

ACCA Paper

P7

Advanced Audit & Assurance (INT)



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Chapter 1

RULES OF PROFESSIONAL CONDUCT

Introduction

The Rules of Professional Conduct apply to accountancy students, graduates and members. Their objective is to ensure that proper standards of professional conduct are observed. They give fundamental principles and specific guidance statements.

The Fundamental Principles

Members should:

- ▶ Behave with integrity in all professional, business and personal financial relationships. Integrity implies not merely honesty but fair dealing and truthfulness.
- ▶ Strive for objectivity in all professional and business judgements. Objectivity is the state of mind which has regard to all considerations relevant to the task in hand but no other.
- ▶ Not accept or perform work which they are not competent to undertake unless they obtain such advice and assistance as will enable them competently to carry out their work.
- ▶ Carry out their professional work with due skill, care, diligence and expedition and with proper regard for the technical and professional standards expected of them as members.
- ▶ Behave with courtesy and consideration towards all those with whom they come into contact during the course of performing their work.



The Specific Guidance Statements

- These deal with the specific areas where independence may be threatened.
 - ▶ Integrity, Objectivity and Independence
 - ▶ Professional Duty of Confidentiality
 - ▶ Changes in Professional Appointments
 - ▶ Books, Documents and Papers
 - ▶ Corporate Financial Advice
 - ▶ Conflicts of Interest

Integrity, objectivity and independence

- The Rules of Professional Conduct state that "A member's objectivity must be beyond question. This can only be assured if the member is, and is seen to be, independent".

Example 1

Common threats to independence are:

- undue dependence on an any single client or group of clients
- overdue fees
- family and other personal relationships
- beneficial interests in shares and other investments
- acceptance of goods, services or hospitality.

What practical steps can a firm take to maintain independence in each of these situations?

- Further threats include:

- ▶ self-interest
- ▶ self-review
- ▶ advocacy
- ▶ intimidation

- Another threat to independence is the provision of other services to clients. The Rules of Professional Conduct state that it is right that members should provide other services for their clients. However, care must be taken not to perform executive functions or make executive decisions. Also, the preparation of accounting records for a public limited company is only allowed in exceptional circumstances.

Example 2

What are the benefits of providing other services to clients?

What are the drawbacks, and how can these be overcome?



- Specialist valuations

- ▶ Auditors may be asked to provide “specialist valuations” which could impair their objectivity.
- ▶ “Specialist valuations” include actuarial valuations, valuations of intellectual property and brands, other intangible assets, property and unquoted investments.
- ▶ The Rules of Professional Conduct state that a member should be independent when carrying out a specialist valuation, the results of which may be included in financial statements or public documents.

- Second opinions

- ▶ Audit firms are often asked to give an opinion on the application of financial reporting standards or principles to specific circumstances or transactions of an entity which they don't audit.
- ▶ The firm should contact the auditor so that they can be made aware of any relevant facts.
- ▶ The firm should, with the client's permission, provide a copy of their opinion to the auditor.



The IFAC code of ethics

Principles

- ▶ The fundamental principles are similar to ACCA guidance. The notable difference is the reference to confidentiality.
- ▶ Integrity: As ACCA guidance.
- ▶ Objectivity: As ACCA guidance.
- ▶ Professional competence and due care: As ACCA guidance.
- ▶ Confidentiality: A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.
- ▶ Professional behaviour: A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession.
- ▶ A professional accountant should carry out professional services in accordance with the relevant technical and professional standards.

Objectives

- ▶ The Code recognises that the objectives of the accounting profession are to work to the highest standards of professionalism, to attain the highest levels of performance, and generally to meet the public interest requirement. These objectives require four basic needs to be met.
- ▶ Credibility
 - In the whole of society, there is a need for credibility in information and information systems.
- ▶ Professionalism
 - There is a need for individuals who can clearly be identified by clients, employers and other interested parties as professional people in the accountancy field.
- ▶ Quality of services
 - There is a need for assurance that all services obtained from a professional accountant are carried out to the highest standards of performance.
- ▶ Confidence
 - Users of the services of professional accountants should be able to feel confident that there exists a framework of professional ethics which governs the provision of those services.
 - Professional fees should be a fair reflection of the value of the professional services performed for the client. They should normally be computed on the basis of appropriate rates per hour or per day for the time of each person engaged in performing professional services.
 - In reply to public advertisement or an unsolicited request to make a submission or submit a tender, a professional accountant in public practice should, if the appointment may result in the replacement of another professional accountant,



state in the submission or tender that, before acceptance, the opportunity to contact the other accountant is required so that enquiries may be made as to whether there are any professional reasons why the appointment should not be accepted. If the submission or tender is successful, the existing accountant should then be contacted.



Professional duty of confidentiality

- The general rule is that information acquired in the course of professional work should not be disclosed to third parties without first obtaining the client's permission.
- There are two situations where disclosure, without the client's permission, needs to be considered:
 - ▶ Obligatory - This is where members are bound to disclose information. This covers situations where they are compelled to disclose information under the process of law. For example, they could be served with a court summons or called as a witness.
 - ▶ Voluntary - These are situations where members are free to disclose information.
 - In the public interest. There is no definition of "public interest". Therefore, legal advice should be taken in order to decide whether disclosure will be justified or not. Disclosure would only be acceptable where it is made to "one who has the proper interest to receive the information".
 - To protect a member's interest. For example, they might wish to defend themselves against a criminal charge or clear themselves of suspicion.
 - Authorised by statute. For example, they should report any non-compliance with law or regulation to the proper authority.
 - To non-governmental bodies. They could be approached by recognised but non-governmental bodies seeking information concerning acts of misconduct not amounting to a crime or civil wrong. If the body has statutory powers, they should comply and supply the relevant information.



Changes in professional appointments

- When a prospective client approaches a member to act as auditor or adviser, the member must communicate with the existing auditor or adviser. The procedure is as follows.
 - ▶ Obtain the client's permission to communicate with the existing auditor or adviser.
 - ▶ If permission is refused, decline the invitation.
 - ▶ If permission is granted, write to the existing auditor or adviser requesting information that may help with making a decision on acceptance of the invitation.
- When the existing auditor or adviser receives the request, they should seek permission from the client to respond. If the client refuses to give permission, the prospective auditor or adviser should be informed and they should decline the invitation.
- When permission is granted, all reasonable information should be provided to enable the prospective auditor or adviser to make an informed decision.
- If the existing auditor fails to reply, the member should send a further letter by registered post or recorded delivery.
- This letter should state that, unless a reply is received within a stated period, the member will assume that there are no matters of which they should be made aware and, at the end of the stated period, will proceed to accept the invitation.
- Once a new auditor or adviser has been appointed, the former auditor or adviser should ensure that all books and papers belonging to the client are promptly transferred. In particular the following should be provided:
 - ▶ a copy of the last set of financial statements, formally approved by the client; and
 - ▶ a detailed trial balance that is in agreement with those financial statements.
 - ▶ European Union recommends a 10 year mandatory requirement for listed companies to put their audit out to tender every 10 years.
 - ▶ The UK Competition Commission says "No, it should be every 5 years"
 - ▶ in addition, UK banks are no longer able to include in their loan contracts "big 4 firms only".



Books, documents and papers

- The general principle is that documents belonging to the client must be given to the client or their legal agents on request. Clients have no rights of access to documents belonging to the audit firm.
- This distinction is a legal one. If the audit firm is acting on behalf of their clients, as their agents, then the documents produced belong to the client. This would cover the preparation of accounting records and tax returns. With the audit, however, the audit firm acts on its own behalf. Therefore, the client has no rights to the documents produced.
- Audit working papers should be retained for a period sufficient to meet the needs of the practice and in accordance with legal and professional requirements of record retention.
- **Right of Lien**
Generally, in the event that fees are not paid, members may exercise a lien over certain books and papers upon which they have been working. This right of particular lien exists when, usually, all of the following conditions apply.
 - ▶ The documents retained must be the client's property
 - ▶ They must have come into the member's possession by proper means
 - ▶ The member must have done work on the documents and issued a fee note
 - ▶ The fees for which the lien is exercised must be outstanding in respect of work on the documents and not in respect of other unrelated work
- A lien cannot be exercised over books or documents of a registered entity which have to be available for public inspection or which have to be kept at the entity's registered office.



Conflicts of interest

- Conflict between members' and clients' interests
 - ▶ Audit firms must always place their clients' interests before their own. Therefore, they should not accept or continue engagements where there are significant conflicts of interest between the firm and its clients.
 - ▶ Any form of financial gain which accrues, or is likely to accrue, to firms as a result of engagements, otherwise than in the form of fees or other reward from clients, or concession properly earned, will amount to a significant conflict of interest.
- Conflicts between the interests of different clients
 - ▶ There is nothing improper in firms having two or more clients whose interests may conflict, provided the work that the firm undertakes is not, in itself, likely to be the subject of dispute between those clients.
 - ▶ The firm's work should be managed so as to avoid the interests of one client adversely affecting those of another.
 - ▶ Where the acceptance or continuance of an engagement would, even with safeguards, materially prejudice the interests of any client, the appointment should not be accepted or continued.
- Safeguards
 - ▶ The Rules of Professional Conduct suggest safeguards that can be instigated to manage conflicts which may arise. These are:
 - use different staff for each assignment;
 - carry out a regular review of the situation;
 - have instructions on maintaining confidentiality, and
 - advise one or both clients to seek additional independent advice.
 - ▶ Whenever a material conflict of interest between clients or potential clients is identified, sufficient disclosure should be made to the clients concerned so that they can make an informed decision as to whether to engage another firm or continue with the existing firm.

Corporate financial advice

- The provision of corporate financial advice can give rise to independence problems and conflicts of interest.
- As long as firms can maintain and demonstrate objectivity and integrity there can be no objection to their accepting these engagements.
- All reasonable steps should be taken to avoid conflicts of interest. When it is clear that material conflicts of interest exist, the firm should decline to act as financial advisers.





Chapter 2

PROFESSIONAL RESPONSIBILITY AND LIABILITY

Since the clarity project in 2009, all ISAs now conform to a standard format:

- Introduction
- Objectives
- Definitions
- Requirements
- Application and other explanatory information

Fraud and error

- Fraud comprises both the use of deception to obtain an unjust or illegal financial advantage and intentional mis-representations affecting the financial statements by one or more individuals among management, employees or third parties.

Fraud is also 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.

Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

- Error would be unintentional mistakes in financial statements (including the omission of an amount or disclosure).
- When planning the audit, auditors should assess the risk that fraud or error may cause the financial statements to contain material misstatements. Based on this risk assessment, auditors should design their procedures so that they have a reasonable expectation of detecting material misstatements arising from fraud or error.
- Responsibility for the prevention and detection of fraud rests with the management and those charged with governance.
They should create a culture of ethics and honesty within the entity.
- This culture should be actively reinforced by active oversight by those charged with governance by:
 - ▶ Considering the potential for controls to be over-ridden
 - ▶ Considering other inappropriate practices eg aggressive earnings management



- It is more difficult to detect misstatements arising from fraud rather than from error
 - ▶ Fraud can involve sophisticated and well-organised schemes
 - Forgery
 - Deliberate failure to record transactions
 - Intentional mis-representations
 - Collusion – particularly at management level
 - ▶ The auditor's ability to detect fraud depends on a combination of factors
 - skill of the fraudster
 - frequency and extent of the manipulation
 - relative size of the amounts manipulated
 - degree of collusion
 - seniority of those involved
- The auditor should enquire of management about:
 - ▶ Management's assessment of the risk that the financial statements may be materially misstated due to fraud including:
 - Nature
 - Extent, and
 - Frequency of these assessments
 - ▶ management's procedures for identifying and responding to risks of fraud including:
 - specific risks identified by management
 - risks brought to their attention by others, and
 - classes of transactions, account balances or disclosures for which a risk is likely to exist
 - ▶ communications by management with those charged with corporate governance concerning the processes adopted for the identification and response to risks
 - ▶ communications by management with employees concerning their views about business practices and ethics
 - ▶ discussions with the internal auditors
- Procedures when there is an indication that fraud or error may exist:
 - ▶ When auditors become aware of information which indicates the existence of fraud or error, they should obtain an understanding of the nature of the event and the circumstances in which it has occurred. They should aim to gain an understanding of the possible effects on the financial statements.
 - ▶ The auditors should document their findings and communicate them to the appropriate level of management. This would usually be the board of directors or the audit committee.



● Reporting to third parties

- ▶ Auditors should also consider whether the matter should be reported to a proper authority in the public interest (e.g. regulatory or enforcement agencies).
- ▶ If, after obtaining legal advice, the auditors conclude that the matter ought to be reported to an appropriate authority in the public interest, they should notify the directors in writing of their view and, if the entity does not report the matter or is unable to provide evidence that the matter has been reported, they should report it themselves.
- ▶ Where a suspected or actual instance of fraud casts doubt on the integrity of the directors, auditors should make a report direct to the proper authority in the public interest without delay, informing the directors in advance.
- ▶ The following matters should be taken into account when deciding whether disclosure is justified in the public interest:
 - the extent to which the suspected or actual fraud is likely to affect members of the public
 - whether the directors have rectified the matter or are taking, or are likely to take, effective corrective action.
 - the extent to which non-disclosure is likely to enable the suspected or actual fraud to recur.
 - the seriousness of the matter; and
 - the weight of evidence and the degree of the auditor's suspicion that there has been an instance of fraud.



Professional liability

- An audit firm owes a duty of care to their client, the entity.
- They may also owe a duty of care to third parties who rely upon the financial statements. In recent years the question of whether the auditor owes a duty of care to third parties has been controversial and the subject of considerable media attention.
- An auditor may be liable in tort to a third party where:
 - ▶ a duty of care exists (legal neighbours/proximity);
 - ▶ that duty has been breached (ie auditor has been negligent)
 - ▶ third party has relied on the auditor's work
 - ▶ financial loss has been suffered
 - ▶ the loss suffered was caused by the third party's reliance on the auditor's negligent work.
- The Caparo case
 - ▶ The key case is the Caparo Industries case. In 1987, Caparo Industries plc brought an action against two of the directors of Fidelity plc and their auditors, Touche Ross. During 1984, Caparo invested in and eventually acquired control of Fidelity plc. They alleged that the financial statements they had relied upon overstated the profits. The case went to the House of Lords where it was decided that proximity did not exist. The Lords stated that an essential element of proximity is that "the defendant knew that his statement would be communicated to the plaintiff, either as an individual or a member of an identifiable class, specifically in connection with a particular transaction or transactions of a particular kind and that the plaintiff would be very likely to rely on it for the purpose of deciding whether or not to enter upon that transaction". The claim by Caparo Industries was rejected.
- The ADT case (1996)
 - ▶ ADT acquired control of Britannia Securities Group who were audited by Binder Hamlyn. Before ADT made a bid, they had a meeting with one of the partners from Binder Hamlyn. At this meeting, the partner was asked if he stood by the results of the 1989 audit. After the take-over, ADT alleged that these financial statements were misstated and sued Binder Hamlyn for £65 million. They believed that the meeting between themselves and the partner created proximity. The judge agreed and Binder Hamlyn were ordered to pay the £65 million in damages together with £40 million in interest.



Limiting auditors' liability

- The auditing profession is concerned about the extent of their liability to third parties. They argue that they are unable to get sufficient insurance cover to meet the level of claims.
- The following suggestions have been put forward as possible methods of reducing liability.
 - ▶ Incorporation
 - ▶ Limited Liability Partnership
 - ▶ Capping Liability
- Incorporation would protect the partners from personal bankruptcy. However, the firm itself could be forced into liquidation. Further, there could be adverse tax implications and the firm would need to publish financial statements and be subject to an audit.
- Limited Liability Partnerships (LLPs) would permit the partners to avoid personal liability for the debts of the firm. Legislation has been enacted allowing LLPs in the UK.
- It has been suggested that auditors should be able to limit the amount of their liability for an individual audit. The maximum amount could be based on some multiple of the audit fee. This is currently not permitted for audit work by the Companies Act 2006 but it is permitted in other countries such as Germany.



Expectation gap

- This term is used to describe the difference between the expectations of those who rely upon audit reports, concerning audit work performed, and actual work performed.
- Contributing factors
- The expectation gap arises due to:
 - ▶ lack of competence,
 - ▶ lack of independence, and
 - ▶ lack of education
- The profession's response to accusations of a lack of competence are:
 - ▶ rules on the issue of practicing certificates
 - ▶ post qualification educational requirements (CPE and CPD)
 - ▶ monitoring of audit activity
 - ▶ disciplinary procedures following investigation of apparent audit failures
- It may be difficult to separate lack of competence and lack of independence. Technical competence and honesty or independence are clearly inter-related.

