts affected by the service organisation may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.

Example

In the case of a furniture-making entity which has a precious stone as an item of inventory (bought to decorate a table) the auditor may not seek an opinion from an expert for the valuation of that stone.

However, if an entity deals in precious stones, precious stones will be the biggest asset appearing in the financial statements of the entity. Under- or over-valuation of the inventory, i.e. precious stones, will affect the profitability of the entity and therefore the auditor may decide to seek the opinion of an expert.

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3. The degree of interaction between the activities of the service organisation and the user entity

An organisation sometimes outsources some of its functions to a service organisation. Outsourcing work to a service organisation involves the following two situations :

(a) Outsourcing of the recording of transactions and processing of related data but not authorisation and maintenance of accountability

In this case, the entity may be able to implement effective policies and procedures within the entity. Also, the service organisation may have certain internal controls. The auditor should assess the effectiveness of the internal controls of the entity as well as those of the service organisation and interaction between the internal control systems of the entity and those of the service organisation.

Example

ICC Ltd, a leading bank, outsourced the work of designing and implementing core banking solutions to Infocom Ltd, a leading IT service provider. Infocom developed a core banking solution for ICC Ltd. Infocom will formulate certain internal controls in the core banking solution to ensure its effective implementation.

In addition, ICC Ltd should have certain internal controls in relation to the core banking solution to support the internal controls already formulated by Infocom in the solution. The external auditor of ICC Ltd should assess the effectiveness of the internal control at ICC Ltd as well as at Infocom (regarding security of the information of ICC Ltd) and also the co-ordination between the two systems.

(b) Outsourcing all the work related to accounting

This means recording of transactions, processing of related data, authorisation and also maintenance of accountability. When all the work is outsourced, the entity has to rely on the policies and procedures prevailing at the service organisation. The service organisation may establish and execute policies and procedures that affect the entity's internal control. The entity has to rely on the service organisation implementing its policies. The auditor of the entity has to assess the effectiveness of the internal control system of the service organisation.

Example

Enrich Ltd has outsourced its assets management to Quality Service Ltd. Internal controls relating to the maintenance of the assets will be implemented only by Quality Service and Enrich Ltd has to rely on the internal controls executed by Quality Service Ltd. An external auditor of Enrich Ltd should assess the effectiveness of the internal control system of Quality Service Ltd.

Therefore the auditor should examine the interaction of the activities of the service organisation and those of the user entity in order to understand the extent to which the internal controls of the service organisation can be relied upon.

4. Contractual terms for the activities undertaken by the service organisation

The agreement between the user entity and the service organisation will provide information about the following matters:

(a) Information to be provided to the user entity
(b) Responsibilities for initiating transactions relating to the activities undertaken by the service organisation
(c) The form of records (including access to the records) to be maintained by the service organisation, in accordance with the appropriate regulatory bodies
(d) The type of report on its controls (i.e. type 1 or type 2) the service organisation will provide to the user entity
(e) The user auditor's rights of access to the accounting records (and other information necessary for the conduct of the audit) of the user entity maintained by the service organisation
(f) Whether the agreement allows for direct communication between the user auditor and the service auditor.

5. Tests of control

(a) Taking into account the above mentioned factors the user auditor may use a service auditor to perform procedures on the user auditor's behalf, such as:

(i) Tests of control at the service organisation; or
(ii) Substantive procedures on the user entity's financial statement transactions and balances maintained by the service organisation.
(b) The user entity may establish controls over the service organisation's services. In this situation, the user auditor may perform tests of the user entity's controls over the service organisation's services.

Example

Jackson Traders outsources the processing of its payroll transactions to Beta Processors. Jackson establishes the following controls over the submission and receipt of payroll information that could prevent or detect material misstatements:

Each month, before the payroll is authorised, Jackson's accountant compares the data (e.g. information on new joinees, their salary details, leave information relating to all employees) submitted to Beta with reports of information received from Beta after the data has been processed.
The accountant recalculates a sample of the payroll amounts for clerical accuracy and reviews the total amount of the payroll for reasonableness.

In this situation, Mason (Jackson's auditor) may perform tests on Jackson's controls over payroll processing that would provide a basis for Mason to conclude that Jackson's controls are operating effectively for the assertions related to payroll transactions.

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6. Additional procedures

If the user auditor is unable to obtain a sufficient understanding of the user entity, the user auditor shall obtain that understanding from one or more of the following procedures:

(a) Obtaining a type 1 or type 2 report, if available

The auditor should consider the scope of the work performed by the service auditor and assess the usefulness and appropriateness of the reports issued by him. The auditor should also consider the professional competence of the auditor of the service organisation in the context of the work assigned to him.

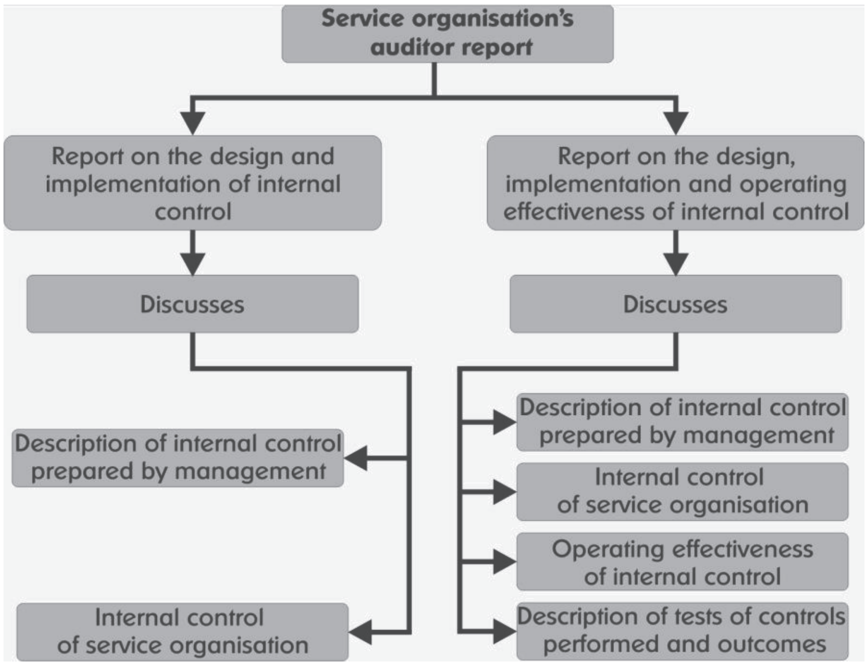
The **report** of the service auditor will ordinarily be one of the following two types:

Type	Comment on description and design of internal controls	Comment on effectiveness of internal controls	Reference to tests of control and results thereof
Type 1	Yes	No	No
Type 2	Yes	Yes	Yes

A **Type 1** report **helps in understanding the internal control** of the entity, but an auditor cannot use a Type 1 report as audit evidence about the effectiveness of the controls as this is not provided.

A **Type 2** report can be **used as audit evidence** as, the auditor of the service organisation has performed tests of control and commented on the effectiveness of the internal control system.

Diagram 5: Service organisation's report



(b) Contacting the service organization, through the user entity, to obtain specific information

The auditor may also consider third party reports on the service organisation such as an internal audit report, regulatory agencies report etc. to determine the effectiveness of the internal control system.

Example

Regulatory agencies such as banking regulators, stock exchange commission's etc. sometimes visit an organisation to check its operations. They provide reports with their remarks on the working of the organisation. These reports by regulators can be used by the auditor of the entity to evaluate the effectiveness of the internal controls of the service organisation.

(c) Visiting the service organisation and performing procedures that will provide the necessary information about the relevant controls at the service organisation

The external auditor may consider visiting the service organisation and performing tests of controls e.g. inquiry, observation etc.

Example

If the maintenance of assets (investments i.e. title deeds, shares, debentures etc.) of the entity has been outsourced, the auditor may decide to visit the service organisation (with whom investment papers are kept for security or for dealing i.e. an investment company) and may review the system existing in the service organisation in relation to the security of assets. If the auditor finds that the papers are kept locked, in the custody of a responsible person, and are protected from theft, fire, flood, misappropriation etc., they will obtain evidence that the investment papers are properly safeguarded.

If not, the auditor may raise this issue with the entity.

Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organisation

7. Responding to the Assessed Risks of Material Misstatement

In responding to assessed risks in accordance with ISA 330, the user auditor shall:

(a) Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from the records held at the user entity

This is facilitated by audit procedures such as:

(i) Inspecting records and documents held by the user entity;
(ii) Inspecting records and documents held by the service organisation;
(iii) Obtaining confirmations of balances and transactions from the service organisation;
(iv) Performing analytical procedures on the records maintained by the user entity or on the reports received from the service organisation.

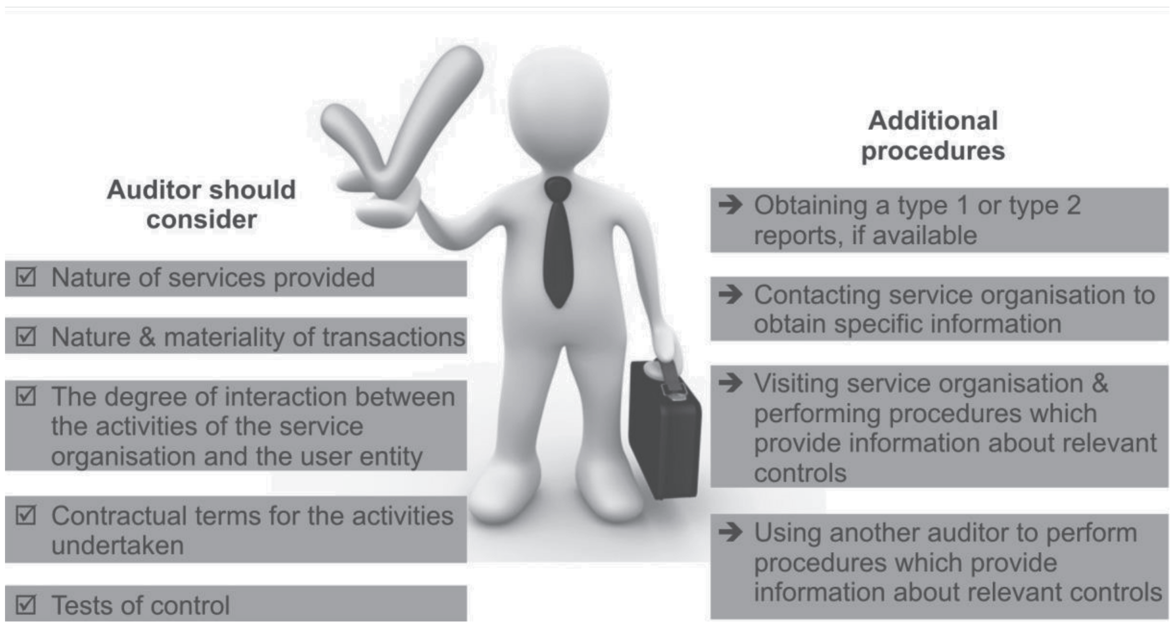
The user auditor of the entity should consider whether the nature, timing and extent of the tests carried out by the auditor of the service organisation provide **sufficient appropriate evidence** of the effectiveness of the accounting and internal control systems to support the auditor's assessed risk of material misstatement.

Example

For inventory counting, the auditor should consider when it was performed. If it was performed on the reporting date, the reliability will increase. This is because the user auditor will be assured that the inventory as stated in the financial statements is in existence and sufficient appropriate evidence exists that inventory at the year-end is fairly stated in the SOFP.

(b) **If sufficient appropriate audit evidence concerning the relevant financial statement assertions is not available** the auditor must perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

Diagram 6: Understanding impact of service organization on internal control of entity



8.3 ISAE 3402, Assurance Reports on Controls at a Service Organization

The ISAE 3402 issued by IAASB in December of 2009 is expected to be a new global standard on assurance reporting on service organizations. With outsourcing becoming a normal trend and almost every company outsourcing at least some of its operations there is a growing requirement from user entities, their auditors (indirectly the stakeholders) of these reports on Controls at a Service Organization. This resulted in need for a comprehensive standard.

The ISAE 3402 standard requires service organisations to "re-think" and reanalyse various aspects of third-party assurance reporting. Service organizations will now need to develop a comprehensive and systematic description of its internal controls along with a written statement of assertion related to the efficiency of these controls.

ISAE 3402 standard has changed the terms from Type A and Type B reports (as used in ISA 402) to Type 1 and Type 2 reports.

ISAE 3402 and ISA 402

The ISAE 3402 standard is related to assurance report to be prepared and submitted by the auditor of service organization to the user entity. The reports prepared as per ISAE 3402 provides appropriate evidence under ISA 402, Audit Considerations Relating to an Entity Using a Service Organization. ISA 402 deals with user auditor's responsibility to obtain audit evidence when a user entity uses the services of any service organizations.

Test Yourself 9

Jack is the auditor of Pickaxe Technologies. Pickaxe has outsourced the function of accounting to Hi Fi Consultants, a firm of accountants.

Required:

Discuss four matters which need to be considered by Jack, in order to understand and assess the impact, significance and related risk of **Pickaxe** outsourcing to **Hi Fi Consultants.**

Answers to Test Yourself

Answer to TY 1

The auditor expresses an opinion on whether the financial statements, in all material respects, **give a true and fair view.** Thus, if an inconsistency or misstatement of fact exists in relation to other information that is not material, the auditor will not issue a modified opinion, considering the immateriality of the facts.

A material inconsistency refers to a situation where the information reported under "other information" does not match the information contained in the audited financial statements. It may give rise to doubts about the auditor's conclusions drawn from the audit evidence and the basis used by the auditor for his opinion on the financial statements. From the scenario it is clear that there exists material inconsistency in the matters relating to the information contained in the director's report.

A material misstatement of fact in the other information is a situation where the information not related to the audited financial statements is stated or presented in a misleading manner. From the scenario it is clear that there exists material misstatement of fact in the matters relating to the information contained in the director's report and the audited financial statements.

Auditor's reporting responsibility

1. Relating to material inconsistency

If a material inconsistency arises in the other information included in the documents accompanying the audited financial statements, the auditor should first determine whether the other information or the audited financial statements need to be amended. If the financial statements need to be amended, the auditor should propose that the financial statements be amended or qualify or disclaim his opinion depending on whether management agrees to amend the financial statements. However, if the material inconsistency exists in the other information, the auditor should suggest that the material information be amended or include the inconsistency in the other matter paragraph in the audit report.

2. Relating to material misstatement of fact

If a material misstatement of fact is discovered in the other information the auditor should recommend that the other information be amended. However, if management refuses to amend the misstatement, the auditor should document their concerns to those charged with governance of the company. From the scenario, we can identify that the matters relating to other information show material inconsistencies with the financial statements. Therefore the auditor's responsibilities relating to material inconsistencies are valid.

Answer to TY 2

When an audit of financial statements is conducted for the first time, the auditor has to perform audit procedures to obtain sufficient appropriate audit evidence. Since opening balances represent the effects of transactions and events of the preceding period and accounting policies applied in the preceding period, the auditor needs to obtain evidence of the nature of the opening balances as well as the materiality of the opening balances and accounting policies.

In the case of opening balances, it will not be possible for the auditor to perform certain procedures, such as observing physical verification of inventories. However, he may perform audit procedures such as obtaining confirmation from third parties for receivables and payables balances, to obtain audit evidence. Similarly, he should perform suitable procedures in respect of non-current assets, investments, etc. The auditor can also obtain management representation with regard to the opening balances.

Accordingly, Peter should perform such procedures to obtain sufficient audit evidence of the reliability of the opening balances.

Answer to TY 3

The scenario clearly indicates that the going concern status of Adder is affected. The going concern assumption is one of the basic assumptions based on which the financial statements of an entity are prepared. Under the going concern assumption, an entity is expected to continue in business for the foreseeable future.

The going concern assumption of an entity affects the classification of assets and liabilities and the nature and extent of certain disclosures. When the entity is a going concern, assets are recorded at historical cost less depreciation and are expected to be realised at the recorded cost. Liabilities are also expected to be paid off in the normal course of the business. On the basis of this assumption, the assets and liabilities are classified as current and non-current.

If the entity is no longer a going concern:

- Any events / uncertainties that might affect the going concern status of the entity need to be disclosed in the financial statements.
- The financial statements will have to be prepared on alternative basis.
  - Non-current assets and liabilities will be classified as current assets and liabilities.
  - Non-current assets are recorded at realisable values.
  - More provisions should be created for inventory and receivable.
  - Additional liabilities should be provided.

Furthermore, if the financial statements are prepared as mentioned above the auditor can issue an emphasis of matter paragraph in the auditor's report wherein the going concern status of the company is discussed.

However, the scenario indicates that the auditor is providing a qualified opinion. Therefore, the audit opinion is inappropriate.

Answer to TY 4

(a) Reduced net profit ratio: Management should have a plan to:

- Reduce expenses or delay expenditure
- Increase profit margin on sales e.g. by increasing the sales price

(b) Inability to pay account payables on due dates: management's plan to arrange finance by:

- Disposing of assets
- Rescheduling loan repayments
- Obtaining additional capital
- Postponing some expenditure on research and development

(c) Long-term borrowings approaching maturity without any intention of renewal: management's plan to:

- Enter into a debt restructuring agreement with bank.
- Make a rights issue of shares to contribute the additional capital.

(d) Short-term borrowings used to finance tangible assets management has declared that:

The company is disposing of the assets which are not operationally interdependent
The company has unused lines of credit from which it will obtain additional long-term borrowing

(e) Consistent substantial operating losses: management should plan to:

Sell the loss making division
Find another source of income without substantial initial expenditure

(f) Material deterioration in assets used primarily for the purpose of generating cash flows:

The company may plan to enter into a lease agreement to replace certain assets
The company can obtain an additional subsidy from the parent company to replace the assets

(g) Inability to obtain finance to develop key new products:

The company can plan to increase the cash distribution from subsidiaries and associates
The owners have agreed to contribute funds towards the new products in the form of additional capital
The company is in the process of introducing employee stock options to the managerial employees of the company

(h) Loss of a major market or franchisee management is planning to:

Explore new market in foreign countries
Reform the existing product in order to make it better able to survive the competition in market

(i) Shortages or loss of key suppliers or customers: company assures the:

Availability of suitable alternative source of supply
Appointment of agents to increase the circle of buyers

(j) Loss of licence or changes in law that may adversely affect the entity: Management assures that:

The company has a different source of income other than the main line of business
The company has already proceeded towards the fulfilment of the requirements or the reissue of the lost licence
The company has power reserves to overcome the situation

(k) Non-compliance with legal requirements:

Management proves that the non-compliance was the result of a management oversight and there is no problem in the fundamentals of the company
The company appoints an adviser to ensure compliance with all legal requirements

Answer to TY 5

(a) For the annual accounts ended on 31 December 19W7

Around the year 19W7 the company was rapidly venturing into new businesses with favourable results. In addition to this, the company's stock price was at an all-time high and the company recorded substantial profits which resulted in favourable long-term and short-term ratios.

The overall economic environment was favourable to the company and allowed for rapid growth. Due to these factors, the company accounts would be prepared as a going concern.

Impact on the auditor's report

In this case, the auditor would issue an unqualified audit report provided there is no reason to issue a qualified or adverse opinion.

(b) For the annual accounts ended on 31 December 20X2

By the end of 20X2, the following events had taken place:

Resignation of its founder member
Cash shortages due to loss of receivables
Inability to pay off loans
Dividends remained in arrears
Failure of new products launched
Collapse of the overall economic environment
Persistent losses and fall in stock price resulting in adverse financial ratios

These events raise significant doubts over the ability of WebTech to continue as a going concern for the foreseeable future.

Impact on the auditor's report

If the notes to the financial statements disclose management's doubts over the ability of the company to continue as a going concern, the auditor would issue an unqualified opinion with an explanatory paragraph emphasising the matter. However, if this issue is not disclosed in the notes to the financial statements, the auditor should discuss the matter with the management and ask them to disclose the necessary provision in the financial statements. If management does not agree, the auditor should issue an adverse opinion.

Answer to TY 6

The following are the circumstances which decide the reporting requirements of Marina where the financial statements are prepared on the going concern basis:

(a) The going concern assumption is appropriate but material uncertainty exists. This means that Marina finds that the going concern assumption is appropriate but there is material uncertainty because of no settlement (or documentation of) with the workers or heavy outstanding amounts on loans but however feels that the company can and has the resources to deal with these problems. In this case, Marina should consider:

(i) If proper disclosure is made in the financial statements

When the financial statements adequately disclose the principal events and conditions such as the ongoing problems with the worker's union, the inability to pay off debts and meet operation expenses (workers dues not paid) that give rise to the significant doubt on the entity's ability to continue in future and also management's plan to deal with these events, Marina should express an unqualified opinion. However, she should add an emphasis of matter paragraph stating these matters drawing attention to the note in the financial statements that disclose the matters set out by management as explained above.

(ii) If adequate disclosure is not made in the financial statements

When adequate disclosure is not made in the financial statements, Marina should express a qualified or adverse opinion as appropriate. The report should also specifically refer to the fact that there is a material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern.

(b) Going concern assumption is not appropriate. Marina concludes that the entity will **not be able to continue as a going concern**, because of no settlement (or lack of documentation) with the workers or heavy outstanding amounts on loans and feels that the company cannot possibly deal with these problems.

(i) No disclosure in the financial statements

Yet the **financial statements are prepared on the going concern basis,** then Marina should give an **adverse opinion** regardless of whether the disclosure is made or not.

When the entity's management is convinced that the going concern assumption used in the preparation of the financial statements is not appropriate, they can additionally prepare financial statements on the alternative basis. If Marina confirms that the alternative basis is appropriate, she can issue an unqualified opinion if there is adequate disclosure but may require an emphasis of matter paragraphs to be included in the auditor's report to draw the readers' attention.

With My Fair Lady's management optimistic about the future turn of events and their faith in turning the company around, but lack of documentation for negotiations with workers, this is more of a possibility in the given case scenario. Management may not wish to disclose internal problems as they fear that any sort of negative publicity may harm the company's reputation in the market. As a result, they may, to an extent not assess the going concern status of the company. In such a situation, Marina would have to follow the following procedure outlined in Point (b)

(ii) Management is unwilling to make or extend its assessment

If Marina finds that the period of assessment made by management is not adequate or it has not made the assessment at all, then Marina should ask them to extend their assessment. If management is unwilling to do so, Marina should modify her report (i.e. qualified opinion or disclaimer of opinion). This is a limitation on the scope of an auditor as it is not possible for her to gather adequate evidence regarding the going concern status of the entity in the absence of the analysis of management.

Answer to TY 7 (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 Tshs1million 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 Tshs1 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)

(i) 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.

(ii) Action to be taken by the auditor in a situation where management refuses to sign the representation letter:

The auditor should ask for the reason for not signing the letter.
They should explain the importance of the representation letter and specifically tell management that they are not passing their responsibility onto it.
They should discuss any matters on which management has an objection.
The auditor should try to convince them to sign the representation letter.
If they find it appropriate, they may redraft the letter so that both they and management will be satisfied and provide sufficient appropriate audit evidence.
If management is still not ready to sign, the auditor may modify the report or provide a disclaimer of opinion on the grounds of limitation on scope of audit.

Answer to TY 8

Amy's observations could relate to either one of the two situations:

(a) If the transaction is from a related party to Tufstyle

If the machinery was purchased from a related party, Amy must confirm that the machine purchase has been included in the list of related party transactions that were made available to her through the company's management. Amy must try to confirm whether the machinery was purchased at an arm's length price (i.e. confirm that the terms and conditions of the transactions with related parties are at market prices). Amy is required to confirm that the purchase price is determined at the current market price of the machinery. She should also confirm that the terms are the same for similar kinds of transactions with a third party.

If Amy is convinced that the machinery was purchased at a price which was not an arm's length price then Amy must disclose the matter in the entity's financial statements.

However, if the list of related party transactions does not include this item of purchase then Amy must make enquiries and carry out the following audit procedures to be sure that Vesta is a related party:

(i) Review prior year's working paper and financial statements to confirm that the list of related parties identified in the previous accounting year includes Vesta Technologies.

(ii) Review Tufstyle's procedure to identify related parties. Amy should be convinced that the set out procedure is appropriate and that the list excluded Vesta out of error.

(iii) Verify the copy of minutes of various meetings i.e. board meeting, audit committee meeting and confirm whether Vesta is identified as a related party.

(iv) Collect information about key management personnel and determine whether Vesta is a related party.

(v) Verify secretarial records for interested parties, register of directors' interest, names of principal shareholders etc., and verify whether Vesta falls within the scope of related parties.

(vi) Enquire with previous auditors about related parties and compare the information provided to check whether Vesta is a related party.

After having identified Vista as a related party, Amy must value the related party transaction by carrying out the following procedures:

Verify and inspect the transaction and the documented evidence of the capital purchase transaction made with Vista, for example, Amy needs to inspect the purchase invoice, payments made, purchase order raised on Vista, and the entries made while recording these transactions.

Discuss the business purpose of the transactions with the appropriate person i.e. the management or directors. Amy should discuss the need for this machine with the CFO or those charged with governance.

Verify whether the transaction has been approved by the board of directors or other appropriate authorities.

Confirm that the transaction is authentic. Accordingly Amy must verify that the purchase took place for a genuine purpose. She should check that the purchase of machinery took place in order to utilise it for its production activity.

(b) If the transaction is not from a party related to Tufstyle

If the procedures carried out in the earlier paragraph do not identify Vista as a related party, then Amy will still have to determine whether the machine was purchased at arm's length. If the machinery was purchased at arm's length then Amy can be sure that the error occurred on account of non-implementation of internal controls. She will have to get the purchase ratified by the board and get the matter included in a management letter to the company.

However, if the evidence indicates that the machinery was not purchased at an arm's length price, then, considering that the value of the machinery is significant to the financial statements, Amy may qualify the audit report.

Answer to TY 9

Jack should take into account the following considerations to understand and assess the impact, significance and related risk of **Pickaxe** outsourcing to **Hi Fi Consultants**:

(a) The nature of the services provided by Hi Fi Consultants and the significance of those services to the user entity, including its effect on Pickaxe

Jack should **consider the impact of the activity outsourced on the internal control of the entity, i.e. if Jack** concludes that outsourcing significantly affects the accounting and / or internal control system of the entity, he should obtain sufficient understanding of the entity and its environment, including the internal control. This will help him in assessing the risk of material misstatement and designing and performing further audit procedures.

The auditor should obtain an understanding of the **nature and scope of the accounting services provided** by Hi Fi, **terms of contract** etc. through the agreement between the Pickaxe and Hi Fi. From the agreement, the auditor will come to know the scope of the accounting function which is outsourced, how the responsibilities are fixed and other details of the agreement.

(b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by outsourcing to Hi Fi

Information on this area will enable the auditor to decide the nature, timing and extent of audit procedures to be carried out by the auditor.

(c) The degree of interaction between the activities of Hi Fi and Pickaxe

As the scenario is silent, the outsourcing function could involve either of the following situations:

(i) Outsourcing of the recording of transactions and processing of related data but not authorisation and maintenance of accountability

In this case, Pickaxe may be able to implement effective policies and procedures within the entity. Also, Hi Fi may have certain internal controls.

The auditor should assess the effectiveness of the internal controls of Pickaxe as well as those of Hi Fi and the interaction between the internal control systems of both the entities.

(ii) Outsourcing all the work related to accounting

This means recording of transactions, processing of related data, authorisation and also maintenance of accountability. When all the work is outsourced, Pickaxe has to rely on the policies and procedures prevailing at HI Fi. Moreover, Hi Fi may establish and execute policies and procedures that affect Pickaxe's internal control. Also, Pickaxe has to rely on Hi Fi for implementing its policies.

Jack has to assess the effectiveness of the internal control system of Hi Fi.

Therefore, Jack should examine the interaction of the activities of Hi Fi and Pickaxe in order to understand the extent to which the internal controls of Hi Fi can be relied upon.

(d) Contractual terms for the activities undertaken by Hi Fi

The agreement between Pickaxe and Hi Fi will provide information about the following matters: (i) Information to

be provided to the user entity

(ii) Responsibilities for initiating transactions relating to the activities undertaken by Hi Fi
(iii) The form of records (including access to the records) to be maintained by Hi Fi, in accordance with the appropriate regulatory bodies
(iv) The type of report on its controls (i.e. type 1 or type 2) that Hi Fi will provide Pickaxe
(v) Jack's rights of access to the accounting records (and other information necessary for the conduct of the audit) of Pickaxe maintained by Hi Fi
(vi) Whether the agreement allows for direct communication between Jack and Hi Fi's auditor.