Misconduct

- Misconduct refers to acts which are likely to bring discredit upon an ACCA member, the ACCA or the profession itself.
- Convictions relating to the personal life of members and students such as obtaining money or goods by false pretences, forgery, theft and other offences involving dishonesty amount to misconduct.
- The Investigations, Disciplinary and Appeals committees will decide each case on its own merits.
- Penalties imposed will reflect the view which the committees take in respect of the individual offences and the seriousness of the matter.



Professional indemnity insurance (PII)

- Members or firms who wish to hold an ACCA practising certificate must hold PII and fidelity guarantee insurance (FGI) in respect of all partners, directors and employees.
- PII must provide cover in respect of all civil liability incurred in connection with the conduct of the firm's business. FGI must include cover against any acts of fraud or dishonesty by any partner, director or employee in respect of money or goods held in trust by the firm.
- For example, in the UK the lower limit of indemnity on PII in respect of each and every claim shall be:
 - ▶ 21/2 times the relevant total income subject to a minimum of 100,000GBP and a maximum of 1.5 million GBP

Insider dealing

- Insider dealing involves the buying or selling of shares by a person connected with a company who, when doing so, is in possession of specific information which is not generally known but which would be likely, if made public, to have a significant effect on the market price of the shares.
- Clearly an auditor is in possession of such information. It would be unethical for an auditor to use that information for personal gain.



Money Laundering

- A process whereby the proceeds of criminal activity are converted into assets appearing to have a legitimate origin
- Usually involves 3 distinct phases
 - ▶ Placement of the funds into legitimate business activity
 - ▶ Transfer of money from business to business (or place to place) to conceal its original source
 - ▶ Integration – the money takes on the appearance of having come from a legitimate source
- Proceeds of Crime Act 2002 seeks to control money laundering by the creation of 3 categories of criminal activity
 - ▶ Laundering (maximum 14 years prison and / or fine)
 - ▶ Failure to report (maximum 5 years prison and / or fine)
 - ▶ Tipping-off (maximum 5 years prison and / or fine)
- The offence of failure to report relates only to individuals acting in the course of business – for example, accountants

Bribery

- Bribery Act 2010 targets both bribery and corruption
- 4 offences
 - ▶ bribing another person
 - ▶ receiving a bribe
 - ▶ bribing a foreign public official (FPO) (see next page)
 - ▶ commercial organisation failing to prevent bribery (see next)
- bribing = offering financial or other advantage to perform a relevant function or activity improperly
- relevant function or activity:
 - ▶ any function of a public nature
 - ▶ any activity connected with a business
 - ▶ any activity performed in the course of a person's employment
 - ▶ any activity performed by, or on behalf of, a group of persons
- these "relevant functions or activities" may be anywhere in the world



Bribing an FPO

- offence to offer, directly or indirectly, a financial or other advantage to an FPO intending to influence them in gaining business or an advantage in connection with business
- an FPO holds an administrative, legislative or judicial position outside the UK
- commercial organisation failing...
 - ▶ a company or partnership is liable if an agent, employee or subsidiary bribes another person intending to gain a business advantage
- Defence - if a company can show that it had adequate procedures in place, appropriate to the level of risk
 - ▶ "adequate procedures" based on six guidance principles

The Six principles

- proportionate procedures
 - ▶ proportionate to risks faced and size of company
- commitment by management
 - ▶ management should assess the nature and extent of risks faced and develop appropriate procedures to manage that risk
- due diligence
 - ▶ the company should apply due diligence procedures in respect of company personnel who are at greater risk of offering bribes
- communication
 - ▶ to ensure all employees / connected persons are aware of the company's culture and attitude
 - ▶ includes training and education procedures
- monitoring and review
 - ▶ procedures should be regularly reviewed and improved as necessary
- "adequacy of procedures" is a matter for a court to decide
- NB "hospitality" that is reasonable and proportionate is acceptable, ie is it not prohibited by the Act.



Penalties

- an individual who is found guilty faces imprisonment up to 10 years
- a guilty company is liable to an unlimited fine
- but, in addition, there is reputation loss...
- ... and potentially, civil claims against the directors for failing to implement adequate procedures

First conviction

- Munir Patel found guilty of accepting £500 to suppress a driving conviction from court records. Serving a 3 year prison sentence



Chapter 3

REGULATORY ENVIRONMENT

Corporate governance

- Corporate Governance is the system by which entities should be directed and controlled (definition from the Cadbury Report in the UK).
- Code of best practice
- Internationally the 2010 UK Corporate Governance Code (CGC) is seen as a good code to follow for listed entities. The principles of good corporate governance are contained in the CGC. These can be split between those applicable to directors, those applicable to relations with shareholders and those applicable to the financial statements and the audit.
- The recommendations applicable to directors are as follows:
 - ▶ There should be a division of duties at the head of the entity. The role of chairman and chief executive officer should be separated.
 - ▶ At least a half of the board should be non-executive directors who are independent of management and free from any business or other relationship which could interfere with the exercise of their independent judgement.
 - ▶ The chairman should ensure that all directors are properly briefed on issues arising at the board meetings.
 - ▶ Directors should be re-appointed every 3 years and they should receive appropriate training when they are first appointed. (FTSE 350 company? All directors should be appointed every year)
 - ▶ Levels of remuneration should be sufficient to attract, retain and motivate directors. A proportion should be linked to corporate performance.
 - ▶ A remuneration committee should be established. This should be comprised of non-executive directors. Details of remuneration policy and remuneration paid should be included in the financial statements.
- Those applicable to relations with shareholders are as follows:
 - ▶ Entities should be ready to enter into dialogue with institutional investors.
 - ▶ The AGM should be used to communicate with private investors and encourage their participation.
 - ▶ Institutional investors have a responsibility to make considered use of their votes.
- The recommendations applicable to the financial statements and audit are as follows:
 - ▶ The board should present a balanced and understandable assessment of the entity's position and prospects.
 - ▶ The board should maintain a sound system of internal control to safeguard shareholders' investment and the entity's assets.



- ▶ The board should establish formal and transparent arrangements to consider how they should apply financial reporting and internal control principles and for maintaining an appropriate relationship with the auditors. This will involve the establishment of an audit committee.
- The CGC is now part of the UK Stock Exchange listing rules. Listed entities must make a statement on how they apply the principles in the Code. The entity is also required to confirm that it complies with the Code provisions or, where it does not, to provide an explanation. Auditors are required to review these matters.
- At present there is no International Code. In comparison, there is no code for entities listed in the United States. However, the SEC (Securities and Exchange Commission) have their own strict rules and, in addition, each of the stock exchanges also have their own rules which embody corporate governance principles.

Provisions that auditors are required to review

- Auditors are required to review seven areas of the Code in the UK only as follows.
 - ▶ The board should have a formal schedule of matters specifically reserved to it for decision.
 - ▶ There should be a procedure agreed by the board for directors to take independent professional advice, if necessary, at the entity's expense.
 - ▶ Non-executive directors should be appointed for specified terms, subject to re-election and to Companies Act provisions relating to the removal of a director, and re-appointment should not be automatic.
 - ▶ All directors should be subject to election by shareholders at the first opportunity after their appointment, and to re-election thereafter at intervals of no more than three years. The names of the directors submitted for election or re-election should be accompanied by sufficient biographical details to enable shareholders to take an informed decision on their election.
 - ▶ The directors should explain their responsibility for preparing the financial statements and there should be a statement by the auditors about their reporting responsibilities.
 - ▶ The directors should, at least annually, conduct a review of the effectiveness of the system of internal controls and should report to the shareholders that they have done so.
 - ▶ The board should establish an audit committee of at least three independent, non-executive directors. The members of the audit committee should be named in the annual report.
- Auditors must obtain appropriate evidence to support the compliance statement made by the directors. The following procedures will normally be performed to obtain that evidence.
 - ▶ Review of board minutes and minutes of relevant board committees.
 - ▶ Review of relevant supporting documents prepared for the board.
 - ▶ Making enquiries of certain directors and the company secretary regarding procedure and its implementation.
 - ▶ Attending meetings of the audit committee (or the full board if there is no audit committee) at which the annual financial statements are considered and approved.



Non compliance with code provisions in the UK

- Where there is a departure from a Code provision specified for the auditors' review, but there is proper disclosure of this fact and the reasons for the departure, the auditors do not refer to this in their report.
- However, where there is not proper disclosure of a departure, the auditors must report this in the opinion section of their audit report.

Audit committees (common internationally)

- Listed entities should have an audit committee of at least 3 non-executive directors and the committee should have written terms of reference which deal clearly with its authority and duties.
- The duties of the audit committee should include reviewing the scope and results of the audit, its cost effectiveness and the independence and objectivity of the auditors. The committee is also responsible for overseeing on behalf of the board, and reporting to the board on:
 - ▶ the financial reporting process and the audit thereof
 - ▶ the internal control of the business and the review thereof, usually by internal audit.
- The external auditors should be open and honest in their communication with the audit committee. They should ensure that all relevant and significant issues are brought to the committee's attention and openly discussed.
- Prior to the audit, matters such as the scope of the audit, role of internal auditors, audit fees and other services provided should be discussed with the audit committee.
- On completion of the audit, the auditors' discussion with the audit committee should cover:
 - ▶ all matters on which they are required by regulation or standards to report
 - ▶ the control environment
 - ▶ any differences of opinion between the auditors and the management and how these have been resolved
 - ▶ significant adjustments made to the financial statements and any unadjusted amounts
 - ▶ observations on other information to be published with the financial statements.



The Turnbull working party, updated by the Flint review in 2004

- The Turnbull Working Party published "Internal Control: Guidance for Directors on the CGC" in September 1999. This gives directors guidance on the scope, extent, nature and review of internal controls to which the Code refers. Again, internationally, similar codes will be introduced over time.
- In order to have effective internal controls, an entity needs to:
 - ▶ identify its business objectives
 - ▶ identify and assess the risks which threaten the achievement of those objectives
 - ▶ design and operate internal controls to manage those risks
 - ▶ monitor controls to ensure they are operating properly.
- The annual report should contain a narrative statement of how the entity has applied the Code in respect of internal controls. The auditors should read this statement and seek to resolve any misstatements or material inconsistencies with the audited financial statements.
- The objective of the auditors' work is to assess whether the entity's summary of the process that the board adopted in reviewing the effectiveness of the system of controls is supported by documentation prepared by the directors and reflects that process.
- The auditors may report by exception if problems arise such as:
 - ▶ The board's summary of the process of review of internal control is not supported or does not reflect the auditors' understanding of that process.
 - ▶ The board have not made an appropriate disclosure if it has failed to conduct an annual review, or the disclosure made is not consistent with the auditors' understanding.
- The audit opinion would be as follows:

Opinion

In our opinion the financial statements give a true and fair view of the state of the entity's affairs as at 31 December 20XX and of its profit for the year then ended and have been properly prepared in accordance with the International Financial Reporting Standards

Other matter

We have reviewed the board's description of its process for reviewing the effectiveness of internal controls set out on page X of the annual report. In our opinion, the board's comments concerning their review do not appropriately reflect our understanding of the process undertaken by the board because...

- the auditor is now required to communicate with those charged with governance about:
 - ▶ an explanation of why significant accounting practice, acceptable according to financial reporting requirements, are not appropriate to the circumstances of the entity
 - ▶ documentation of matters communicated orally
 - ▶ communication of difficulties encountered during the audit



Consideration of law and regulations

- Auditors should plan and perform their audit procedures, and evaluate and report on the results thereof, recognising that non-compliance by the entity with law or regulations may materially affect the financial statements.
- Responsibility of the directors
 - ▶ To take appropriate steps to provide reasonable assurance that the entity complies with law and regulations applicable to its activities.
 - ▶ To establish arrangements for preventing any non-compliance with law or regulations and detecting any that occur; and
 - ▶ To prepare financial statements that give a true and fair view of the state of affairs of an entity or group and of its profit or loss for the financial year.
- The following steps may assist the directors in discharging their responsibilities for the prevention and detection of non-compliance with law or regulations:
 - ▶ Maintaining an up-to-date register of significant laws and regulations with which the entity has to comply within its particular industry.
 - ▶ Monitoring legal requirements and any changes therein and ensuring that operating procedures are designed to meet these requirements.
 - ▶ Instituting and operating appropriate systems of internal control.
 - ▶ Developing a code of conduct, ensuring employees are properly trained in, and understand, its provisions, maintaining compliance and taking appropriate action in cases of non-compliance.
 - ▶ Engaging legal advisers to assist in monitoring legal requirements; and
 - ▶ Maintaining a record of complaints.
- Procedures when possible non-compliance is discovered
 - ▶ When the auditors become aware of information which indicates that non-compliance with law and regulations may exist, they 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.
 - ▶ Any non-compliance with law or regulations should be documented and discussed with the appropriate level of management. Auditors should consider the implications in relation to other aspects of the audit, particularly the reliability of written representations.





Chapter 4

PRACTICE MANAGEMENT

Quality control

Quality control policies and procedures are defined as those 'designed to provide reasonable assurance as to the appropriateness of the auditors' report and of adherence to Auditing Standards, ethical and other requirements'.

The firm

Firms should establish and communicate to audit engagement partners and audit staff quality control policies and procedures. This will involve the establishment of an appropriate structure within the firm, including the appointment of a senior audit partner to take responsibility for these matters.

The key roles within the firm:

	<i>Must be:</i>	<i>Cannot be:</i>
Partner who takes responsibility for establishing quality control policies and procedures	a senior audit partner of the firm	an external consultant
Partner who takes responsibility for monitoring the quality of audits	a senior audit partner of the firm and not the partner mentioned above	an external consultant
Audit Engagement Partner	a partner or other person in the firm who is authorised to issue an auditors' report on behalf of the firm	the "independent partner" for the audited entity or any other entities in the same group
Individual who performs "independent review"	an "independent partner" with sufficient experience and authority to fulfil the role; or a suitably qualified external consultant	a partner engaged in the performance of the audit or the provision of other services or with any responsibilities for the audited entity or any entities within the same group



Acceptance and retention of engagements

- Before accepting a new audit engagement firms should ensure that they:
 - ▶ Are competent to undertake the work.
 - ▶ Consider carefully whether there are threats to their independence and objectivity and, if so, whether adequate safeguards can be established.
 - ▶ Assess the integrity of the owners, directors and management of the entity, and
 - ▶ Comply with the ethical requirements of the professional accountancy bodies in relation to changes in appointment.
- Firms should also ensure that they reconsider these matters when deciding whether they are willing to continue in office as auditors.

Resources

- Firms should have sufficient engagement partners and audit staff with the competencies necessary to meet their needs.

Competencies

- Competencies are developed through:
 - ▶ Professional education and development (including technical and management training, in-house courses and external training).
 - ▶ Work experience and coaching by other members of the audit team.
 - ▶ Assignment of personnel to engagements
- An audit engagement partner should be appointed to each audit engagement undertaken by a firm, to take responsibility for the engagement on behalf of the firm.
- Firms should assign audit staff with the competencies necessary to perform the audit work expected of them.
- Competencies to be considered include:
 - ▶ Understanding and practical experience of auditing.
 - ▶ Understanding applicable accounting, auditing, ethical and other technical standards.
 - ▶ Knowledge of specific industries.
 - ▶ Professional judgement.
 - ▶ Understanding the firm's quality control policies and procedures.



Consultation

- Firms should establish procedures to facilitate consultation and to ensure that sufficient resources are available to enable appropriate consultation to take place in relation to difficult or contentious matters.
- The results of consultation that are relevant to audit conclusions should be documented.
- Consultation on technical matters may amount to a simple request for advice from a technical department or from an expert within the firm.
- The procedures are designed to ensure that individuals of appropriate seniority and experience are consulted on all difficult or contentious issues and that the results of consultations relevant to audit conclusions are properly documented.

Direction, supervision and review

- Audit engagement partners should ensure that audit work is directed, supervised and reviewed in a manner which provides reasonable assurance that the work has been performed competently.
- Audit planning is an important means of providing direction to audit staff.
- Supervision includes:
 - ▶ Both direction and review.
 - ▶ Monitoring the progress of the audit to consider whether:
 - assistants have the necessary skills, plus competence to carry out the assigned tasks
 - assistants understand the audit directions; and
 - the work is being carried out in accordance with the overall audit plan and the audit program.
 - ▶ Addressing significant accounting and auditing questions raised during the audit, assessing their significance and modifying the overall audit plan and audit programme as appropriate; and
 - ▶ resolving any differences of professional judgement between personnel and considering the level of consultation that is appropriate.
- Work performed by staff is reviewed by more senior staff or the audit engagement partner.
- Independent review
 - ▶ Firms should ensure that an independent review is undertaken for all audit engagements where the audited entity is a listed entity. In addition, firms should establish policies setting out the circumstances in which an independent review should be performed for other audit engagements, whether on the grounds of the public interest or audit risk.
 - ▶ The independent review should take place before the issue of the auditors' report in order to provide an objective, independent assessment of the quality of the audit.



- Monitoring
- Firms should appoint a senior audit partner to take responsibility for monitoring the quality of audits carried out by the firm.
- The objective of monitoring reviews is to provide an independent assessment of:
 - ▶ The appropriateness of the auditors' report and the conduct of the audit in accordance with Auditing Standards, ethical and other regulatory requirements.
 - ▶ Whether the firm's quality control policies and procedures have been applied in practice and appropriate consultation has taken place in relation to difficult or contentious issues.
 - ▶ Rotation of auditors according to European Directive
 - auditor firms of public companies should retire from office after 10 years
 - that 10 year period may be extended if the audit is shared
 - but the auditor in office must retire , in that situation, after 15 years
 - ▶ the idea is to reduce the familiarity threat to independence companies must put the audit out to tender after 10 years or
 - ▶ if they don't, they must indicate the date within the next five years when tenders will be invited
 - ▶ a further amendment refers to the level of fees received for non-audit work – there is to be a cap on the earnings limit for a serving firm of auditors in that they shall not earn more than 70% of the audit fee from non-audit work




Advertising, publicity and obtaining professional work

- The Rules of Professional Conduct give guidance in relation to the above.
- Audit firms are allowed to advertise. The following considerations should be borne in mind when preparing advertisements or promotional material.
 - ▶ They should not bring discredit to the audit firm, the member or the profession in general.
 - ▶ They should not discredit the service offered by other firms.
 - ▶ Care should be taken to ensure that any reference to fees does not mislead the reader as to the precise range of services and time commitment that the reference is intended to cover.
- In the UK, the material should comply with the requirements of the British Code of Advertising Practice and the IBA Code of Advertising Standards and Practice, as to legality, decency, clarity, honesty and truthfulness.



Fees

- The Rules of Professional Conduct state that fees should be fair and reasonable.
- They recommend that the basis of charging fees should be mentioned in the engagement letter.
- Fees should not be charged on a contingency, percentage or similar basis except where that course of action is generally accepted practice for certain specialised work.
- Fee disputes may arise when the client believes that the fee charged is excessive. If a firm is about to issue a fee note which is higher than previous fees, it is good practice to explain the reasons for the variation to the client concerned.
-  Lowballing
- This refers to the practice of setting the initial audit fee low in order to win the client's business.

Example 1

Explain the ethical implications of the following two practices in relation to fees.

- (a) Fixed fees
- (b) Lowballing



Tendering introduction

- when an audit firm is approached by a prospective client, it must first decide whether the accounting framework in use is acceptable
- in addition, the firm is faced with two initial questions:
 - ▶ does the firm want the work?
 - ▶ does the firm think they will get a reasonable fee for a quality job?
- the risk attaching to the client must be considered. The audit firm would wish to consider the following:
 - ▶ How has the approach arisen?
 - ▶ Why has the firm been asked? Is it due to their reputation, a recommendation from a mutual contact or is the entity unhappy with the current fees?
 - ▶ What it is being asked to do?
 - ▶ What is the risk in getting involved?
 - ▶ Can the firm afford to spend time on the proposal?

Example 2

What work would you perform in order to assess the risk attaching to a prospective client?

- Can the firm do the work for a reasonable fee?
- The firm will need to consider the amount of work required, resources available and the location of the client.
- A preliminary estimate of the fee should establish if the return is likely to be acceptable.
- Content of the proposal document
- The basic format of the proposal will depend on the circumstances and the prospective client's requirements. The main objective is to convince the client to appoint the audit firm. The firm will therefore want to demonstrate that it has understood the unique features and requirements of the business and considered how best it can meet those.
- The following matters will usually need to be covered:
 - ▶ The fee and details of how it has been calculated;
 - ▶ An assessment of the requirements of the prospective client;
 - ▶ An outline of how the firm proposes to address those requirements for the fee;
 - ▶ The assumptions made, for example regarding deadlines or availability of information;
 - ▶ The proposed approach to the engagement;
 - ▶ An outline of the firm and the staff involved.



Terms of audit engagements

- The auditors and the client should agree on the terms of the engagement. This should be recorded in writing.
- Once the terms of the engagement have been agreed, they will remain in force from one year to the next unless they are replaced. Auditors should regularly review the terms of the engagement to ensure they are appropriate.
- The engagement letter documents and confirms the auditors' acceptance of the appointment, and includes a summary of the responsibilities of the directors and the auditors, the scope of the engagement and the form of any reports.

Descriptions of practising firms

- A firm may describe itself as a firm of "Chartered Certified Accountants" or "Certified Accountants" only where:
 - ▶ at least half of the partners are ACCA members; and
 - ▶ these partners control at least 51% of the voting rights under the firm's partnership agreements.
- Firms holding an auditing practising certificate issued by the ACCA may describe themselves as "Registered Auditors".
- A practice name should be consistent with the dignity of the profession in the sense that it should not project an image inconsistent with that of a professional bound by high ethical and technical standards.



Chapter 5

AUDIT PROCESS

Fundamental concepts relating to an audit

- Ethical requirements
- Professional scepticism
- Professional judgement
- Limitations of an audit
- Sufficiency of audit evidence
- Audit risk
- Responsibilities of management

Planning

- The primary objective of audit planning is to reduce audit risk to an acceptable level.
- Planning entails developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit.
- The objectives of planning are to:
 - ▶ ensure that appropriate attention is devoted to the different areas of the audit;
 - ▶ ensure that potential problems are identified; and
 - ▶ facilitate review.
- The audit firm should consider materiality and its relationship with audit risk during the planning phase. This will assist with meeting the first two objectives above.



Threshold of significance

- This standard requires auditors to establish a threshold of significance to be applied when:
 - ▶ a control is designed, implemented or operated in such a way that it is unable to prevent or detect misstatements on a timely basis
 - ▶ such a control, as necessary to prevent and detect misstatements, is missing
- The auditor must ask "Are the identified deficiencies, either individually or collectively, "significant"?"
- Any significant deficiencies must be communicated in writing to those charged with governance.
- Other, insignificant, deficiencies should be communicated to management

Materiality

- A misstatement or omission can be considered material if, individually or in aggregate, it would reasonably be expected to influence the economic decisions of users of the financial statements.
- Materiality is concerned not just with size / value but also with the nature of the matter and the circumstances of the entity
- judgements about materiality are made in the light of the surrounding circumstances and are affected by the size and nature of a misstatement, or a combination of both
- judgements about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group
- The audit firm must be concerned with identifying "material" errors, inclusions, omissions and misstatements.

● Performance materiality

- ▶ A relatively new idea!
 - set materiality for the financial statements as a whole
 - but set an amount less than this when designing the nature, timing or extent of audit procedures
 - this lower value is to be used when considering particular classes of transaction, account balances and disclosures
- ▶ The level of materiality set at the planning stage will always be a matter of professional judgement. Most firms set criteria for guidance – a benchmark. For example:
 - between 1/2% and 1% turnover
 - between 1% and 2% of net assets; or
 - between 5% and 10% of net profit.
- ▶ If using a benchmark approach, the auditor should consider:
 - the elements of the financial statements



- whether there are matters upon which users are likely to focus
 - the nature of the entity, its life cycles and the industrial / economic environment
 - the ownership structure and the way the entity is financed
 - the relative volatility of the benchmark
- ▶ The levels chosen for materiality and for performance materiality will depend on the confidence the auditor has in the client's figures. Therefore, the level of risk attaching to the client will influence the levels of materiality used.
- ▶ The materiality level will impact on three areas:
- the nature and extent of audit tests.
 - whether to seek adjustments; and
 - the degree of any audit report qualification.

Risk assessments and internal controls

• Auditors should

- ▶ obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach and,
- ▶ use professional judgement to assess audit risk and to design audit procedures to ensure it is reduced to an acceptably low level.

• Audit risk is the ultimate risk that the audit opinion is inappropriate, after completion of all audit procedures.

• It is made up of two component parts:

- ▶ material misstatement risk, and
- ▶ detection risk.

• Material misstatement risk is the combination of inherent risk and control risk



Inherent risk

- This is the susceptibility of an account balance or class of transaction to material misstatement either individually or when aggregated with misstatement in other balances or classes assuming that there were no related internal controls.

Example 1

Suggest circumstances or factors that would cause you to believe that the level of inherent risk attaching to your client was higher than usual.

Control risk

- This is the risk that the entity's accounting and internal control procedures fail to detect or prevent fraud or error on a timely basis.
- The auditor should make a preliminary assessment of control risk and should plan and perform tests of control to support that assessment.

Detection risk

- This is the risk that the auditors' substantive procedures fail to detect a material misstatement in an account balance or class of transaction. It is primarily a consequence of the fact that the auditors do not, and cannot, examine all available evidence.
- The auditors' control risk assessment, together with their assessment of inherent risk will influence the nature, timing and extent of substantive procedures needed to reduce detection risk, and therefore overall audit risk, to an acceptable level.

Example 2

You are the audit manager for Vortex Ltd, an entity involved in the manufacture and sale of clothing for teenagers. Half of its sales are on credit to a variety of outlets and the other half are through its own chain of shops. Staff are chosen for their youth, enthusiasm and knowledge of the fashion scene.

Identify the inherent risks that may arise and suggest appropriate controls to reduce the impact of these risks.



Planning, materiality and assessing risk of misstatement

- This involves determining the level of risk attaching to the different areas of the client's operations. The chance of detecting errors is increased and excessive time isn't wasted on low-risk areas.
- Some audit firms will concentrate on understanding management's control of business risk and their overall control of the information systems.
- Business risk is the risk that an entity fails to meet its objectives.
- Business risks can be split into three categories:
 - ▶ Financial risk
 - ▶ Operational risk
 - ▶ Compliance risk
- Financial risk
 - ▶ These are the risks arising from the entity's financial activities or the financial consequences of operations. Examples include:
 - going concern problems
 - overtrading
 - credit risk
 - interest risk
 - high cost of capital
 - unrecorded liabilities
- Operational risk
 - ▶ These are the risks arising from the operations of the business such as:
 - stock-outs,
 - physical disasters,
 - loss of key staff,
 - poor brand management and
 - loss of orders.
- Compliance risk
 - ▶ These are the risks arising from non compliance with laws, regulations, policies, procedures and contracts. Examples include:
 - breach of listing rules
 - breach of statutory requirements
 - litigation risk
 - vat problems
 - tax penalties
 - health and safety risks
- Management need to satisfy themselves that their systems of risk management and internal controls are working properly. Internal audit can make a valuable contribution to the monitoring of risk management.



Analytical procedures

- The auditor should apply analytical procedures at the planning stage, throughout the audit and at the overall review stage of the audit.
- Analytical procedures include the following type of comparisons:
 - ▶ prior periods
 - ▶ budgets and forecasts
 - ▶ predictive estimates
 - ▶ industry information
 - ▶ relationships between elements of financial information ie ratio analysis
 - ▶ financial and non-financial information eg the relationship between payroll costs and the number of employees.
- The auditors should apply analytical procedures at the planning stage to assist in understanding the entity's business and in identifying areas of potential risk.
- When intending to apply analytical review as a substantive procedure, the auditor needs to consider the following factors:
 - ▶ objectives of the analytical review procedures
 - ▶ the nature of the information and the degree to which the information can be sub-divided eg apply procedures to divisions or products rather than the overall results.
 - ▶ the comparability, availability, reliability and source of information
- The auditors should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the entity's business.
- When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information, or that deviate from predictable patterns, the auditors should investigate and obtain adequate supporting evidence.



Chapter 6

EVIDENCE

Audit evidence

- The Standard states that auditors should obtain sufficient, appropriate audit evidence to be able to draw conclusions on which to base the audit opinion.
- This evidence is obtained in a number of ways including appropriate tests of control and substantive tests.
- "Sufficient" means that enough evidence has to be obtained.

Example 1

What factors will influence the sufficiency of audit evidence?

- "Appropriate" means that the evidence is relevant and reliable. Therefore it must assist the auditor to form an opinion and it must be trustworthy and persuasive.



- For evidence to be reliable the following general presumptions apply:
 - ▶ documentary evidence is more reliable than oral evidence.
 - ▶ independent evidence is more reliable than internal evidence.
 - ▶ original evidence is more reliable than copied evidence
 - ▶ evidence generated by the auditor is more reliable than that generated by the entity itself.
- Procedures for obtaining evidence
 - ▶ analytical procedures
 - ▶ enquiry of management and employees
 - ▶ inspection
 - ▶ observation
 - ▶ computation
 - ▶ previous audit file
 - ▶ reperformance

Example 2

Discuss the appropriateness of the following evidence gathered during the audit of a client.

- (1) Agreement of the bank balance to the entity's year end bank reconciliation**
- (2) Inspection of title deeds**
- (3) Agreement of a receivable's balance to an accounts receivable circularisation response.**



Written representations

- Auditors should obtain written confirmation of appropriate representations from management before their report is issued.
- Auditors should obtain evidence that the directors acknowledge their collective responsibility for the preparation of the financial statements.
 - ▶ These representations provide necessary audit evidence
 - ▶ But only as support for other evidence
 - ▶ They can never be used as the sole evidence on any material matter within the financial statements
 - ▶ In addition, the auditor requires written confirmation from management that they have:
 - Fulfilled their responsibilities for preparing the financial statements
 - Provided the auditor with all relevant information and access to records and personnel as agreed in the terms of engagement
 - Recorded and reflected in the financial statements all transactions
- If there is doubt about management's integrity and therefore the representations are unreliable, or if management refuses to provide written representations, then the auditor should disclaim their opinion on the financial statements

Example 3

In what situations are written representations an appropriate source of audit evidence?

- Procedures
 - ▶ The chair of the board or other appropriate senior management should sign the letter.
 - ▶ It should be dated after the completion of all other audit work but before the date of the audit report.



Using the work of an expert

- An expert means a person or firm possessing special skill, knowledge and experience in a particular field other than auditing.
- Before using an expert, the auditor should agree in writing:
 - ▶ The nature, scope and objectives of the expert's work
 - ▶ The roles and responsibilities of the auditor and the expert
 - ▶ The nature, timing and extent of communication between the two parties, and
 - ▶ The need for the expert to observe confidentiality
 - ▶ Procedures for evaluating the expert's work
- Auditor must consider:
 - The consistency of the expert's findings with the other audit evidence
 - The significant assumptions used by the expert, and
 - The use and accuracy of source data
- Reliance on an expert might be necessary in the following situations:
 - ▶ valuation of a non-current asset
 - ▶ inventory counts or valuations
 - ▶ legal opinions
 - ▶ actuarial valuations eg on pensions
- Auditors need to obtain evidence that the work of the expert is adequate. This will involve an assessment of the objectivity and professional competence of the expert.

Example 4

During the year ended 31 December 2010, the head office of Udens Ltd was valued by an external valuer.

What audit procedures would you perform in order to determine whether the valuer has provided an accurate and reliable valuation?



Considering the work of internal auditing

- The external auditors should consider the activities of internal audit and their effect, if any, on the external audit procedures.
- The external auditors need to assess the internal audit function during audit planning. This will not reduce the external auditors' responsibility in any way.
- The criteria for assessing the internal audit function are as follows:
 - ▶ organisational status
 - ▶ scope of function
 - ▶ technical competence
 - ▶ due professional care
- As a general rule the external auditor should be involved in the audit of all material matters and of those where there is a significant risk of error or misstatement.
- If the external auditor decides to place reliance on the work of the internal audit function, the timing and extent of the work should be agreed with the chief internal auditor.

Accounting estimates including fair value accounting estimates and disclosures

- There is an increased requirement for the auditor to exercise greater scepticism
- The auditor should also consider the likelihood of management bias in the estimation process
- The auditor needs to obtain an increased understanding of the process and any related controls
- **Procedures to be adopted by the auditor include:**
 - ▶ Determine whether any subsequent events provide evidence regarding the estimate
 - ▶ Test of management's methods of measuring the estimate, and the assumptions used
 - ▶ Test the effectiveness of controls over the estimation process, and
 - ▶ Develop a point estimate (or range estimate) to evaluate management's own point estimate



Sampling

- Sampling means the application of audit procedures to less than 100% of the items within an account balance or class of transactions in order to assist in forming a conclusion concerning the account balance or class of transaction.
- The auditor must select a sample that is representative of the whole population.
- Selection of the sample
- The most common methods are:
 - ▶ Random sampling: This ensures that each item in the population has the same chance of being selected. For example, random number tables could be used to generate the sample.
 - ▶ Systematic or interval sampling: This method would usually use a random starting point and there-after select every nth item. If the population is not spread randomly this method will not result in a representative sample.
 - ▶ Haphazard sampling: This method is truly random, and is entirely dependent upon the (possibly) unstructured choice of the individual auditor
- The size of the sample selected is influenced by the following factors:
 - ▶ the assessment of risk of material misstatement. A higher risk will result in a larger sample size.
 - ▶ the expected error rate in the population. The greater the expected error rate, the larger the sample size needed in order to reach a conclusion.
 - ▶ the tolerable error. This is the maximum error rate or amount of error that the auditor will accept. The lower the tolerable error, the greater the sample size.