Quick Quiz

1. What are the components of other information contained in the annual report of an entity?

2. When is an audit of the financial statements of an entity called an initial engagement?

3. List two possible causes of misstatement in the financial statements.

4. When do subsequent events occur?

5. List two financial and two non-financial indicators of doubts on the entity's ability to continue as a going concern.

Answers to Quick Quiz

1. The other information in the annual report may comprise the following:

    A report by directors or those charged with governance
    Financial summaries or highlights
    Employment data
    Planned capital expenditure
    Financial ratios
    Names of officers and directors
    Selected quarterly data
    Financial and operating reviews

2. In an initial engagement, either the auditor is engaged to carry out the audit of the financial statements of an entity which has not been audited, or the preceding period's audit reports were audited by another auditor.

3. Misstatement may occur for a number of reasons. Listed below are two possible causes of misstatement:

    (i) Management's accounting estimates are considered inaccurate by the auditor because of a misunderstanding or misinterpretation of accounting policies or facts.
    (ii) Data may be inaccurately collected and processed in the accounts.

4. Subsequent events occur between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

5. Financial indicators

    The entity uses short-term finance to fund non-current assets.
    The financial analysis of the entity's financial information reveals adverse key financial ratios.

    Non-financial indicators

    Loss of key management personnel.
    Difficulties with labour unions.

Self-Examination Questions

Question 1

Listed below are certain issues experienced by MarcoMax Technologies, a corporation engaged in the manufacture and sale of medical equipment that may indicate a deviation from the going concern assumption used when preparing accounts.

Required:

Ascertain whether or not, with reasons, the issues listed below could cast reasonable doubt over the ability of Marco Max Technologies to continue as a going concern.

1. The schedule of working capital indicates a fall in liquidity ratio from 1.04 in the previous year to 0.54 in the current year. It also indicates a considerable increase in the receivable collection period from 78 days in the previous year to 123 days in the current year. Moreover, there are large quantities of unsold finished inventory attributed to a considerable fall in sales due to new technological developments.

2. The sales for the current year fell by more than 30% which resulted in net losses of more than 130%. This was attributed to a substantial fall in sales in the current year while costs remained relatively constant. The fall in sales was a result of a new innovation in medicine which resulted in the bulk of MarcoMax's major product line in neurosurgery equipment becoming obsolete.

3. The company's management has made short-term arrangements to tide over this financial emergency by increasing the overdraft facility from the banks until the development and production of the new medical equipment is complete. This arrangement will be evaluated within the next two months. The management's forecasts show a return to profitability within the next year since the company is optimistic about receiving new contracts especially from new luxury healthcare centres being established in the area.

Question 2

Peaceful Technology Ltd is a fast growing software company. The company owned a guesthouse in the outskirts of a city. The location of the guesthouse made it difficult for staff to make use of it. During 20X7, the company decided to sell its guesthouse and purchase another guesthouse. The company put advertisements for the sale of its property but didn't receive any offers.

Therefore the company sold the guesthouse to Sam who was the senior technical director of the company. The commercial value of the property was Tshs1.5 million. The company was in urgent need of funds to buy another guesthouse. However due to the lack of demand the board decided to sell the property for Tshs1.10 million, which was the written-down value of the property in the company's books.

The financial statements for the year 20X7 did not contain this disclosure.

Required:

From the scenario, discuss the matters that the auditor should consider; and explain the audit evidence that you should expect to find, to ensure that the financial statements do not include any material misstatements.

Question 3

The concept of going concern is neither defined in the International Accounting Standards nor by the IFAC, but ISA 570 (REVISED) states that, under the going concern assumption, an entity is ordinarily viewed as **continuing in business** for the **foreseeable future.** According to standards this foreseeable future is stated at **12 months.**

Required:

Explain the significance of the concept of going concern and the importance of the need for going concern reviews.

Question 4

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.

Answers to Self-Examination Questions

Answer to SEQ 1

1. Weakened liquidity position

MarcoMax's liquidity ratio has fallen by almost 50% from the previous year. In addition, the debt collection period has increased considerably which has resulted in a larger amount of working capital being locked up in receivables. The company's liquidity ratio will fall even more if a provision for bad debts is provided or uncollectible receivables are directly written off which would result in increased losses.

In addition, using the bank overdraft facility to tide over current cash flow problems, would lead to increased interest costs which would lead to a drain on future profits. Besides, this would place the entire financing burden on short-term finance which would not secure finance for future projects; especially the production of the new neurosurgical equipment production line.

The corporation's weakened liquidity position coupled with falling revenue and profits would lead to major problems when negotiating with banks and financial institutions to procure finance.

2. Loss of revenue and falling profits

The fall in revenue due to the major product line becoming obsolete is a very dangerous situation as it results in the loss of customers: both those loyal to the company as well as potential customers. These customers provide revenue to the company.

In a fast changing technological environment like medical equipment engineering, a major product line becoming obsolete would result in a loss of reputation and goodwill in the industry.

A fall in revenue by almost 130% could make the return back to profitability very difficult especially with the damage to the company's goodwill. In addition, this may cause several problems when negotiating finance sources with banks and financial institutions.

3. Overoptimistic management

The management believes that the company will return to profitability within the next year.

The auditor has to check whether this estimate and forecast has been made taking into account the general perception of the company, since one of its product lines has now become obsolete.

The management's plan to review its overdraft facility after the year end may ignore some important problems that may arise due to increased reliance on only one form of finance.

If management's perception is analysed as being overoptimistic, then the auditor should not rely substantially on the management's representation but instead look for other sources of information.

Answer to SEQ 2

1. Matters

(a) Related party

Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial decisions. In context with the above definition, a related party may be management, or any person who is in position to influence the operating policies and financial decisions of an entity. Sam is the technical director and therefore a member of Peaceful's key management personnel and is therefore a related party.

(b) Related party transactions

Related party transactions mean the transfer of resources or obligations between related parties irrespective of the value of these transactions. The sale of property to Sam is therefore a related party transaction, even though the company has received a consideration.

2. Audit evidence

Auditor's duty with respect to audit evidence

As part of the risk assessment procedures and related activities that ISA 315 and ISA 240 require the auditor to perform during the audit, the auditor shall perform the audit procedures and related activities to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.

Related party transactions are material by nature and information about them should be disclosed so that users of financial statements understand the potential effect of related party relationships on the financial statements. In normal business practices, there is no legal restriction or ban on dealing with the related parties. However, the auditor always faces a high risk of occurrence of material misstatement on transactions relating to related parties.

According to IAS 24, all related parties and the transactions between related parties are to be disclosed in the financial statements. This is because a disclosure of a related party transaction will enable the users of the financial statements to determine whether the transaction has led to a manipulation of the financial statements. **However disclosures that related party transactions were made on terms equivalent to those that occur in arm's length transactions are made only if such terms can be substantiated.**

The selling price should have been the fair market value and not the written-down value (which is lower than the fair market value). This implies that the sale of property was not made at arm's length. However the auditor will have to establish the fact and then disclose the matter in the audit report.

For this the auditor would have to verify the terms and conditions and the price of the transaction. The documents

to be verified include:

- The sale agreement
- Fair market value certificate from the independent valuer
- Written representation from the management / board confirming that there are no related party transactions requiring disclosure other than those that have been disclosed
- Board resolution sanctioning the sale
- Ledger extract of the property account and Sam's account

The auditor would have to confirm that:

- The consideration mentioned in the sale agreement matches the amount mentioned in the books of account
- The board resolution sanctions the sale on the terms mentioned in the sale agreement
- The written representation from the management includes the transaction with Sam
- The company has received the proceeds of the transaction in accordance with the terms mentioned in the sale deed
- The fair value certificate is issued by an 'independent expert'

Auditors may seek an opinion or report from an expert for services which are performed by experts like actuary, engineering, valuers. This is because auditors are generally knowledgeable about business matters in general and are considered to have expertise in accounting and auditing, whereas the auditor is not expected to have expertise of any other occupation or profession like valuers.

Answer to SEQ 3

Significance of the concept of going concern

When the going concern assumption holds good, the assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. The classification of assets and liabilities depends on whether the entity is considered as a going concern.

However, the going concern assumption is not applicable to general purpose financial statements when:

- The entity is ceasing further operations
- The entity is going into liquidation
- The circumstances are such that management finds no realistic alternative but to cease operations or to liquidate

Importance of review of going concern

The whole purpose of an audit is to give adequate assurance to the readers of the financial statements. The auditor therefore has to give their opinion on whether the financial statements prepared by the management are true and fair regarding the going concern status of the entity.

The reliability of the financial statements is affected significantly by the assumptions on the basis of which they are prepared. The **assets** and liabilities are valued depending on the assumption of whether the entity is a going concern or not.

If the financial statements are prepared based on the going concern assumption and in the next month the company goes into liquidation, it will mean that the financial statements were not true and fair. The assets should have been valued at the current realisable value since the going concern assumption was wrong.

Answer to SEQ 4

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.

SECTION E

EVALUATION OF ACCOUNTING TREATMENTS AND OTHER AUDIT CONSIDERATIONS

E3

STUDY GUIDE E3: PROSPECTIVE FINANCIAL INFORMATION

Get Through Intro

This Study Guide deals with prospective financial information (PFI). PFI means the prediction of the future financial information of the company. A company has to prepare reports on PFI for various reasons. The utility of these reports increases if an auditor provides an assurance on them.

For example, Perfect Placements approaches a local bank for a loan of Tshs2 million, with which it wants to purchase an office building. The CEO, who has just seen the project report prepared by his accounts department, is confident of getting the loan. The project report showing financial projections for the next three years indicates a bright future for his company. However, the bank officials are not so easy to please! They ask Perfect Placements to submit its auditor’s opinion on the project report, after which they will consider approving the loan.

This Study Guide discusses the matters to be considered by an auditor before he accepts engagements to report on PFI, the examination procedures, the risks involved and the reports to be submitted. This is very useful information because, after qualifying, many such engagements will come your way!

Learning Outcomes

a) **Explain the meanings of 'prospective financial information' (PFI), 'forecast', 'projection', 'hypothetical illustration' and 'target'.**
b) **Explain the characteristics of useful PFI.**
c) **Discuss the audit considerations prior to accepting a specified engagement relating to PFI.**
d) **Explain the level of assurance provided by an auditor in a PFI engagement and discuss the factors to be looked into before determining the nature, timing and extent of examination of PFI.**
e) **Describe the matters to be examined in relation to forecasts and projections.**
f) **Compare and contrast the contents of a report on the examination of PFI with reports on providing audit-related services.**

1. Explain the meanings of 'prospective financial information' (PFI), 'forecast', 'projection', 'Hypothetical illustration' and 'target'.

[Learning Outcome a]

The term 'prospective' literally means 'future'. Sometimes companies need to predict their future financial position for various reasons like an increase in capital, for a loan application, in prospectus for providing investors with information, etc. To determine future financial position, a company needs to apply logical and reasonable estimates and assumptions based on its past experience. It has to take into consideration **future possible events**, their effect on profitability, and the action that a company might take against such events. This is known as Prospective Financial Information.

1. Prospective financial information (PFI)

International Standards on Assurance Engagement (ISAE) 3400 The Examination of Prospective Financial Information, issued by the IAASB, provides guidance on engagements to examine and report on prospective financial information, including examination procedures for best-estimates and hypothetical assumptions.

Definition

'Prospective financial information (PFI) means financial information based on assumptions about events that may occur in the future and possible actions by an entity.'

ISAE 3400

'Assumptions about future events' can be in the form of a forecast or a projection, or a combination of both. Assumptions for probable future event are highly subjective in nature and can vary from situation to situation. The preparation of PFI requires a high degree of judgment. The management is responsible for the preparation and presentation of PFI. The management has to identify and disclose the sources of information that the PFI is generated from. The basis of forecasts and projections (i.e. assumptions) are also decided by the management.

The most common examples of PFI are:
- Cash flow forecasts
- Profit forecasts
- Projected earnings for, say, 5-10 years

To understand the term better, let us look at an example.

Example

Roy Industries is planning to purchase a crane for loading and unloading material in its factory. While preparing the future cash flow and profit statement, depreciation is calculated on the assumption that the useful life of the crane is 15 years. Furthermore, it is assumed that the crane will require annual maintenance from the fifth year of its purchase. Before making these assumptions, the management has considered expenses from another crane of a similar make.

This future cash flow and profit statement contains prospective financial information based on the assumption about the useful life of the crane and the expenditure on annual maintenance after the fifth year of purchase. The management has determined these assumptions on the basis of sources like their past experience about the previous crane.

PFI can be prepared for **internal as well as external use**. To ensure the accuracy and reliability of a PFI and enhance the confidence of its users, companies generally prefer audited PFI. An auditor verifies the forecasts and projections made by applying different analytical procedures (such as a trend analysis) in order to give assurance about the correctness of the PFI. He may also confirm that the accounting policies followed in the preparation of PFI are same as those followed while preparing historical financial statements.

As discussed above, assumptions used in PFI can either be forecasts or projections or a combination of both. It is important to understand the terms 'forecast' and 'projection' and the differences between the two.

2. Forecast

Definition

'A **forecast** means prospective financial information prepared on the basis of assumptions as to future events which the management expects to take place and the actions the management expects to take as of the date the information is prepared (best-estimate assumptions).'

ISAE 3400

A forecast is usually made for a period of no more than one year.

Example

Grace Ltd wants to declare an interim dividend on 30 September 20Y0 on the basis of the estimated profitability of the whole financial year. To calculate the profitability for the year 20Y0, the management has prepared profit forecasts for the remaining period from 1 October 20Y0 to 31 December 20Y0.

Grace has many foreign exchange transactions during the year 20Y0. While preparing the estimated profits for the year 20Y0, Grace wants to make a provision for the likely foreign exchange gain / loss at the end of the year. The management has estimated an exchange rate of $44/INR at the end of the year for this purpose.

Both these are examples of a forecast.

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3. Projection

Definition

A **projection** means prospective financial information prepared on the basis of:

hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a start-up phase or are considering a major change in the nature of operations or

a mixture of best-estimate and hypothetical assumptions.

ISAE 3400

Unlike a forecast, a projection is made generally for a period of more than one year. Usually, it is made for the period ranging from two to twenty years.

Example

Heights Plc has been engaged in a construction business for the last 8 years. As a part of its expansion programme, the management of Heights wants to raise additional capital by issuing equity shares to its existing shareholders.

In order to attract its shareholders, Heights wants to issue a prospectus containing business projections for the next five years. For this PFI, the management has estimated a growth rate of 5% each year based on past sales figures. The raw material cost is calculated on the basis of the rate of inflation which is expected to rise @ 3% each year from the current rate.

Hypothetical illustration is the prediction of probable results depending upon assumptions made about the events likely to happen in future.

Target means the intended future results planned by the company. It is different from a forecast or a projection in the sense that a target is what the management wants and may not be based on any assumptions, whereas a forecast or a projection is based on certain assumptions.

Example

Knights Rubber Ltd is an ISO 9001 company engaged in the business of manufacturing industrial rubber. After seven years of operation, Knights felt a need to increase its capital for the expansion of its business by introducing a multiple product line. The management decided to opt for a bank loan at the interest rate of 10% per annum.

Knights approached a national bank for a loan repayable over the next ten years. The bank demanded audited prospective financial information to assess the company's future repaying capacity.

Knights' management prepared the PFI on the basis of the following forecasts and projections:

Knights have issued five years of 6% convertible preference shares which mature in the next two years. It is assumed that 50% of the shareholders will opt for conversion in equity shares and the remaining 50% will take the maturity proceeds in cash.

The vulcanisation machine costing Tshs50,000 will be replaced in the next four years and the sale proceeds from the old machine are expected to be nil.

The company plans to acquire land in the next 2 years in a nearby area; for this, it will issue right shares to raise finance.

The salary of the employees is expected to rise by 20% in next six months.

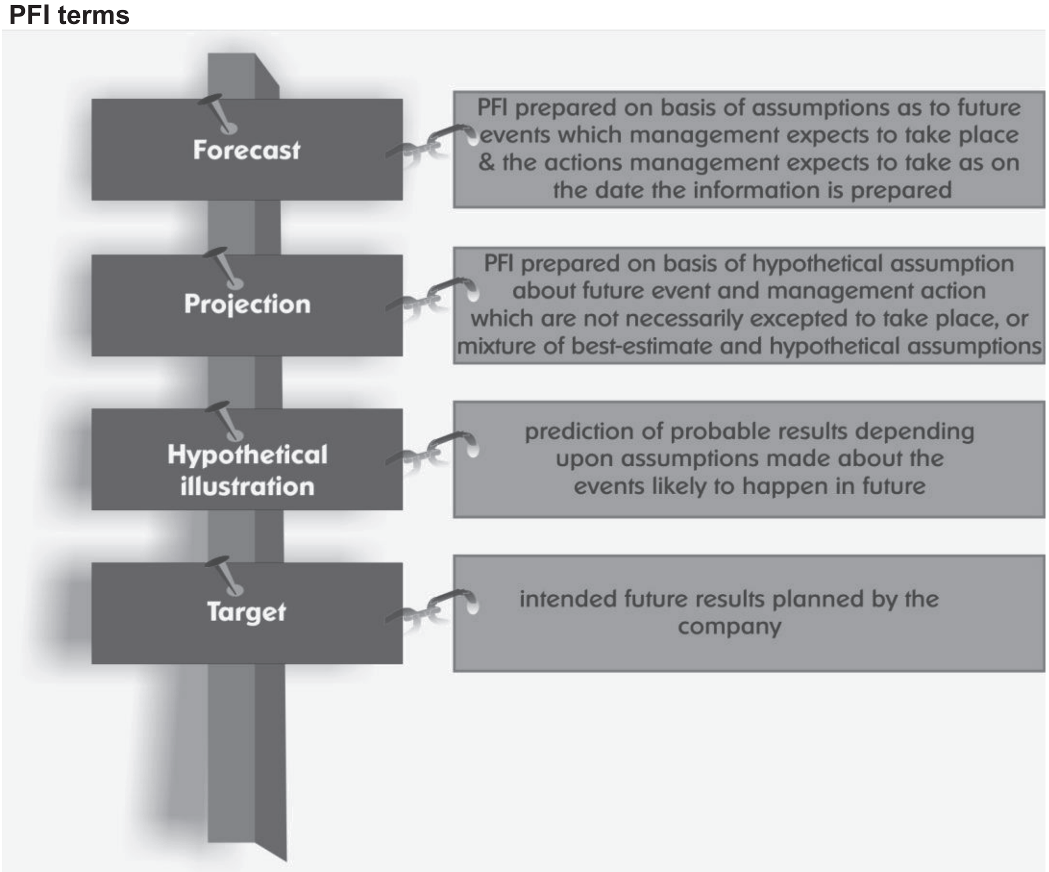
The bonus payable will be based on individual performance but an ad hoc provision of Tshs20,000 has been made in the PFI.

The management has predicted a 30% increase in sales volumes for the next three years.

Income from other sources is expected to increase by 10%, as the company is planning to start an agency for marketing rubber products.

This is a PFI in which assumptions are made in the form of combination of forecasts and projections.

Diagram 1: PFI terms



Test Yourself 1

Answer with reasons:

(a) Is PFI accurate?
(b) Is the auditor responsible for reliable PFI?
(c) Can assumptions about the future be in the form of a combination of forecasts and projections? (d) Do companies generally prefer to present audited PFI?

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2. Explain the characteristics of useful PFI.
[Learning Outcome b]

As discussed in Learning Outcome 1, PFI is prepared by the management for internal as well as external use. To prepare PFI and make it useful to the users, the management must identify who the user is.

For example, PFI can be used for the following purposes:

Internal purposes

In the **annual report** for information to shareholders and other interested parties regarding the future prospects of the company.

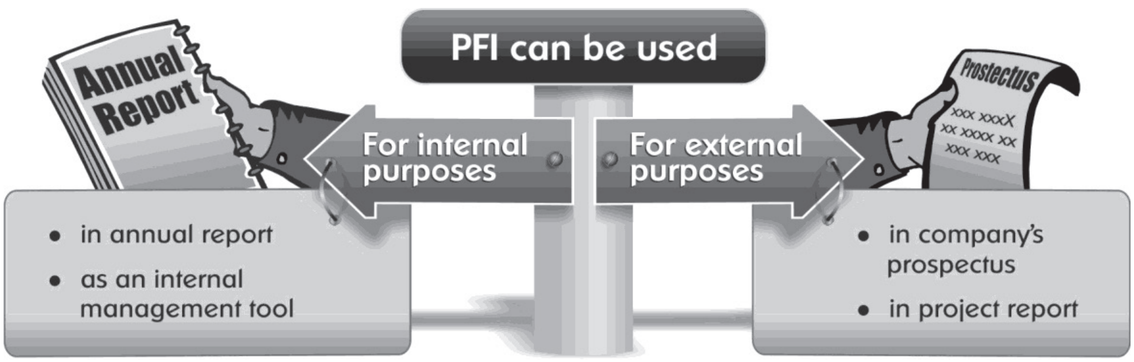
As an **internal management tool** to identify the future financial position or future capital requirement.

External purposes

In a company's **prospectus** to attract prospective investors to invest in the company.

In the **project report** submitted to lenders such as banks or financial institutions as justification for their application for loan.

Diagram 2: Uses of PFI



A useful PFI would be one which is prepared in an appropriate format and with all the information available to support the assumptions made while preparing the PFI.

Therefore, **the characteristics of a useful PFI** could be as follows:

1. Understandability

PFI should be prepared taking its probable user into consideration. Disclosure and explanation of the forecasts and projections are essential for enabling the user to understand the PFI calculations.

Example

During the course of reviewing PFI, an auditor would be interested to know the basis on which the management has made a provision for doubtful debts.

---

2. Relevance

All the assumptions and forecasts should be **rational and relevant**. All the estimates should be in line with accounting policies. Giving too much or unnecessary information in the PFI might divert the attention of the user from the important details and decrease the effectiveness of the PFI. The extent of information that needs to be disclosed in a PFI depends on its user.

Example

If a sales forecast report for the next month is drafted for the management for internal use, then detailed information regarding the customers and the quantity likely to be ordered by each may not be submitted. However, if the same report is for the purposes of a bank from which a working capital loan is taken, then such details supporting the calculations of the PFI might be mentioned in the report.

---

3. Reliability

A useful PFI would certainly be one which is reliable. As PFI is prepared on the basis of certain assumptions based on future probable events which **may or may not occur**, there is always a possibility of error in the PFI. However, a margin of error should be noted, within which the PFI can be considered reliable. Reliability of PFI is enhanced if it is prepared with the **best available information** and the **best judgement assumptions** based on past experience and performance. Material assumptions should be disclosed clearly to enhance reliability. It should be supported by an analysis of the company's business.

4. Comparability

The results of a PFI should be comparable to the **actual results** derived at a later date. If PFI is prepared by applying the accounting policies used in the preparation of regular accounts of the company, a comparison will be possible.

Example

Income and profit forecasts can be drawn in the same format as that of the existing statement of consolidated income format so that each line item can be compared in future.

---

5. Presentation

The PFI should be presented in an **appropriate format**. Sometimes the intended user indicates the format in which the PFI must be submitted. In this case, the person responsible for preparing the PFI must submit it in the stated format to ensure its effectiveness.

Example

A bank may have a loan application format which includes captions where the PFI details must be filled in. In this case, the person applying for the loan need not submit a separate report. Instead he must present the PFI in the format suggested by the bank.

Test Yourself 2

Grange Hill, a holiday resort, has prepared PFI on the requirements of its new recreation wing, as requested by the management. Determine which characteristic of the preparation of useful PFI is affected in the following situations:

(a) Grange Hill prepared PFI using the straight line method for calculating depreciation while the existing accounting policies follow the written down value method.

(b) The growth rate of Grange Hill ranges between 5%-7% per year depending on past data. While preparing the PFI, it has applied a growth rate of 20% per year.

(c) The PFI does not disclose the basis of forecasts and assumptions.

(d) The PFI was prepared for the next seven years instead of five years, as requested by the management.

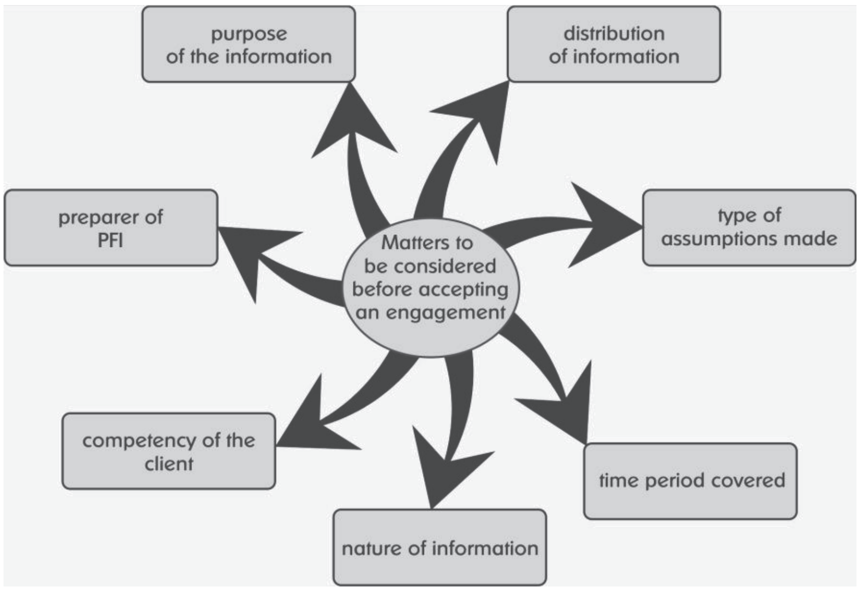
---

3. Discuss the audit considerations prior to accepting a specified engagement relating to PFI. [Learning Outcome c]

As discussed in Learning Outcome 1, the management is responsible for the preparation and presentation of PFI. In order to increase the reliability and authenticity of the forecasts and projections used in PFI, sometimes an auditor may be asked to verify and report on PFI. This is known as a specific engagement to report on PFI.

As studied earlier, PFI is the combination of forecasts and projections which includes best judgement estimates or hypothetical illustrations. All these estimates are based on the management's logical assumptions about the likeliness of future events. The capability to arrive at such assumptions depends on the expertise and experience of the management. As the assumptions relate to future events where the actual results are not known, an element of uncertainty always exists with these PFIs. Therefore, an audit / assurance engagement to examine PFI always consists of a greater risk to report about what might happen in the future.

Diagram 3: Matters to be considered before accepting an engagement



ISAE 3400 provides guidance to a professional accountant on the acceptance of an engagement to report on the PFI of a client. The accountant must consider the following matters before accepting an engagement to minimise risk:

1. Purpose of the information

The intended use of information should be taken into consideration. The auditor must see whether the information is used by the **internal management or by any external user** i.e. banks or investors. The implications of both situations are different. If the information is used by the internal management, the use is limited within the company. But if it is used by external user, it will be relied upon by a large group of people i.e. third parties, probably for making an investment decision. So, if anything goes wrong on the part of the auditor, it will affect a lot of people and the consequences might be much greater than with internal users.

Example

Backstreet Ltd is a fast-growing cement manufacturing company and the board is thinking of replacing major tangible assets in the next two years. It has appointed David & Associates as its auditor for reporting on the preparation of statement of cash flow for the next two years. For the replacement of assets, Backstreet wants to take long-term financial support from a bank. The bank has demanded a five year projection report to assess the creditworthiness of Backstreet. The engagement of preparing a project report is also given to David & Associates.

From the point of view of David & Associates, the engagement of preparing a project report is more risky than preparing a statement of cash flow. The cash flow will be referred or circulated through limited personnel inside the company but the project report will be referred by an external party. Based on this, the bank will grant a loan to Backstreet. A material misstatement in the project report has more severe consequences than it does in the cash flow projections, as an important financial decision needs to be taken on the basis of a project report.