Evaluation of sample results

- Having carried out the audit procedures on the sample the auditor needs to determine the number of errors in the sample and draw inferences for the population as a whole.
- For example, the auditor may have performed tests of control on a sample of 20 items and found 2 errors. An "error rate" can then be calculated:
- $2/20=10\%$
- A decision must then be made as to whether this level of error is acceptable or not.



Related parties

- There is a basic assumption that businesses trade with other parties at arm's length. However, if there is a relationship between two businesses, this assumption may not reflect reality because one business may have a high level of control or influence over the other.
- Parties are considered to be related if one party has the ability to control the other party or both parties are subject to common control. Material related party transactions must be disclosed in the financial statements.
- The auditor has an obligation to perform audit procedures to obtain sufficient appropriate evidence regarding the disclosure of related party transactions and the control of the entity in the financial statements.
- The management are responsible for the identification and disclosure of related party transactions. The auditor should review the information provided by the management and should be alert for other material related party transactions.

Example 5

What audit procedures should be performed to identify related parties?

- During the audit, the auditor should be aware that certain transactions may indicate the existence of unidentified related parties. Examples include:
 - ▶ transactions which have abnormal terms of trade such as unusual prices, interest rates, guarantees and repayment terms.
 - ▶ transactions which seem to lack a logical business reason for their occurrence.
 - ▶ transactions where the substance differs from the legal form.
 - ▶ transactions processed or approved in a non-routine manner.
 - ▶ unusual transactions which are entered into shortly before or after the year end.
 - ▶ a high volume of transactions with one supplier or customer compared with others.
 - ▶ unrecorded transactions such as the receipt or provision of management services at no charge.
- The auditors should obtain written representations from management concerning the completeness of information provided about related parties and disclosures in the financial statements.



Audit conclusions and reporting

- If the auditors are unable to obtain sufficient appropriate evidence regarding related parties and transactions with such parties, this gives rise to a limitation of scope.
- If the auditors conclude that the disclosure of related party transactions is not adequate, this gives rise to a modification on the grounds of material misstatement.

Documentation

- Auditors should document in their working papers matters that are important in supporting their report. The files must support the statement in the audit report regarding the conduct of the audit in accordance with Auditing Standards.
- The audit files should demonstrate:
 - ▶ planning the audit work
 - ▶ the nature, timing and extent of audit procedures performed
 - ▶ the results of audit work
 - ▶ the conclusions drawn from the audit evidence obtained.
- The partner should ensure that there is a proper documentary record of discussions and conclusions relating to going concern, provisions and subsequent events.

Review

- At the end of the audit, review procedures will help to ensure that all material issues have been properly dealt with and the audit report is supported by the work performed, and its conclusions.
- A discussion between reviewers and those involved with the audit should take place to allow the reviewers to understand the audit approach and the thought process behind it. It will also enable the reviewers to determine how well the audit team understood the client.



Chapter 7

EVALUATION AND REVIEW

Final review

- Near the end of the audit process the auditors must assess a number of areas before they can form an overall opinion on the financial statements. The main areas to consider are as follows:
 - ▶ overall review of the financial statements
 - ▶ other information
 - ▶ subsequent events
 - ▶ going concern

Overall review of financial statements

- The auditors should carry out a review of the financial statements that is sufficient, in conjunction with the conclusions drawn from other evidence, to give them a reasonable basis for their opinion.
- The review will determine whether
 - ▶ acceptable accounting policies have been used.
 - ▶ information included in the financial statements is compatible with audit findings.
 - ▶ adequate disclosure has been made and there is proper classification and presentation of information.
 - ▶ the financial statements comply with statutory and other regulatory requirements.



Analytical procedures

- The auditor can use analytical procedures at the overall review stage of the audit. This will help the auditor to decide whether the figures in the financial statements appear to be reasonable.
- This task is normally performed by more experienced staff because considerable knowledge and experience is needed to carry out the procedures effectively.

Example 1

At the final review stage of the audit of Tervyseks Ltd you find that the accounts receivable payment period has increased from 45 days in 2009 to 50 days in 2010.

What factors could have led to this increase?

Initial engagements - opening balances

- Auditors should obtain sufficient appropriate audit evidence that:
 - ▶ opening balances do not contain errors or misstatements which materially affect the current period's financial statements,
 - ▶ appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately disclosed, and
 - ▶ comparatives agree with the amounts and disclosures in the preceding period and are free from errors that would impact on the current period
- Audit work required
 - ▶ check that the balances have been brought forward correctly from the previous period
 - ▶ check that consistent accounting policies have been used or that any change of policy is correctly dealt with in accordance with IAS 8
 - ▶ check that comparatives have been properly disclosed by checking them against the previous period's financial statements.



New Clients

- With new audit clients additional procedures may be required due to the fact that the preceding period was not audited by the current audit firm. These procedures would include the following:
 - consultations with the management
 - review of the client's records, working papers and systems details for the previous period
 - the audit work on the current period
 - consultations with the previous auditors. However, there is no legal or ethical obligation for them to co-operate
 - in exceptional circumstances, the opening balances would be retested.

Qualification in the previous period

- If the matter has been resolved, and properly dealt with in the current period no qualification will be required in the current period.
- If the matter has not been resolved, and is material to the current period, then a qualification will be required in the current period. The audit report would refer to the fact that the audit report on the previous period's financial statements was qualified on the same matter.



Other information

- The auditor is required to give an opinion on the truth and fairness of the financial statements. These are comprised of:
 - ▶ the Statement of Financial Position
 - ▶ the Statement of Comprehensive Income
 - ▶ the Statement of Cash Flows
 - ▶ The Statement of Total Recognised Gains and Losses / Statement of Changes In Equity
 - ▶ the notes to the financial statements
 - ▶ other matters identified as being part of the financial statements
- Other information often included in an entity's annual report with the financial statements:
 - ▶ the directors' report
 - ▶ the chairman's report
 - ▶ five year summary
 - ▶ financial and operating review
- The audit opinion is not given on these items. However, this information could include details that are misleading or inconsistent and may serve to create doubts about the financial statements.
- The auditor should read the other information. If they become aware of any misstatement or inconsistency, they should consider whether an amendment is required to the financial statements or to the other information. They should seek to resolve the matter through discussion with the directors.
- If, after discussion with the directors, the auditors conclude that the financial statements require amendment and no such amendment is made, they should consider the implication for the audit report.
- If the other information requires amendment, and this is not made, the appropriate action will depend on the item which contains the inconsistency or error. The auditor should seek legal advice and consider resigning from the appointment.



Subsequent events

- Subsequent events are defined as “those events occurring between the end of the reporting period and the date of the auditors’ report and facts discovered after the date of the auditors’ report”.

Example 2

Give 3 examples of subsequent events.

- The auditors should perform procedures designed to provide sufficient appropriate evidence that all material subsequent events up to the date of the audit report which require adjustment of, or disclosure in, the financial statements have been identified and properly reflected.
- When, after the date of the audit report but before the financial statements are issued, the auditor becomes aware of subsequent events which may materially affect the financial statements, they should establish whether the financial statements need amendment, discuss the matter with management and consider the implications for their report, taking additional action as appropriate.
- If the directors amend the financial statements, the auditors should issue a new audit report on these amended financial statements.
- When, after the financial statements have been issued, but before they are laid before the members, the auditors become aware of subsequent events which had occurred by the date of the audit report and which, if known at that date, might have caused them to issue a different report, they should consider whether the financial statements need amendment, discuss the matter with management, and should consider the implications for their report, taking additional action as appropriate.
- If the directors revise the financial statements, then the auditors will need to audit the changes and issue a new report. The report should refer to a note in the financial statements describing the changes and it should refer to the previous report.



Going concern

- When forming an opinion as to whether the financial statements give a true and fair view, the auditors should consider whether the entity has the ability to continue as a going concern.

Example 3

If the going concern assumption does not apply, what is the impact on a set of financial statements?

- Directors' and auditors' responsibilities
 - It is the directors' responsibility to determine whether the entity is a going concern. The auditors' responsibility is to satisfy themselves that the use of the going concern basis is appropriate and its use has been adequately disclosed in the financial statements.
 - The auditors should make enquiries of the directors and examine appropriate financial information. They should also plan and perform procedures designed to identify any material matters which could indicate doubt about the entity's ability to continue as a going concern.

Example 4

Suggest five factors that might cause you to believe that the going concern basis is not appropriate for an entity



Evidence available on going concern

- At the planning stage, the auditor would wish to assess the risk that the entity may not be a going concern. They would do this through obtaining a thorough knowledge of the business, its products and the environment it operates in. They would also assess the controls to help them decide how much confidence they should have in forecast data. Finally, analytical procedures can help the auditor identify potential problems.
- The auditors would also review the cash flow forecast and forecast financial statements to ensure that the assumptions on which they are based are realistic and reasonable.
- The foreseeable future
 - ▶ "foreseeable future" is defined as "generally a period not to exceed one year after the period end".
- Audit Report implications
 - ▶ where the use of the going concern concept is appropriate but there is a material uncertainty and ...
 - ▶ ... management has made full and transparent disclosure ...
 - ▶ ... the auditor is able to express an unmodified opinion
 - ▶ however, there is now a requirement to include a separate section under the heading 'Material Uncertainty Related to Going Concern' (MURGC)
 - ▶ in addition, the readers' attention must be brought to the disclosure note in the financial statements and ...
 - ▶ ... the auditor must state that these events or conditions indicate that a material uncertainty exists which may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter
- the MURGC is included within the report immediately after the Basis of Opinion paragraph but before the KAM paragraph
- if full and transparent disclosure is not made, the auditor will modify the audit opinion
- naturally matters that indicate doubt over going concern are likely to be considered a KAM but where audit evidence confirms that no material uncertainty exists, this is referred to as a 'close call'
- and close calls may be disclosed as a KAM (even though no material uncertainty exists!)
- examples given include:
 - ▶ substantial operating losses
 - ▶ available borrowing facilities and possible debt refinancing
 - ▶ non-compliance with loan agreements
- for a fuller look into the 'new' audit reports follow these links:
 - ▶ <http://www.accaglobal.com/gb/en/student/exam-support-resources/fundamentals-exams-study-resources/f8/technical-articles/auditor-report.html>
 - ▶ <http://www.accaglobal.com/gb/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/auditor-reporting.html>





Chapter 8

AUDIT OF FINANCIAL STATEMENTS

Objectives of an audit

- The primary objective of the statutory audit is to give an opinion on the truth and fairness of the financial statements of an entity.
- During an audit the auditor will assess the risk attaching to the entity together with an assessment of the internal controls in operation. These procedures will assist the management in reducing risk and improving performance.

Example 1

What are the limitations of the statutory audit?

- The auditor will also perform substantive tests on the transactions and balances appearing in the financial statements. In the earlier auditing paper, consideration was given to some of the "easier" audit areas. Let's look at some of the more exotic areas!



The audit of inventory and construction contracts

- Inventory is normally a significant asset of any manufacturing company and is an item that has a direct impact on the profit reported. Therefore inventory is normally a risky and material balance which requires considerable audit effort. The audit of inventory was covered in preparation for the earlier auditing paper, but we need to look again at some of the considerations concerning inventory.
- Inventory should be valued at the lower of cost and net realisable value. There are many methods available for the estimation of the cost of an item of inventory. These include FIFO, LIFO, AVCO and standard cost. (LIFO is no longer an acceptable method!)

Example 2

Where standard costs are used, what factors would you consider before accepting them as an appropriate basis for the estimation of cost?

- Construction contracts
- A long term contract is generally a contract entered into for the design, manufacture or construction of a single substantial asset, or the provision of a service, where the time taken is such that the contract activity falls into different accounting periods.
- The major risks attaching to such contracts are as follows:
 - the costs incurred to date may be misstated
 - the stage of completion may not be accurate leading to errors in the profit recognised in the financial statements
 - estimates of future costs may be inaccurate
 - invoices issued and cash received to date may be incorrectly calculated
 - the account receivable may be irrecoverable

Example

During the audit of Mumbai Crafts Ltd, a shipbuilder, you are provided with the following information relating to a long term contract that the entity is involved in:

Customer	Chennai Ferries
Contract price	\$120m
Costs to date	\$80m
Estimated costs to complete	\$50m
Stage of completion	60%
Progress payments received	\$71m

Describe the audit work that you would perform on this contract.



The audit of deferred tax

- Auditors should obtain sufficient appropriate audit evidence that the deferred tax provision is correctly calculated.
- IAS 12 states that deferred tax should be calculated on a full provision basis.
- The following substantive procedures would be performed:
 - ▶ review the tax computation to identify timing differences at the year end.
 - ▶ recalculate the timing difference and the deferred tax calculation on each item ensuring that the correct tax rate was used.
 - ▶ prepare a reconciliation of the tax charge in the statement of comprehensive income.
 - ▶ check the notes to the financial statements to ensure that the disclosure of deferred tax is fairly presented.

The audit of Statements of Cash Flow

- An audit opinion covers the cash flow statement.
- The audit work required is as follows:
 - ▶ trace and reconcile all details to the working papers.
 - ▶ obtain or prepare a supporting analysis of items, such as tax payments and dividends paid, that do not already appear in the working papers.
 - ▶ cross check the amount of any items (eg depreciation) that appear elsewhere in the financial statements.



The audit of leases

- The auditors should ensure that leased assets are correctly classified in the financial statements. The following procedures would be performed:
 - ▶ obtain a schedule of leases brought forward from last year
 - ▶ review the lease agreement for each leased asset to determine whether it is a finance lease or an operating lease.
 - ▶ confirm to board minutes that each lease was authorised.
 - ▶ recalculate the interest on each finance lease.
 - ▶ physically verify the existence of assets held under finance lease.
 - ▶ recalculate depreciation on leased assets.
 - ▶ check the notes to the financial statements to confirm that correct disclosure is given regarding leased assets.



Chapter 9

GROUP AUDITS

Introduction

- In a group situation, the parent entity will have to prepare its own audited financial statements together with audited group financial statements incorporating the results of all subsidiary entities. The group financial statements will be audited by the parent entity auditors, who are known as the Group Auditors.

Using the work of another auditor

- The group auditors have sole responsibility for the opinion on the group financial statements. The auditors of the subsidiary entities (component auditors) are a source of evidence only.
- The group auditors must decide how much reliance they will place on the work performed by these component auditors. In order to do this they will consider the qualifications, experience and resources of the component auditors.
- Generally the group auditors should have the right to ask the component auditors for all reasonable information and explanations. In addition, the component auditors should inform the group auditors of any matter they discover during their audits that might be relevant to the audit of the group financial statements.
- Matters to discuss with the component auditors
 - The component auditors must be informed of the use that is to be made of their work. They should also be advised of the standard and scope of work required, together with reporting deadlines.
 - It is common practice to ask the component auditors to complete a checklist to confirm that they have applied the required audit procedures.



Issues arising when a subsidiary is located overseas

- When a subsidiary is located overseas a number of potential difficulties could arise:
 - ▶ Different accounting policies might be used in the overseas country. The subsidiary financial statements must be brought into line with the accounting policies used by the parent entity in order to consolidate properly. The group auditors will use the checklist mentioned above to determine the accounting policies used.
 - ▶ There may be cultural problems unique to the country in which the subsidiary operates. The group auditor will need to be sensitive to these during dealings with the other auditors.
 - ▶ Language problems may arise. This problem can be easily overcome by using staff who can speak the relevant language or by using a translator.
 - ▶ There may be issues in existence which are specific to the country in which the subsidiary operates. For example, in some countries in the continent of Africa, inflation runs at in excess of 100% per annum. Financial statements produced in these circumstances will need to be adjusted prior to consolidation with the parent entity. Factors such as these will need to be identified for each subsidiary and resolved as appropriate during the audit.

Matters to consider before accepting appointment as group auditor to a group

- The group auditor must participate sufficiently in the audit of the group to enable them to give an opinion on the group financial statements.
- Before accepting appointment as group auditor they should consider:
 - ▶ the materiality of the portion of the financial statements which they do not audit
 - ▶ the degree of their knowledge regarding the business of the subsidiaries
 - ▶ the nature of their relationship with the component auditors
 - ▶ their ability where necessary to perform additional procedures to enable them to act as group auditors; and
 - ▶ the risk of material misstatements in the financial statements of the subsidiaries audited by component auditors



The correct classification of investments

- An investment is treated as a subsidiary when the parent entity has dominant influence over that invested entity. Where significant influence is held the investment is treated as an associate in accordance with IAS 28. It is important that the degree of control exercised by the parent entity is tested by the auditors.
- The auditors need to consider how an investment fits into the activities of the group. They should review board minutes for evidence of the degree of influence exercised by the parent entity. They should also discuss the matter with the parent entity directors.
- The existence of other significant shareholders may indicate that the parent entity has little influence. The auditors should check the register of members to determine the level of shareholding and potential influence held by other shareholders.
- The auditors should also consider how easy it is to obtain information about the invested entity. This could also be an indicator of significant influence.
- And beware IFRS 10 Effective control

Group consolidation - audit procedures

- After receiving and reviewing the financial statements from all subsidiaries and associates, the group auditor must audit the group financial statements. The main procedures would be as follows:
 - ▶ check the transcription of the audited financial statements of each invested entity to the consolidation schedule.
 - ▶ check that the adjustments made on consolidation are appropriate and consistent with prior years. The adjustments could be permanent or current year adjustments.
 - ▶ the consolidation schedules should be checked for arithmetical accuracy.
 - ▶ the group financial statements should be checked for compliance with international financial reporting standards.
 - ▶ an opinion should be formed on the truth and fairness of the group financial statements.