2. Distribution of information

The auditor has to assess whether the information is for **general distribution or limited distribution**. As discussed in an earlier point, if the distribution of information is limited, the risk is relatively lower than in the case of general distribution, as it will be referred to by a particular user only. On the other hand, in the case of general distribution, the information is distributed to the public at large and is more risky because many people will rely on this information.

Example

Bergerac Ltd is a large textile industry in the Philippines. After five years of successful operation, it wants to expand its business to other countries. Due to the need for more capital, the company decides to raise funds through the introduction of additional share capital by listing of its shares on the stock exchange and inviting the public to invest in the shares.

The management has prepared a projected profitability statement for the next seven years, for inclusion in the prospectus. Mr. Wan, a certified accountant, is appointed as an auditor to report on the reliability of the project report prepared and the assumptions and estimates used by the management.

This engagement carries a higher risk of material misstatement, as the information contained in the project report will reach the masses whose decision to invest in the company will depend on the auditor's report.

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3. Type of the assumptions made

As seen in an earlier Learning Outcome, PFI is prepared using forecasts or projections. The assumptions that form the basis of projections / forecasts can be divided into two categories i.e. **best-estimate or hypothetical**. Best-estimate is more fact-based as compared to a hypothetical situation.

Example

The assumption that the useful life of a piece of machinery would be five years is a best-estimate, whereas the likelihood of the sale of the machinery after five years is a hypothetical assumption. The risk involved is dependant on the type of assumption that is made.

If the information is based on a best estimate assumption, it is less risky. Best estimate is an approximate judgement of what might happen. It is always reasonable, relevant and rational.

As opposed to this, a hypothetical assumption is more difficult to rely on as it depends upon the occurrence of certain future events. There is very little information to support the assumption so it is more risky for an auditor to provide assurance on the results derived from such assumptions.

Example

Eldorado Inc has engaged Joey & Co, Chartered Certified Accountants, for a review of PFI prepared with respect to profitability for the next four years, in order to assist the management in deciding whether or not to introduce a new line of business. Joey finds that while preparing PFI, the management has used a best estimate as well as hypothetical assumptions such as:

- The calculation of depreciation was based on the best estimate that the machinery will have an economic life of five years with no salvage value.
- The sales projection is based on the hypothetical assumption that there will not be any competitors and the advertising cost will be zero.

Joey sees more risk in certifying the assumption that no competitor will exist or that no advertisement cost will be incurred by Eldorado.

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4. Time period covered

The time period i.e. whether the assumption is for **short period of time** (such as forecast) **or for longer period** (such as projection) is an important matter to be considered. The risk involved in giving assurance regarding long term assumptions is generally more than that compared to a short term assumptions. Short term forecasts are generally more reliable as the estimates can be derived considering the current situation and the likely changes, which can be predicted more reliably in the short term.

Assumptions based on events that are likely to occur over a long period of time are less reliable, as no one can predict accurately what is going to happen in the future. Planning over a long period of time requires a high degree of judgment and experience in a particular area of work; in the absence of this, it is difficult to rely on the PFI.

Example

Fred Accountants have been engaged for the audit of Flintstones' Bank's projected cash flow. These projections are prepared for a period of ten years and contain various forecasts and projections.

Fred finds it difficult to rely on the projection that the banks non-performing assets (NPAs) will come down by 50% over the next ten years, as it feels that ten years is a long period of time and various unseen changes can take place over this period, which might result in more than a 50% decrease in the NPAs.

Fred, however, finds the forecast suggesting that salary expense will increase by 10% in the next six months more reliable, as it is a short-term assumption.

---

5. Nature of the information provided

The auditor must take into consideration the extent and relevance of the information provided. It will become difficult for an auditor to deal with data that he has **very little information** on. For example, if a detailed calculation of provision for a contingent liability is not given, the auditor may not be able to verify that item.

Similarly, the auditor should be able to understand the information provided. If the information is **highly complex and technically difficult to understand**, it can be a barrier for an auditor to accept the engagement.

For example, the actuarial valuation of the future retirement benefits of the client's employees may be complex to understand and, therefore, simply submitting details of these calculations to the auditor may not be enough. The auditor may have to discuss and understand the information with the help of the management or the actuary. Information that is subjective in nature, i.e. which is subject to change and has different interpretations from different people, becomes difficult for auditors to understand.

For example, whether R&D expenses are classified as revenue or capital expenditure depends on whether the expense is incurred after or before the point at which the asset is recognised i.e. starts to give future economic benefits. Determining this point of recognition of the asset is highly subjective in nature.

6. Competency of the client's firm

Before accepting the engagement, the auditor must verify whether the firm is **competent enough to achieve** the claims made by the PFI or not. If the financial position of the company is not reliable, or if the auditor feels that the company will not be able to achieve the target presented in the PFI i.e. the auditor is doubtful of the company's capacity, then he should not accept the engagement.

Example

Holby Brick Co is a brick manufacturing company which has been making losses continuously for the last four years. In order to repay the working capital loan and payables pending from last two years, it wants to get short-term financial help from its bank. The bank requires a certified report of projected cash flow for the next two years as a supporting document for applying for the loan. Holby approaches Shaw Accountants to report on the projected statement of cash flow. After reviewing Holby's situation, Shaw is doubtful of Holby's recovery and feels that the projections are fictitious and not reliable. It therefore refuses to accept an engagement.

---

7. Preparer of the PFI

Preparation of PFI is the prime responsibility of the management. The auditor, before accepting the audit engagement, must verify **who has prepared the PFI** and whether the preparer is **reliable, experienced** and **competent**. There is a high risk involved if the PFI is prepared by a person who is not competent.

Example

Elaine & Co accepted an engagement for examining Getwell Ltd's PFI. Elaine, the audit manager, was under the impression that the PFI was reviewed by the senior management. However, on enquiry, she realised that it was prepared by a junior accounts officer and not reviewed by any senior personnel. She refused to continue the engagement after realising that the management was unwilling to review the PFI in spite of Elaine's request for them to do so.

At the time of acceptance, the auditor and the client should agree the terms of engagement in order to avoid any misunderstandings between them. This is in the interest of both the parties.

ISAE 3400 states that the auditor should not accept, or should withdraw from, an engagement if the assumptions are clearly unrealistic or if the auditor believes that the prospective financial information will be inappropriate for its intended use.

Test Yourself 3

Jude Accountants has been approached by Featherlite Furniture Co to examine the financial projections of its new office in its application for a bank loan. The company is newly established and is managed by senior managers, most of whom are fresh graduates.

Required:

Identify the most important aspects that Jude Accountants must consider before accepting the assignment.

---

4. Explain the level of assurance provided by an auditor in a PFI engagement and discuss the factors to be looked into before determining the nature, timing and extent of examination of PFI.

[Learning Outcome d]

The management and the auditor are unaware of the actual results of a PFI. So each of them needs to employ his best judgment, i.e. the management needs to do this while preparing the PFI, and the auditor needs to do this while reporting on the PFI in order to arrive at a conclusion. Under such uncertain conditions, the auditor's level of assurance on the subject matter is limited.

The following are the points that need to be considered in determining **the level of assurance**:

1. **Negative assurance:** in an engagement of examination of PFI, the auditor provides a negative assurance. A negative assurance means that the auditor **will not state** that 'the assumptions used for projections are reasonable and sufficient to provide a reliable PFI'. **Instead, the auditor will make a negative statement**, i.e. 'nothing has come to his attention to prove that the assumptions made are not reasonable'. This shows that the level of assurance is limited.

A negative assurance looks like this:

'Based on our examination of the evidence supporting the assumptions, **nothing** has come to our attention that causes us to believe that these assumptions do not provide a reasonable basis for the projection.'

2. **The** auditor can provide an **opinion** that the PFI is **prepared 'properly'** based on the assumptions he has made, but he **cannot give an assurance that the PFI is 'correct'**. This is because a PFI is based on certain hypothetical assumptions which may or may not be true.

3. An auditor can give his opinion that the **relevant financial reporting framework has been properly adhered to** while preparing the PFI.

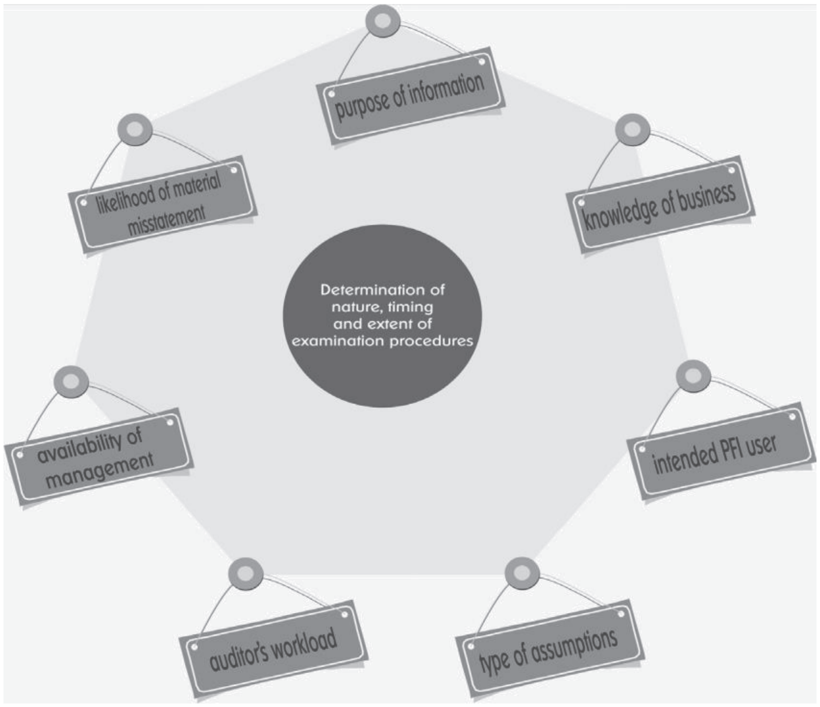
4. The auditor can **draw attention to the risk associated with any particular area** that comes to his attention. If any material error or irregularity is found, he can identify and report it.

5. The auditor should **give an appropriate word of warning** to PFI users **if he finds that the results shown are not achievable.**

6. An auditor can state that the actual **results are likely to be different from prospective financial information** since anticipated events frequently do not occur as expected and the variation could be material.

Factors to be considered in determining the timing, nature and extent of examining procedures under an examination of PFI engagement:

Diagram 4: Determination of nature, timing and extent of examination procedures



Purpose of information

Example

Philip, a Chartered Certified Accountant, is appointed to examine and report on the projected profitability statement for inclusion in the prospectus of Poirot Ltd. The management of Poirot informs Philip that it wants to list the company's shares from 1 April 20X3. It wants a prospectus to be ready for printing on 31 January 20X3. The profitability statement in the prospectus should contain a detailed projection statement of consolidated income, statement of financial position, as well as a statement of cash flows according to the stock exchange requirement.

This information on the purpose of the PFI can help Philip to decide the nature, timing (i.e. before 31 January 20X3) and extent of the engagement.

Knowledge of business

Without proper knowledge of the client's business, it becomes difficult for the auditor to decide on the nature, timing and extent of the work required. This is because **he may take time to understand the PFI**, which is a reflection of the client's business or a part of its processes.

Example

Reliable Ltd is a fast growing IT company. It has appointed George as the auditor for the examining certain PFI regarding research and development (R&D) costs relating to the 'cash control software' for a bank for the next four years. The PFI has been prepared on the basis of several assumptions about various stages of the software development process. George has very little knowledge about software development processes. In this case, the audit will require more time because George will need to conduct a detailed study of various processes to understand the logic behind various PFI items.

Intended PFI user

Generally, if the PFI is intended for the use of the **internal management**, the procedures employed need not be very detailed, whereas if it is for the use of **external users** such as lenders, shareholders or the government, the procedures adopted need to be much more detailed. However, this may not always be true. In either case, an auditor will have to carry out all the important procedures in order to be able to report on the reliability of the PFI.

Types of assumption

As seen earlier, if a **best estimate** is used as the basis for an assumption, the scope of work will be comparatively limited. As opposed to this, if the PFI is based on too many **hypothetical assumptions** (for example, the likelihood of bankruptcy of a competitor), the auditor has to spend more time assessing the reasonableness of such an assumption. If a hypothetical assumption is not acceptable to the auditor, all the calculations made by the management on the basis of the assumption will change and the auditor will have to spend more time reporting on the changed figures.

Auditor's workload

The auditor must keep his **prior commitments** in mind while deciding the audit plan, as this may affect the timing and extent of the PFI engagement's audit procedures. For example, if a meeting is scheduled with another client who is currently not in the country and will be available sometime during the PFI engagement, the time allotted for the meeting must be taken into consideration, as it will prolong the PFI engagement. In fact, an auditor must consider such aspects while determining the timing of any assignment (and not just a PFI engagement).

Example

If an auditor has started the audit of PFI when other deadlines are approaching (perhaps deadlines for tax audits) he may have a lot of other work and therefore may not complete the PFI audit on time. This will ultimately affect the timing, nature and extent of the PFI audit.

Availability of management

The management is **responsible for providing all the necessary details and information on the PFI** to the auditor in order to enable him to verify the PFI. In the absence of key managerial persons (i.e. those who are responsible for decision making), the auditor may find it difficult to resolve his queries. Waiting for the correct information or explanation for the available information will affect the time required for completing the audit.

Example

The management of Royale Ltd has appointed Elmo for examining the sales forecasts for the next five years. These have to be submitted to an interested party. After Elmo starts working on the assignment, he realises that the sales prices were only estimated in line with the increase in the rate of inflation. Elmo is not convinced with this assumption as he feels that other factors, such as an improvement in the quality of the product and demand for the product, must also be taken into consideration while estimating the sales price.

Elmo therefore wants to discuss the issue with Mr Bingo, who has prepared the forecasts. However, Mr Bingo is not available, as he is visiting Royale's branch office in another country. Elmo's work is therefore delayed until he can get in touch with Mr Bingo.

ISAE 3400 lists the following determinants for the nature, timing and extent of a PFI engagement:

The likelihood of **material misstatement**: if it is more likely, then more work will need to be done and more time allotted

The knowledge obtained during any previous engagements: assuming the auditor also audits the company, he will have an idea of risk areas etc. and therefore can allot more time

The management's competence regarding the preparation of prospective financial information: if a qualified accountant is performing the work, there will be more reliance as he is professionally qualified

the extent to which the prospective financial information is affected by the management's judgment: e.g. if bad debt rates are artificially low because management want them to be, more time will be allotted for working out a more reasonable bad debts rate

The adequacy and reliability of the underlying data: if it comes from the same system as the financial accounts are prepared and there have been unmodified audit reports, the auditor may rely more on the figures being correct

Test Yourself 4

Raymond, a Certified Accountant, has been appointed to examine the PFI of one of his clients. Since he has not conducted such an assignment before, he seeks advice from one of his colleagues regarding the procedures that need to be followed while examining PFI.

Required:

Give a brief outline about the procedures that need to be followed while examining the PFI.

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5. Describe the matters to be examined in relation to forecasts and projections.

[Learning Outcome e]

In the previous Learning Outcome, we have seen how an auditor can determine the nature, timing and extent of the examination procedure of a PFI. An auditor will have to follow this process whenever he is appointed for the examination of a PFI irrespective of the type of forecast or projection.

Let us now discuss the specific examination procedures that an auditor must consider while verifying forecasts and projections.

5.1 Revenue

Revenue includes income through sale of goods, profit on assets sold, gain from foreign exchange and other income such as dividends, interest and rent.

The auditor must include the following examination procedures:

1. Verify the historical trends of each item of income i.e. rate of increase in sales, the likelihood of gain from foreign exchanges, considering the market situation, level of other income and comparison with forecasted figures.

2. Verify the basis of assumptions used in estimating each item of revenue, for example:

(a) **Sales:** is the growth rate in line with what is reflected in the past trend? Is there any threat from a competitor which would affect the existing growth rate in future? What is the basis of the increase in the sales price of each unit? What does the market analysis for the product's demand say about future sales? Do the records in sales order book to date support various assumptions? etc.

(b) **Profit on assets sold:** how is the sales price of the asset estimated? How is the depreciation on asset calculated? Are there any foreign exchange loss / gain in the process?

(c) **Other income:** items such as rent, dividends or interest on bank deposits or securities follow a more or less fixed trend and are not very difficult to review. The auditor must verify the past trend in the receipt of such income and consider changes, if any. For example, if rent was received from a piece of land which has now been sold, then there is no need to include rent in the PFI.

5.2 Capital Expenditure

Capital expenditure refers to expenditure incurred on capital assets (i.e. non-current assets such as land, building, machinery, research and development etc.) which have a useful life of **more than a year** and which create future benefits for the organisation. This can be incurred for buying new capital assets or making additions to the existing capital assets. This is long term in nature. The extent of capital expenditure can vary from low to very large.

Example

If the client wants to install new machinery in his factory, the capital expenditure involved may not be significant. Therefore, the auditor may not have to verify many details. However, if the client wants to set up an entire factory, then the PFI will be comprehensive and the auditor will have to verify each and every aspect of the expenditure.

In general, the auditor must include the following examination procedures while verifying capital expenditure PFI:

1. Verify historic trends. For example, if the client has incurred a similar capital expenditure in the past (such as setting up a factory), the auditor can refer to the details of such expenditure and compare it with the forecasts made. Any variation in the levels of expenditure can be discussed with the management. In making such a comparison, the latest price trends and effects of inflation must be considered.

2. Compare the competitor's forecasts of similar expenditure, if this information is available.

3. Assess the basis of assumptions based on the current performance of the business. For example, if the PFI shows a payback period of five years which cannot be justified on the basis of the current performance of the client's business, the auditor must get clarification from the management.

4. Verify the financial sources through which the management expects to raise funds and the possibility of raising finance for the projected capital expenditure.

5. Examine existing commitments with lenders. For example, the debt-equity ratio which has been committed to an existing lender, which might be affected due to the capital expenditure, and how the management plans to deal with this.

5.3 Revenue expenditure

Revenue expenditure means expenditure incurred for the day-to-day expenses of the organisation which relate only to the current year. This includes all the debit items in the statement of consolidated income, such as salary expenses, rent paid, administrative expenses, maintenance charges etc.

The auditor must include the following examination procedures:

1. Verify the past available data to determine the trend of expenditure for each item. For example, the average rate at which employees' salaries rises each year.

2. Verify the basis of assumptions (such as inflation rate, foreign exchange rate, interest rate etc.) used for calculating each item of expenditure. For example, if the rent agreement for rent payable on factory premises is valid for the next five years, then it can be used as the basis for calculating the rent for that period.

5.4 Profits

Verification of projected profits would include the following:

1. Verification of each item of revenue income and expenditure of the projected statement of consolidated income

2. Analysis of past trends in profits through ratio analyses such as gross profit ratio and net profit ratio

3. Verification of the basis for various assumptions

4. Market analysis to verify various rates such as inflation rates, interest rates etc.

5. Comparison with a competitor's past results and profit trends

5.5 Cash flow

Examination procedures include:

1. Identifying each item of cash inflow and outflow and comparing with cash flow projections
2. Verifying the reliability / validity of assumptions, for example, loan repayments can be verified with loan agreement
3. Analysis of historic trends to verify flow of cash i.e. payment and receipt
4. Verifying whether cash flow projections match with other projections such as the income and expense projection
5. Checking whether the opening cash balance matches with the previous year's closing balance

5.6 Working capital

Examination procedures include:

1. Verifying past trends for each item of working capital. For example, average level of receivables, payables, cash-in-hand etc.
2. Verifying the basis of assumptions, for example, level of bad and doubtful debts may be determined on the basis of the customers' past and future behaviour. The possibility of a customer going bankrupt must be considered.
3. Examining past variations in working capital in comparison to the projected plans.

Test Yourself 5

Bright Accountants is a firm of certified accountants. The firm has been receiving a lot of work relating to examining prospective financial data. This examination mainly involves verifying the projected financial figures (such as capital or revenue expenditure, revenue and profit figures, cash flows or working capital and long-term liabilities). The quality control partner of the firm, Britney, wants to prepare a control document on 'Examination of Projections and Forecasts' which will include the basic procedures for examining all such prospective information.

Required:

List the common verification procedures for examining the financial projections that Britney can consider for including in the control document.

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6. Compare and contrast the contents of a report on the examination of PFI with reports on providing audit-related services.

[Learning Outcome f]

An auditor expresses his opinion in the form of an auditor's report after concluding an audit assignment or an assurance engagement. Different types of reports are issued for different types of assignments. For example, the audit report for an audit of historical financial statements differs from that issued under a review engagement. Similarly, a report on an examination of PFI differs from that of other reports, as it has some distinct features.

Due to the fact that PFI is an estimate of what will happen in the future, it is highly subjective. Therefore, an auditor would only really **be able to give a 'negative assurance'**, in which he says that nothing has come to his attention to make him believe that the information is wrong.

A PFI report would also state that the **management is responsible for preparing the PFI**, and the auditor would give his opinion on whether he thinks the information has been properly prepared **based on the assumptions made.**

There is certain content which is common to all audit / assurance reports. This includes:

Date of the report
Name and signature of the auditor
Name of the client
Title of the report
Purpose of the report

We have studied the different types of audit-related services in Study Guide C6. These are review engagements, compilation engagements and an agreed-upon procedures' engagement. A report on an examination of PFI has certain distinct features and differs from the reports made in providing the audit-related services.

In the following paragraphs, we will discuss only the **differences between a PFI report and a report under audit-related services:**

1. Identification of PFI

A PFI report contains a clause identifying the subject matter of PFI i.e. whether the PFI is for cash flow projections or sales forecasts etc. Similarly, audit-related reports identify the financial (or non-financial information) which is compiled or reviewed.

2. Negative assurance

A PFI report contains a negative assurance just as in the case of review engagements. This is different from compilation engagements and agreed-upon procedures' engagements, under which no opinion is expressed and no assurance is given by the auditor on the subject matter.

3. Statement of management's responsibility

A PFI report includes a statement that the management is responsible for the PFI, including the assumptions it is based on. This is similar to a report made for audit-related services, in which the management is held responsible for the accuracy of the financial information provided.

4. Purpose and/or restricted distribution

When applicable, a reference to the purpose and/or restricted distribution of the PFI must be made in the report. No such reference is given in audit-related reports.

5. Achievability of results

A PFI report mentions appropriate caveats in relation to the achievability of the results indicated by the PFI. This is not applicable to audit-related reports.

Test Yourself 6

What do each of the following opinions stated in a PFI report refer to?

(a) Even if the events anticipated under the hypothetical assumptions described above do occur, the actual results are still likely to be different from the projection, since other anticipated events often do not occur as expected, and the variation may be material.

(b) Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the projection.

4.0 Audit of Specialised Entities and Non Governmental Organisation

The handout covers the following areas of the syllabus;

- Audit of insurance companies
- Audit of Banks and Similar financial institutions
- Audit of Charities
- Audit of Clubs and association

- Audit of shipping companies
- Audit of pension scheme
- Audit of Small companies
- **Audit of group accounts**
- Joint audits
- Audit of contracts
- Audit of stock markets
- Guidelines for anti-money laundering

INTRODUCTION

Certain types of organization require special treatment because of

nature of work Covered by statutes which requires treatment and presentation of specific information However other entities may be of significant public interest because, as a result of their business, their size or their corporate status they have a wide range of stakeholders. Examples of such entities might include listed companies, credit institutions, insurance companies, and pension funds. Because of the strong public interest in the financial statements of listed entities

Generally auditors' needs to use knowledge apply skills and judgment acquired on similar types of audit and augments this imagination concerning type of procedure likely to be involved in all environments requiring special treatment.

AUDIT OF INSURANCE COMPANIES

The specific audit problem which arise in respect with these audits relate to four main areas:-

i) Ascertainment of debtors and creditors

Insurance companies rarely maintain their personal ledger in such a way as to produce directly a separate list of debtors and creditors, since their ledgers frequently reflect the section of the market from which the business originates, e.g. brokers, re-insurance, direct –policy holders. Etc. hence it is possible that the debtors and creditors balances will exist in one ledger, sometime for the same person. Nor is the legal position clear in respect to the right of set-off between the debit and credit balances with the same person; it is therefore vital for the auditor to ensure that the company applies consistent approach in establishing the separate amount of debtors and creditors, especially since the circularization procedures are inappropriate.

ii) Unearned premiums

This represents the appropriate proportion of a premium received during the year under review, which is applicable to a later accounting period. It is important that a consistent approach is adopted and that the accounts declare the bases selected by the insurance company, under the heading accounting policies, since number of variations are in fact possible.

iii) Unexpired risks

The amount represents the carry forward to the next accounting period in circumstances where it appears that insurance business is undertaken in the period under review is unprofitable; it is thus similar to the provision for future losses on long –term contracts in the construction industry. The chief audit difficulty is that a considerable element of adjustment enters the computation of such unexpired risks and the auditor will be required to form an opinion on the need for such a provision and, if one exists, in whether the sum provided is adequate.

iv) Outstanding claims

Such claims may be classified as those which:

- Have been notified and agreed, but are still outstanding at the balance sheet date
- Have been notifies before, but not yet agreed at the balance sheet date and
- Have arisen but which have not yet been notified to the company by the balance sheet date. The audit procedures will include a review of the claims files in order to appraise the company's estimates. It will also to compare the average cost of outstanding claim for each class of business with current experience. Finally, the auditor should examine statistical elements comparing past estimates with actual results, and should employ and use "market intelligence" wherever possible.

The auditors of insurance companies should prepare a well designed ICQs on the revenue accounts, balance sheet and a profit and loss account as ordinary companies (Act No.12) 2002 on auditing for other companies. Insurance company must prepare a revenue account, balance sheet, and a profit or loss account.

The following matters should be emphasized on preparation of ICQ's

- Income and expenditure
  - To ensure consistent application of methods of recognition of debit and credit balances which might differ between the same client in various sections
  - The auditor must satisfy herself as to the amounts shown in debtors and creditors
  - Vouch the premiums received with premium register and the receipts
  - The premium received by branches should also be checked for different insurance business, fire, marine , etc
  - The auditor should inquire to establish whether the business would make profits of all unexpired risk were taken into account. (Remember Examination of unexpired contracts in the contractors accounts)
  - Get a statement on all investments and see that the interest and or dividends are received in respect of each of them(the insurance companies should have to invest their funds in government and other approved securities)
  - Check the accounts of the re-insurance companies and get their confirmations on commission on premiums on reinsurance ceded
  - Ensure that all outstanding claims have been modifies and agreed at balance sheet date; if not
  - Form an opinion after full discussions and the examination of all available evidence in the light of consistency of practice

The audit procedures for outstanding claims

i) Reinsurance and recoveries on reinsurance and provision for all amounts outstanding should be checked
ii) The premium reserve carried forward should be checked to ensure its adequacy
iii) Claims paid should be tested with documents and correspondences. Claims made but not yet settled should be examined to ascertain that adequate provision is made against these
iv) A thorough assessment of the internal control system particularly in regard to the opening, recording and maintenance of ledger accounts.
v) Vouch assessment of the internal control system particularly in regard to the opening, recording and maintenance of ledger accounts
vi) Vouch premium income, should be checked with receipts and endorsed policies
vii) The auditor should ascertain that where separate funds are maintained for each business, not part of any such funds has been applied directly /indirectly for any purpose other than the business to which it is applicable
viii) Commission is another item of expenditure, check up the account of each agent and their calculation for commissions. Vouch with reference to receipt obtained from them. Check the commission received/receivable
ix) Management expenses attributable to each revenue account should be directly debited under each revenue account
x) Common expenses should be properly apportioned
xi) vouch all expenses of general management in the profit and loss account

Reinsurance accepted-premium is received-commission is given

Reinsurance

Reinsurance ceded- premium paid-commission is received

xii) vouch the reinsurance claims received and receivable and also the reinsurance claims received /paid
xiii) Verify assets such as investments personally, the minutes for purchase or sale of investment with their respective registers. Verify market value of investments and provisions for investment interest receivable but not received

xiv) verify the cash in hand by physical verification, reconciliation and obtain certificates confirming the balances
xv) verify title deeds of properties and see whether all properties are insured
xvi) carefully audit of any investments
xvii)verify the securities and agreements on loans and advances should not exceed value of securities; securities should be full insured, and ensure that no loans or advances have been made to directors (otherwise it must be disclosed)
xviii) verify that the annual accounts are prepared in the statutory forms prescribed under the Insurance Act,

AUDIT OF BANKS AND SIMILAR FINANCIAL INSTITUTIONS

Banks play a vital role in economic life and the continued strength and stability of the banking system is a matter of general public concern. The separate roles of banking supervisors and external auditors are important in this regard. The growing complexity of banking makes it necessary that there be greater mutual understanding and, where appropriate, more communication between banking supervisors and external auditors. The main guidance is provided by International Auditing Practice Statement (IAPS) 1004, "The Relationship between Banking Supervisors and Banks' External Auditors" Banks' financial statements are also subject to audit by external auditors. The external auditor conducts the audit in accordance with applicable ethical and auditing standards, including those calling for independence, objectivity, and professional competence and due care, and adequate planning and supervision. The auditor's opinion lends credibility to the financial statements and promotes confidence in the banking system

The International Auditing Practices Committee and the Basel Committee share the view that greater mutual understanding about the respective roles and responsibilities of banking supervisors and external auditors and, where appropriate, communication between them improves the effectiveness of audits of banks' financial statements and supervision to the benefit of both disciplines

In carrying out the audit of a bank's financial statements, the external auditor recognizes that banks have the following characteristics that generally distinguish them from most other commercial enterprises, and which the auditor takes into account in assessing the level of inherent risk:

• They have custody of large amounts of monetary items, including cash and negotiable instruments, whose physical security has to be safeguarded during transfer and while being stored. They also have custody and control of negotiable instruments and other assets that are readily transferable in electronic form. The liquidity characteristics of these items make banks vulnerable to misappropriation and fraud. Banks therefore need to establish formal operating procedures, well-defined limits for individual discretion and rigorous systems of internal control.

They often engage in transactions that are initiated in one jurisdiction, recorded in a different jurisdiction and managed in yet another jurisdiction.

• They operate with very high leverage (that is, the ratio of capital to total assets is low), which increases banks' vulnerability to adverse economic events and increases the risk of failure.

• They have assets that can rapidly change in value and whose value is often difficult to determine. Consequentially a relatively small decrease in asset values may have a significant effect on their capital and potentially on their regulatory solvency.

• They generally derive a significant amount of their funding from short term deposits (either insured or uninsured). A loss of confidence by depositors in a bank's solvency can quickly result in a liquidity crisis.

• They have fiduciary duties in respect of the assets they hold that belong to other persons. This may give rise to liabilities for breach of trust. Banks therefore need to establish operating procedures and internal controls designed to ensure that they deal with such assets only in accordance with the terms on which the assets were transferred to the bank.

• They engage in a large volume and variety of transactions whose value may be significant. This necessarily requires complex accounting and internal control systems and widespread use of information technology (IT).

• They ordinarily operate through a network of branches and departments that are geographically dispersed. This necessarily involves a greater decentralization of authority and dispersal of accounting and control functions with consequential difficulties in maintaining uniform operating practices and accounting systems, particularly when the branch network transcends national boundaries.

• Transactions can often be directly initiated and completed by the customer without any intervention by the bank's employees, for example over the Internet or through automatic teller machines (ATMs).

• They often assume significant commitments without any initial transfer of funds other than, in some cases, the payment of fees. These commitments may involve only memorandum accounting entries. Consequently their existence may be difficult to detect.

• They are regulated by governmental authorities whose regulatory requirements often influence the accounting principles that banks follow. Non-compliance with regulatory requirements, for example, capital adequacy requirements, could have implications for the bank's financial statements or the disclosures therein.

• Customer relationships that the auditor, assistants, or the audit firm may have with the bank might affect the auditor's independence in a way that customer relationships with other organizations would not.

• They generally have exclusive access to clearing and settlement systems for checks and fund transfers, foreign exchange transactions, etc. They are an integral part of, or are linked to, national and international settlement systems and consequently could pose a systemic risk to the countries in which they operate.

• They may issue and trade in complex financial instruments, some of which may need to be recorded at fair value in the financial statements. They therefore need to establish appropriate valuation and risk management procedures. The effectiveness of these procedures depends on the appropriateness of the methodologies and mathematical models selected, access to reliable current and historical market information, and the maintenance of data integrity.

A detailed audit of all transactions of a bank would be not only time consuming and expensive but also impracticable. The external auditor therefore bases the audit on the assessment of the inherent risk of material misstatement, the assessment of control risk and testing of the internal controls designed to prevent or detect and correct material misstatements, and on substantive procedures performed on a test basis. Such procedures comprise one or more of the following: inspection, observation, inquiry and confirmation, computation and analytical procedures. In particular, the external auditor is concerned about the recoverability and consequently the carrying value of loans, investments and other assets shown in the financial statements and about the identification and adequate disclosure in the financial statements of all material commitments and liabilities, contingent or otherwise.

While the external auditor has the sole responsibility for the audit report and for determining the nature, timing and extent of audit procedures, much of the work of internal auditing can be useful to the external auditor in the audit of the financial statements. The auditor, therefore, as part of the audit assesses the internal audit function insofar as the auditor believes that it will be relevant in determining the nature, timing and extent of the audit procedures.
ISA 610, "Considering the Work of Internal Auditing" requires external auditors to consider the activities of internal auditors and their effect, if any, on the nature, timing, and extent of the external auditor's procedures. The external auditor considers the organizational status of the internal audit function, the scope of its function, the technical competence of its members and the professional care they exercise when assessing the work of the department.

Judgment permeates the auditor's work. The auditor uses professional judgment in areas such as:

• Assessing inherent and control risk and the risk of material misstatement due to fraud and error;

• Deciding upon the nature, timing and extent of the audit procedures;

• Evaluating the results of those procedures; and

• Assessing the reasonableness of the judgments and estimates made by management in preparing the financial statements.

The development of sophisticated real-time computerized information systems has greatly improved the potential for control, but in **turn has brought with it additional risks** arising from the possibility of computer failure or fraud. The introduction of electronic commerce has also introduced significant new risks and requires, in turn, additional controls.

Supervisors are concerned to ensure that the quality of management is adequate for the nature and scope of the business. In regulatory environments in which on-site inspections are regularly carried out, the examiners have an opportunity to notice signs of management deficiencies.

Enquiries should be aimed at establishing:

- The area in which the bank is dealing, eg
  - Investments; Certificates of deposit; Foreign exchange; Commodities; Land and property

- The fee earning activities of the bank
    - Loan commitment; Acceptances; Portfolio management; Corporate advisory work

All banks and similar financial institutions are required to follow the provisions of the Companies Act No.12 of 2002 and the Bank Act number 4 of 2006. The liabilities, powers, appointments and removal of auditors apply also to the banks.

The banks are entrusted with investments and if they are misused, or the operations are manipulated, the operation of financial markets is such that a failure of these businesses or fraud perpetrated against the investors will strike directly to the general public. Because of these consequences that such businesses require special audit treatment.

The statutory auditor applies also to banks; the statutory auditors can rely on performance and work of inspectors and internal auditor depending on

- Caliber of the staff of the internal audit department
- Independence enjoyed by them
- Use of standard procedures and adoption of a standard and uniform checklist
- Extent to which management depends on their report ie action taken by management on their report.

A financial institutions means any person authorized by law or by Bank of Tanzania to engage in banking business not involving receipt of money on current accounts subject to withdrawal by cheque. The following are excluded; insurance company, social security scheme, financial intermediary, savings or credit society and other savings and credit scheme established under any village or other authority

Banking business is a business of receiving funds form the public through acceptance of money deposits payable upon demand or after fixed a period or after notice or any similar operation through the frequent sale or placement of bonds, certificates, notes or other securities and the use of such funds either in whole or part for loans or investments for the account and at the risk of person doing such a business.

The Bank of Tanzania Act, 2006 and Banks and Financial Institutions Act, 2006

1. The section which deals with Audit and accounts requires that:

- The bank or financial institution to ensure that proper books of accounts and other records are kept in relation to the operation of the bank or financial institution; The accounts must be ready for submission to the auditors within the two months of the close of the financial year of each bank or financial institution.
- Every bank or financial institution shall appoint annually an independent auditor approved by the central bank. The auditor so appointed shall have considered necessary to bring to the attention of the central bank for purposes of improving the operation of the bank or financial institution
- Submission of quarterly report to the Central Bank certified by auditors of the bank; within one month of the end of the quarter.
- Within three months of the close of the financial year the financial statements and audit report must be submitted to the central bank.
- The central bank must arrange for meeting with banks or financial institutions for purpose explaining the supervisory role of CB in course of statutory audit of Bank or financial institutions including; all relevant aspect of the business; its accounting and internal control; and its annual accounts..
- All banks and financial institutions in Tanzania must use English or Kiswahili in preparation of books and accounts.

The central bank has issued number of standards on implementation of BFIA, 2006 such as;

- Prudential standard on management of Risk Assets, classification of loans and other Risk Assets, provisioning for losses and accrual of interest
- The standards on measuring capital adequacy
- Standard on concentration of credits and other exposure limits
- Policy and prudential standards on licensing of Banks and financial institutions

2. **The auditor's main concern is on establishing whether the bank is trading safely and operating as a going concern.**

- Checking returns from branches are properly recorded in heads office books
- Check ledger balances on current, deposit, advances and loan accounts
- Ensure that the system of internal control is adhered to and that no deviation is entertained
- Be conversant with the computerized systems
- Ensure that machine operators are changed about and that cashiers have no access to ledgers
- Ensure that investments and bills are verified and approved by authorized persons
- Check market values of securities deposited for loans and overdrafts

3. **Audit procedures**
   Borrowings

- Confirm borrowings, over and above the usual checking of balances and respective ledgers
- Security for borrowings should be verified

Demand and time liabilities

- Ask for details of balances for demand drafts payable, TTs payable, bills payable, Debit notes payable and clearinghouse adjustments. Any uncleared amount for considerable time should be inquired.
- Inspect the statement of suspense Account receipts, and see how they are disposed off during the current year, Receipts pending adjustments for a long time should be noted
- Ensure that the correct amount has been carried over to the next year for
  - Interest payable for time deposit and demand deposits
  - Auditor must satisfy that an adequate provision has been made for interest remaining still outstanding

Deposits

- Scrutinize ledger balances with balance book with particular attention to the accounts showing debit balances for a considerable period
- Inquire for sanctions form Head office or respective authority sanctioning the same. Absence of such sanction or authority should be brought to notice
- Check the fixed deposits and cash certificates remaining uncashed after the date of maturity
- The respective ledgers for the time deposit should be checked with particular attention to date of maturity
- Check the individual ledger with respective balance book for saving account
- Check the balances on ledger for letters of credit deposit, margin deposit, and other deposits
- The reconciliation on balance due to head offices and branches should be confirmed and verified
- A statement of guarantees outstanding as on the date of balance sheet should be asked for and should be verified with the register maintained for the same.

Assets

- Particulars of closing balance should be asked or and the cash on hand as on the date of audit should be verified with cashiers scroll or officer's scroll or physical verification should be made
- Reconciliation statements with the banks should be verified and a confirmation should be obtained of the other banks for the balances.
- Verify the balances outstanding loans, overdrafts and cash credits, with respective ledgers, with particular attention to sanction list of drawable limits.
- Advances given on security, the security should be verified
- Ensure that the life insurance policy and up to date from the point of view of premium paid
- Verify the fixed deposits and they should be the seen to be properly discharged
- Verify ornaments such as gold and their marked value form authorized quotation
- Verify the registers for supply bills
- Verify title deeds of immovable properties. Obtain valuer's report to ascertain the market value of the same should be verified in the authorized quotations lists
- Get a confirmation from the borrower of the balance due form him
- A statement should be obtained and scrutinized as to how the items in transit /remittances have been adjusted in the current year, subsequent to the date of balance sheet
- Check the balances outstanding with the furniture registers; additions during the year should be checked with the supplier's bill.
- Verify the suspense accounts, clearing house adjustments and cheques, stamps on hand and sundry deposits should be confirmed form parties verified
- Test check and verify the vouchers directly in the general ledger account for expenses such as salaries, rent, telephones and trunk calls, printing and stationery and building repairs. The vouchers should be verified in the ledger account.

Furthermore, there should be a continuous dialogue between the banks supervisors and the accountancy profession for purpose of improving the standards relating to banks and financial institutions

AUDIT OF CHARITIES

Charities are institutions established exclusively for charitable purposes according to the laws of the country. They are unusual organization managed for beneficiaries of the charity, rather than the benefits of shareholders/ members.

Charities may be companies limited by guarantee, which will make them to be governed by companies Act 2002. Others are registered under various Acts. The main Act, covering all charities is NGO Act, 2004. However many of its provisions, notably relating to accounting, have not yet come into force.

This makes charities to have special consideration regarding internal control set up. The auditor should study and evaluate internal control system, paying particular attention to segregation of duties and existence of qualified staff, with a view of establishing whether there is sufficient evidence on completeness of accounting records. The auditor must understand the constitution of the charity in detail with particular reference to any accounting or auditing regulations. Most of charities produce accounts although these are often just cash receipts and payments accounts. The auditor should study and evaluate the internal control system, paying particular attention to segregation of duties and existence of qualified staff, with a view of establishing whether there is sufficient evidence on completeness of accounting records.

When reviewing the financial statements the auditor should consider the appropriateness of the accounting policies. Consistency and adequacy of disclosure of the policies and the presentation of the results for the year under review. Particular attention should be given to the basis of

- *Disclosure of income form fund raising activities*
- *Accounting for income and expenses*
- *Capitalizing administrative expenditure*
- *Recognizing income from donation and legacies*
- *Treating exceptional items*

1. Audit procedures

- *A letter of engagement* is essential and should make clear what the auditor should report to.
- Areas requiring special attention include; Activities; Income; Specific funds; Branches; Overseas activities; Grants to beneficiaries
- ***Receipt***
    - Donation received by charitable trusts should be verified with copies of the receipts issued other documentary evidence or correspondence. Whether there are conditions attached to the donations. Check if the donation is applied to the trust fund and authenticity of recording. They can often be verified by proper system for opening the post or by the publication of list of donors.
    - Verify the income of interest and dividend form interest warrants and dividend warrants. If tax is deducted at source, should be accounted
    - Cash collections are impossible to verify for completeness but some work can be done. The charity should have a system for issuing collecting tins and for recording their return. Counting should be done by several people and cash counts acknowledged in writing. A good system is required not only for the benefit of the charity but also for the protection of volunteers.
    - Verify the rent received from copies of receipt issued see whether the rent receivable is full received. Arrears of rent should be accounted for
    - Verify the cash closing balance, investments, assets and bank fixed deposit receipts
    - Legacies are form of income and it is difficult for an auditor to be sure all have been received especially if these are reversions. The auditor should see that the charity has procedures to ensure all legacies are received. This may require legal assistance to search all notified wills.
- ***Expenditure***
    - Verify the receipts and other evidence in respect of expenditure to be as per trust deed. The expenditure should be authorized by committee minute or by delegated authority. Year-end liabilities should be particularly examined to ensure all are included.
    - Verify expenditure on establishment, repairs, and maintenance and in respect of buildings and properties. Fixed assets can be verified in the usual way. However, a particular problem arises with gifts of fixed or other assets in kind. These should be valued in some appropriate way to recognize and account for the assets.
    - Check and verify if the purchases of new investment to be authorized by the trustee by resolutions
    - Ensure that provisions of the applicable acts are complied with e.g filling budgets, investment funds, maintenance of minutes books and meetings
- Going concern
    - Some charities are government, international organizations or other grant dependent. In wake of lowered expenditure by these bodies, some charities may have liquidity problems and may not even be going concern.

Review question:

Your firm has recently been appointed auditor of 'SAIDIA WAZEE', a national charity that receives substantial proportion of its income form voluntary sources. You are the Manager in charge of the audit assignment and have agreed to draft a memorandum to the senior setting out the matters that should be considered in planning the audit

Required
Draft a memorandum to the senior detailing the matters peculiar to the audit of SAIDIA WAZEE that may warrant consideration at the forthcoming audit-planning meeting.

AUDIT OF CLUBS AND ASSOCIATIONS

The auditor should examine the articles and memoranda of Association and examine any amendments and special issues concerning financial regulations including authorization limits; *decision making machinery; election procedures* and appointments; minutes books; finances; sources of revenues and expenditures.

Study, evaluate and Enquirer on the internal control system, its strength, adequacy and in particular; annual subscription and membership entrance fees, should be checked and confirmed and verified with the current enrollment lists; inquire on steps for recovery of arrears in annual subscription fees; vouch the admission fees and annual subscription fees with the counter foil or duplicate copy of receipt; special care on life membership fees; sometimes are of capital nature; check the subscription received in advance and their recording

Income and expenditure

- *vouch other interests income and cash receipts; vouch receipts on account of supply of meals, drinks and refreshments to members , see that members are billed properly; check the distinction between capital and revenue expenditure*
- *verify expenses on purchases of provisions , supplies , food stuffs, drinks, furniture, crockery , linen; also other expenses such as salaries and wages*

AUDIT OF SHIPPING COMPANIES

To audit shipping companies, the auditor should consider the following procedures:

i) An auditor must obtain the articles of association and memorandum of understanding with the ship owner and captains for each vessel.
ii) Examine ownership of each vessel, verifying it with a proper documentation including certificate of registration and any mortgage attached.
iii) Verify purchase price of each vessel owned by client ,care being taken to ensure that cost of repairs, alteration, and refitting are included only to the extent of capital works undertaken
iv) Examine revaluation certificates if any ensuring that it given by independent expert
v) Accounts with home and foreign agents submitted by captains ,should be checked and vouched
vi) Charter parties should be checked as to brokerage commission and freight rates, noting the returns are agreed and credited to voyage accounts
vii) Posting of voyage accounts should be checked ,noting that credit is given at the end of each voyage for stores in hand which are subsequently transferred to next voyage.
viii) Income : Check that the freight is properly recorded in the cash book and other books of account and voyage ledger also Check the passenger fare on basis of receipt issued by the company
ix) Check statement of each commission and brokerage costs, check up also the calculations and vouch the payments with reference to receipts obtained thereon
x) Check separately the expenses for floating staff and office staffs
xi) Vouch the insurance premium with the policies and receipt obtained for the payments to insurance companies
xii) Vouch for contracts expenses for chipping and painting with reference to contracts, bills and receipts obtained.
xiii) Check up the carry forwards which at each year and all the voyages not complete
xiv) Check the returns of statements of accounts from all their offices which may be abroad
xv) Vouch purchases of ships , vessels and other fixed assets; see that appropriate rate of depreciation
xvi) Check-up taxed paid to foreign ports
xvii) The taxes paid at various foreign ports
xviii) Check all contracts for purchase of ships

AUDIT OF PUBLISHERS

The auditor should consider the following procedures:

i) Study the constitution of charity especially on matters relating to accounts and audit
ii) Check the value of stocks of publications on hand at cost and verify cost of each book produced
iii) Check slow moving stocks , and confirm policies to write down value and whether these are adhered to
iv) Check stocks returns and verify with records, confirming figures
v) Ascertain system of accounting regarding publication eg use of separate account for each book published
vi) Check the system of transactions with authors particularly in regard to royalties payable. And ascertain whether all those due have been properly recorded.

AUDIT OF PENSION SCHEME

Audit procedures:

i) The audit should plan an audit so as to detect any material misstatement in accounts arising from breaches of trust deed and any breach should be brought to the attention of trustees and reflected in accounts.
ii) The auditor should have reasonable understanding of the Act/statute/Law establishing the pension scheme. Also should ensure that all disclosures required by law have been made.
iii) The auditor should examine using the standard procedures of internal control evaluation, sample substantive test through inspection, recalculation, observation and analytical review the following area;
   - Receipt of contribution during the year
   - Evaluate the actuarial statement for the year
   - The way of calculating benefits and transfers by schemes administration
   - Involvement and co-option of members on schemes investment
   - Extend which benefit transfers are calculated and settled by administration
   - Maintenance of members records
   - Trust deed and rules of the scheme
   - Management of Scheme's investment
iv) In the audit of pension funds, apart from a normal opinion the auditor is required to report: Whether the accounts include all items which must be disclosed by law; State whether the contributions have been paid in accordance the funds rules
v) The auditor should consider the following issues: rules of the fund, and confirm that the fund's transactions are within its rules; The matters in which the auditor is required to report ;Who maintains the membership records
vi) Who is responsible for maintaining the scheme's investments; Benefit calculations and settlement; Vouch the transactions which have occurred during the year; Verify assets at balance sheet date; Confirm the solvency of the fund by reference to the accounts

4. AUDIT OF SMALL BUSINESS

Guidance is IAPS 1005 which defines small entity as entity is any entity in which: (a) There is concentration of ownership and management in a small number of individuals (often a single individual2); and (b) One or more of the following are also found: (i) Few sources of income; (ii) Unsophisticated record-keeping; or (iii) Limited internal controls together with the potential for management override of controls. The qualitative characteristics described above are not exhaustive, they are not exclusive to small entities and small entities do not necessarily display all of those characteristics. For the purposes of this IAPS, small entities will ordinarily display characteristic (a), and one or more of the characteristics included under (b).

The word "individual" denotes ownership by a natural person, rather than by another entity. An entity owned by another enterprise may, however, be regarded as a "small entity" for the purpose of t IAPS if the owner exhibits the relevant characteristics.

Most small entities employ few, if any, personnel who are solely engaged in record-keeping. Consequently the bookkeeping functions and accounting records are often unsophisticated. Record keeping may be unsophisticated ING

or poor, which results in a greater risk that the financial statements may be inaccurate or incomplete. Many small entities outsource some of or all their record keeping.

personal computer. Many of these packages have been widely tested and accredited and can, if chosen and implemented with care, provide a reasonable basis for a reliable and cost-effective accounting system.

Usually the auditor ascertain, records, evaluate and carry out compliance tests on systems of internal control in those situations where it is intended that some reliance be placed upon such systems, and as a consequence of such reliance, the level of detailed substantive testing can be reduced.

If the system of internal controls are evaluated as being poor there is little point in carrying out compliance tests . Instead the auditor should move directly to the substantive tests of the financial statements; the scope and extent of such substantive tests should be determined by the auditors judgment as to which areas of accounts are of greater concern, using both financial materiality and assessed risk as starting criteria

The impact of the owner-manager and the potential for management override of internal controls on the audit depend to a great extent on the integrity, attitude, and motives of the owner-manager. As in any other audit, the auditor of a small entity exercises professional skepticism. The auditor neither assumes that the owner-manager is dishonest nor assumes unquestioned honesty. This is an important factor to be considered by the auditor when assessing audit risk, planning the nature and extent of audit work, evaluating audit evidence, and assessing the reliability of management representations.

Inadequate system of internal control can occur in companies of all sizes ; however small companies pose a particular problems for auditors

- The size of the staff may be too small to ensure adequate segregation of duties
- The owner-manager may be in position to override such controls as to operate or to suppress information about transactions from the auditor.
- Audit evidence may not always meet the criteria of being relevant, reliable and sufficient because operations and transactions are conducted more informally than they might be in larger organization
- The auditor of a small company may also be an accountant, the company being too small to employ a book keeper or accountant capable of maintaining satisfactory accounting records to companies Act 2002 standards. Thus it may be difficult for the auditor /accountant to maintain a clear cut distinction as to what is *“accounting evidence” and what is “auditing evidence”*

Generally,

  - There is mixing of personal and company issues and property, which if reflected in accounting records, would lead to errors in the accounts and possible problems with other authorities eg tax officials.
  - There is lack of understanding of why audit is necessary due to ignorance in accounting expertise. Even where they are aware of the benefits of audit, they tend to ignore or give it little weight because the directors are the same as shareholders. Hence they tend to view audit exercise as part of tax assessment exercise.
  - For a small but a rapidly expanding business , much of the proprietor’s time is devoted in steering the business along an expansion path at the expense of the supervision of the business
  - Additionally, the audit work should reflect the nature of the client’s business, the risk of material errors and the results of analytical review procedures.
  - The audit procedures need to be modified to suit the objective of an audit in a specified business. Where the population is large enough, sampling techniques are useful to carry out substantive tests in a cost effective manner.
- Most small businesses lack formal system of internal control, audit procedures do not involve of controls except that the risk of errors is high. Even where some controls are in place, the auditor should employ substantive procedures and avoid use of compliance tests.
- Sometimes the risk to an auditor is offset by number of measures taken e.g. consulting evidence from external agents.
- Sometimes the auditor is engaged to do both the accounting and audit work; the following factors are important to consider on:-
  - The client must understand that the two assignment are separate
  - Accounting works should be reviewed by a suitably qualified person with relevant experience in various aspects of the business.
  - The audit evidence obtained while doing the accounting work. Should be recorded showing evidence of
  - Accountancy work carried out
    - Type and extent of audit assurance is provided by accounting work
    - The effect on detailed audit procedures

- The accountancy work should never replace all the necessary audit procedures. Eg. If the auditor had written the cash book and prepare the bank reconciliation, it will still be necessary to confirm the final balance by

obtaining the bank confirmation. Invoices given to them by the client but this to given them any assurance that sales invoice have been raised for all stock issues made by the client to customers
- Generally, the accountancy work will reduce significantly the extent of audit procedures in those areas where accountancy work was done. This can be verified by sequence checks on invoice numbering , alternative methods such as analytical reviews, comparisons and external evidences or related population

It is often of little use for the auditor to make recommendation to the effect that the system of internal control should be strengthened; the client may be too small for such strengthening to occur, naturally and additional costs incurred will usually outweigh any benefits obtained.

Satisfactory (**sufficient and appropriate**) audit evidence can often be obtained from

Observation and inquiry techniques; Proprietor –operated controls; Examination of prime documentation (such as purchase invoices, purchase orders, GRN and paid cheques) as a part of accounts compilation procedures; Auditor generated data (such as bad debts provisions or prepayments); Accounting work (such as ledger postings) carried out by auditor as a part of accounting engagement; Overall reconciliation of quantities of goods bought and sold; Use of analytical review procedures

In order to minimize the possibility that the auditors will qualify the financial statements on grounds for inadequate internal controls; it is usually suggested that a combination of evidence obtained from detailed substantive testing should enable the auditor to provide a positive audit opinion.
The bulk of assurance will, however come from substantive testing approaches rather than form compliance testing, simply because of the inadequacy of may small companies system of IC there are many situations where sufficient, relevant, reliable audit evidence is not forthcoming and the auditors have to qualify their reports.

5. GROUP ACCOUNTS

The company with subsidiaries, in additional to the normal own accounts, it should prepare the accounts showing a combined position of the company and its subsidiaries

The auditor of the holding company is called *“the primary auditor*” whereas the auditor of a subsidiary *companies a secondary* auditor.

- The onus to report on truth and fairness of the group accounts as whole is with primary auditor, and sometimes the following problems arises ;
  - She may not be the auditor of some or any of the subsidiary companies
  - There is no right of access to books , vouchers , etc of subsidiary where she is not the auditor
  - Some of the reports upon the accounts of the subsidiary companies may be qualified.
  - All the year-end dates may not be co-terminus.

It is a duty of the holding company to furnish the primary auditor with the information and explanation required from the subsidiary. The primary auditor may request the secondary auditor to complete a questionnaire to obtain information he requires and on the following matters; internal controls, fixed assets, stocks and WIP; long term contracts, debtors, investments, bank balance , goodwill ,trademarks, patents, creditors, accruals and provisions and taxation

- Where the secondary auditor has qualified his report, the primary auditor should consider if such qualification is material to the group. If it is , then the audit report of the group accounts must also be qualified in the respect of it
- Where the financial year is not co-terminus, the auditor should get reasons and adjust the accounts of the subsidiary accordingly.

Circumstances where the primary auditor should review the activities of the subsidiary

- At time of first audit of the group
- Where a subsidiary company is formed or acquired
- Where there has been a change in auditors of the subsidiary
- Where there has been a substantial change in the business of a subsidiary

- The primary auditor is responsible for the opinion he expresses in the audit of the group accounts; and if he is unable to satisfy himself in relation to the subsidiary (and associated companies) which he himself not audited, she should qualify her report indication clearly the reasons and identifying material item affected.