Letters of support

- A 'letter of support' is an agreement made between a parent entity and its subsidiary or fellow subsidiary under which one entity agrees to provide support, in the form of funding, to the other entity in order that it may meet its debts and liabilities.
- A letter of support may be required from the parent entity where it appears that a subsidiary is not a going concern and will be unable to pay non-group creditors as they fall due.

Audit work

- The auditor needs to determine whether the parent entity has the power to provide a letter of support. The following should be obtained:
 - ▶ written confirmation from the parent entity's solicitors to the effect that the giving of the support is permitted under the constitution, is not beyond the entity's powers, and that it is within the powers of the board of directors to give the support; or
 - ▶ if the transaction is not permitted by the constitution, a certified copy of the special resolution amending the constitution to authorise the parent entity to give the letter of support.



Implications for the auditors' report where a subsidiary has been qualified

- In a group situation, materiality and risk must be assessed in the context of the group as a whole. It is possible therefore for a qualification in a subsidiary to be wholly immaterial in the group financial statements. If this is the case, an unqualified opinion could be given on these financial statements.
- Where the group auditors conclude that adequate evidence about the work of the component auditors cannot be obtained and they have been unable to perform sufficient additional procedures with respect to that subsidiary, they should consider the implications for the audit report.

Example 1

You are auditing the group financial statements of the Royle Group plc for the year ended 30 September 2010.

The group has three group subsidiaries, James plc, Barbara plc and Anthony plc.

You are not the auditor of Anthony plc, a manufacturer.

Describe the audit work that you would carry out before placing reliance upon the work carried out by the auditors of Anthony plc.



Joint audits

- A joint audit can be defined as one “where two or more auditors are responsible for an audit engagement and jointly produce an audit report to the client”.
- Reasons for joint audits
 - ▶ Two or more firms could act as joint auditors for the following reasons:
 - in a new acquisition the parent entity may insist that their auditors act jointly with those of the new subsidiary.
 - an entity operating from many distant locations may find it useful to have joint auditors.
 - overseas subsidiaries may need to employ local audit firms to satisfy the laws of the country in which they operate. These local auditors may act jointly with the group auditors.
 - some entities may prefer to use local auditors while at the same time enjoying the greater range of services offered by a large international firm.
- Before accepting appointment as a joint auditor it will be necessary to consider the experience and standards of the other firm.
- The allocation of work between the firms needs to be agreed and the auditors should agree whether joint or separate engagement letters will be sent.
- Both firms must sign the audit report and both are responsible for the whole audit. They are jointly liable in the event of litigation.



Fair values

- Goodwill must be calculated based on fair values according to IFRS 13. The auditors will need to audit these calculations.

Example 2

One of your firm's largest clients, Sydney plc, is in the process of negotiating a substantial takeover of Lake Eyre plc. The following calculation of goodwill has been prepared:

	\$m	\$m
Fair value of consideration:		
Cash	730	
\$1 Equity shares	460	
Non-controlling interest investment	250	
		1,440
Fair value of assets acquired		1,213
Positive goodwill		227

- State the audit work that you would perform on the goodwill relating to Lake Eyre arising on consolidation**



Responsibilities of the component auditor

- before accepting appointment the component auditor should:
 - ▶ communicate with the group engagement auditor about the scope and timing of the audit work expected of them
 - ▶ obtain a clear understanding from the engagement auditor about the use of the component auditor's work
 - ▶ satisfy themselves in their own mind that they are qualified and competent to take on the engagement of auditing the component
 - ▶ satisfy themselves that they shall be able to obtain sufficient appropriate audit evidence in order to be able to express an audit opinion for later consideration by the group engagement team
 - ▶ determine in their own minds whether or not they would feel comfortable working as a component auditor where the group engagement auditor is a different firm
 - ▶ assess whether their experience in the business of the component is sufficient for them to be able to carry out a professional, competent assignment
 - ▶ confirm that there are no matters that would impair their objectivity in accepting the appointment
 - ▶ confirm that they are independent from the component and its management



Procedures to be performed in a group situation

- procedures that a component auditor should expect to perform include:
 - ▶ communicating matters relevant to the group engagement team's conclusion with regard to the group audit including:
 - whether the component auditor has complied with ethical requirements that are relevant to the group audit, including independence and professional competence
 - whether the component auditor has complied with the group engagement team's requirements
 - identification of the financial information of the component on which the component auditor is reporting
 - information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group financial statements
 - a list of uncorrected misstatements of the financial information of the component (the list need not include misstatements that are below the threshold for clearly trivial misstatements communicated by the group engagement team)
 - any indicators of possible management bias
 - a description of any identified significant deficiencies in internal control at the component level
 - any other significant matters that the component auditor has communicated or expects to communicate to those charged with governance of the component including fraud or suspected fraud where the fraud has resulted in a material misstatement of the financial information of the component
 - any other matter 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
 - the overall findings, conclusions or opinions





Chapter 10

THE EXTERNAL AUDIT REPORT

National legislation

- most national legislation requires an audit report on the truth and fairness of entity financial statements
- audit reports of entities compliant with UK Corporate Governance Code must contain significantly detailed disclosure about the audit work carried out
- the major revision introduced for financial statements for periods ended on or after December, 2016 is the requirement for auditors to communicate "key audit matters" and how the auditor dealt with those matters

Definitions

- the ISAs define the following terms:
 - ▶ Financial statements
 - Statement of Financial Position
 - Statement of Comprehensive Income
 - Statement of Changes in Equity
 - Statement of Cash Flows
 - notes to the financial statements, and
 - other statements and explanatory material which are identified as being part of the financial statements.
 - ▶ Key audit matters
 - those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period
 - key audit matters are selected from matters communicated with those charged with governance, which include significant findings from the audit of the financial statements of the current period
 - communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit and may also assist them in understanding the entity and areas of significant management judgment in the audited financial statements
 - ▶ Materiality
 - information is material if its inclusion, omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements
 - materiality depends on the size of the item or error judged in the particular circumstances of its inclusion, omission or misstatement
 - thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful



- ▶ True and fair
 - there is an over-riding requirement in international financial reporting and auditing that financial statements give a true and fair view
 - the IASC does not, however, define true and fair. Literally the phrase can be interpreted:-
 - ▶ True
 - information is not false but factual and conforming with reality
 - in addition, the information conforms with required standards and law
 - in practical terms the financial statements have been correctly extracted from the accounting records.
 - ▶ Fair
 - information is free from discrimination and bias and in compliance with expected standards and rules
 - in practical terms the financial statements should reflect the commercial substance of the entity's underlying transactions
- ⦿ the auditors' report must include an opinion on whether such a true and fair view has been given
 - ⦿ ultimately true and fair must be decided by.....
 - ⦿ the Courts will treat compliance with accepted accounting principles as evidence that the financial statements are true and fair
 - ⦿ confirmed in the UK law case Littlejohn v Lloyd Cheyham



Auditors' report on financial statements

- the auditors' report on financial statements should contain a clear expression of opinion on the financial statements as a whole, based on review and assessment of the conclusions drawn from evidence obtained in the course of the audit
- the financial statements should have been prepared in accordance with an acceptable financial reporting framework, for example International Financial Reporting Standards

Requirements of the standard

- the audit report should include the following basic elements, normally in this layout: (remember **OBAMA**)
 - title
 - addressee
 - O**pinion paragraph
 - B**asis of opinion paragraph
 - M**anagement's responsibilities
 - A**uditors' responsibilities
 - date of the report
 - name of the engagement partner and signature, and
 - auditors' address
- Opinion paragraph (remember DANTE) shall:
 - specify the Date of (or period covered by) each statement comprising the financial statements
 - state that the financial statements have been Audited
 - refer to the Notes, including the summary of significant accounting policies
 - identify the Title of each statement comprising the financial statements
 - identify the Entity whose financial statements have been audited
- where the auditor's opinion is to be unmodified, the opinion shall use one of the two similar expressions
- in our opinion, the financial statements give a true and fair view of (or "present fairly, in all material respects") in accordance with (the applicable financial reporting framework)



- **Basis of Opinion** paragraph shall: (remember **ARISA ERISA**)
 - ▶ refer to the section of the auditor's report that describes the **A**uditor's **R**esponsibilities
 - ▶ state that the audit was conducted in accordance with **I**nternational **S**tandards on **A**uditing
 - ▶ confirm that the auditor has fulfilled the auditor's other **E**thical **R**esponsibilities
 - ▶ include a statement that the auditor is **I**ndependent of the entity
 - ▶ state whether the auditor believes that the audit evidence that has been obtained is **S**ufficient and **A**ppropriate to provide a basis for the auditor's opinion
- for audits of complete sets of financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report
- an unmodified opinion of financial statements is expressed when, in the auditors' judgement, they give a true and fair view and have been prepared in accordance with relevant accounting or other requirements. This judgement entails concluding whether, amongst other things
 - ▶ the financial statements have been prepared using appropriate accounting policies, which have been consistently applied
 - ▶ the financial statements have been prepared in accordance with relevant legislation, regulations or applicable financial reporting standards (and that any departures are justified and adequately explained in the financial statements) and
 - ▶ there is adequate disclosure of all information relevant to the proper understanding of the financial statements



Management's Responsibilities for the Financial Statements

- the auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements" although the report may refer instead to "those charged with governance"
- this section of the auditor's report shall describe management's responsibility for:
 - ▶ preparing the financial statements in accordance with the applicable financial reporting framework
 - ▶ implementing such internal control as management determines necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error
 - ▶ assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate
 - ▶ disclosing, if applicable, matters relating to going concern
- the explanation of management's responsibility for this shall explain the concept of the going concern basis of accounting
- this section of the report shall also identify those responsible for the oversight of the financial reporting process



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 states that the 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, error or other irregularity
 - ▶ issue an auditor's report that includes the auditor's opinion
 - ▶ 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
 - ▶ state that misstatements can arise from fraud or error, and either:
 - describe that they are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements, or
 - provide a definition or description of materiality in accordance with the applicable financial reporting framework
- state that, as part of an audit in accordance with ISAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit



- describe an audit by stating that the auditor's responsibilities are to: (remember **PEG DIGGERS**)
- design and **P**erform audit procedures responsive to assessed risks
- evaluate the appropriateness of accounting policies used and the reasonableness of accounting **E**stimates
- conclude on the appropriateness of management's use of the **G**oing concern basis of accounting
 - ▶ (if the auditor concludes that a material uncertainty exists about the entity's continuing viability, 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 be a going concern)
- evaluate the appropriateness of accounting policies used and the related **D**isclosures
- obtain an understanding of **I**nternal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, and not for the purpose of expressing an opinion on the effectiveness of the entity's internal control
- obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the **G**roup to be able to express an opinion on the group financial statements
- accept responsibility for the direction, supervision and performance of the **G**roup audit
- obtain audit **E**vidence that is sufficient and appropriate to provide a basis for the auditor's opinion
- identify and assess the **R**isks of material misstatement of the financial statements, whether due to fraud or error
- state acceptance of **S**ole responsibility for the auditor's opinion



The Auditor's Responsibilities section of the report shall also state:

- that the auditor communicates with those charged with governance regarding:
 - ▶ the planned scope and timing of the audit
 - ▶ significant audit findings
 - ▶ any significant deficiencies in internal control that the auditor identifies during the audit
- that, for audits of financial statements of listed entities, the auditor
 - ▶ provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence
 - ▶ communicates with them all relationships and other matters that may reasonably be thought to influence the auditor's independence and, where applicable, related safeguards
 - ▶ that, for audits of financial statements of listed entities, from the matters communicated with those charged with governance, the auditor:
 - determines those matters that were of most significance (key audit matters) in the audit of the financial statements
 - communicates these key audit matters to those charged with governance
 - describes these key audit matters in the auditor's report unless, exceptionally
 - law or regulation prohibits public disclosure about the matter, or
 - the auditor determines that a matter should not be disclosed in the auditor's report because the adverse consequences of disclosure could reasonably be expected to outweigh the public interest benefits of disclosure (very rare)
- when misstatements are identified by the auditor during the audit, the auditor should:
 - ▶ communicate all such misstatements to management on a timely basis, unless they are considered to be trivial
 - ▶ ask management to correct all material misstatements which the auditor has identified
 - ▶ get an understanding of management's refusal to adjust, if appropriate, and
 - ▶ obtain written representations from management and from those charged with governance that they believe the effect of uncorrected misstatements is immaterial, both individually and in aggregate



Modifications in audit reports

- in certain circumstances, it may not be appropriate to issue a completely unmodified report, as the auditors may disagree or have doubts about items in the entity's financial statements
- however, each situation is different and the wording needs to reflect how the auditors view the problem
- in summary, the audit report will be modified in the following situations:
 - matters that do not affect the auditors' opinion:
 - ▶ emphasis of matter – required to refer to a matter which is appropriately presented or disclosed in the financial statements but, in the auditors' judgement, is fundamental to the users' understanding of the financial statements
 - there may be other matters which require similar treatment – "Other matters"
 - ▶ the auditor is required to refer to a matter not presented or disclosed in the financial statements that, in the auditors' judgement, is relevant to the users' understanding of the audit, the auditors' responsibilities or the audit report
 - matters that do affect the auditors' opinion
 - ▶ qualified opinion
 - disagreement – the financial statements include a material misstatement
 - scope limitation – the auditor is unable to obtain sufficient appropriate audit evidence
 - ▶ each of these modifications has two levels
 - material but not pervasive
 - material and pervasive

Matters that do not affect the auditors' opinion

- if there is a significant matter affecting the financial statements, then an additional paragraph AFTER the opinion paragraph may be appropriate, specifically to draw the attention of the reader to the disclosed matter
- this paragraph will start by stating 'Without qualifying our opinion above ...' It will then go on to describe the matter and make a reference to the note in the financial statements which explains the matter more fully
- note that this does NOT change the auditors' opinion - it is still unqualified. It merely serves to highlight something significant that may, or may not, affect the entity in the future



Matters that do affect the auditors' opinion

- here, the auditor feels that, because of certain circumstances, a true and fair view is not given.
- it could either be because the auditor DISAGREES with something in the financial statements, or that he is UNCERTAIN about something.
- 2 degrees of qualified opinion
 - ▶ material (affecting a part of the financial statements, but not the whole understanding)
 - ▶ pervasive (affecting the whole understanding and basis of the financial statements)
 - for insufficient audit evidence, could make financial statements misleading (and so are meaningless)
 - for material misstatements, makes the financial statements misleading - the financial statements do not give a true and fair view

Illustration 1

Unqualified opinion with emphasis of matter paragraph

"In our opinion...(remaining words are the same as illustrated in the opinion paragraph)

"Without qualifying our opinion above, we draw attention to Note 15 to the financial statements. Three days before the directors formally approved the financial statements, the entity received notification that they are to be named as joint-defendants in a proposed legal action that alleges involvement in an organisation established to smuggle illegal immigrants into the Baltic States.

As stated in Note 15, the directors are not aware that the activities of the entity could in any way be connected with any illegal activity, and it is their intention to defend vigorously these allegations.

At this early stage it is not possible to estimate the ultimate outcome of this matter, and no provision has been included within the financial statements."