Factors auditor should consider in preparing the report

- The computation of the amount shown under the heading of goodwill
- The liability of minority interests in the subsidiary company
- The cancellation of any inter company profits
- The conversion of into currency of the holding company for purpose of the consolidation accounts of the figures relating to foreign subsidiaries

Where the accounts, which have been consolidated are made up at different dated, the adjustments (if any) which have been made must be carefully examined in order to ensure that the financial position which the primary

- and loss statements of the group , as shown by consolidated accounts are not misrepresented or misrepresented.
- In consolidated profit and loss account it should be seen that proper adjustments has been made for dividends paid by the subsidiary company to the parent company. Dividends from purchase price of the shares in arriving at value of a goodwill and should not appear in the consolidated profit and loss account
- if any assets of the subsidiary company has been revalued for the purpose of the consolidated balance sheet , it should be seen that proper effect has been given to such revaluation in arriving at minority interests. It should be ascertained that the charge to consolidated profit and loss account for the depreciation, by reference to such revaluation has been adjusted correctly and the profit

JOINT AUDITS

- Circumstances may occur, where two or more auditors are required to undertake and audit assignment jointly.
- Special problem of control arise in situations where more than one firm are appointee as auditor
- Circumstances for joint audit
  - Change in administration (e.g New chairman)
  - Reporting/investigating accountants being asked to become joint auditor
  - Legal requirements in some overseas countries
  - In take overs
  - When local expertise/availability is important
  - When small firms are unable to supply specialist services e.g. Electronic Data Processing
- Possible division of work
  - Natural division for reason of geography, language and special expertise
  - Agreed division of work
  - Rotation of aspects of audit work, year by year between the joint audit firms
  - Methods of documentation
    - Each firm has its own file
    - Treating each firms file as one with cross reference
    - Using common audit program and documentation
- Legal responsibilities
  - All auditors may be jointly and severally liable for the consequences of loss arising from negligence.
- Before accepting a joint office and auditor must
  - Consider whether he/she is prepared to serve jointly with the other auditor, consider if he would take as a partner
  - Assure herself that adequate control and review of all aspects of audit can be organized
  - Ensure that professional indemnity insurance cover can be obtained to cover special situation.

1. *APPLICATION OF FORENSIC AUDITING*

An obvious example of a forensic auditing is the investigation of a fraud or presumptive fraud with a view to gathering evidence that could be presented in a court of law. However there is increasing use of auditing skills to prevent fraud by identifying and rectifying situations which could lead to frauds being perpetrated (i.e risks). It is useful therefore to disc

uss forensic auditing as either ‘Reactive’ or proactive’

PROACTIVE FORENSIC AUDIT

Forensic auditing in this sense could viewed from different aspects depending on its application, some of which are discussed below:

Statutory Audit

INTOSAI auditing standards prescribe that internal controls should be studied and evaluated in respect of safeguarding assets and resources when performing regularity and financial audits and in respect of assisting management in complying with laws and regulations when performing compliance audits.

Regulatory Compliance

Government ministries, departments and agencies could themselves use the techniques of forensic auditing to assess compliance with regulations governing payments of grants and subsidies, performance auditors could also use these techniques when auditing such governmental programs

Diagnostic tool

Forensic auditing can be used either by management or by the auditors to carry out general review of activities to highlight risks arising either out of the fraud or from any other source with the purpose of initiating focused reviews of a particular area, targeting specific threats to the organization. An example could be tracking down the quality of construction of public buildings such as schools, and /provision of public services in the schools and hospitals.

Investigation of allegations

Complaints, allegations in the press or in the parliament, anonymous tips from employee or others could all in their separate ways require to be adequately addressed by investigation. The techniques of forensic auditing are useful in such cases. It is being cited as proactive because it is widely felt that the existence of a system of investigation in such cases is a significant deterrent to fraud or corruption.

REACTIVE FORENSIC AUDITING

In reactive forensic auditing the objective is to investigate cases of suspected fraud so as to prove or disapprove the suspicions and if the suspicions are proven, to identify the person involved, support the findings by evidence and to present evidence in acceptable format in any subsequent disciplinary or criminal proceedings.

In such cases it is important to keep in view the following:

- Working relations with an investigating and prosecuting agencies
- Authorization and control of the audit investigation
- Documentation of relevant information and safeguarding all prime records pertaining to the case
- Rules of evidence governing admissibility/ authentication of records
- Confidentiality
- Evaluation of evidence to assess whether the case is sustainable
- Legal advice where appropriate
- Reporting the findings in a manner that meets legal requirements.

Answers to Test Yourself

Answer to TY 1

(a) No, PFI is based on estimates and assumptions which cannot be predicted perfectly. PFI can be reliable, or reliable and fair, but cannot be perfectly accurate.

(b) No, the management of an organisation preparing PFI is responsible for its reliability. An auditor, if appointed for this, is responsible for giving assurance regarding the reliability of the PFI.

(c) Yes, according to the definition of PFI, assumptions about future events can be in the form of a forecast or a projection or a combination of both.

(d) Yes, to provide an assurance regarding the reliability of PFI to the users, companies generally prefer to present PFI that is audited by a professional accountant.

Answer to TY 2

(a) Comparability is affected as the historical accounting policy of recording depreciation is not followed.

(b) A growth rate of 20% is not justifiable on the basis of past data. This could affect the reliability of the PFI unless the management has reasons to justify such a high growth rate.

(c) The PFI cannot be understood in the absence of adequate disclosure of the basis for assumptions. However, since the PFI is required for internal purposes, very many details may not be required.

(d) Although preparing a PFI for a longer period than required does not do any harm, it is a waste of time and effort. Especially when the PFI is for external users, it must be presented just as required and unnecessary details should be eliminated.

Answer to TY 3

Before accepting the assignment to examine the financial projections, Jude Accountants must consider the following two important aspects:

Featherlite is a newly established company. Hence it will not have records of past financial information for verification of historical trends in growth etc. Jude needs to check carefully the basis on which various important assumptions such as growth in sales and demand or increase in major expenditure are made to ascertain their reasonableness.

Since the management comprises fresh graduates, Jude must ensure that the financial projections are prepared by a person possessing the appropriate technical skills, experience and moreover, professional judgement in making assumptions.

Answer to TY 4

Raymond must carry out the following procedures while examining the PFI:

Recheck the arithmetic accuracy of the forecast

Estimated costs to be agreed to quotations

Review information for any obvious omissions (e.g. depreciation expense)

review for consistency between statement of financial position and statement of consolidated income (e.g. depreciation charge is in line with assets on the statement of financial position or financing costs are in line with debt on the statement of financial position)

Review figures for reasonableness by making comparisons with other similar entities

If part of the period under review has elapsed, check by comparing with actual figures

Compare previous year's forecasts to actual results achieved to assess reliability of estimates

Ensure any assumptions made are within client capabilities

Carry out analytical review and investigate fluctuations

Agree key figures according to underlying evidence (e.g. expected sales figures in relation to market research results)

Ensure accounting policies used are consistent with those used in the statutory accounts

Answer to TY 5

Some of the important and basic verification procedures of financial projections that Britney can include in the control document are:

Checking the historical trend of the items from the past financial information available
Checking the actual results of past projections, if any
Verifying whether the broad economic indicators such as inflation rates, interest rates or foreign exchange rates have been considered in preparing the projections
Conducting ratio analysis
Comparing with competitors' performance or industry standards to assess whether the assumptions made are reasonable

Answer to TY 6

(a) This statement reflects the auditor's opinion on the achievability of PFI results. It is a caveat for the achievability of the results indicated by the prospective financial information.

(b) This statement is a negative assurance which gives a limited assurance on the PFI indicating that the auditor has not come across a situation to believe that the assumptions considered in preparing the PFI are not reasonable.

Quick Quiz

1. Fill in the blanks

   (a) _______ means the intended future results planned by the company.

   (b) If the distribution of information is limited, the risk is relatively lower than that of _______ distribution.

   (c) If a ___________is used for an assumption, the scope of work will be comparatively limited.

   (d) _____________means expenditure incurred for the organisation's day-to-day expenses relating only to the current year.

   (e) A PFI report necessarily contains a __________assurance.

2. Answer in one sentence

   (a) What is meant by PFI?

   (b) Why do users prefer audited PFI?

3. Choose the correct option

   (a) PFI can be used for internal and/or external purposes in all except:

   A Annual report
   B Prospectus
   C Project report
   D Memorandum of association

   (b) The characteristics of useful PFI include all except:

   A Understandability
   B Relevance
   C Uncertainty
   D Comparability

Answers to Quick Quiz

1.
   (a) Target

   (b) General

   (c) Best-estimate

   (d) Revenue expenditure

   (e) Negative

2.
   (a) PFI stands for prospective financial information based on assumptions about events that may occur in the future and possible actions that can be taken by an entity.

   (b) An audited PFI enhances the confidence of its users with regard to its reliability and correctness to a certain extent and reduces the risk involved in decision-making.

3.
   (a) The correct option is **D**.

   (b) The correct option is **C**.

Self-Examination Questions

Question 1

Markinson Tyre Co is engaged in the business of manufacturing tyres. During the current year, the company has received a hostile bid for takeover from a large tyre company. Although Markinson is experiencing a slowdown in its business, its management is confident about the company's future prospects. The company is planning to collaborate with a German company to introduce a new rubber technology for manufacturing 'puncture resistant' tyres. With this it hopes to capture 20% more of the market share and therefore to experience an increase in profits.

Mr Riggs, the finance manager, has prepared some prospective financial information in the form of profit forecasts for the next five years for circulation to shareholders and prospective investors as a defence against the bid. Markinson's management appoints Rubel Accountants, Chartered Certified Accountants, to examine and report on the profit forecasts. Rubel Accountants has not performed such an assignment before.

Required:

(a) Explain the term prospective financial information (PFI).

(b) Discuss the matters that Rubel Accountants should consider before accepting the assignment to report on the profit forecasts. Also outline the procedure which it must follow while examining the profit forecasts.

Question 2

Mr Dawson is an audit partner in Sunrise Accountants Co, a firm of chartered certified accountants. He has been given the task of examining the financial projections of one of the clients, Prestige Wirings Ltd. These projections are prepared for the purpose of a loan application for investment in new machinery. The client has recently purchased some patent rights which would enable it to produce a specialised product for which the machinery is required. The financial projections are for two financial years ending 31 March 20X9 and 31 March 20Y0. Mr Dawson takes up the assignment on 1 July 20X8.

Required:

(a) Explain the matters that Mr Dawson should consider while planning the nature and scope of the examination of Prestige's financial projections.

(b) What could Mr Dawson be liable for if his report on the financial projections is not appropriate? How can he reduce this liability?

Answers to Self-Examination Questions

Answer to SEQ 1

(a) Prospective financial information (PFI)

ISAE 3400 states that PFI is financial information based on:

Assumptions about events that may occur in the future; and
Possible actions by an entity.

Prospective financial information can be in the form of a forecast, a projection or a combination of both.

Forecast

Remember to explain the meaning of the terms 'forecast' and 'projection' as these form an important part of PFI.

A forecast is defined by ISAE 3400 as PFI prepared on the basis of assumptions about future events that management expects to take place and the actions management expects to take at the time the information is prepared (best-estimate assumptions).

Projection

A projection is defined by ISAE 3400 as PFI prepared on the basis of:

Hypothetical assumptions about future events and management actions which are not necessarily expected to take place (e.g. when entities are starting up or restructuring); or
A mixture of best-estimate and hypothetical assumptions.

(b) Prior to accepting the appointment, Rubel Accountants must go through the guidelines provided by the International Standard on Assurance Engagement (ISAE) 3400, on the examination of prospective financial information (PFI) as these relate specifically to the examination of PFI. This is in addition to the general rules of accepting an appointment (as laid out by the IFAC Code of Conduct and Ethics) which need to be followed by a professional accountant.

These ISAE guidelines include the matters to be considered prior to accepting an engagement to examine PFI and the procedure of doing so.

Acceptance of engagement

Apart from the general rules of accepting an appointment (such as consideration of the fundamental principles) Rubel Accountants should consider the following:

Purpose of PFI i.e. profit forecasts and risk involved

Rubel Accountants must understand why the forecasts are prepared and how they are going to affect the users' decisions. This will also help with understanding the risk factor involved in the assignment. As Markinson's profit forecasts are intended for the existing shareholders and other prospective investors, there seem to be a large number of users. Therefore, the risk is high.

Although other factors might play their role in affecting the shareholders' decision (such as the price offered by the bidding company), these forecasts would certainly affect the users' decision (to some extent) of whether to let the company be taken over by another company or whether to remain invested in the original company. Therefore, there seems to be a higher risk of material misstatement in Rubel's assurance on the profit forecasts. Rubel must consider all these points before accepting the appointment.

Type of assumption made

In assessing the risk, Rubel must verify the type of assumptions made in calculating the financial figures of various items of expenditure or income. This is because an assumption based on a hypothetical situation will be more risky than a best estimate assumption. In the given scenario, Markinson expects an increase in profits upon implementation of the new technology. This is a hypothetical assumption because it does not know whether the new technology will result in better quality tyres. Additionally, Markinson's competitor might already be in the process of implementing such a technology so that by the time Markinson actually adopts the new technology, the competitor might have captured an additional market share, leaving very little left over for Markinson. Rubel must discuss the viability of the company's plan to develop new technology and accordingly assess the risk involved.

Time period covered

This will enable Rubel to assess the basis of assumption that might have been used by the management. For example, the rate of inflation over five years or likely fluctuations in the foreign exchange rate that might be expected during the five years.

Responsibility of preparing PFI

Rubel must check whether Mr. Riggs, who has prepared the profit forecasts, has the technical expertise and professional experience and judgment to do this work. This will enhance the reliability of the forecasts. However, Rubel should not solely depend on this fact while examining the forecasts.

Procedure of examining the PFI

After the accepting the appointment, Rubel should verify various aspects of the PFI step-by-step. The procedure would include the following:

Examination of the results of the past projections if any

If possible, Rubel should verify the results of past projections, if any were made by the management, and compare the results of such projections with the actual figures in order to assess the accuracy of the management's judgment. The auditor must ensure that too much time is not spent on this exercise as it will divert him from the main assignment and will also eat into the time allotted for the main assignment i.e. examining the profit forecasts. The sole purpose of examining any past results must be to judge the expertise of the management in preparing such projections and to determine the nature, timing and extent of the examination.

Verification of the basis of assumption

In examining any type of projections or forecasts, the auditor must verify the basis of various assumptions that have been made to assess the reliability of such projections. Rubel has been appointed to examine profit forecasts. It must therefore verify the basis of the assumptions made for various income and expense figures in order to estimate yearly profits.

For example, if Markinson has agreed to pay consulting fees to the technicians of the German company, the estimated consulting fees can be verified on the basis of a management contract entered with the German company.

While verifying the basis of the assumption, Rubel must focus on its appropriateness and whether it is capable of giving reliable results. For example, Rubel must check whether the management's negotiations with the German company, with respect to the final agreement, are complete or still in progress. This is so because, if the agreement is not yet finalised, then the reliability of all the assumptions made on the basis of the agreement happening is questionable.

Analysis of past trend

Analysis of the past trend of movements in various prices can be used to verify the calculations of various incomes and expenses affecting the profit figures. Rubel could check the following:

- Change in sales prices
- Change in sales volume
- Change in purchases
- Average growth in the number of employees
- Average increase in the salary of employees
- Level of salary of directors and senior managers
- Intervals at which maintenance charges are incurred on machinery

Ratio analysis is an important and useful tool that Rubel could use to analyse the past trends for various figures, for example, calculating the gross profit ratios for each year and comparing the average ratio with that of the projected gross profit ratio.

Market analysis

A study of the market trend of various elements that affect the financial decisions of the management is essential. Rubel can check the following market parameters to assess whether Mr. Riggs has taken them into consideration:

- Prevailing and forecasted rate of inflation
- Likely fluctuations in exchange rates
- Estimated movements in interest rates
- Potential changes in customer preferences and demand
- Position of Markinson's competitors

Opening balances

Rubel must ensure that Mr. Riggs has reflected the correct opening position of the company while preparing the forecasts. In the case of profit forecasts, this would include the opening inventory figures, which must coincide with those of the previous year's closing figures.

Apart from the above, Rubel must conduct regular audit procedures (such as checking mathematical accuracy) before arriving at an opinion on the reliability of such forecasts and issuing a report.

Answer to SEQ 2

(a) Matters to be considered while planning the nature and scope of the examination of Prestige's financial projections:

Remember, you have to discuss matters to be considered while planning the nature and scope of the PFI examination and not matters to be considered before accepting the engagement.

Scope of engagement

Scope refers to the work involved. This will depend on collection of evidence regarding the reasonableness and consistency of assumptions made, proper preparation of projections (on the basis of stated assumptions) and consistent presentation (with historical financial statements, using appropriate accounting principles) to enable comparison with actual results at a later date.

Basis of assumption

The basis of preparation of the financial projections is important. For example, the extent to which the projections are based on pro forma financial information (i.e. historical financial information adjusted for the effects of the planned loan and capital expenditure transaction) or new information and assumptions about future performance (e.g. the operating capacity of the new machinery and sales generated).

Type of assurance

Mr Dawson should consider that the auditor's report on the financial projections will provide only negative assurance as to whether the assumptions provide a reasonable basis for the projections and an opinion on whether the projections are properly prepared and presented in accordance with the relevant financial reporting framework.

User of the financial projections

The financial projections are prepared for an external user, i.e. the bank, and contained in an application for a loan to finance the purchase of new machinery. Therefore the information is for limited use i.e. for a particular user and not for general distribution or publishing.

Later, when the loan is sanctioned by the bank, these financial forecasts can serve as a management tool for comparing the expected results of buying the machinery with the actual results. Therefore the financial forecasts will be used internally for management decision making purposes.

Management expertise

Prestige's management's previous experience in preparing prospective financial information such as projections and forecasts will help in planning the nature of the examination. For example, this experience will help in making accounting estimates (e.g. for provisions and impairment losses) or preparing cash flow forecasts (e.g. in support of the going concern assertion). If the management is experienced and has lived through various business cycles then the assumptions made are likely to be reasonable.

Time period covered

The financial projections are for two years. The assumptions for the year ending 31 March 20Y0 are likely to be more speculative than those for the year ending 31 March 20X9, particularly in relation to the impact on revenue, demand, per unit costs etc. of the investment in new machinery.

The projections for the year ending 31 March 20X9 include an element of historical financial information which relates to the period from 1 April 20X8 to 30 June 20X8. Therefore Mr Dawson has actual evidence available for verification of the projections for the first three months of the projected period.

Applicable guidelines

Mr Dawson should consider the regulations or guidelines applicable to the examination as they will help him to perform his duties. For example, ISAE 3400 on the examination of prospective financial information (PFI) establishes standards and provides guidance on engagements to examine and report on PFI including the procedures for examination. These will help Mr Dawson to determine the nature and scope of the examination.

(b) Mr Dawson's professional liability

Professional accountants are called upon to report on prospective financial information for various reasons (e.g. for securing a bank loan). The forecasts and projections which form a part of the PFI are inherently unreliable as they are based on certain assumptions. If the forecasts or projections do not come true then the client or lenders (or investors) may consequently sustain financial loss and the accountant may face lawsuits.

In the given scenario, as the financial projections are meant for securing a loan and would be used by a bank, the consequences of providing an inappropriate or incorrect report would be that the bank will sanction the loan for a project that may not be feasible. This could result in a financial loss to the bank and Mr Dawson could face legal suits from the bank. Prestige could also face financial losses if it relies on such projections.

In order to reduce the liability, Mr Dawson should follow the following measures:

- Ensure that all the assumptions are adequately disclosed
- Clearly state that the preparation of the financial projections is the responsibility of Prestige's management
- Clearly distinguish hypothetical assumptions from best estimates
- Carefully word the report including:
  - A caveat that the prospective results may not be attained
  - Specific and extensive warnings such as 'the actual results … will vary'
  - Disclaimers such as 'we do not express an opinion'
  - ensure that his report clearly states for whom the projections are meant, its purpose, the work performed by him and his findings
  - Ensure that his report does not include ambiguous wording such as 'we certify that…'
  - Ensure that the engagement terms include an appropriate liability clause that is reasonable in the circumstances of the engagement.
  - try to obtain indemnity from Prestige in respect of claims from third parties (i.e. the bank)

By ensuring that the engagement terms are favourable and the report is carefully drafted, Mr Dawson can protect himself from being sued for inaccuracies in Prestige's financial projections which he has reported on.

SECTION F

DRAWING CONCLUSIONS AND REPORTING

F1

STUDY GUIDE F1: AUDIT FINALISATION

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, we will discuss the various facets of the overall review of the evidence obtained by the auditor and the significance of uncorrected misstatements. We will also discuss the issues identified during the course of an assignment that may be raised and dealt with by communicating with management. Go through this Study Guide carefully since it provides important knowledge which will be useful for audit finalisation.

Learning Outcomes

a) Analyse, evaluate and propose how issues identified during the course of an assignment may be raised and dealt with in communication with management, directors and those charged with governance including action taken when such issues cannot be agreed.
b) Identify, apply and explain procedures that may be used and considerations relating to the identification of subsequent events that may require adjustment or disclosure.
c) Identify, apply and explain procedures that may be used and considerations relating to the identification of risk issues that may require disclosure.
d) Evaluate and apply quantitative and qualitative judgments based on the results of tests and evidence obtained.
e) Evaluate the significance of uncorrected misstatements.

1. Analyse, evaluate and propose how issues identified during the course of an assignment may be raised and dealt with in communication with management, directors and those charged with governance including action taken when such issues cannot be agreed.
[Learning Outcome a]

An audit can be described as being an official and independent examination of an organisation's accounting records, operations as well as its financial performance and position by a professionally-qualified expert. Its objective is to provide an independent assurance as to whether an organisation's reporting policies and procedures are accurately reflecting the relevant financial information about its operations and activities.

This assurance comes in the form of a report in which the auditor states that the organisation's financial statements truly and fairly portray the financial condition and performance of the organisation over a given time period. Through ISAs, auditors are regulated on how they must carry out their audits and part of that task is communication with the organisation whilst performing their audits. Both ISAs and local auditing regulations have policies and procedures in place in regards to what must be communicated and to whom.

Example

For instance, ISA 260 specifically states that "the auditor should communicate audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity." For example, if an auditor uncovers any instances of fraud, these should be directly and immediately reported to the organisation's board of directors.

Definition

Those charged with governance - The person(s) or organization(s) (for example, a corporate trustee) with 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.

IFAC Glossary of terms

Although there is no universal rule, in most instances, these persons will either be members of the board of directors and/or the audit committee of an organisation. If the organisation being audited were a trust, then those charged with governance would be the trustees. If the organisation were a school, then those charged with governance could be the board of governors.

Definition

Management – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

ISA 260

1.1 Matters to be communicated and action taken when such issues cannot be agreed

1. "Audit matters of governance interest arising from the audit of financial statements" that need to be communicated, and the action taken when issues are not agreed with the client are discussed below.

Sr No	Matters to be communicated	Action taken when such issues cannot be agreed
(a)	**The auditor's responsibilities in relation to the financial statement audit**	
	the auditor's responsibility relating to forming and expressing an opinion on the financial statements (FS) that have been prepared by management; and the fact that the audit of the FS does not relieve management or those charged with governance of their responsibilities.	In an assurance engagement, there cannot be a disagreement on the above point as the responsibilities mentioned above are provided in the ISAs

Continued on the next page

(b)	Planned Scope and Timing of the Audit (overview of the planned scope and timing of the audit)	
	This includes an: how the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error the auditor's approach to internal control relevant to the audit the application of the concept of materiality in the context of an audit Such a communication enables: those charged with governance: to understand the auditor's work, to discuss issues of risk and the concept of materiality with the auditor, and to identify any areas in which they may request the auditor to undertake additional procedures. The auditor to understand the entity and its environment better.	This is another area where there would generally not be any disagreement with the client as the methodology of conducting the audit is decided by the auditor, as the auditor is finally responsible for providing the audit opinion.
(c)	**Significant findings from the audit**	
	The auditor shall communicate the various significant findings from the audit with those charged with Governance.	
(i)	**Change in accounting policies:** Whether there have been any changes made to the accounting policies and practices being used by the organisation (e.g. the audit client has changed the inventory valuation method from LIFO to FIFO). There can be disagreement between the auditor and the auditee when the auditee changes the accounting policies but does not carry out adjustments to the financial statements in accordance with IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors.	The auditor would have to assess the audit opinion, and even modify the audit opinion if the 'change in accounting policies' affects the 'true and fair' view of the financial statements.
(ii)	**Potential risks or exposures that need to be included in the statements** For example, disclosure of pending litigation.	The auditor will have to determine whether it will affect the 'true and fair' opinion, and if so, whether the audit opinion would have to be modified.
(iii)	**Assessment of going concern:** Whether there is any material risk present that may affect the organisation's ability to continue as a going concern and whether the risk should be reported in the financial statements (e.g. if 90% of the organisation's revenues come from just one client and if this client goes bankrupt, the ability of the organisation to continue operations will come into question).	As discussed before, in the case of disagreement, the audit opinion would be modified. This is explained in detail in Study Guide E2.
(iv)	**Deficiency in internal control systems:** Insufficiency of internal control systems in relation to the nature and complexity of the organisation's transactions as well as material weaknesses in the internal control systems, need to be communicated. (For example, inadequate segregation of duties in major areas of business).	The communication as well as action required to be taken, in case of disagreement, is explained in detail in Study Guide D1.
(v)	**Fraud** Whether the auditors have come across any occurrences of fraud or any other management impropriety, the matter needs to be reported. (e.g. an auditor may discover that certain managers are using their corporate credit cards to pay their personal bills). Communication of fraud and error is discussed below this table.	If the auditor has facts to prove that there exist errors / fraud matters will have to be communicated to authorities mentioned in the adjacent column. Furthermore the auditor will have to modify the audit report if required.

Continued on the next page

(d)	Material disagreements with management on the financial statements / reporting process	
	For example management wants a lower value for provision of bad debts and the auditor disagrees).	The auditor will have to understand whether it will affect the 'true and fair' opinion and if so, whether the audit opinion would have to be modified.
(e)	**Significant difficulty faced by auditor**	
	For example non-availability of records, needed to carry out the audit.	The auditee will have to make arrangements to ensure smooth continuance of audit.
(f)	**Written representations not provided**	
	Management may refuse to provide representation: when it feels that, by obtaining the representation, the 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 with the management the reason for the refusal. 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 . take appropriate action, including issuing a modified report with a disclaimer of opinion on the financial statements.
(g)	**Auditor Independence**	
	In the case of listed entities, the auditor shall communicate with those charged with governance a statement that the engagement team and others in the firm have complied with relevant ethical requirements regarding independence.	The course of action to be taken is discussed in Study Guide A1.

2. Fraud

(a) Whether the auditors have come across any occurrences of fraud or any other management impropriety (e.g. an auditor may discover that certain managers are using their corporate credit cards to pay their personal bills).

(b) Fraud and error are to be reported:

(i) 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.

(ii) On a timely basis: when the auditor determines that fraud exists, the matter needs to be reported promptly.

(iii) To those charged with governance

when the auditor identifies fraud / suspected fraud involving management, employees (who have a significant role in internal control) or others.

when the auditor becomes aware of fraud in which employees (other than management) are involved, and which does not result in a material misstatement, This is done 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.

(iv) 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. The communication may be either oral or written.

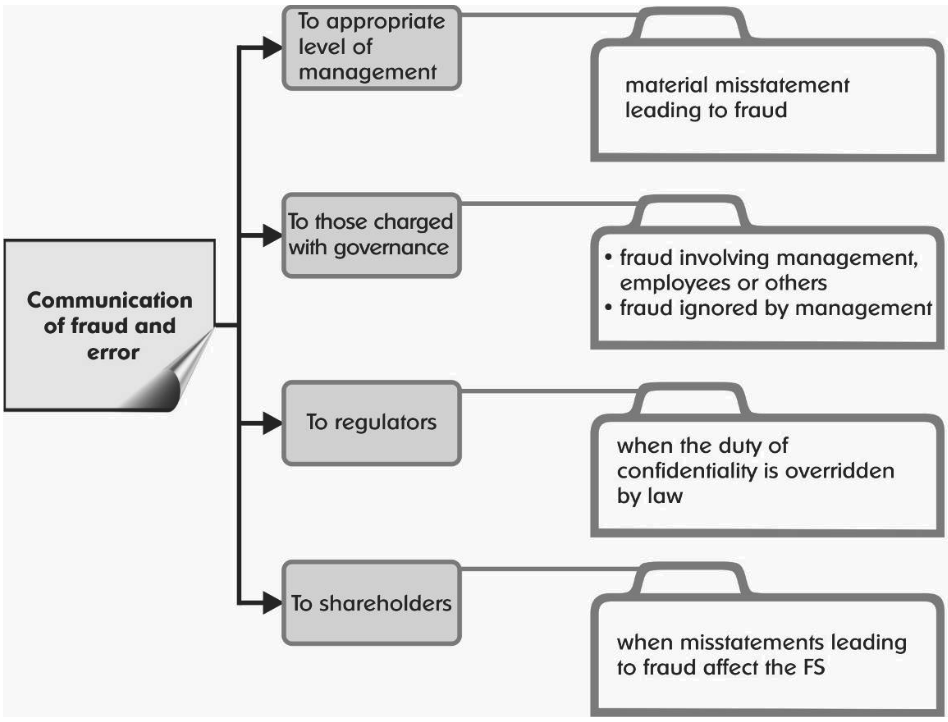
(v) Communication to regulators

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.

(vi) Communication to 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 any fraud that affects the true and fair nature of the financial statements.

Diagram 1: Communication relating to fraud



(h) Need for auditors to communicate with those charged with corporate governance

Although the prime duty of auditors is to report to shareholders on the truth and fairness of the financial statements, auditors are expected to work with those who are also ultimately responsible for an organisation's financial reporting and financial statements throughout the course of the financial year. Whilst maintaining their objectivity and independence, they are also expected to periodically review and report any material matters that may affect the integrity and accuracy of the financial statements.

This practice allows those charged with corporate governance the time and opportunity to rectify any defects or weaknesses in their organisation's financial reporting and/or activities. However, this can only happen if there is an open, honest and systematic line of communication between them and their auditors. All communications by the audit firm should be made on a timely basis.

Test Yourself 1

Explain why management is sometimes unwilling to provide a letter of representation and describe the actions an external auditor can take if management refuses to sign a letter of representation.

Tip

If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take the following actions:

Modifying the auditor's opinion on the basis of a scope limitation.

Obtaining legal advice about the consequences of different courses of action.

Communicating with third parties (for example, a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (for example, shareholders in a general meeting), or the responsible government minister or parliament in the public sector.

Withdrawing from the engagement, where withdrawal is possible under the applicable law or regulation.

2. Identify, apply and explain procedures that may be used and considerations relating to the identification of subsequent events that may require adjustment or disclosure.

[Learning Outcome b]

Before going into detail as to what an auditor is supposed to do when subsequent events that require adjustment are discovered, we need to understand a few terms first.

Definition

Date of the financial statements: The date of the end of the latest period covered by the financial statements.

Date of approval of the financial statements: the date on which all the statements that comprise the financial statements, including the related notes, have been prepared (which is later than the date of the financial statements) and those with the recognised authority have asserted that they have taken responsibility for those financial statements. The directors literally sign the financial statement to approve them.

Date of the auditor's report: the date the auditor dates the report on the financial statements in accordance with ISA 700.

Date the financial statements are issued: the date that the auditor's report and audited financial statements are made available to third parties.

Subsequent events: events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

ISA 560

ISA 560 requires the auditor to consider the effects of subsequent events on the financial statements and on the auditor's report. There are two standards dealing with subsequent events. One is **IAS 10** that deals with the accounting treatment of events after the SOFP date and the other is **ISA 560** Subsequent Events that outlines the auditor's responsibility regarding the audit of subsequent events.

Example

Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

Two types of events can be identified:

(a) Those that provide evidence of conditions that existed at the end of the reporting period (**adjusting events after the reporting period**); and

(b) Those that are indicative of conditions that arose after the reporting period (**non-adjusting events after the reporting period**).

IAS 10

2.1 Auditor's responsibility in the case of subsequent events

1. Events that occur between the date of the financial statements and the date of the auditor's report

According to ISA 560, the auditor should perform all the audit procedures designed to obtain sufficient appropriate audit evidence. He should ensure that all events up to the date of the auditor's report **that may require adjustment of, or disclosure in, the financial statements have been identified.**

Until the date of the audit report, the auditor has an active responsibility **to identify and review all the subsequent events.**

Under normal circumstances, the auditor should complete all audit procedures designed to identify and obtain sufficient evidence that all events that have occurred between the date of the auditor's report and the date of the financial statements have been identified before the date of the auditor's report. However, if events have been identified that occurred during this period and that materially affect the financial statements, the auditor should check that all necessary accounting and disclosures for these events have been complied with.

Audit procedures would include the following:

(a) Understanding the procedures that **management has put in place in order to identify and record subsequent procedures.**

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred that might affect the financial statements

(c) Reading minutes of meetings that take place after the date of the financial statements and enquiring **about** meetings that have taken place after the date of the financial statements and for which no minutes have been recorded.

(d) Reading the entity's latest internal and external interim financial statements in order to gain information on subsequent events.

(e) Obtaining information from legal counsel concerning any pending litigation or claims.

(f) Determination of the appropriateness of the adjustments or disclosures to financial statements, on account of the above stated audit procedures.

(g) Obtaining management representation that the financial statements include all disclosures or adjustments in the financial statements relating to subsequent events.

2. Events that are discovered after the date of the auditor's report but before the financial statements have been issued

Once the auditor's report is issued, the auditor is not responsible for conducting a continuing review of the events that occur after the date of the audit report but before the issue of the financial statements. However, if he becomes aware of a fact which may materially affect the financial statements through newspapers, media or some other reliable sources he should **consider whether the financial statements need to be amended**.

Audit procedures

(a) The auditor should discuss the matter with management and take appropriate action.

Example

Hody, the auditor of Hinfield Plc read a detailed report of a major fraud in the inventory department in one of its subsidiaries located in another country. The fraud happened during the year being audited. Hody had not yet prepared his audit report.

He was of the opinion that this fraud could lead to a major fall in the share prices of the entity and hence its market reputation would be damaged. It would also cause a revision in the figures of the inventories of the subsidiaries. In this case, he should suggest to management that they should amend the financial statements by increasing the provisions for losses occurring due to the effects of the misappropriation in inventory.

(b) The auditor should **determine whether the financial statements need amendment and, if so,** i**nquire how management intends to address the matter in the financial statements.** If the financial statements are amended, the auditor should **perform the appropriate audit procedure** on all subsequent events which occur after the date of the audit report, up to the date of the new audit report and issue a **new audit report on the amended financial statements.** The date of this audit report should not be earlier than the date on which the amended financial statements are issued.

(c) If the financial statements are amended, the auditor should perform the appropriate audit procedure and **issue a new audit report** on the amended financial statements. The date of this audit report should not be earlier than the date on which the amended financial statements are issued. While doing so, the auditor has to perform all the necessary steps as regards the audit from the date of the original audit report to the date of the new audit report for the matters that arose after the date of the first audit report.

Example

Continuing the example of Hinfield Plc

If the management of Hinfield Plc increases the provisions to safeguard against the losses of inventory, Hody will conduct a further audit of inventories. He will have to conduct all the audit procedures required to verify the inventory position according to applicable standards. He will also take letters of representation from management regarding the inventory position at the unit in another country, if he is not able to physically verify the inventory himself.

(d) If the laws or the financial reporting framework permits the amendment of the financial statements relating to the effects of the subsequent event or events causing that amendment, the auditor is permitted to:

(i) **Restrict the audit procedures on the specific subsequent events** which are **discovered after the date of the auditor's report** but before the financial statements are issued, or

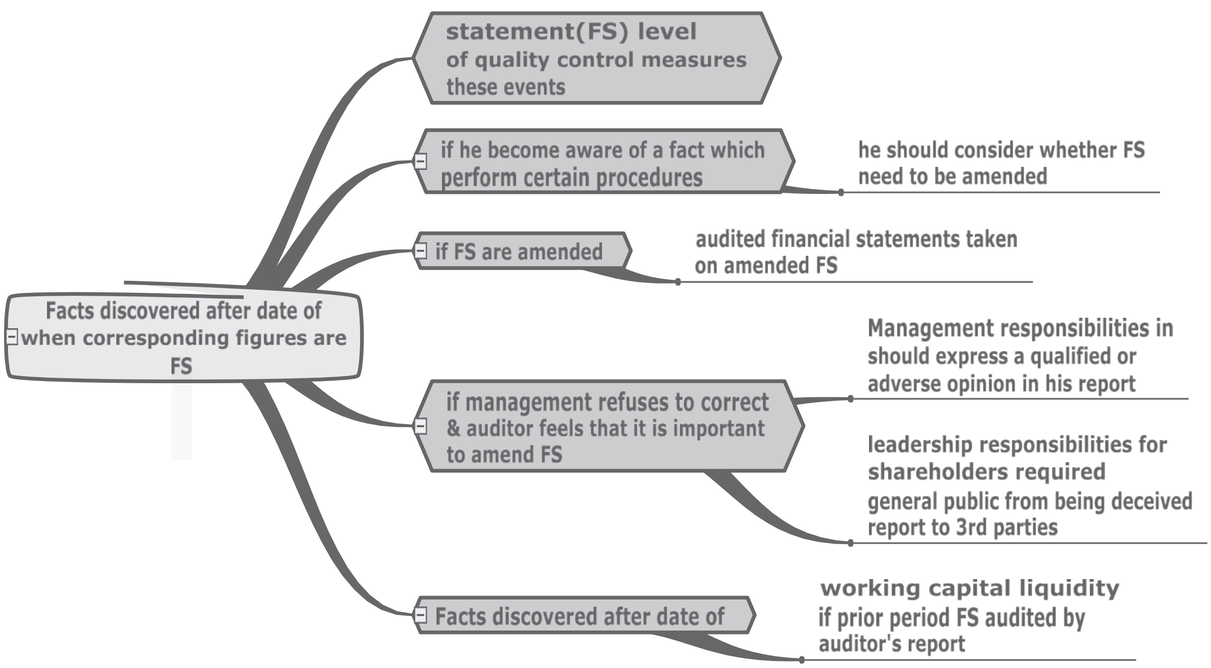
(ii) **Provide an amended auditor's report** that includes an **'Emphasis of Matter' paragraph or 'Other Matter' paragraph** that conveys that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

(e) **If** management does not amend the financial statements and the auditor feels it is necessary to amend them, and the report has not been issued to the entity, the auditor should express a **qualified or an adverse opinion in his report.**

(f) If the audit report has already been issued to the entity, the auditor should notify those charged with governance (charged with the responsibility of the overall direction of the company) not to issue the financial statements and audit report to third parties.

(g) However, if the financial statements are subsequently released, the auditor should take appropriate legal action to prevent reliance on the auditor's report.

SUMMARY



3. Events discovered after the financial statements have been issued

After the financial statements have been issued the auditor has **no obligation to conduct audit procedures or make enquiries** on the financial statements.

Audit procedures

If the auditor comes across a misstatement in the financial statements after they have been issued, which may have caused the auditor's report to be revised, the auditor should **consider the need for revision of the financial statements.** The audit procedures include:

(a) Discussion of such matters with management and take appropriate action.
(b) Determination of whether the financial statements need amendment; and, if so,
(c) Inquiry as to how the management intends to address the matter in the financial statements.

In the above circumstances, if the financial statements are revised, the auditor should **review the steps taken by management and issue a new audit report** on the revised financial statements.

The detailed audit procedures when FS are to be revised are discussed in detail earlier. They are also applicable here!

The audit procedures in this case can be restricted to the effects of the subsequent events according to the local regulations of certain countries.

The auditor should ensure that the revised financial statements and the new audit report should be made available to those to whom the previous report was issued.

ISA 560 requires that the new audit report should include an 'emphasis of matter' paragraph that emphasises the reason for the revision of the audit report or 'other matters' paragraph that more extensively discusses the reason for the revision of the previously issued financial statements and to the earlier report issued by the auditor.

Example

Trunket Plc finalised a deal to acquire a large multinational, Bunket Plc on 22 April 20X9. The financial statements were issued on 20 April 20X9 (the reporting date was 31 March 20X9). The auditor, in this case, does not have any obligation to enquire into such events. However, this event can significantly affect the decisions taken by the readers of the financial statements.

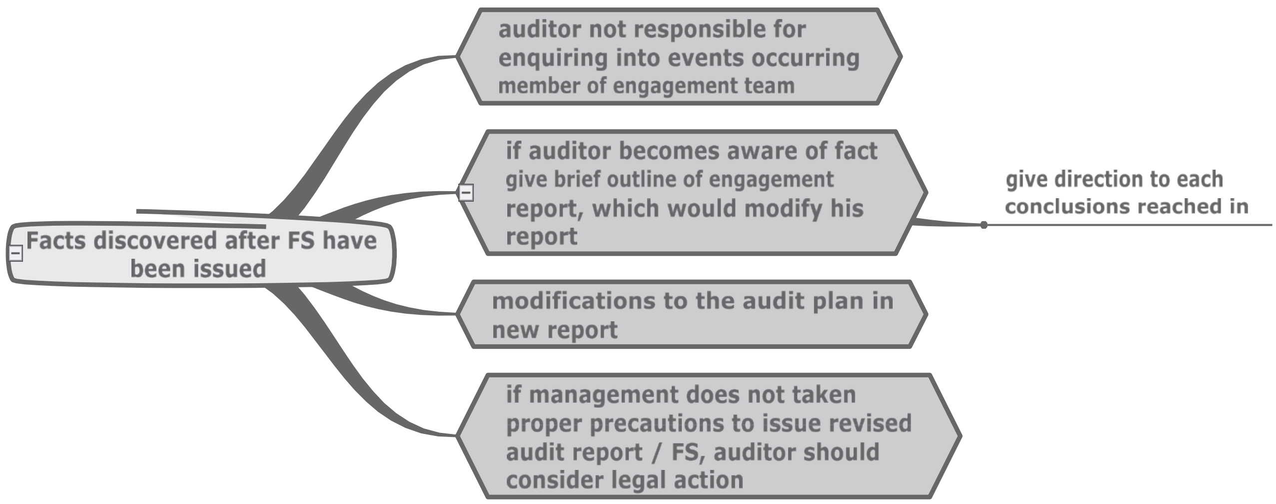
In this case the auditor should consider revising his audit report and discuss with management the need to revise the notes in the financial statements. If management revises the financial statements, the auditor will have to extend his audit procedures to check the details of the acquisition.

In the revised audit report, he is required to include a paragraph referring to a note in the financial statements that discusses the acquisition made by the company in detail. For example:

Note to the consolidated financial statements (audited).

On 22 April 20X9, the company completed the acquisition of Bunket Plc for approximately $800 million. Bunket Plc is a publicly traded software company that provides network management software. The acquisition will be integrated into the company's software segment.

SUMMARY



Test Yourself 2

Mega Chemicals Plc produces different chemicals that are required to produce other products such as ant and cockroach repellents etc.

As an external auditor for Mega Chemicals, your staff have discovered the following events that relate to the audit period ending 31 December 20X8.

Date	Event
25/03/20X9	Directors of Mega Chemicals approved the financial statements.
26/03/20X9	The auditor's report was signed on this date.
24/05/20X9	Financial statements were issued to the members of Mega Chemicals Plc.
31/05/20X9	An accident took place that caused a fire at one of the company's plants. This damaged the whole plant. It will take at least six months for it to resume production. The directors of Mega Chemicals have proposed outsourcing the work until the plant resumes production. Although this will cause the production costs to rise, it will help the factory to run effectively.

Required:

As a senior auditor,

(a) Analyse the event that occurred on 31 May 2008, in view of IAS 10 'Events after the reporting period' and explain to your staff whether the event is adjusting or non-adjusting.

(b) Explain what the responsibilities of the external auditor are, relating to this event. Additionally, state what audit procedures should be carried out to discharge your duties as auditors, while auditing the event after the reporting period.

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3. Identify, apply and explain procedures that may be used and considerations relating to the identification of risk issues that may require disclosure.

[Learning Outcome c]

This is discussed in detail in Study Guide C1, Learning Outcome 1 and Study Guide C3, learning Outcomes 2 and 3.

4. Evaluate and apply quantitative and qualitative judgments based on the results of tests and evidence obtained.

[Learning Outcome d]

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) conducts an overall review of the audit work carried out by the audit team. The objective of this review is to make an assessment of the audit evidence which is obtained by the audit team and then decide whether the audit evidence is sufficient to arrive at the audit opinion.

Furthermore, the senior auditor also examines the final edition of the financial statements before arriving at the audit opinion which is appropriate. The various audit opinions are explained in Study Guide F2

Therefore, 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.

This process of assessment involves the auditor making both quantitative as well as qualitative judgments on the results of tests and evidence obtained by the audit team. This method of assessment involves the following:

1. Review of financial statements, analytical procedures

The auditor reviews 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:

(a) Calculation of important ratios
(b) Changes in products
(c) Product mixes
(d) Trends of sales, purchases, production
(e) Variances in consumption of materials

2. Sufficiency and appropriateness of audit evidence

An auditor assesses 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.

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.

(a) The quality of evidence or its appropriateness depends upon:

(i) Its relevance i.e. whether the audit evidence contributes to conclusions that assist in forming an opinion by the auditor. 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. The auditor will confirm that the team has tested the controls on sales as the controls of the previous year will no longer be relevant

(ii) Its reliability in supporting the classes of transactions, account balances, and disclosures and related assertions, or detecting misstatements in them. Following are some indicators of reliable evidence:

Evidence is more reliable when it is obtained from independent sources outside the entity e.g. confirmation of balance from a customer.

Internal evidence (evidence generated within an entity) is more reliable when the related controls are effective.

Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly or by inference.

Evidence is more reliable when it exists in documentary form i.e. paper, electronic, or other media.

Evidence provided by original documents is more reliable than evidence provided by photocopies or facsimiles.

(b) 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: (i) Source and

reliability of available information (explained above).

(ii) 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).

(iii) Results of audit procedures (if the physical count of assets indicates anomalies, the auditor will have to increase the quantum of evidence).

(iv) Risk assessment (areas where the risk of material misstatement is high need to be supported with greater quantity of evidence).

(v) 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).

(vi) Materiality (the quantitative and qualitative factors which determine materiality need to be considered).

(c) 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. For 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.

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:

(i) The financial statements have been prepared using **acceptable accounting policies** and are **applied consistently** and are appropriate for the entity's business

(ii) The information included in the financial statements and the results of operations are **compatible** with the auditor's knowledge of the entity's business

(iii) **Adequate disclosures** are made wherever appropriate

(iv) the financial statements **comply with all statutory and other requirements** relevant to the entity's business

(v) 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: (a) Adherence with the

applicable financial reporting framework; and

(b) Consistency with the financial statements.

4. 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.

This is discussed in detail in Learning Outcome 2.

5. 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.

This is discussed in detail in Study Guide E2.

6. 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 E2.

7. Uncorrected Misstatements

The auditor's responsibility for uncorrected misstatements will be discussed in the following Learning Outcome.

8. 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.

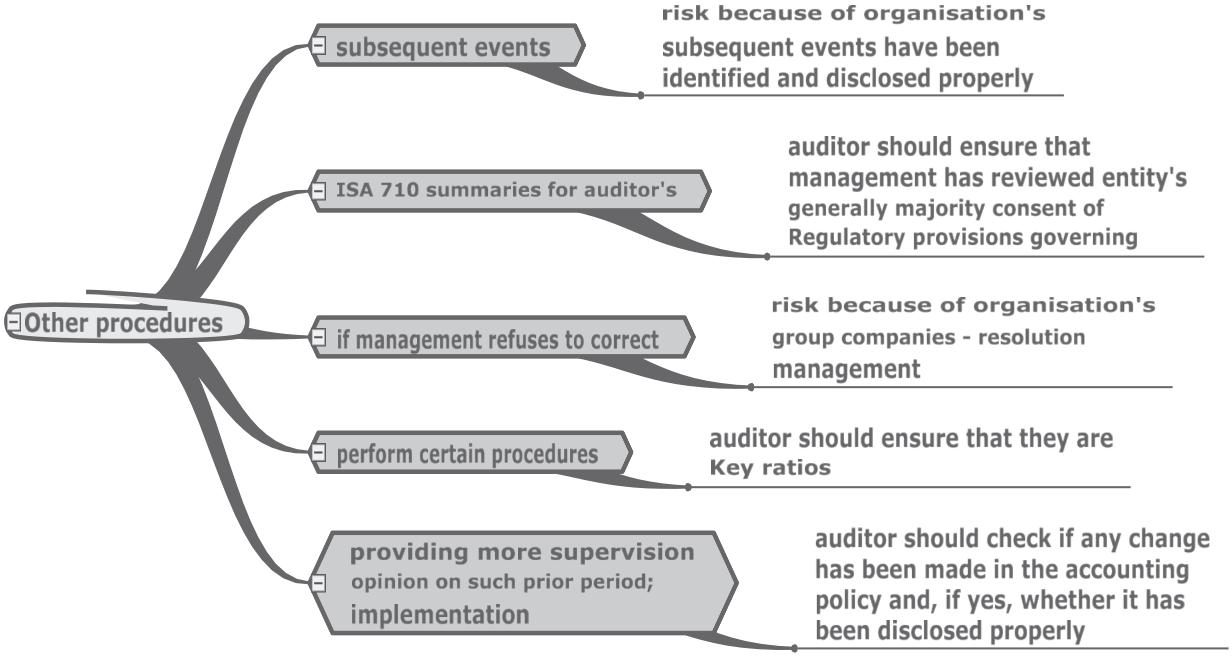
Factors to be considered by the auditor, in order to determine the appropriateness of accounting policies are as follows:

(a) 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.

(b) Whether the accounting policies adopted by the client are commonly adopted by other industries under which the client falls.

(c) If the applicable accounting standards are not implemented, would the financial statements still be true and fair.

SUMMARY



Test Yourself 3

Discuss the benefits of the overall assessment of available audit evidence by the audit senior.

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5. Evaluate the significance of uncorrected misstatements.

[Learning Outcome e]

5.1 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.**

5.2 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.

(a) When an auditor concludes that the aggregate of uncorrected misstatements is material.

(b) 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.

(c) 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.

5.3 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 Tshs5,000 (total receivables: Tshs400,000)
An overstatement of sales by Tshs10,000 (total sales: Tshs5,000,000)
An overstatement of inventory by Tshs2,000 (total inventory: Tshs1,500,000)

In this case, as management considers these misstatements immaterial, (individually as well as collectively, Tshs17,000 i.e. Tshs5.000 + Tshs10,000 + Tshs2,000) 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.

5.4 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 Tshs5,000 in relation to Tshs400,000). 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 Tshs2,000 in relation to Tshs1,500,000).

(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 Tshs500 and a turnover of Tshs500,000. During the course of the audit, a misstatement (overstatement of sales) of Tshs10,000 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 Tshs500, the financial statements would show a loss of Tshs9,500. 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 Tshs500, 000 is misstated as Tshs4,999,000.
(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 4

On 31 December 20W9, an inventory count was undertaken at the factory and warehouse of Rex Motors, a car manufacturer. The auditors were informed that inventory worth Tshs95,000 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 20W9 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.

Answers to Test Yourself

Answer to TY 1

(a) Management unwilling to sign written representation and action to be taken 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 TY 2

(a) The fire occurred after the financial statements were issued. The fire that took place on 31 May does not give any additional evidence of the conditions that existed on the date of the statement of financial position.

The fire destroyed the company's workshop, Reconstruction of the workshop will take six months, with a consequent increase in the cost of production. This simply means that there will be a dramatic fall in the profits of Mega Chemicals in the coming year. Therefore, the event does not require any adjustments in the financial statements. However, if this incident had occurred before the date of issue of the financial statements, it would warrant a disclosure of the event in the notes to the financial statements.

(b) As the fire took place after the issue of financial statements, the auditor has no responsibility to conduct inquires relating to this event.

Special procedures that the auditor has to implement in order to ensure correct disclosure if he is aware of the fire are as follows:

(i) The auditor should review the minutes of the board of director's meeting and the insurance claim, to confirm that the insurance claim covers the entire loss. The possibility of any contingent liability and the adequacy of the claim proceeds to replace the non-current assets and clear up the environmental damage should be considered.

(ii) He should obtain information regarding how the company intends to inform its members about the said events.

(iii) If it is decided to re-issue the financial statements, he should ensure that appropriate disclosure relating to the said event is made.

(iv) If the auditor thinks that the event is material enough to reissue the financial statements and the directors are not cooperating then he should attempt to contact the members of Mega Chemicals independently. This could be done by different methods available in different countries.

(v) If required, the auditor can consult his lawyers about the non-disclosure of the said event, and his responsibilities in the given situation.

Answer to TY 3

(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.

The need for further audit evidence depends on the sufficiency and appropriateness of the evidence.

(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.

Answer to TY 4

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 20W9 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. The duty of the auditor to report on the effectiveness of internal controls is restricted to reporting to

   A The management of the entity or those charged with governance
   B The management of the entity and other shareholders
   C All the shareholders
   D None of the above

2. ________________________are communicated to those charged with governance; ____________________ can be communicated to the other management staff.

3. State the purpose for review of the evidence obtained during audit.

4. What is meant by uncorrected misstatements?

5. 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. The correct option is **A**.

   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.

2. Significant deficiencies, less important deficiencies

3. 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

4. Uncorrected misstatements are the aggregate of the errors that an auditor discovers and which have not been corrected or adjusted in the financial statements.

5.
   (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 Questions

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.

Question 2

List four factors that influence the reliability of audit evidence.

Answers to Self-Examination Questions

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.

Answer to SEQ 2

According to ISA 500, the following factors influence the reliability of audit evidence:

(i) Audit evidence is more reliable when it is obtained from independent sources outside the entity.

(ii) Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.

(iii) 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).

(iv) 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.)

(v) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

(vi) Evidence created in the normal course of business is better than evidence specially created to satisfy the auditor.

(vii) 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).

(viii) Evidence about the future is particularly difficult to obtain and is less reliable than evidence about past events.

SECTION F

DRAWING CONCLUSIONS AND REPORTING

F2

STUDY GUIDE F2: 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 analyses the format and content of all types of audit reports and also discusses the circumstances under which they are issued.

Learning Outcomes

a) Draw conclusions and advise on the capability to report on an assurance engagement or audit engagement, including reporting findings, giving an external audit opinion or dealing with other issues that may need to be included in an audit report.
b) Draft extracts of a suitable assurance report or management report based on a given scenario and entity.
c) Draft extracts of a suitable audit report or management report based on a given scenario and entity and in accordance with local law and international standards of accounting and audit.
d) Identify and explain the issues that may be relevant and the nature of report that may be given relating to risk management, internal controls and governance.
e) Evaluate and apply suitable judgements on when it may be appropriate to withdraw from, withdraw an opinion on or take other such appropriate action on an audit or assurance engagement.

1. Draw conclusions and advise on the capability to report on an assurance engagement or audit engagement, including reporting findings, giving an external audit opinion or dealing with other issues that may need to be included in an audit report.
Draft extracts of a suitable assurance report or management report based on a given scenario and entity.
Draft extracts of a suitable audit report or management report based on a given scenario and entity and in accordance with local law and international standards of accounting and audit.
[Learning Outcomes a, b and c]

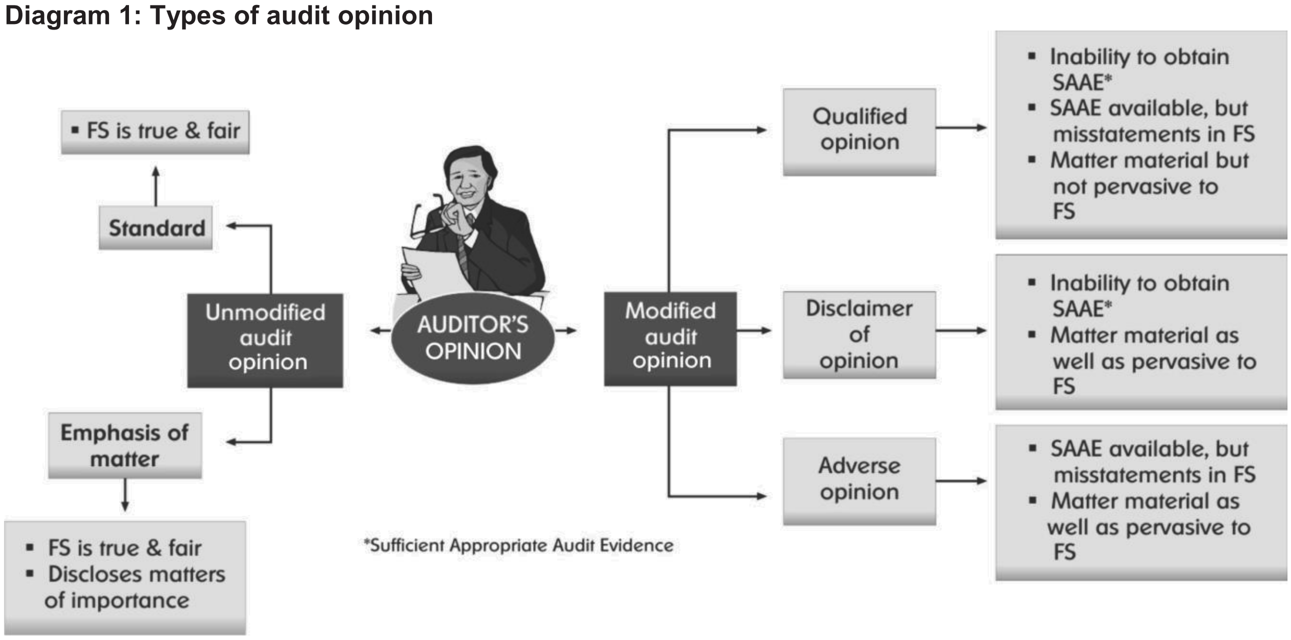
ISA 700 states that the auditor's report should contain a clear expression of the auditor's opinion on the financial statements.