- in all circumstances, when the auditor issues a modified audit opinion, the auditor should:
 - ▶ communicate with those charged with governance
 - ▶ explain the circumstances behind their decision, and
 - ▶ communicate the proposed wording of the modification
 - ▶ adapt the title of the "opinion" paragraph to "qualified opinion", "adverse opinion" or "disclaimer of opinion" as appropriate
 - ▶ adapt the title of the "basis of opinion" paragraph to "basis of qualified opinion", "basis of adverse opinion" or "basis of disclaimer of opinion" as appropriate

	<i>MATERIAL</i>	<i>PERVASIVE</i>
inability to obtain sufficient appropriate audit evidence	'Except for adjustments ... that might have been found...'	Disclaimer "unable to express an opinion"
Material misstatement	'Except for'	Adverse "do not give a true and fair view"



Material misstatement concerning accounting treatment or disclosure

- where the auditors conclude that there is a material misstatement concerning the accounting treatment or disclosure of a matter in the financial statements
 - ▶ the auditors should include in the opinion section of their report:
 - a description of all substantive factors giving rise to a disagreement
 - the implications for the financial statements where practicable
 - a quantification of the effect on the financial statements, or if not practicable
 - an explanation of why not
- when the auditors conclude that the effect of the material misstatement is pervasive and the financial statements are seriously misleading, they should issue an adverse opinion
- in the case of other material misstatements, the auditors should issue a qualified opinion indicating that it is expressed “except for” the effects of the matter giving rise to the misstatement

Insufficiency of appropriate audit evidence (also referred to as a “limitation of scope”)

- when the auditor has been unable to obtain sufficient evidence to express an unqualified opinion
 - ▶ the auditors’ report should include a description of the factors leading to the lack of evidence in the basis of opinion section of their report, and indicate the possible adjustments to the financial statements that might have been determined to be necessary had no limitation existed
 - ▶ the auditors should issue a disclaimer of opinion when the possible effect of this lack of evidence is so pervasive that they are unable to express an opinion on the financial statements
 - ▶ a qualified opinion should be issued when the effect of the lack of evidence is not so pervasive as to require a disclaimer, and the wording of the opinion should indicate that it is qualified as to the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed
- in considering the importance of a lack of evidence the auditors should assess
 - ▶ the quantity and type of evidence which may reasonably be expected to be available to support the particular figure or disclosure in the financial statements, and
 - ▶ the possible affect on the financial statements of the matter for which insufficient evidence is available
 - ▶ when the possible affect is, in the opinion of the auditors, material to the financial statements, there will be insufficient evidence to support an unqualified opinion



Example 1

During the audit of Mombasa Ltd it comes to your notice that the entity has valued a certain line of inventory at the cost price of \$7,000.

This inventory has not been sold for a number of years and it is unlikely to be sold in the future unless it is reduced to \$3,000.

If the write-down were charged it would have a material affect on the financial statements.

How will this affect your audit report?

Example 2

During the audit of Pratchett Ltd, you discover that the entity has not kept any records relating to their cash sales.

Pratchett has pre-tax profits of \$500,000 and cash sales total \$100,000. The entity has total sales of \$1m.

What affect will the above have on your audit report?



Chapter 11

AUDIT RELATED SERVICES (NON AUDIT SERVICES)

Introduction

- Audit firms are often asked to provide services to clients which do not involve the expression of an opinion on the truth and fairness of the financial statements. For example, the firm might be asked to give assurance that interim financial statements are correctly prepared in a business or they might be asked to prepare the financial statements for a private entity audit client.

Differences between an audit assignment and a non-audit assignment

- An audit is a statutory requirement for the majority of entities whereas non audit assignments are usually voluntary.
- During an audit, the auditor has an obligation to form an opinion on the truth and fairness of the financial statements and their compliance with local legislation and international financial reporting standards. This will involve the auditor in the following activities:
 - ▶ an assessment of the risks attaching to the business
 - ▶ an assessment of the adequacy of the internal controls
 - ▶ obtaining evidence to confirm the assertions embodied in the financial statements
 - ▶ designing procedures so that there is a reasonable expectation of detecting material errors arising from fraud, and
 - ▶ considering whether the entity is a going concern.
- A non audit assignment will not involve these activities. The scope of the work is not laid down in statute so it will be agreed between the entity and the audit firm. Therefore, it is important to agree a detailed engagement letter with the client prior to the commencement of any work.



Reviews

● Objective of a Review Engagement

- ▶ the objective of a review of financial statements is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework (negative assurance).
- ▶ the auditor should plan and perform the review with an attitude of professional scepticism recognising that circumstances may exist which cause the financial statements to be materially misstated.
- ▶ for the purpose of expressing negative assurance in the review report, the auditor should obtain sufficient appropriate evidence primarily through enquiry and analytical procedures to be able to draw conclusions.

● Scope of a Review

- The term "scope of a review" refers to the review procedures deemed necessary in the circumstances to achieve the objective of the review.
- The procedures required to conduct a review of financial statements should be determined by the auditor having regard to the requirements of the ISA, relevant professional bodies, legislation, regulation and, where appropriate, the terms of the review engagement and reporting requirements.

● Moderate Assurance

- ▶ a review engagement provides a moderate level of assurance that the information subject to review is free of material misstatement. This is expressed in the form of negative assurance.

● Terms of Engagement

- ▶ the auditor and the client should agree on the terms of the engagement.
- ▶ the agreed terms would be recorded in an engagement letter or other suitable form such as a contract.
- ▶ an engagement letter will be of assistance in planning the review work.
- ▶ it is in the interests of both the auditor and the client that the auditor send an engagement letter documenting the key terms of the appointment.
- ▶ an engagement letter confirms the auditor's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the auditor's responsibilities and the form of reports to be issued.
- ▶ matters that would be included in the engagement letter include:
 - the objective of the service being performed.
 - management's responsibility for the financial statements.
 - the scope of the review, including reference to this international standard on auditing (or relevant national standards or practices).
 - unrestricted access to whatever records, documentation and other information requested in connection with the review.
 - a sample of the report expected to be rendered.



- the fact that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities, for example fraud or defalcations, that may exist.
- a statement that an audit is not being performed and that an audit opinion will not be expressed. To emphasise this point and to avoid confusion, the auditor may also consider pointing out that a review engagement will not satisfy any statutory or third party requirements for an audit.

● Planning

- ▶ the auditor should plan the work so that an effective engagement will be performed.
- ▶ in planning a review of financial statements, the auditor should obtain or update the knowledge of the business including consideration of the entity's organisation, accounting systems, operating characteristics and the nature of its assets, liabilities, revenues and expenses.
- ▶ the auditor needs to possess an understanding of such matters and other matters relevant to the financial statements, for example, a knowledge of the entity's production and distribution methods, product lines, operating locations and related parties.
- ▶ the auditor requires this understanding to be able to make relevant enquiries and to design appropriate procedures, as well as to assess the responses and other information obtained.

● Work Performed by Others

- ▶ when using work performed by another auditor or an expert, the auditor should be satisfied that such work is adequate for the purposes of the review.

● Documentation

- ▶ the auditor should document matters which are important in providing evidence to support the review report, and evidence that the review was carried out in accordance with the ISA.

● Procedures and Evidence

- ▶ the auditor should apply judgement in determining the specific nature, timing and extent of review procedures. The auditor will be guided by such matters as:
 - any knowledge acquired by carrying out audits or reviews of the financial statements for prior periods.
 - the auditor's knowledge of the business including knowledge of the accounting principles and practices of the industry in which the entity operates.
 - the entity's accounting systems.
 - the extent to which a particular item is affected by management judgement.
 - the materiality of transactions and account balances.
- ▶ the auditor should apply the same materiality considerations as would be applied if an audit opinion on the financial statements were being given. Although there is a greater risk that misstatements will not be detected in a review than in an audit, the judgement as to what is material is made by reference to the information on which the auditor is reporting and the needs of those relying on that information, not to the level of assurance provided.



● Procedures for the review of financial statements will ordinarily include:

- ▶ obtaining an understanding of the entity's business and the industry in which it operates.
- ▶ enquiries concerning the entity's accounting principles and practices.
- ▶ enquiries concerning the entity's procedures for recording, classifying and summarising transactions, accumulating information for disclosure in the financial statements and preparing financial statements.
- ▶ enquiries concerning all material assertions in the financial statements.
- ▶ analytical procedures designed to identify relationships and individual items that appear unusual. Such procedures would include:
 - comparison of the financial statements with statements for prior periods.
 - comparison of the financial statements with anticipated results and financial position.
 - study of the relationships of the elements of the financial statements that would be expected to conform to a predictable pattern based on the entity's experience or industry averages.
- ▶ in applying these procedures, the auditor would consider the types of matters that required accounting adjustments in prior periods.
- ▶ enquiries concerning actions taken at meetings of shareholders, the board of directors, committees of the board of directors and other meetings that may affect the financial statements.
- ▶ reading the financial statements to consider, on the basis of information coming to the auditor's attention, whether the financial statements appear to conform with the basis of accounting indicated.
- ▶ obtaining reports from other auditors, if any and if considered necessary, who have been engaged to audit or review the financial statements of components of the entity.
- ▶ enquiries of persons having responsibility for financial and accounting matters concerning, for example:
 - 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.
 - matters which have arisen in the course of applying the foregoing procedures.
 - obtaining written representations from management when considered appropriate.
- ▶ the auditor should enquire about events subsequent to the date of the financial statements that may require adjustment of, or disclosure in, the financial statements.
- ▶ the auditor does not have any responsibility to perform procedures to identify events occurring after the date of the review report.
- ▶ if the auditor has reason to believe that the information subject to review may be materially misstated, the auditor should carry out additional or more extensive procedures as are necessary to be able to express negative assurance or to confirm that a modified report is required.



Conclusions and Reporting

- ▶ the review report should contain a clear written expression of negative assurance.
- ▶ the auditor should review and assess the conclusions drawn from the evidence obtained as the basis for the expression of negative assurance.
- ▶ based on the work performed, the auditor should assess whether any information obtained during the review indicates that the financial statements do not give a true and fair view in accordance with the identified financial reporting framework.
- ▶ the report on a review of financial statements describes the scope of the engagement to enable the reader to understand the nature of the work performed and make it clear that an audit was not performed and, therefore, that an audit opinion is not expressed.

The review report should contain:

- ▶ title
- ▶ addressee
- ▶ opening or introductory paragraph including:
 - identification of the financial statements on which the review has been performed; and
 - a statement of the responsibility of the entity's management and the responsibility of the auditor;
- ▶ scope paragraph, describing the nature of a review, including:
 - a reference to the International Standard on Auditing applicable to review engagements, or to relevant national standards or practices;
 - a statement that a review is limited primarily to enquiries and analytical procedures; and
 - a statement that an audit has not been performed, that the procedures undertaken provide less assurance than an audit and that an audit opinion is not expressed;
- ▶ statement of negative assurance;
- ▶ date of the report;
- ▶ auditor's address; and
- ▶ auditor's signature.



- The review report should:
 - ▶ state that nothing has come to the auditor's attention based on the review that causes the auditor to believe the financial statements do not give a true and fair view in accordance with the identified financial reporting framework (negative assurance); or
 - ▶ if matters have come to the auditor's attention, describe those matters that impair a true and fair view in accordance with the identified financial reporting framework including, unless impracticable, a quantification of the possible affect on the financial statements, and either:
 - express a qualification of the negative assurance provided; or
 - when the affect of the matter is so material and pervasive to the financial statements that the auditor concludes that a qualification is not adequate to disclose the misleading or incomplete nature of the financial statements, give an adverse statement that the financial statements do not give a true and fair view in accordance with the identified financial reporting framework; or
 - ▶ if there has been a material scope limitation, describe the limitation and either:
 - express a qualification of the negative assurance provided regarding the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed; or
 - when the possible effect of the limitation is so significant and pervasive that the auditor concludes that no level of assurance can be provided, not provide any assurance.
- The auditor should date the review report as of the date the review is completed, which includes performing procedures relating to events occurring up to the date of the report. However, since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the review report earlier than the date on which the financial statements were approved by management.



Example of an Engagement Letter for a Review of Financial Statements

The following letter is for use as a guide in conjunction with the considerations outlined in the ISA and will need to be varied according to individual requirements and circumstances.

To the Board of Directors

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will review the Statement of Financial Position of Vendens Ltd as at December 31, 2010, and the related Statements of Income and Cash Flows for the year then ended, in accordance with the International Standard on Auditing applicable to reviews. We will not perform an audit of these financial statements and, accordingly, we will not express an audit opinion on them. Accordingly, we expect to report on the financial statements as follows:

(see next page for specimen report)

Responsibility for the financial statements, including adequate disclosure, is that of the management of the entity. This includes the maintenance of adequate accounting records and internal controls and the selection and application of accounting policies. As part of our review process, we will request written representations from management concerning assertions made in connection with the review.

Our engagement cannot be relied upon to disclose whether fraud, errors, or illegal acts exist. However, we will inform you of any material matters that come to our attention.

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 review of the financial statements.

Sweep, Broom & Co

Acknowledged on behalf of Vendens Ltd

(signed)

Name and Title

Date



Example of a form of Unqualified Review Report

REVIEW REPORT TO

We have reviewed the accompanying Statement of Financial Position of Vendens Ltd at December 31, 2010, and the related Statements of Income and Cash Flows for the year then ended. These financial statements are the responsibility of the entity's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Auditing applicable to review engagements. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to enquiries of entity personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view in accordance with International Financial Reporting Standards.

Date

Reporting Accountant

Address



Examples of Review Reports other than Unqualified***Qualification For a Departure From International Financial Reporting Standards*****REVIEW REPORT TO**

We have reviewed the accompanying Statement of Financial Position of Vendens Ltd at December 31, 2007, and the related Statements of Income and Cash Flows for the year then ended. These financial statements are the responsibility of the entity's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Auditing applicable to review engagements. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to enquiries of entity personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Management has informed us that inventory has been stated at its cost which is in excess of its net realisable value. Management's computation, which we have reviewed, shows that inventory, if valued at the lower of cost and net realisable value as required by International Financial Reporting Standards, would have been decreased by \$X, and net income and owners' equity would have been decreased by \$X.

Based on our review, except for the effects of the overstatement of inventory described in the previous paragraph, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view in accordance with International Financial Reporting Standards.

Date

Reporting Accountant

Address



Adverse Report For a Departure From International Financial Reporting Standards**REVIEW REPORT TO**

We have reviewed accompanying the Statement of Financial Position of Vendens Ltd at December 31, 2007, and the related Statements of Income and Cash Flows for the year then ended. These financial statements are the responsibility of the entity's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Auditing applicable to review engagements. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to enquiries of entity personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

As noted in footnote X, these financial statements do not reflect the consolidation of the financial statements of subsidiary entities, the investment in which is accounted for on a cost basis. Under International Financial Reporting Standards, the financial statements of the subsidiaries are required to be consolidated.

Based on our review, because of the pervasive effect on the financial statements of the matter discussed in the preceding paragraph, the accompanying financial statements do not give a true and fair view in accordance with International Financial Reporting Standards.

Date

Reporting Accountant

Address



Agreed-upon procedures

Objective of an Agreed-upon Procedures Engagement

- ▶ The objective of an agreed-upon procedures engagement is for the auditor to carry out 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.
- ▶ As the auditor simply provides a report on the factual findings of agreed-upon procedures, no assurance is expressed. Instead, users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work.
- ▶ 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.

Defining the Terms of the Engagement

- ▶ The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed-upon procedures and the conditions of the engagement. Matters to be agreed include the:
 - nature of the engagement including the fact that the procedures performed will not constitute an audit or a review and that accordingly no assurance will be expressed.
 - stated purpose for the engagement.
 - identification of the financial information to which the agreed-upon procedures will be applied:
 - nature, timing and extent of the specific procedures to be applied.
 - anticipated form of the report of factual findings.
 - limitations on distribution of the report of factual findings. When such limitation would be in conflict with the legal requirements, if any, the auditor would not accept the engagement.

- ▶ It is in the interests of both the client and the auditor that the auditor send an engagement letter documenting the key terms of the appointment. An engagement letter confirms the auditor's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the auditor's responsibilities and the form of report to be issued.



- ▶ Matters that would be included in the engagement letter include:
 - a listing of the procedures to be performed as agreed between the parties.
 - a statement that the distribution of the report of factual findings would be restricted to the specified parties who have agreed to the procedures to be performed.
- In addition, the auditor may consider attaching to the engagement letter a draft of the type of report of factual findings that will be issued.
- Planning
 - ▶ The auditor should plan the work so that an effective engagement will be performed.
- Documentation
 - ▶ The auditor should document matters which are important in providing evidence to support the report of factual findings, and evidence that the engagement was carried out in accordance with the ISA and the terms of the engagement.
- Procedures and Evidence
 - ▶ The auditor should carry out the procedures agreed upon and use the evidence obtained as the basis for the report of factual findings.
 - ▶ The procedures applied in an engagement to perform agreed-upon procedures may include:
 - Enquiry and analysis
 - Re-computation, comparison and other clerical accuracy checks
 - Observation
 - Inspection
 - Obtaining confirmations
- Reporting
 - ▶ The report on an agreed-upon procedures engagement needs to describe the purpose and the agreed-upon procedures of the engagement in sufficient detail to enable the reader to understand the nature and the extent of the work performed.