An auditor's report can be divided into two broad categories. It is 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

Uniformity in the form and content of each type of the modified audit reports enhances the user's understanding of such reports.

Diagram 1: Types of audit opinion



1.1 Basis for audit opinion

The **auditor's conclusion** on the audit opinion would be based on the following factors:

Sufficiency and appropriateness of audit evidence
Materiality of uncorrected misstatements
Adequacy of disclosures relating to selection and application of accounting policies
Appropriateness of accounting policies selected
Consistency of the entity's accounting policies with the applicable financial framework
Reasonableness of accounting estimates used by the entity
Qualitative characteristics of financial information i.e. Whether relevant, reliable, comparable and Understandable
Fair presentation of financial information

All the above points are explained in detail in Study Guide F1.

When the audit is conducted in accordance with ISA 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.

An audit report contains a standard 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.

ISA 700 sets out the requirements for the content of the audit report.

1.2 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:

Title

The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.

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.

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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 or those charged with governance** such as the directors

Auditor's Opinion

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

(a) Identify the entity whose financial statements have been audited;

(b) State that the financial statements have been audited;

(c) Identify the title of each statement comprising the financial statements;

(d) Refer to the notes, including the summary of significant accounting policies; and

(e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

(a) In our opinion, the accompanying financial statements present fairly, in all material respects, […] in accordance with [the applicable financial reporting framework]; or

(b) In our opinion, the accompanying financial statements give a true and fair view of […] in accordance with [the applicable financial reporting framework].

When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the accompanying financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework].

If the reference to the applicable financial reporting framework in the auditor's opinion is not to IFRSs issued by the International Accounting Standards Board or IPSASs issued by the International Public Sector Accounting Standards Board, the auditor's opinion shall identify the jurisdiction of origin of the framework.

Basis for Opinion

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

(a) States that the audit was conducted in accordance with International Standards on Auditing;

(b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the ISAs;

(c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction of origin of the relevant ethical requirements or refer to the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* (IESBA Code); and

(d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Going Concern

29. Where applicable, the auditor shall report in accordance with ISA 570 (Revised).

Key Audit Matters

30. For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with ISA 701.

31. When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with ISA 701.

Responsibilities for the Financial Statements

The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." The auditor's report shall use the term that is appropriate in the context of the legal framework in the particular jurisdiction and need not refer specifically to "management". In some jurisdictions, the appropriate reference may be to those charged with governance.

This section of the auditor's report shall describe management's responsibility for:

(a) ***Preparing the financial statements*** in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(b) ***Assessing*** the entity's ability to continue as a ***going concern*** and whether the use of the going concern basis of accounting is appropriate.

Responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from those who fulfil the responsibilities described above. That is Those Charged with Governance" or such term that is appropriate in the context of the legal framework in the particular jurisdiction.

When the financial statements are prepared in accordance with a fair presentation framework, the description of responsibilities for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view," as appropriate in the circumstances.

Auditor's Responsibilities for the Audit of the Financial Statements

The auditor's report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements."

This section of the auditor's report shall:

(a) State that the objectives of the auditor are to:

(i) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and

(ii) Issue an auditor's report that includes the auditor's opinion.

(b) State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists; and

(c) State that misstatements can arise from fraud or error, and either:

(i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or

(ii) Provide a definition or description of materiality in accordance with the applicable financial reporting framework.

The section shall further:

(a) State that, as part of an audit in accordance with ISAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and

(b) Describe an audit by stating that the auditor's responsibilities are:

(i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

(ii) To obtain an understanding of internal control relevant to the audit 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. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

(iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

(iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.

(v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

(c) When ISA 600 applies, further describe the auditor's responsibilities in a group audit engagement by stating that:

(i) The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the group to express an opinion on the group financial statements;

(ii) The auditor is responsible for the direction, supervision and performance of the group audit; and

(iii) The auditor remains solely responsible for the auditor's opinion.

The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall:

(a) State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;

(b) For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and

(c) For audits of financial statements of listed entities and any other entities for which key audit matters are communicated in accordance with ISA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Location of the description of the auditor's responsibilities for the audit of the financial statements

The description of the auditor's responsibilities for the audit of the financial statements required by shall be included:

(a) Within the body of the auditor's report;

(b) Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or

(c) By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

When the auditor refers to a description of the auditor's responsibilities on a website of an appropriate authority, the auditor shall determine that such description addresses, and is not inconsistent.

Other Reporting Responsibilities

If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the ISAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the ISAs.

If other reporting responsibilities are presented in the same section as the related report elements required by the ISAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the ISAs.

Name of the Engagement Partner and the firm

The name of the engagement partner shall be included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat. In the rare circumstances that the auditor intends not to include the name of the engagement partner in the auditor's report, the auditor shall discuss this intention with those charged with governance to inform the auditor's assessment of the likelihood and severity of a significant personal security threat.

Signature of the Auditor

The auditor's report shall be signed.

Auditor's Address

The auditor's report shall name the location in the jurisdiction where the auditor practices. In Tanzania context this part shall mention the name of the audit firm and address.

Date of the Auditor's Report

The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:

(a) All the statements that comprise the financial statements, including the related notes, have been prepared; and

(b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Example of unmodified report

Test Yourself 1

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.

1.3 Details of audit opinions

We shall now discuss the various kinds of audit opinions in detail. Refer to diagram 1, on various audit opinions given at the start of this Learning Outcome.

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 (REVISED)

Definition

This is 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.

The auditor shall include an Emphasis of Matter paragraph in the auditor's report only:
(a) The auditor would not be required to modify the opinion in accordance with ISA 705 (Revised) as a result of the matter; and

(b) When ISA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

The auditor shall:

(a) Include the paragraph with the heading that includes the term "Emphasis of Matter";
(b) Include in the paragraph a clear reference to the matter being emphasized and to where disclosures can be found in the financial statements.
The paragraph shall refer only to information presented or disclosed in the financial statements; and
(c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

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 paragraph 1.2 earlier.

It contains the following matters:

- Title
- Addressee
- Auditor's opinion
- Basis of opinion
- Emphasis of Matter
- Key Audit matters
- Management's responsibility for the financial statements
- Auditor's responsibility
- Other Reporting responsibilities
- Auditor's signature
- Date of the report
- Auditor's address

When an auditor includes an emphasis of matter paragraph in their report, they should: (a) Include it immediately

after the Basis for 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 - Material Uncertainty Related to Going Concern

We draw attention to Note 6 in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

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 (REVISED)

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.**

3. Modified audit opinion

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 (REVISED)

(a) 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:

Are not confined to specific elements, accounts or items of the financial statements;
If so confined, represent or could represent a substantial proportion of the financial statements; or
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

Continued on the next page

Qualified Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying consolidated financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Group as at December 31, 20X1, and (*of*) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Qualified Opinion

The Group'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 consolidated statement of financial position as at December 31, 20X1, and ABC's share of XYZ's net income of xxx 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 December 31, 20X1 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Illustration 3 in ISA 705 (REVISED)

(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 IFRS, 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

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Qualified Opinion

The Company's inventories are carried in the statement of financial position at xxx. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from IFRSs. The Company's records indicate that, had management stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Illustration 1 in ISA 705 (REVISED)

(b) Disclaimer of opinion

In case 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

Disclaimer of Opinion
We were engaged to audit the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying consolidated financial statements of the Group. Because of the significance of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

Basis for Disclaimer of Opinion
The Group's investment in its joint venture XYZ Company is carried at xxx on the Group's consolidated statement of financial position, which represents over 90% of the Group's net assets as at December 31, 20X1. We were not allowed access to the management and the auditors of XYZ Company, including XYZ Company's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company'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 consolidated statement of changes in equity and the consolidated cash flow statement..

Illustration 4 in ISA 705 (REVISED)

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

(c) 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

Adverse Opinion
We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the *Basis for Adverse Opinion* section of our report, the accompanying consolidated financial statements do not present fairly (or *do not give a true and fair view of*) the consolidated financial position of the Group as at December 31, 20X1, and (*of*) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International

Continued on the next page

Financial Reporting Standards (IFRSs).

Basis for Adverse Opinion
As explained in Note X, the Group has not consolidated subsidiary XYZ Company that the Group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under IFRSs, the Company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

Illustration 2 in ISA 705 (REVISED)

(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 opinion paragraph of the auditor's report to state that the auditor was engaged to audit the financial statements.

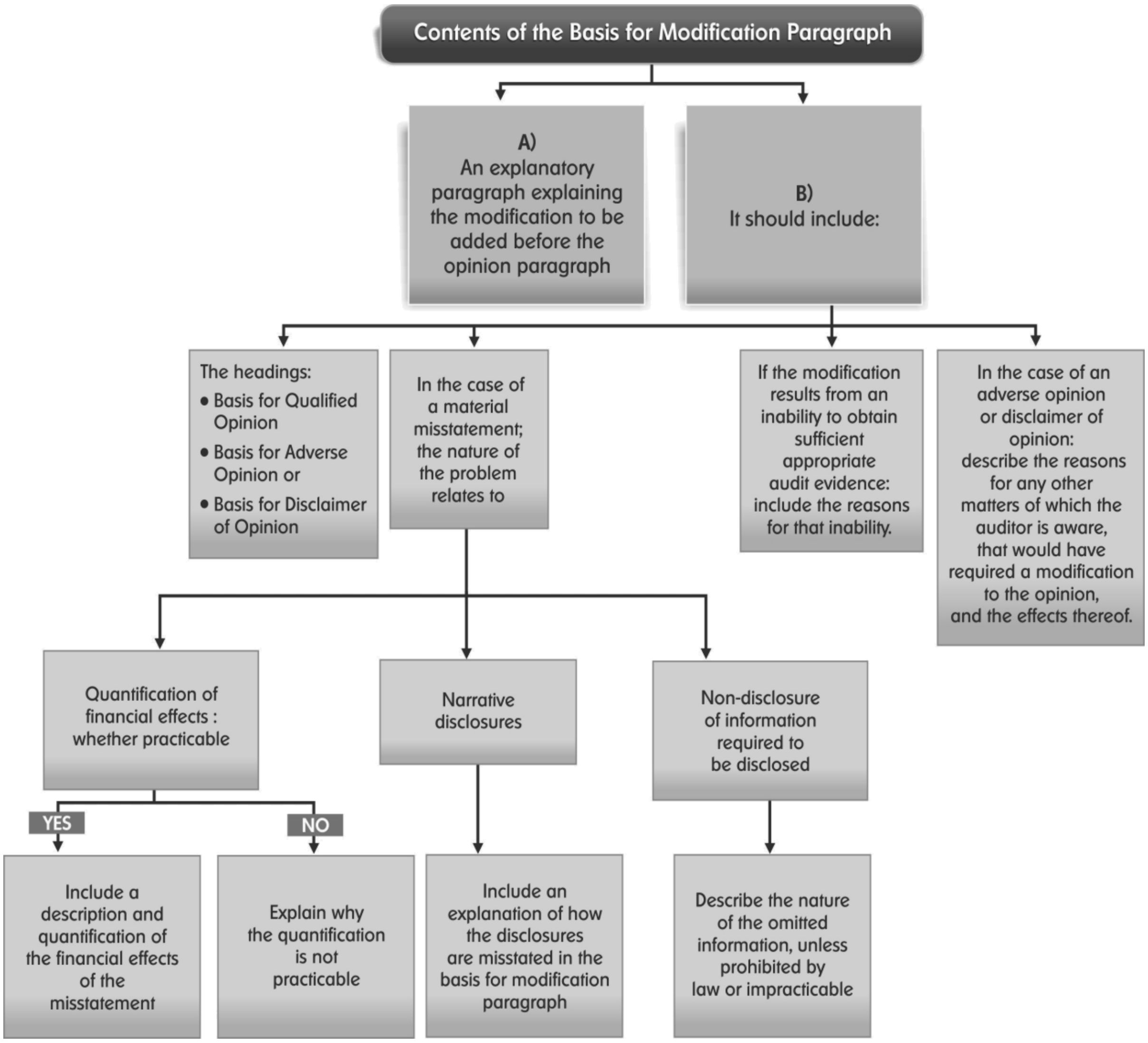
Amendments to the description of the auditor's responsibility and to the description of the scope of the audit to state the matters given in the following example:

Example

"Our responsibility is to conduct an audit of the Group's consolidated financial statements in accordance with International Standards on Auditing and to issue an auditor's report. However, because of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements."

Diagram 2: Basis for Modification Paragraph



1.4 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 (REVISED)

The auditor shall include an Other Matter paragraph in the auditor's report only if:
(a) This is not prohibited by law or regulation; and
(b) When ISA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading.

Communication 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, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph.

For example, if an entity prepares its financial statements under IFRS and US GAAP, 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 Key Audit Matters paragraph, or elsewhere in the auditor's report if the content of the Other Matter paragraph is relevant to the Other Reporting Responsibilities section.

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 Audit opinion**	**Audit report containing Other matter paragraph**
1.	Title	Title	Title	Title
2.	Addressee	Addressee	Addressee	Addressee
3.	Auditor's Opinion	Auditor's Opinion	**adverse opinion / qualified opinion / disclaimer of**	Auditor's Opinion
4.	Basis for Opinion	Basis for Opinion	**Basis for adverse opinion / qualified opinion /**	Basis for Opinion
5.		**Emphasis of Matter**		
6	Going Concern (where applicable)	Going Concern (where applicable)	Going Concern (where applicable)	Going Concern (where applicable)
7	Key Audit Matters	Key Audit Matters	Key Audit Matters	Key Audit Matters
8.				**Other matters**
9.	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
10.	Auditor's responsibilities for the Audit of the Financial Statements	Auditor's responsibilities for the Audit of the Financial Statements	Auditor's responsibilities for the Audit of the Financial	Auditor's responsibilities for the Audit of the Financial Statements
11.	Other Reporting Responsibilities	Other Reporting Responsibilities	Other Reporting Responsibilities	Other Reporting Responsibilities
12	Name of the Engagement Partner	Name of the Engagement Partner	Name of the Engagement Partner	Name of the Engagement Partner
13	Auditor's signature	Auditor's signature	Auditor's	Auditor's signature
14.	Auditor's address ***(and name of audit firm in case of Tanzania)***	Auditor's address *(and name of audit firm in case of Tanzania)*	Auditor's address *(and name of audit firm in case of Tanzania)*	Auditor's address *(and name of audit firm in case of Tanzania)*
15.	Date of the report	Date of the report	Date of the report	Date of the report

The above table indicates that items mentioned under serial numbers 1, 2, 6, 7 and 9 to 15 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.

1.5 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.
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 2

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.

1.6 Auditor's responsibility for other information

ISA 720 Other Information in Documents Containing Audited Financial Statements deals with the auditor's responsibility in relation to other information in documents containing audited financial statements. Furthermore, it refers to matters over which the auditor has no reporting responsibilities.

This is discussed in detail in Study Guide E2.

1.7 ISA 800, "Special considerations—audits of financial statements prepared in accordance with special purpose frameworks"

This ISA is applicable to an audit of financial statements prepared in accordance with a special purpose framework.

Definition

Special purpose financial statements are financial statements prepared in accordance with a special purpose framework.

Special purpose framework is a financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.
ISA 800

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1. Forming an Opinion and Reporting Considerations

When forming an opinion and reporting on special purpose financial statements, the auditor shall apply the requirements in ISA 700.

Description of the Applicable Financial Reporting Framework

ISA 700 requires the auditor to evaluate whether the financial statements adequately refer to the applicable financial reporting framework. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.

2. Contents of auditors' report

In addition to the contents prescribed by ISA 700, the auditor's report on special purpose financial statements should contain:

(a) A description of the purpose for which the financial statements are prepared and, if necessary, the intended users, or a reference to a note in the special purpose financial statements that contains that information;

and

(b) If management has a choice of financial reporting frameworks in the preparation of such financial statements, the explanation of management's responsibility for the financial statements shall also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

3. Alerting Readers that the Financial Statements Are Prepared in Accordance with a Special Purpose Framework

The auditor's report shall include an Emphasis of Matter paragraph alerting users of the auditor's report that the financial statements are prepared in accordance with a special purpose framework and that, as a result, the financial statements may not be suitable for another purpose. The auditor shall include this paragraph under an appropriate heading.

1.8 ISA 805 Special considerations - audits of single financial statements and specific elements, accounts or items of a financial statement

This ISA is effective for audits of single financial statements or of specific elements, accounts or items of financial statements.

Definition

A single financial statement or a specific element of a financial statement includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.

ISA 805

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1. Considerations when accepting the engagement

ISA 200 requires the auditor to comply with all ISAs relevant to the audit.

2. Forming an opinion and reporting considerations

When forming an opinion and reporting on a single financial statement or on a specific element of a financial statement, the auditor shall apply the requirements in ISA 700 (discussed in the Learning Outcome above) adapted as necessary in the circumstances of the engagement.

3. Reporting on the entity's complete set of financial statements and on a single financial statement or on a specific element of those financial statements

If the auditor undertakes an engagement to report on a single financial statement or on a specific element of a financial statement (like accounts receivable) in conjunction with an engagement to audit the entity's complete set of financial statements, the auditor shall express a separate opinion for each engagement.

An audited single financial statement or an audited specific element of a financial statement may be published together with the entity's audited complete set of financial statements.

4. Modified opinion, emphasis of matter paragraph or other matter paragraph in the auditor's report on the entity's complete set of financial statements

If the opinion in the auditor's report on an entity's complete set of financial statements is modified, or that report includes an Emphasis of Matter paragraph or an Other Matter paragraph, the auditor shall determine the effect that this may have on the auditor's report on a single financial statement or on a specific element of those financial statements.

If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole, ISA 705 (REVISED) does not permit the auditor to include in the same auditor's report an unmodified opinion on a single financial statement that forms part of those financial statements or on a specific element that forms part of those financial statements.

However, the exception to the above would be permitted if:

The auditor is not prohibited by law or regulation from doing so;

that opinion is expressed in an auditor's report that is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion; and

The specific element does not constitute a major portion of the entity's complete set of financial statements.

The auditor shall not express an unmodified opinion on a single financial statement of a complete set of financial statements if the auditor has expressed an adverse opinion or disclaimed an opinion on the complete set of financial statements as a whole.

1.9 ISA 810: Engagements to report on summary financial statements

Definition

Summary financial statements – Historical financial information that is derived from financial statements but contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time. Different jurisdictions may use different terminology to describe such historical financial information.

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1. Engagement acceptance

The auditor shall accept an engagement to report on summary financial statements in accordance with this ISA only when the auditor has been engaged to conduct an audit in accordance with ISAs of the financial statements from which the summary financial statements are derived.

2. Form of Opinion

When the auditor has concluded that an unmodified opinion on the summary financial statements is appropriate, the auditor's opinion shall use one of the following phrases:

(a) The summary financial statements are consistent, in all material respects, with the audited financial statements, in accordance with [the applied criteria]; or

(b) The summary financial statements are a fair summary of the audited financial statements, in accordance with the applied criteria].

3. Reporting requirements can be summarised as follows:

Type of opinion on the audited financial statements	Type of opinion on summary financial statements (FS)	Contents of audit report
Qualified opinion, an **emphasis of matter** or **other matter** paragraph	Unmodified opinion	Affirmation that the auditor's report on the audited FS contains a qualified opinion, an emphasis of matter or other matter paragraph The basis for the qualified opinion or emphasis of matter or other matter paragraph The effect on the summary financial statements if any
An **adverse opinion** or a **disclaimer of opinion**	Inappropriate to express an opinion	Affirmation that the auditor's report on the audited FS contains an adverse opinion or a disclaimer of opinion The basis for the adverse opinion or a disclaimer of opinion The inappropriateness of expressing an opinion

4. Modified opinion on summary financial statements

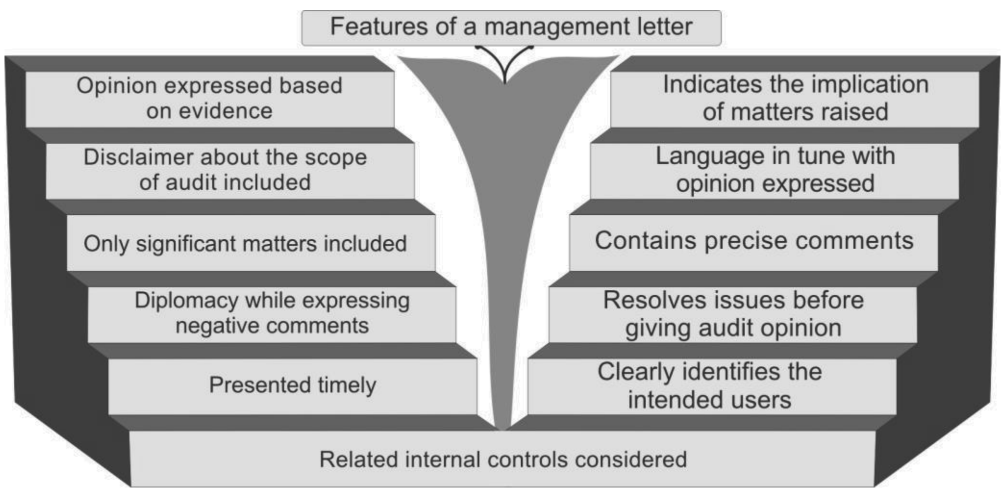
If the summary financial statements are not consistent, in all material respects, with or are not a fair summary of the audited financial statements, in accordance with the applied criteria, and management does not agree to make the necessary changes, the auditor shall express an adverse opinion on the summary financial statements.

1.10 Management letters

Management letters are used to convey audit results to those charged with governance before the audit report is issued. It is important to understand the difference between 'management' and 'those charged with governance'. Important distinguishing points are detailed below:

Those charged with governance	Management
Person or organisation with responsibility of overseeing the entity's **strategic direction** and obligations related to the entity's **accountability**.	The person(s) with **executive responsibility** for the conduct of the entity's operations.
Are responsible for approving the entity's financial statements.	In some cases management is also responsible for approving the entity's financial statements.
Are responsible for overseeing the financial reporting process.	Management is responsible for the preparation of the financial statements.

Diagram 3: Features of a management letter



1. Disclaimer about scope of audit

Management letters need to make it clear that matters identified in the letter are significant and have come to the auditor's attention as a result of the audit. The auditor has not undertaken any additional procedures to identify other matters e.g. an investigation of fraud is not the subject matter and will only be investigated if the auditor comes across evidence to indicate an occurrence of fraud. Non-detection of such factors by the auditor does not mean that financial statements are free from fraud.

2. Entity's personnel

While commenting on the entity's personnel, the auditor needs to be very careful if making any negative comments and should try to phrase any concerns about personnel in a diplomatic way.

3. Comments

While referring to any particular issues in the management letter, the auditor should make specific comments which are supported by evidence.

4. Opinions

Observations made out of the audit should be reasonable and supported by evidence. It must be evaluated in the light of subsequent clarification.

5. Timing

It is critical that the letter is first discussed with management and then is promptly sent to the appropriate level of management. Also, if a particular group of management fails to respond within a reasonable time, the next level of management should be consulted.

6. Identification of the user

Management letters should clearly identify the intended user as the letter will contain confidential information.

7. Obtaining feedback

The auditor should try to resolve the issues arising from the audit before issuing an opinion. The management letter, therefore, must provoke a timely response. It should specify the consequences of failure to resolve the matters in time. This might serve as a red flag for management.

8. Subject matter

Only significant matters that have come to the auditor's attention as a result of the audit need to be included. These matters may or may not have an effect on the financial statements. The letter should indicate the implications of the matters raised and, where necessary, use specific examples identified during the audit to illustrate the matter raised and assist the user's understanding.

9. Language

The language should support the opinion expressed in the audit report.

10. Internal control

The auditor's report should point out that the related control on financial systems was considered. However, his findings were neither directed towards assessing the effectiveness of internal controls and identifying weakness in the same nor expressing any assurance on the same.

2. Identify and explain the issues that may be relevant and the nature of report that may be given relating to risk management, internal controls and governance.

[Learning Outcome d]

2.1 Risk management and internal controls

Tip

The issues that may be relevant to risk have been discussed in detail in Study Guides C1 and C3. The issues that may be relevant to internal controls have been discussed in detail in Study Guide D1. Furthermore Study Guide D1 also illustrates the nature of report that may be given relating to risk management and internal controls.

2.2 Corporate governance

1. Meaning

Corporate governance represents the set of policies and procedures that determine how an organisation is directed, administered and controlled. It sets the broad framework or parameters from which the organisation must operate. Corporate governance sets out what an organisation is supposed to do thus providing a benchmark against which the future performance and actions of managers / executives can be measured and evaluated.

Example

Although the contents of corporate governance will vary from organisation to organisation, almost all will have the following components:

(a) Accountability: managers, executives and the board of directors are ultimately responsible to and must always act with the best interests of shareholders in mind (e.g. all strategies and operations of the organisation must be planned and carried out so as to ultimately maximise shareholder wealth or other stated objectives).

(b) Compliance: managers, executives and the board of directors must always comply with all laws and regulations (e.g. if the organisation operates in a country with a minimum wage law, all employees of the organisation must be paid at least this amount).

(c) Transparency: information on the financial performance and position of the organisation as well as any activities in which the organisation is engaged should always be available and known to shareholders (e.g. if an organisation buys another business it should make this information known to its existing shareholders).

(d) Integrity: managers, executives and the board of directors must always behave in an ethical manner. Their actions and decisions should represent not only what is legal but also what is morally right (e.g. most multinational organisations do not allow their overseas factories to use child labour even if the practice is legal in that particular country).

It should be remembered that the need for a system of corporate governance stems from the concept of separation of ownership and control. For many businesses, especially for large publicly traded organisations, the concept of separation between ownership and control has resulted in one set of individuals owning the business and another set running the business.

2. Objectives

Therefore, the objectives of corporate governance can be said to be to provide the necessary structure and rules through which the:

Interests of an organisation's board of directors, executives and management can be **aligned with those of its shareholders**;

Activities of the organisation can be directed and controlled; and

Effectiveness, efficiency and ethics of the board of directors, executives and managers as well as the organisation as a whole can be measured.

Overall, corporate governance involves organisations being transparent and honest in all their dealings – be they with customers, suppliers, investors, employees or any type of stakeholder and shareholder. In addition, the traditional view that corporate governance is an internal and private matter for an organisation has disappeared. Today legislation such as the Sarbanes-Oxley Act in the United States and the Combined Code in the UK are placing many basic requirements on listed companies with respect to their corporate governance systems.

Lastly the importance of having an effective system of corporate governance is that it:

Builds investor and shareholder confidence in the organisation (e.g. research has found that investors worldwide are willing to pay more for shares of an organisation that has a reputation for good corporate governance);

Demonstrates the commitment an organisation has towards being ethical, efficient and effective (e.g. an organisation conducts an audit on all of its directors' expenses claims on an annual basis);

helps an organisation's board of directors, executives and management to take **ethical decisions** (e.g. all strategies have to be evaluated not only in terms of their potential profitability but also as to how ethical they are) and

Provides a system of checks and balances so that neither management nor large shareholders can abuse their power at the expense of other shareholders or the organisation (e.g. an organisation has a policy that at least 50 percent of its board must comprise of non-executive directors).

Test Yourself 3

Discuss the importance of corporate governance.

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3. Need for auditors to communicate with those charged with corporate governance

Although the prime duty of auditors is to report to shareholders on the truth and fairness of the financial statements, auditors are expected to work with those who are also ultimately responsible for an organisation's financial reporting and statements throughout the course of the financial year. Whilst maintaining their objectivity and independence they are expected to periodically review and report any material matters that may affect the integrity and accuracy of the financial statements. This practice allows those charged with corporate governance the time and opportunity to rectify any defects or weaknesses in their organisation's financial reporting and/or activities. However this can only happen if there is an open, honest and systematic line of communication between them and their auditors.

All communications by the audit firm should be made on a timely basis

4. Corporate governance practices

Along with the push for adoption of international standards on accounting and auditing there has also been a push for adoption of international standards on corporate governance. This movement has gained much momentum after the occurrence of several large global financial scandals such as Enron, Worldcom, Parmalat and others.

Initial corporate governance developments in the UK began in the late 1980s and early 1990s in the wake of corporate scandals such as Polly Peck and Maxwell. After each of these scandals and subsequent ones there was always an investigation and a report. The best ideas from a number of reports have been brought together into the Combined Code of Corporate Governance (1998) covering areas relating to structure and operations of **the board, directors' remuneration, accountability and audit, relations with institutional shareholders and the** responsibilities of institutional shareholders. The current edition of Combined Code is UK Corporate Governance Code, 2010.

The key source of corporate governance recommendations for UK-listed companies is the UK Corporate Governance Code, 2010.The Stock Exchange Listing Rules require annual reports to state how the company has applied the principles, where it has complied with the Code and where it has not.

The principles deal with the following areas:

Leadership
Effectiveness
Accountability
Remuneration
Relations with shareholders

You need to understand certain terms before looking at the points of the UK Corporate Governance Code requirements.

An executive director: an executive director is a director responsible for the administration of a company and is primarily responsible for carrying out the strategic plans and policies as established by the board of directors.

A non-executive director (NED): a non-executive director is a director without day-to-day operational responsibilities of the company.

The non-executive directors play a pivotal role in several important matters such as financial reporting done by the company, remuneration of executive directors and nomination of directors.

(a) Leadership

Main principles

Every listed company should be headed by an effective board that is collectively responsible for the long-term success of the company.

There should be a clear division of responsibilities at the board level, between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision.

The chairman is responsible for leadership of the board and for ensuring its effectiveness on all aspects of its role.

Non-executive directors should constructively challenge and help develop proposals on strategy.

Supporting principles

The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls, which enables risk to be assessed and managed.

The chairman is responsible for setting the board's agenda and ensuring that adequate time is available for discussion of all agenda items, in particular strategic issues.

Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.

Code provisions

The board should meet regularly.

A formal schedule of matters should be specifically reserved for the board of directors to decide.

The roles of chairman and CEO should not be performed by the same individual. If a single person is to be appointed to these two posts, then the board should consult major shareholders in advance and set out its reasons at the time of the appointment, and in the next annual report as well.

The board should appoint one of the independent non-executive directors to be the senior independent director who would serve as an intermediary for the other directors as well as shareholders when necessary.

(b) Effectiveness

Main principles

The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively.
There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.

All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively.

All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.

The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

Supporting principles

The number of executive and non-executive directors on the board, including independent non-executives, should be properly **balanced** to ensure that no individual or small group of individuals can dominate the board's decisions.

The board should be of sufficient size to meet the requirements of business.

Board members should be appointed based on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender.

In order to maintain an appropriate balance of skills and experience, the board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management.

The chairman should ensure that the directors continually update their skills, knowledge and familiarity with the company, which is required to fulfill their role both on the board and on the board committees.

The chairman is responsible for ensuring that the directors receive accurate, timely and clear information.

The company secretary should be responsible for advising the board through the chairman on all governance matters.

The chairman should act on the results of the performance evaluation by the board.

Code provisions

A **nomination committee** should be established to make recommendations to the board on all new board appointments and a majority of the members of this committee should be non-executive directors.

The nomination committee should evaluate the balance of skills, experience, independence and knowledge on the board.

All NEDs should be subject to election by shareholders at the first annual general meeting after their appointment. Any term beyond six years for a non-executive director should be particularly subject to a rigorous review.

The board should not agree to a full time executive director taking on more than one non-executive directorship in an FTSE 100 company or the chairmanship of such a company.

The chairman should ensure that new directors receive a full, formal and tailored induction on joining the board.

Evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years.

(c) Remuneration

The Level and Components of Remuneration

Main principles

Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

There should be a formal and transparent procedure for developing policies for executive remuneration and for fixing the remuneration packages of individual directors.

Supporting principles

The performance-related elements of executive directors' remuneration should be designed to promote the long-term success of the company.

The remuneration committee should consult the chairman and/or chief executive about the proposals relating to the remuneration of other executive directors.

Code provisions

The level of remuneration for non-executive directors should be at par with the responsibilities taken up as well as their time commitment towards this role.

Remuneration to non-executive directors should not include any performance related elements.

The remuneration committee should avoid rewarding poor performance. Therefore, while appointing directors, the committee should deliberate upon the compensation commitments (like pension contributions) which would be payable to directors in the event of early termination.

The board should establish a remuneration committee of at least three, or in the case of smaller companies, two independent non-executive directors.

The remuneration committee should have delegated the responsibility for setting the remuneration for all executive directors and the chairman, including pension rights and any compensation payments.

(d) Accountability

Financial and business reporting

Main principles

The board should present a balanced and understandable assessment of the company's position and prospects.

The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.

A formal arrangement should be established by the board for the following matters:

How to apply the corporate reporting, risk management and internal control principles; and
How to maintain a suitable relationship with the company's auditor.

Supporting principle

The board's responsibility to present a balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements.

Code provisions

(i) The annual report should include:

The directors' responsibility towards preparing the accounts; and
The reporting responsibilities of the auditors.

(ii) The annual report should include an explanation for how the entity upholds the strategy for delivering the objectives of the company.

(iii) The annual report and half-yearly financial statements should include an explanation from the directors on whether the business is a going concern along with supporting assumptions / qualifications as necessary.

(iv) The auditors should include in their audit report a statement that details their reporting responsibilities.

An annual review of the effectiveness of the entity's risk management and internal control system should be conducted by the directors. Furthermore, this matter must be communicated to the shareholders. The review should include risk management as well as financial, operational and compliance controls.

(v) The board should establish an audit committee of at least three directors, all non-executive, with written terms of reference which deal clearly with its roles and responsibilities.

(vi) The roles and responsibilities include a review of the effectiveness of the internal audit function. (vii) With

regard to the external auditors, the audit committee should:

Recommend their appointment

Approve their remuneration and terms of engagement
Monitor and review their independence, objectivity and effectiveness

(e) Relations with shareholders

Main principles

The board must ensure that a satisfactory dialogue with shareholders takes place. The dialogue would relate to understanding of objectives.

Boards should use AGMs as a platform to communicate with investors, thereby encouraging their participation.

Supporting principles

The chairman should ensure that all directors are made aware of their major shareholders' issues and concerns.

Code provisions

The chairman should be ready, where practicable, to initiate dialogue with major shareholders (i.e. institutional shareholders) on matters relating to governance and strategy. The chairman in turn would have to ensure that the concerns of the major shareholders are communicated to the board. AGMs should include separate resolutions for each substantial issue (for example, resolutions relating to the report and accounts).

The chairman of the board should arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions.
Notices relating to AGMs should be sent to shareholders at least 20 working days prior to the meeting.

5. Corporate governance report

Case Study

The following is an extract from the corporate governance report of Jestinson Plc, a UK based company that manufactures high quality glass for use in offices and homes.

Corporate governance report of Jestinson Plc

Statement of compliance with the provisions in the UK Corporate Governance Code

The board is committed to maintaining high standards of corporate governance in line with the Combined Code issued by the UK Listing Authority, which sets out the principles of good corporate governance and Code of Best Practice.

If the board has not complied with any of the Code provisions, the statement will disclose the provisions which are not complied with, along with the company's reasons for non-compliance.

The board has complied fully with the Combined Code throughout the year and is committed to upholding the highest standards of integrity and transparency in its dealings with investors, customers and employees.

The company believes in adopting the best global practices in the area of corporate governance and follows the principles of full transparency and accountability, thereby protecting the interests of all its stakeholders. The board considers itself a trustee of all shareholders and acknowledges its responsibilities to the shareholders for creating and safeguarding shareholders' wealth.

During the year under review, the board continued its pursuit of these objectives through the adoption and monitoring of corporate strategies, prudent business plans, monitoring of the major risks faced by the company's business and ensuring that the company pursues policies and procedures to satisfy its legal and ethical responsibilities.

Board of directors

The board of directors provides strategic direction and thrust to the operations of the company. The board has a non-executive chairman and six other directors. Out of these, four members are independent directors. Hence, the company complies with the listing agreement norms for independent directors. During the year, the board of directors of the company has approved and laid down a code of conduct applicable to all board members and employees of the company. This code of conduct has been posted on the company's website.

Furthermore, all board members and employees of the company have affirmed their adherence to the code. The company's vice-chairman and managing director's (CEO's) declaration to this effect forms a part of this report.

Board procedures

The company secretary prepares the agenda in consultation with the chairman of the board of directors, the chairmen of various committees and the vice-chairman and managing director. The agenda for the meetings of the board and its committees, together with the appropriate supporting documents, are circulated well in advance of the meetings. The meetings are normally held in London.

The board also approves by circular resolutions, important items of business which are permitted by the Companies Act, 1956 and which cannot be postponed until the next board meeting. At regular intervals, the management also circulates board notes to the board members on important material developments affecting the company.

Attendance at meetings

During the year under review, the board of directors met 8 times on 28 February, 16 April, 21 May, 30 June, 23 October, 11 November, 2 December and 16 December, 20X7.

Continued on the next page

The attendance record of the directors at each board meeting, and at the last annual general meeting held on 5 May 20X7, is given below:

Name of the director	Type of director	Board meetings attended	AGM attended	No. of committee memberships held (excluding private companies)	No. of outside directorships held (excluding private companies)
Peter Bullock (Chairman)		8	No	Nil	4
Denson Angel	NPD, NED, ID	6	No	3	2
Tony Nair	NPD, NED, ID	6	Yes	3	2
K. Thomas	NPD, NED, ID	7	Yes	2	6
Andrew Shrine	NPD, NED, ID	8	Yes	Nil	Nil
Jack Holman	NED, NID	2	Yes	4	1
Beck Bohemian	NID, NPD	1	No	Nil	Nil
Anna Varghese (Vice-chairman, MD)	PD, ED, NID	8	Yes	1	4

PD: Promoter Director, ED: Executive Director, ID: Independent Director, NPD: Non-Promoter Director, NED: Non-Executive Director, NID: Non-Independent Director

Nomination committee

The board decides the number of directors needed to run the business. Based on this decision, it plans for recruitment. While doing so, it looks for people from various backgrounds, especially with certain exceptional qualities that will help the company to operate effectively in the competitive market. At regular intervals, it also recommends changes in the structure, size and composition of the existing board (bearing in mind the required skills, knowledge and experience).

The evaluation process of the board members involves three procedures:

- The use of probing questionnaires based on ‘best practice’ that tease out a deep and meaningful assessment
- The use of interviews led by the chairman to confirm whether the company has met its objectives, roles, tasks and performance and to bring in some peer review
- Thorough and well-debated analysis of strengths and weaknesses of the board members

The levels and components of remuneration

The description of the work done by this committee is mentioned here.

The remuneration committee has proposed a remuneration policy that requires the company to pay a total of $2.5 million to the directors as a monthly payment. The amount proposed is in line with the other FTSE 500 companies. The committee had proposed a figure of $2 million after assessing the job profile, skill sets required and the directors’ performance. The budget for the executive remuneration for the year is $2 million.

Risk management, internal control and internal audit

Internal controls are the systems (manual or electronic), procedures and processes adopted by management to provide reasonable assurance regarding the achievement of objectives with respect to effectiveness and efficiency of operations, safeguarding of the company's assets, compliance with applicable laws and regulations, supporting business sustainability under normal as well as adverse operating conditions, reliable reporting and the prevention and detection of fraud, theft and other financial / accounting irregularities.

Jestinson Plc’s internal audit department regularly evaluates the adequacy and effectiveness of the company’s internal controls and financial reporting systems. This is conducted in accordance with the annual audit plan which ensures comprehensive coverage without unnecessary duplication.

The scope of the audit plan is to determine whether the company's risk management, control and governance processes, as designed and represented by management, is adequate and functioning in a manner that ensures risks are appropriately identified and managed and that employees' actions are in compliance with policies, standards, procedures and applicable laws and regulations.

Continued on the next page

The relevant audit plans are reviewed and approved by the audit and risk management committee on a bi- annual basis. These plans cover the six-month periods to the end of August and the end of February respectively.

The internal and external audit teams coordinate their work by sharing information and planning together to ensure comprehensive audit coverage and avoidance of unnecessary costs. The internal and external auditors have unrestricted access to the chairman of the audit and risk management committee.

External audit

The external auditors' plan is reviewed by the audit and risk management committee to ensure that significant areas of concern are covered, without infringing on the external auditors' independence and right to audit, to enable them to express an opinion on the annual financial statements.

Audit committees and auditors

If the internal audit function is absent, the reasons would be explained here!

The audit committee meetings are attended by the audit committee members, the company secretary, the finance director and the internal auditor.

The audit committee is a significant component in managing risk and in ensuring that financial reporting, CSR reporting and information to shareholders and the financial markets is transparent, complete and accurate. This committee challenges executives who control information in order to ensure executives cannot influence the objectivity or reporting, including the external audit opinion.

Dialogue with shareholders

Relations with investors: the board attaches a high priority to communications with investors. Linda Forth, the company secretary, meets significant investors on a regular basis.

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3. Evaluate and apply suitable judgements on when it may be appropriate to withdraw from, withdraw an opinion on or take other such appropriate action on an audit or assurance engagement.

[Learning Outcome e]

Instances of **circumstances where it may be appropriate to withdraw from, withdraw an opinion on or take other such appropriate action on an audit or assurance engagement** are discussed below.

1. When reasonable assurance cannot be obtained and a qualified opinion is insufficient for reporting

According to ISA 200, 'Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing', in all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient for purposes of reporting to the intended users of the financial statements, the ISAs require that the auditor disclaim an opinion or withdraw (or resign) from the engagement, where withdrawal is possible under the applicable law or regulation. For example, when an entity is affected by going concern issues, but the financial statements of the entity are prepared in the normal way rather than the liquidity / break-up basis.

2. Non- achievement of the objectives of audit

According to ISA 230, Audit documentation, if an objective in a relevant ISA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the ISAs, to modify the auditor's opinion or withdraw from the engagement (where withdrawal is possible under the applicable law or regulation).

Example

If the auditor will not be able to carry out the physical verification of the organisation's inventory due to it being located in a foreign country, the auditor will perform alternative procedures to confirm the correctness of the inventories in the book. However, if the alternative procedures indicate a misstatement in the valuation of the inventories, but it is not accepted by the client, the auditor would qualify the audit opinion or withdraw from the engagement.

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3. Non-compliance with laws

If the entity does not comply with laws and regulations and furthermore, does not take the remedial action that the auditor considers necessary in the circumstances, even when the non-compliance is not material to the financial statements, the auditor may decide to withdraw from the engagement.

One of the reasons for such a decision by the auditor could be that the senior management is not considering the auditor's suggestions and therefore the auditor may have to reconsider the reliability of the management and the representation given by management. However, before reaching this conclusion, the auditor would ordinarily seek legal advice.

Example

Albert is an auditor of Comp Co. He has obtained written representation from the management of Comp Co that all the applicable laws and regulations have been complied with except the renewal of the export licence for which it has paid a penalty.

However, Albert has obtained sufficient appropriate audit evidence from Comp's legal advisor that Comp has not complied with the environmental laws and may have to pay a heavy penalty as a result. In this case, Albert has to reconsider the reliability of the management and of the representation given by the management.

In order to deal with the situation professionally, he may seek legal advice and may withdraw from his engagement.

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4. 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 need to be 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.

5. Suspected fraud

When fraud and errors are suspected or detected, the auditor may withdraw from the engagement under the following conditions:

(a) Sometimes the auditor may come across situations which will not permit the auditor to continue performing the audit.

Examples of such situations are as follows:
The auditor has serious concerns about the integrity of the management or those charged with governance, e.g. an arms manufacturer supplying arms to a terrorist organisation
The entity does not address fraud which is not material to the financial statements, but for which the auditor
Requires the management to take suitable action.

(b) All entities have various complexities. Hence, fraud **occurs under different situations in different entities.** Therefore, there are no clear guidelines of the situations in which the auditor can withdraw from the engagement. However, the auditor may decide to withdraw from the assignment when the auditor is worried about the implications of the involvement of those charged with governance or the effect on the auditor of continuing the association with the entity. For example, the auditor of the arms manufacturer may be worried about being associated with the client on account of the client's dealings.

(c) The auditor will also need to consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities.

If the auditor withdraws:

the auditor should discuss with the appropriate level of management and those charged with governance the auditor’s withdrawal from the engagement and the reasons for the withdrawal; and

the auditor should determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor’s Withdrawal from the engagement and the reasons for the withdrawal.

(d) However, according to ISA 240, auditors of public sector entities often do not have the option of withdrawing from the engagement due to public interest considerations.

If certain rectification is necessary in the other information and the management refuses to make the revision, the auditor shall:

Communicate this matter to those charged with governance (unless all of those charged with governance are involved in managing the entity); and

Include a description of the material inconsistency in the ‘other matters’ paragraph of the audit report, or

Withhold the auditor’s report; or

Withdraw from the engagement, if withdrawal is possible under applicable laws or regulation.

6. Engagements relating to prospective financial information (PFI)

ISAE 3400 states that the auditor should not accept, or should withdraw from, an engagement if the assumptions relating to PFI are clearly unrealistic or if the auditor believes that the prospective financial information will be inappropriate for its intended use.

7. Engagements relating to money laundering

If, at any time during the course of a client relationship, auditors begin to have doubts about the client's identity, further evidence should be obtained. If auditors are unable to satisfy themselves of the identity of the client, the client relationship should be terminated.

8. Change to the terms of the audit engagement

According to ISA 210 in a recurring audit, if the auditor is unable to agree to a change to the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall withdraw from the audit engagement where possible under the applicable law or regulation.

9. Threats to independence

According to ISA 220, the engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall take appropriate action to eliminate threats to independence faced by the auditors, or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is possible under the applicable law or regulation.

For example, if the audit firm has insufficient audit staff, due to which the firm is not able to assign separate staff for the internal audit as well as external audit of an assurance client, the firm will face a self-review threat which cannot be mitigated, due to which the firm would have to withdraw from either of the two engagements i.e. external and internal audit.

Test Yourself 4

Discuss whether a partner, who is an actuary, can provide valuation services to an audit client.

Answers to Test Yourself

Answer to TY 1

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 2

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 3

Corporate governance represents the set of policies and procedures that determine how an organisation is directed, administered and controlled. It sets the broad framework or parameters from which the organisation must operate. It sets out what an organisation is supposed to do thus providing a benchmark against which the future performance and actions of managers / executives can be measured and evaluated.

Some of the benefits of having an effective system of corporate governance are that it:

Builds investor and shareholder confidence in the organisation;
Demonstrates the commitment an organisation has towards being ethical, efficient and effective;
Helps an organisation's board of directors, executives and management to take ethical decisions and
Provides a system of checks and balances so that neither management nor large shareholders can abuse their power at the expense of other shareholders of the organisation.

Answer to TY 4

IFAC's 'Code of Ethics for Professional Accountants' deals with valuation services in general (not specifically actuarial services).

A valuation service requires:
Making assumptions with regard to future developments; and
The application of certain methodologies and techniques, in order to compute a certain value, for an asset, a liability or for a business as a whole.

When a firm performs valuation services for an audit client which will be incorporated into the client's financial statements, it causes a self-review threat. If the valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity, the self-review threat created cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should not be provided or, alternatively, the only course of action would be to withdraw from the financial statement audit engagement.

However, if the valuation service performed by the auditor is neither separately, nor in the aggregate, material to the financial statements, or if it does not involve a significant degree of subjectivity, the self-review threat could be reduced to an acceptable level by the application of safeguards.

Such safeguards might include:
Involving an additional professional accountant (who was not a member of the assurance team) to review the work done or otherwise advise as necessary;
Confirming with the audit client their understanding of the underlying assumptions of the valuation and the methodology to be used, and obtaining approval for their use;
Obtaining the audit client's acknowledgement of responsibility for the results of the work performed by the firm; and
making arrangements so that the personnel providing such services do not participate in the audit engagement.

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 ______________________ is appropriate.

4. State whether true or false

   The main objective of implementing a system of corporate governance is to ensure an organisation's profitability is achieved at any costs.

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

4. False, the main objective is for the overall well-being of stakeholders

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

Jack is the external auditor of Lords Ltd. He gives his qualified opinion because there is a lack of an internal control system.

The following are relevant points:

Jack was surprised to see a high staff turnover at Lords Ltd. While examining documents; he discovers that there were twenty-nine engineers appointed to the production department. After the completion of their probation period, they all left the organisation since their appraisal was not conducted by management. However, they all are qualified young engineers. This is because no training was offered to newly recruited staff. Jack had confirmed that there is no process for training new staff in those cases where they are not able to meet the job requirements.

Jack also suspected those in the purchasing department of making amendments to hard copy purchase orders. The purchase orders are also not updated in the accounting system until the end of the month.

Jack was unsatisfied with the accounting of bank transactions. Jack noticed an unusual transfer of funds between specific two bank accounts.

Required:

What content must the external auditor's report to management cover?

Question 3

You are the auditor for Trycom Ltd; a small family owned and operated engineering business. The organisation manufactures valve components and supplies to automotive companies. Trycom has had a long history of profitability and enjoys an excellent reputation in the marketplace. The board of directors has recently decided to try and capitalise on these two factors and list the organisation on their country's local stock exchange.

However they have been informed that in order to have a successful listing, they will first need to implement a strong system of corporate governance into place. The directors are unfamiliar with the term and what good corporate governance entails for their organisation and themselves. Therefore they have come to you for advice and guidance on this matter.

Required:

Write a letter to the board of directors: Explaining what corporate governance is; why it becomes particularly relevant if they are considering listing their business and what responsibilities and requirements it will place on them.

Question 4

Financial statements are prepared on a going concern basis. This is an assumption that the company will continue in operation and meets its future obligations. The assets are valued on historical basis. If on the other hand, a company is not a going concern, then the basis of valuing the assets is the break up basis which could result in the non current assets being classified as current assets. Auditors carry out specific audit procedures to assess whether or not an audit client is a going concern. When there are doubts on the going concern assumption, the auditor may consider the effect that will have on the audit report. The following scenarios arose from four of the clients:

Client one

The audit senior is satisfied that the going concern assumption made by management is appropriate but there is material uncertainty which management has adequately disclosed in the financial statements.

Client Two

The going concern assumptions made by management is appropriate, but there is material uncertainty which is not adequately disclosed by management in the financial statements.

Client Three

The audit senior does not agree with the going concern assumption made by management and, therefore, considers the going concern assumption inappropriate.

Client Four

Management made an assessment of the going concern assumption for a period less than twelve months. Further, management is unwilling to extend its assessment.

REQUIRED:

Recommend the audit opinion that should be issued basing on each of the above scenarios.

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

An external auditor's report to management will address the following:

- Weaknesses in internal control and recommendations on how they may be rectified.
- Prevent workings in the accounting systems and material errors from occurring.
- Additional audit time taken as required.
- Inadequate accounting procedures / policies and recommendations as to how they may be improved.
- Suggestions as to how financial and accounting efficiency may be improved.
- Practical suggestions (not necessary related to accounting procedures but noted by the auditor during the course of investigations, with the benefit of an outsider's viewpoint).

Accordingly, the suitable content for external auditor's report to management will consist of:

- Basis of given information, including statement of facts
- Potential effects
- Appropriate recommendations for action

Statements of facts	Potential effects	Recommendations for action
High staff turnover in the organisation. Qualified persons leave the unit. According to Jack's report, there is no process for training new staff in cases where they do not meet the job requirements.	Failure to complete the job on time and correctly. Dissatisfaction on the part of the employee due to inability to meet the deadline	A complete analysis should be undertaken in order to know employee's abilities and training needs. Proper training must be given during non-productive hours to develop skills and to increase efficiency.
Amendments to purchase orders placed by Lords Ltd are made on the hard copy. They all are not updated in the system until the end of the month.	Any cancelled order will not be identified at the time the amount is settled and payment would be made for amounts not purchased. Non-genuine purchases could be being made. Both of the above could lead to unnecessary expenses in the financial statements and an incorrect balance on payables at the period end.	Each amendment should be recorded on both hard and soft copy at the same time otherwise time is wasted in updating the supplier's ledger. Also all changes must be authorised by the purchase manager. Purchase orders should be booked on the system daily or weekly.
Unusual transfer of funds between two specific bank accounts.	Possibility of funds being misappropriated as well as money laundering.	Bank reconciliation statement will help to find out the actual position of balances and overdrafts in different bank accounts. Try to find the cause of doing so.

Answer to SEQ 3

Dear Sir,

The term "good corporate governance" represents the set of policies and procedures that determine how an organisation is directed, administered and controlled. Businesses today are expected to implement a system of sound corporate governance so that the organisation has a benchmark against which the actions and performance of managers / executives can be measured and evaluated.

An effective system will set out a broad framework and parameters from which all management and employees must operate. This helps an organisation to be transparent and honest in all of its dealings – be they with customers, suppliers, employees and, especially, investors. It is important to remember that the need for a system of corporate governance stems from the concept of separation of ownership and control.

Given that you are considering listing your organisation you must bear in mind that you will be asking people to invest their money into a business they are not running or controlling. Having a strong system of corporate governance in place will definitely increase investor confidence about your business as well as your chances for a successful listing. This is mainly because the main objective of a corporate governance system is to align the interests of an organisation's board of directors, its management with those of its shareholders.

Some of the responsibilities that such a system will place on you as a board of directors include:

Establishing a code of corporate ethics (e.g. establishing a rule that any employee found guilty of harassment of any form will be dismissed).

Ensuring that the organisation establishes policies, procedures and controls to manage the potential risks it will face (e.g. implementing a quality control system of conducting quality checks on a random sample of finished products).

Ensuring that the organisation is in compliance with all laws and regulations (e.g. ensuring that all health and safety standards are always met).

Ensuring that an effective system of internal controls is in place and functioning (e.g. establishing the requirement that inventory is physically verified by management once every quarter).

Regularly reviewing the need for an internal audit department.

Appointing non-executive directors to the board. There should be a balance of executive and non-executive directors.

Establishing audit, remuneration and nomination committees. The majority (or all) of the members of these committees should be non-executive directors.

Separating the roles of chairman and chief executive officer. Overall designing and implement a system of good corporate governance will definitely be an investment on your part in terms of both time and money. However, once such a system is in place and running I am very confident that you will find the returns will far outweigh the costs.

Answer to SEQ 4

Impacts on the audit report
Client one

In the case where there is a material uncertainty on the going concern assumption and this is adequately disclosed by management in the financial statements, the auditor will issue an unmodified opinion and may want to explain this in the emphasis of matter paragraph.

Client two

In the case where there is an uncertainty and this is not adequately disclosed by management in the financial statements, this will result in the auditor modifying the audit opinion either by way of an adverse or qualified opinion depending on the materiality and pervasiveness of the uncertainty to the financial statements.

Client three

In the case where the auditor concludes that the use of the going concern assumption by management is inappropriate the auditors will modify the opinion by issuing an adverse opinion.

Client four

In the case where management refuses to extend the assessment to cover a period of at least twelve months, the auditors may modify the opinion either by qualifying or issuing of a disclaimer of opinion.