- The report of factual findings should contain:
 - ▶ title;
 - ▶ addressee (ordinarily the client who engaged the auditor to perform the agreed-upon procedures);
 - ▶ identification of specific financial or non-financial information to which the agreed-upon procedures have been applied;
 - ▶ a statement that the procedures performed were those agreed with the recipient;
 - ▶ a statement that the engagement was performed in accordance with the International Standard on Auditing applicable to agreed-upon procedures engagements;
 - ▶ when relevant, a statement that the auditor is not independent of the entity;
 - ▶ identification of the purpose for which the agreed-upon procedures were performed;
 - ▶ a listing of the specific procedures performed;
 - ▶ a description of the auditor's factual findings including sufficient details of errors and exceptions found;
 - ▶ statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed;
 - ▶ a statement that, had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported;
 - ▶ a statement that the report is restricted to those parties that have agreed to the procedures to be performed;
 - ▶ a statement (when applicable) that the report relates only to the elements, financial statements, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole;
 - ▶ date of the report;
 - ▶ reporting accountant's address; and
 - ▶ reporting accountant's signature.



Example of a Report of Factual Findings in Connection with Accounts Payable**REPORT OF FACTUAL FINDINGS**

To (those who engaged the reporting accountant)

We have performed the procedures agreed with you and enumerated below with respect to the accounts payable of Flyfal Ltd as at (date), set forth in the accompanying schedules. Our engagement was undertaken in accordance with the International Standard on Auditing applicable to agreed-upon procedures engagements. The procedures were performed solely to assist you in evaluating the validity of the accounts payable and are summarised as follows:

1. We obtained and checked the addition of the trial balance of accounts payable as at (date) prepared by Flyfal Ltd, and we compared the total to the balance in the related general ledger account.
2. We compared the attached list of major suppliers and the amounts owing at (date) to the related names and amounts in the trial balance.
3. We obtained suppliers' statements or requested suppliers to confirm balances owing at (date).
4. We compared such statements or confirmations to the amounts referred to in 2. For amounts which did not agree, we obtained reconciliations from Flyfal Ltd. For reconciliations obtained, we identified and listed outstanding invoices, credit notes and outstanding payments in transit, each of which was greater than \$xxx. We located and examined such invoices and credit notes subsequently received and remittances subsequently paid and we ascertained that they should in fact have been listed as outstanding on the reconciliations.

We report our findings below:

- a) With respect to item 1 we found the addition to be correct and the total amount to be in agreement.
- b) With respect to item 2 we found the amounts compared to be in agreement.
- c) With respect to item 3 we found there were suppliers' statements for all such suppliers.
- d) With respect to item 4 we found the amounts agreed, or with respect to amounts which did not agree, we found Flyfal Ltd had prepared reconciliations and that the invoices, credit notes and outstanding payments over \$xxx were appropriately listed as reconciling items with the following exceptions:

(Detail the exceptions)

Because the above procedures do not constitute either an audit or a review made in accordance with International Standards on Auditing, we do not express any assurance on the accounts payable as of (date).

Had we performed additional procedures or had we performed an audit or review of the financial statements in accordance with International Standards on Auditing, other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. This report relates only to the accounts and items specified above and does not extend to any financial statements of Flyfal Ltd taken as a whole.

Date

Reporting accountant

Address



Engagements to compile financial information

- Objective of a Compilation Engagement

- ▶ The objective of a compilation engagement is for the accountant to use accounting expertise, as opposed to auditing expertise to collect, classify and summarise financial information. This ordinarily entails reducing detailed data to a manageable and understandable form without a requirement to test the assertions underlying that information. The procedures employed are not designed, and do not enable the accountant, to express any assurance on the financial information. However, users of the compiled financial information derive some benefit as a result of the accountant's involvement because the service has been performed with professional competence and due care.
- ▶ A compilation engagement would ordinarily include the preparation of financial information (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.
- ▶ In all circumstances, when an accountant's name is associated with financial information compiled by the accountant, the accountant should issue a report.





Chapter 12

ASSURANCE SERVICES

Introduction

- The objective of an assurance engagement is the evaluation of a subject matter that is the responsibility of another party using identified suitable criteria, and to express a conclusion that provides the user with a level of assurance about that subject matter.

Elements of assurance engagements

- Whether a particular engagement is an assurance engagement will depend upon whether it exhibits all the following elements:
 - ▶ a three party relationship involving:
 - a professional accountant;
 - a responsible party; and
 - an intended user (this is the party that the report is prepared for).
 - ▶ a subject matter;
 - ▶ suitable criteria: these are the standards or benchmarks used to evaluate or measure the subject matter
 - ▶ a conclusion.
- The subject matter may include:
 - ▶ information such as historic or prospective financial information, statistical information or performance indicators.
 - ▶ systems and controls
 - ▶ behaviour such as corporate governance, compliance with regulation or human resource practices
- Level of assurance provided
 - ▶ In an attest engagement, the conclusion relates to an assertion by the responsible party. The assertion is the responsible party's conclusion about the subject matter based on identified suitable criteria. The professional accountant can either express a conclusion about the assertion made by the responsible party, or provide a conclusion about the subject matter in a form similar to the assertion made by the responsible party.
 - ▶ In a direct reporting engagement, the professional accountant expresses a conclusion on the subject matter based on suitable criteria, regardless of whether the responsible party has made a written assertion on the subject matter.
 - ▶ Professional accountants ordinarily undertake engagements to provide either a high or a moderate level of assurance. Engagements are affected by various elements, for example, the degree of precision associated with the subject matter, the nature, timing



and extent of procedures, and the sufficiency and appropriateness of the evidence available to support a conclusion.

- ▶ 'High level assurance' means that the professional accountant has obtained sufficient appropriate evidence to conclude that the subject matter conforms in all material respects with identified suitable criteria.
- ▶ 'Moderate level assurance' means that the professional accountant has obtained sufficient appropriate evidence to be satisfied that the subject matter is plausible in the circumstances.

Work required

- The terms of the engagement should be agreed with the party who engages the practitioner.
- Effective planning is required as with an audit.
- The criteria to be used in the engagement must be considered as they will affect the amount of work required. Suitable criteria must be relevant, reliable, neutral, understandable and complete.
- Sufficient appropriate evidence is required on which the conclusion is based. Sufficient documentation should be retained to provide evidence to support the conclusions reported and to show that appropriate standards were applied.

Form and content of reports

- The international standard does not stipulate a standardised format for the report. Different wording will have to be used depending on the engagement.
- A conclusion conveying a high level of assurance about the subject matter should usually be provided, with the report containing a clear expression of opinion.
- Contents of report
 - ▶ The report must always include the following:
 - title;
 - addressee;
 - description of the engagement and identification of the subject matter;
 - statement to identify the responsible party and describe the accountant's responsibilities;
 - if the report is for a restricted purpose, identification of the parties to whom it is restricted and for what purpose it was prepared;
 - identification of the standards under which the engagement was conducted;
 - identification of the criteria against which the subject matter was evaluated or measured;
 - a conclusion, including any reservations or denial of a conclusion;
 - date of the report; and
 - name of the firm or practitioner, and the place of issue of the report.

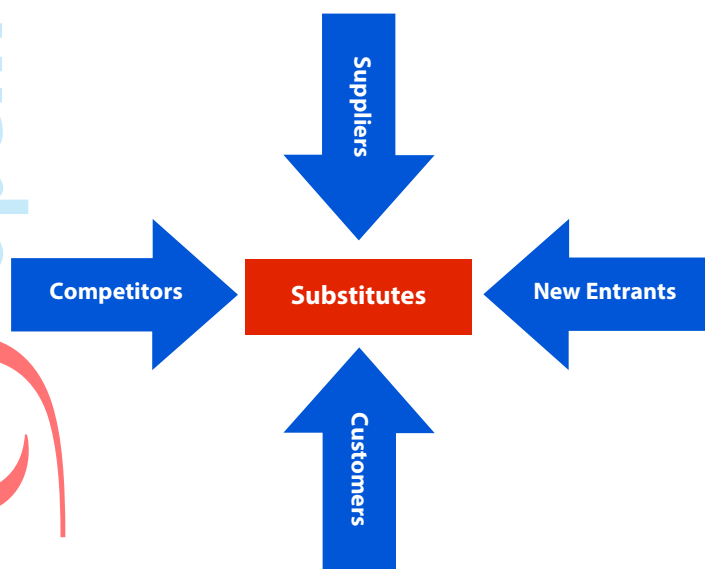


Risk assessment

- Identification of business risks and how they are managed is a favourite topic of the examiner. In practice, an audit firm might be engaged to give assurance on the management of such risks.
- The management of business risk is critical as directors must safeguard the assets of the entity.
- Identification of risks
 - ▶ Many models are used to identify risks including:
 - Porter's Five Forces
 - PEST analysis
 - SWOT analysis

Porter's Five Forces

- The examination of each of the five forces enable management to identify and evaluate the risks to the business. Collectively these factors determine the ability of the entity to make a profit.



PEST Analysis

- This is a way of considering external factors which may impact upon the business.
- The factors are:
 - ▶ Political
 - Industry regulations
 - Taxation issues
 - Social legislation
 - ▶ Environmental/Economic
 - Inflation
 - Exchange rates
 - Interest rates
 - ▶ Social
 - Welfare issues
 - Health and safety
 - ▶ Technological

SWOT Analysis

- This approach is used to analyse the business internally in order to understand its current position with a view to developing a strategic plan. The following need to be identified:
 - ▶ Strengths
 - ▶ Weaknesses
 - ▶ Opportunities
 - ▶ Threats
- The idea is to match strengths with opportunities and convert weaknesses into strengths. Threats should be converted into opportunities.



- Analysing the risks
 - ▶ Risks need to be evaluated and quantified to determine how serious the risk is.
 - ▶ Risks are often prioritised as follows:

High Impact High Likelihood A	High Impact Low Likelihood B
Low Impact High Likelihood C	Low Impact Low Likelihood D

- ▶ A - Immediate action is needed
 - ▶ B - Consider action and develop a contingency plan
 - ▶ C - Consider action
 - ▶ D - Keep under review
- Control strategies will be needed to manage or mitigate the more serious risks identified.



Performance measurement

- An audit firm may be asked to provide assurance on performance measures operating within a business.
- Performance measurement aims to establish how well something or somebody is performing in relation to previous or expected activity or in comparison with another item or body.
- The 'item' may be a machine, a factory, a subsidiary or the business as a whole. The 'body' may be an employee, a manager or a group of staff.
- Performance measures
 - ▶ Different measures are appropriate for different businesses. Traditional financial performance measures are:
 - profit
 - revenue - costs
 - share price
 - cash flow
 - return on investment.
 - ▶ Financial measures do not give a full picture of a business' performance. Increasingly entities are turning to non-financial performance measures.

Example 1

Suggest five non-financial performance measures that a manufacturing business could use internally.

Systems reliability

- Businesses are exposed to risk if their computerised systems are unreliable. An audit firm may be asked to give assurance on the reliability of the systems in operation.

Example 2

What risks is a business exposed to as a result of unreliable systems?

- Controls over computerised systems have been covered in earlier auditing studies.



Electronic commerce

- The Internet
 - ▶ Many clients now conduct their business through the Internet.
- Risks associated with the Internet.
 - ▶ Entities that engage in electronic commerce are subject to additional risks. Inherent risks arising can be categorised as follows:
 - Financial: if transactions fail then an entity will have difficulty remaining in business.
 - Reputational: if the entity's reputation is damaged, or confidence in its operations is lost, the entity will also have difficulty remaining in business.
 - Legal: new legal issues need to be faced. Breach of these could give rise to serious problems.
 - ▶ Entities who sell via the Internet are faced with the following potential risks:
 - customer validity: how do they know that a customer is who they say they are?
 - server reliability: the site may be subject to denial of service attacks preventing the receipt of legitimate orders.
 - data theft: firewalls can prevent this as they will deny external users the opportunity to access parts of the system.
 - ▶ A number of business risks are also faced including:
 - cash flow difficulties due to investment in the systems
 - loss of competitive advantage in a fast-moving market place if systems or processes fail or are suspended
 - failure of systems development
 - lack of profitability
 - customer dissatisfaction due to poor service
- Assessment of internal controls

The assessment of controls becomes more complex as technology advances. The audit firm must consider the following in order to assess the system properly:

 - how many servers does the entity have?
 - what processing methods are used?
 - how is the network configured?
 - how are customers and suppliers authenticated?
 - what security methods are used?
 - how good are the general internal controls?
- E-mail
 - ▶ E-mail reduces paperwork and results in speedier communication. However, there is a risk that unauthorised e-mails could result in unauthorised processing. Therefore, access controls over the system are paramount.
- Electronic data interchange (EDI)
 - ▶ EDI refers to the exchange of electronic business documents between trading partners. The exchange of a fully integrated EDI system involves no papers and no human input.



- ▶ The organisation needs to have controls in place to ensure that the data exchanged is authentic and secure.

Webtrust

- Webtrust is designed to create confidence in consumers and entities who conduct business transactions over the Internet. Having the Webtrust seal on a business web site provides some assurance that the site owner has systems in place to preserve the confidentiality and security of a credit card holder.
- The owner of a web site can engage a specially licensed accountant to provide the Webtrust assurance service. This accountant must conduct an updated assurance examination of the procedures in place at the site at least once every three months.



Chapter 13

PROSPECTIVE FINANCIAL INFORMATION (PFI)

The examination of prospective financial information

- Prospective financial information means financial information based on assumptions about events that may occur in the future and possible action by the entity. Listed entities should have procedures that allow them to generate reliable PFI, compare it to market expectations, publish it when necessary and subsequently report actual performance against it.

• Matters to consider before accepting an engagement to report on prospective financial information

- Before accepting such an engagement, the audit firm should consider:
 - ▶ the intended use of the information. For example, is it intended for internal or external use?
 - ▶ whether the information will be for general or limited distribution.
 - ▶ the nature of the assumptions on which the information is based.
 - ▶ the information to be included.
 - ▶ the period covered by the information.

Examination procedures

- The audit firm should obtain sufficient appropriate evidence as to whether:
 - ▶ management's assumptions on which the PFI is based are not unreasonable.
 - ▶ the information is properly prepared on the basis of the assumptions.
 - ▶ the information is properly presented and all material assumptions are adequately disclosed.



Example 1

The directors of Ebagum Limited are planning a management buy-out from their parent entity and have asked your firm to report on the accuracy of the profit forecast and Statements of Financial Position of the entity for the following five years.

Ebagum buys car parts from manufacturers and sells them to retailers mainly on a cash basis from about 20 retail outlets throughout the UK.

The management is planning to finance the buy-out from their own resources and from funds provided by financial institutions. It is expected that:

- (a) the equity shares will be purchased by the directors and a financial institution.
- (b) the current loan account between Ebagum and their parent will be repaid and be replaced by loans from banks and financial institutions. Some of these loans will have the option of conversion into equity at a later date.

A detailed monthly forecast Statement of Comprehensive Income and budgeted Statements of Financial Position have been prepared for the first year's trading and an annual forecast Statement of Comprehensive Income and Statement of Financial Position have been prepared for the following four years:

Describe the work that you will perform on the forecast Statements of Comprehensive Income and the forecast Statements of Financial Position.



Chapter 14

INTERNAL AUDIT

Considering the work of internal auditors

- Internal auditing is an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation. It is a control which functions by examining and evaluating the adequacy and effectiveness of other controls.
- The establishment of an internal audit function is seen as good corporate governance.

Types of internal audit

- The internal audit department could be involved in the following types of audit:

▶ Compliance auditing	This would be concerned with the compliance of procedures with internal controls as laid down by management.
▶ Efficiency auditing	This would be concerned with determining whether resources are being used efficiently. For example, the auditor would be interested in determining whether costs are being minimised.
▶ Effectiveness auditing	This would be concerned with determining whether resources are being used to proper effect. For example, the auditor might consider whether it would be better for the entity to lease vans rather than purchase them outright.
Operational auditing	This encompasses both efficiency and effectiveness. The idea is that the auditor is concerned with the whole organisation and not just with finance and accounting.



Relationship with external auditors

- The external auditor
 - ▶ The objective of the external auditor is to form an opinion on the truth and fairness of the financial statements. Reliance may be placed on the internal controls but this is seen as a short cut to examining all the transactions for the period.
- The internal auditor
 - ▶ The prime objective of the internal auditor is to advise the management on whether its major operations have sound systems of internal controls. Therefore, they will test transactions to confirm the evaluation and determine the implications of any systems weaknesses. These systems are designed to ensure the future welfare of the entity rather than accounting for its activities.
- Similarities
 - ▶ Both the external and the internal auditor carry out controls testing and both are concerned that the entity complies with its control procedures. However, the external auditor is more focused on financial systems and the financial statements.
 - ▶ Both operate as professionals and both produce formal reports on their activities.
- Differences
 - ▶ The external auditor is not an employee of the entity. Internal auditors work for and on behalf of the entity.
 - ▶ Internal audit is not a legal requirement. It is a voluntary function which covers all the entity's operations, not just the financial ones.
 - ▶ Internal auditors report to the board of directors or the audit committee. The external auditors report to the shareholders.

Example 1

Explain the reasons why internal auditors should, or should not, report their findings on internal control to the following selection of entity officials:

- (a) the finance director
- (b) the board of directors
- (c) the audit committee



Outsourced internal audit services

- Internal audit is not mandatory, so many entities have decided to outsource or contract out the function. This may result in the external audit firm providing both the external and the internal audit function.
- The advantages of outsourcing internal audit include the following:
 - ▶ some organisations are not large enough to warrant a separate internal audit department. Outsourcing is therefore the only means by which they can benefit from the function.
 - ▶ the independence of the function is enhanced.
 - ▶ the investigation of sensitive areas such as management fraud are easier if outsourcing is used.
 - ▶ external providers may have easier access to specialist knowledge.
- However, there may be disadvantages as well:
 - ▶ outsourcing internal audit appears to go against the spirit of corporate governance which regards regular monitoring of key controls by internal audit as an integral part of the entity's system of controls.
 - ▶ using external providers may be more expensive because they are paid fees which include a profit element.
 - ▶ external staff may change frequently and the new staff will have to become acquainted with the system. Internal staff usually know the system better and can therefore identify problems more easily. They are also closer to the daily activities of the entity and may get earlier indications of developments or problems.

Example 2

What are the ethical implications of the external audit firm providing both external and internal audit services to a client?





Chapter 15

OUTSOURCED FINANCE AND ACCOUNTING FUNCTIONS

Introduction

- Outsourcing is the use of external suppliers as a source of finished products, components or services. It is also known as 'sub-contracting'.
- The use of the services of such an external supplier does not diminish the ultimate responsibility of the directors for conducting the business of the entity.

Advantages and disadvantages

- The advantages of outsourcing are as follows:
 - ▶ it frees time for the employees.
 - ▶ it allows the entity to take advantage of specialist expertise rather than investing in these facilities itself and under-utilising them.
 - ▶ services may be performed more quickly and to a higher standard.
 - ▶ it may be cheaper, once time savings and opportunity costs are taken into account.
- However there are a number of disadvantages:
 - ▶ there is no guarantee that the service will be performed to the organisation's satisfaction.
 - ▶ it may be more expensive than providing the service in-house.
 - ▶ by performing services itself the organisation retains or develops skills that may be needed in the future and will otherwise be lost.
 - ▶ commercially sensitive data may get into the wrong hands.
 - ▶ there may be opposition from employees if outsourcing involves redundancies.



Audit considerations relating to entities using service organisations

- A “service organisation” is an entity that provides services to another. They undertake a wide variety of activities such as:
 - information processing
 - maintenance of accounting records
 - facilities management
 - maintenance or safe custody of assets; and
 - initiation or execution of transactions on behalf of the other entity
- Service organisations may undertake activities on a dedicated basis for one entity, or on a shared basis, either for members of a single group of entities or for unrelated customers.

Impact on the audit planning

- At the planning stage, the auditor should determine the significance of the service organisations to the client and relevance to the audit.
- They should also obtain an understanding of the contractual terms which apply and the controls in place. These should be documented for the audit file.
- The auditor would consider the following:
 - ▶ whether the terms contain an adequate specification of the information to be provided to the entity and responsibilities for initiating transactions relating to the activity undertaken by the service organisation
 - ▶ the way accounting records are maintained
 - ▶ whether the entity has rights of access to the accounting records prepared by the service organisation
 - ▶ whether the terms take proper account of any applicable regulations concerning the form of records to be maintained, or access to them
 - ▶ the nature of relevant performance standards
 - ▶ whether the service organisation has agreed to indemnify the entity in the event of performance failure and
 - ▶ whether the auditor will be able to access sources of evidence



Audit procedures

- The auditors should assess the effect of the service organisation activities on their assessment of risk of material misstatement. The following factors will be relevant to inherent risk:
 - ▶ the nature of services provided
 - ▶ the degree to which authority is delegated to the service organisation
 - ▶ the arrangements for ensuring quality of service
 - ▶ whether the activities involve assets with a high risk of loss or misappropriation and
 - ▶ the reputation and integrity of those managing the service organisation.
- The auditors will also need to assess the controls operated by the entity over information given to the service organisation. They should also review the actual experience of adjustments to, and errors in, the information received from the service organisation.
- If a service organisation maintains all or part of the entity's accounting records, the auditors should assess whether the arrangements affect their reporting responsibilities in relation to accounting records.
- The auditors should:
 - ▶ assess whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the entity and, if not
 - ▶ determine effective procedures to obtain necessary evidence for the audit, either by direct access to the records kept by the service organisation or through information obtained from the service organisation or their auditors.
- The auditors would normally perform the following procedures:
 - ▶ inspect records and documents held by the entity
 - ▶ establish the effectiveness of controls
 - ▶ obtain representations to confirm balances and transactions from the service organisation
 - ▶ perform analytical review procedures on records maintained by the entity or on returns received from the service organisation
 - ▶ inspect records and documents held by the service organisation
 - ▶ request the service organisation auditor or the entity's internal auditors to perform specified procedures
 - ▶ review information from the service organisation and its auditors concerning the design and performance of control systems



- When an entity is using a service organisation, the auditor should:
 - ▶ increase their focus on whether to include the service organisation's audit report as audit evidence
 - ▶ when carrying out risk assessment, the auditor should perform procedures to ensure that the service organisation's controls are operating effectively
 - obtain a report on the description, design and operating effectiveness of the controls in place at the service organisation
 - this involves a report prepared by the management of the service organisation, and
 - a reasonable assurance report by the service organisation's auditor
 - ▶ the auditors will need to satisfy themselves about the competence and independence of the service organisation's auditor, and
 - ▶ that the service organisation's auditors' report provides sufficient appropriate evidence about the effectiveness of the entity's controls



Chapter 16

SOCIAL AND ENVIRONMENTAL AUDITS

- Environmental audit has been defined as 'A management tool comprising a systematic, documented, periodic and objective evaluation of how well organisations, management and equipment are performing with the aim of contributing to safeguarding the environment by facilitating management control of environmental practices and assessing compliance with entity policies which would include meeting regulatory requirements and applicable standards'.
- Environmental issues cannot be ignored by external auditors.
- Potential impact on the financial statements may arise from:
 - ▶ the application of environmental laws and regulations
 - ▶ the operation of processes that may cause pollution or the use of dangerous or poisonous substances
 - ▶ the holding of an interest in land and buildings that have been contaminated by previous occupants, or
 - ▶ dependence on a major customer segment whose business is threatened by environmental pressures
- Auditors do not have a specific knowledge of environmental matters. However, in planning the audit, they should obtain sufficient knowledge of the business to understand the events, transactions and practices that may have a significant affect on the financial statements or the audit.



Difficulties in measuring social and environmental performance

- It is accepted that measuring social and environmental performance is difficult.
- The following types of measures may be used:
 - ▶ Direct – for example the number of kilos of contaminant emitted.
 - ▶ Relative – data compared to another parameter. For example, kilos of contaminant / kilo of product.
 - ▶ Indexed – measured over a period of time.
 - ▶ Aggregated – information of the same type, but from different sources expressed as a combined value.
 - ▶ Weighted – information modified by applying a factor relating to its significance.
- Entities usually provide such information by way of disclosure in their financial statements.
- and with effect from 2013, the top 100 UK companies are required to provide the information.



Controls over social and environmental risks

- Where environmental matters represent a significant risk, they may fall within the coverage of the internal control system.
- Management may achieve control over environmental matters in the following ways:
 - ▶ entities with low exposure to environmental risk, or smaller entities, will probably monitor and control environmental matters as part of their normal accounting and internal control system;
 - ▶ some entities that operate in industries with a high exposure to environmental risk may design and operate a separate internal control sub-system, known as an Environmental Management System (EMS);
 - ▶ other entities design and operate all their controls within an integrated control system, encompassing policies and procedures related to accounting, environmental and other matters (eg quality, health and safety);
 - ▶ some entities may have obtained registration for the environmental controls at specific sites where they operate under the European Commission's Eco-Management and Audit Scheme (EMAS).



Substantive procedures

- Auditors may perform substantive testing to obtain evidence in relation to environmental matters. It is not intended that all of the procedures listed below will be appropriate in any particular case. In many cases, the auditor may judge it unnecessary to perform any of these procedures.
- General
 - ▶ Documentary review
 - ▶ Consider minutes from meetings of directors, audit committees, or any other sub-committees of the board specifically responsible for environmental matters.
 - ▶ Consider publicly available information regarding any existing or possible future environmental matters.
 - ▶ Where relevant, consider:
 - reports by environmental experts about the entity, such as site assessments, due diligence investigations or environmental impact studies
 - internal audit reports and other internal reports dealing with environmental matters
 - reports issued by, and correspondence with, regulatory and enforcement agencies
 - publicly available registers or plans for the restoration of soil contamination and
 - correspondence with the entity's lawyers
 - ▶ Obtain written representations from management that it has considered the effects of environmental matters on the financial statements, and that it:
 - is not aware of any material liabilities or contingencies arising from environmental matters, including those resulting from illegal or possibly illegal acts
 - is not aware of environmental matters that may result in a material impairment of assets or
 - if aware of such matters, has disclosed to the auditor all related facts



Assets

- Asset impairment
 - ▶ Enquire about any planned changes in capital assets, for example, in response to changes in environmental legislation or changes in business strategy and their impact on the valuation of those assets or the entity as a whole.
 - ▶ For any asset impairments related to environmental matters that existed in previous periods, consider whether the assumptions underlying a write-down of related carrying values continue to be appropriate.

Liabilities, provisions and contingencies

- Completeness
 - ▶ Enquire about policies and procedures operated to identify liabilities, provisions or contingencies arising from environmental matters
 - ▶ Enquire about events or conditions that may give rise to liabilities, provisions or contingencies arising from environmental matters
 - Penalties or possible penalties arising from breaches of environmental laws and regulations or
 - Claims or possible claims for environmental damage
 - ▶ For property abandoned, purchased, or closed during the period, enquire about requirements or intentions for site clean-up and restoration
 - ▶ For property sold during the period and in prior periods, enquire about any liabilities relating to environmental matters retained by contract or by law
- Accounting estimates
 - ▶ For liabilities, provisions, or contingencies related to environmental matters, consider whether the assumptions underlying the estimates continue to be appropriate.
- Disclosure
 - ▶ Review the adequacy of any disclosure of the effects of environmental matters on the financial statements.





Chapter 17

INTEGRATED REPORTING AND PUBLIC SECTOR PERFORMANCE INFORMATION

Three amendments to the P7 syllabus for the December 2014 examination are:

- ▶ the audit of social, environmental and integrated reporting, and
- ▶ the audit of performance information in public sector
 - describe the audit of performance information and differentiate from performance auditing
 - plan the audit of performance information, and describe examination procedures to be used in the audit of performance information
 - discuss the existence, measurability and relevance of reported performance information
 - discuss the form and content of a report on the audit of performance information
 - discuss the content of an audit conclusion on an integrated report of performance against predetermined objectives
- ▶ plan an engagement to provide assurance on integrated reporting with specific reference to performance measures and sustainability indicators

Integrated reporting (IR)

Background

for a number of years there has been an increasing awareness of the damage suffered by the environment as a result of industrial activity particularly in the areas of carbon emissions, water usage and waste disposal / recycling

the more recent developments in the area (1 February 2014) include a joint invitation (by ACCA, the International Integrated Reporting Council (IIRC) and the International Association for Accounting Education and Research (IAAER)) for

- ▶ researchers to submit proposals addressing three areas of IR that need further development
- ▶ the IR Framework was issued in December 2013 but, in the opinion of the triumvirate, requires refinement in
 - meeting users' information needs
 - materiality and completeness whilst still being concise in IR
 - application of the Framework to the varied diversity of organisations with different characteristics in different jurisdictions and under different circumstances
- ▶ 7 February 2014 the Global Reporting Initiative released their updates relating to G4 Sustainability Reporting Guidelines (G4 = Brazil, Germany, India and Japan)
- ▶ **18 February 2014 ACCA survey shows that most companies are adopting a "wait and see" approach to IR**



▶ **25 March 2014 ACCA report calls for governance to focus on sustainability and new measures of performance**

- paper seeks to explore the nature of existing corporate governance and risk-management framework, and
- whether those systems are fit for the purpose
- in addition, the paper recommends that the sustainable value creation
- should be the ultimate purpose of governance, and ...
- that companies and investors should develop and report using more suitable measures of performance and value creation

● 27 March 2014 Proposal for a global standard in stock exchange listing requirements on sustainability reporting

● 3 areas addressed

▶ Environmental, social and governance (ESG) materiality assessment. Within this are included:

- companies disclosing within the annual report the ESG factors that are material to its business together with the outcome / conclusion of the assessment
- the disclosure would have three key components
- how the factors were determined
- who was involved in the process
- which issues are determined as material, and why
- a discussion of both risks and opportunities presented by the material issues and their connection to:
- financial performance
- accounting
- growth
- market position, or
- business strategy

▶ ESG issue disclosure. Involved within this sub-heading are:

- on a "comply or explain" approach, disclosure on a quantitative and qualitative basis the following:
- governance and ethical oversight
- environmental impact
- government relations and political involvement
- climate change
- diversity
- employee relations
- human rights
- product and service impact and integrity
- supply chain and subcontracting, and
- communities and community relations

▶ ESG disclosure index

- every company shall provide a hyperlink in its annual report to an ESG Disclosure Index
- the index is designed to make easier for investors to find information about the company's key performance indicators

● 31 March 2014 World stock exchanges form a sustainability working group



- 16 April 2014 The European Parliament votes in favour of amendments to European accounting legislation requiring large companies to provide additional information on social and environmental matters.
 - ▶ these companies will have to disclose:
 - information on policies
 - risks and results as regards environmental matters
 - social and employee-related aspects
 - respect for human rights
 - anti-corruption and bribery issues, and
 - diversity on the boards of directors.
- 8 May 2014 The Global Reporting Initiative (GRI) has published a booklet aimed at small and medium-sized entities (SMEs) who are considering whether sustainability reporting is relevant for them and, if so, how to start the reporting process
- 19 May 2014 ACCA published 'Sustainability Matters', a new policy paper collating the ACCA's views on various sustainability-related issues. The paper sets out ACCA's thinking on six topics:
 - ▶ sustainability reporting
 - ▶ integrated reporting
 - ▶ the assurance of non-financial reporting and disclosure
 - ▶ climate change
 - ▶ natural capital
 - ▶ the green economy
- Overall, ACCA believes that "accountants, whether working in business, in public practice or the public sector, have an important role to play in making organisations more accountable in the pursuit of sustainable development."

● Sustainability reporting and integrated reporting

- ▶ ACCA believes that regulatory bodies around the World should introduce sustainability reporting obligations for listed and large companies, with smaller organisations being encouraged to adopt some form of sustainability reporting
- ▶ In order to achieve this, existing sustainability reporting standards need to be harmonised to ensure comparability
- ▶ ACCA also believes that there is a necessary linkage between sustainability reporting and integrated reporting, and that the GRI and IIRC should provide guidance on this aspect
- ▶ This, along with the wider development of integrated reporting, "offers a significant opportunity to improve the quality of corporate reporting and encourage investment decisions to be made based on a long-term view of performance and value"

● Assurance of non-financial reporting and disclosure

- ▶ ACCA believes that assurance over non-financial reporting will enhance stakeholder confidence, particularly when provided in the context of a generally accepted set of non-financial assurance standards
- ▶ In particular, the application of materiality to non-financial information will be key to this process.



- ▶ ACCA believes that non-financial reports should be assured, with such an assurance engagement likely to require a multidisciplinary team with accountants at its core.

● Natural capital

- ▶ ACCA believes that natural capital is not being measured sufficiently accurately, leading to the depletion of resources and services critical to the planet's function and having an increasing impact on corporate profits.
- ▶ ACCA believes that organisations in both the private and public sectors should report on their material impacts and dependencies on natural capital, and that the skills and experience of accountants will be crucial in creating natural capital accounting methodologies for governments and companies.

● 3 July 2014 **Finalised framework on public sector governance released**

The International Federation of Accountants (IFAC) and the Chartered Institute of Public Finance and Accountancy (CIPFA) have released a finalised international framework on governance in the public sector.

- ▶ The framework contains seven key principles designed to ensure that public sector entities achieve their intended outcomes whilst acting in the public interest at all times.
- ▶ The framework encourages a focus on sustainable economic, social and environmental outcomes and the links between governance and public financial management, and supports the use of International Public Sector Accounting Standards (IPSAS) and Integrated Reporting.

▶ The seven principles:

- ethics
- openness
- defining outcomes and how they are achieved
- capability development
- risk management
- strong financial management
- implementing "good" practices! See next
- ▶ the seventh principle focuses on implementing good practices in transparency, reporting and audit to deliver effective accountability.
- ▶ specific recommendations related to the seventh principle include:
 - accountability reports should be written and communicated in an open and understandable style appropriate to the intended audience, whilst striking a balance between the right amount of information and imposing expensive and time-consuming efforts on the entity to prepare
 - public sector entities should report publicly at least annually in a timely manner, and performance information and accompanying financial statements should be prepared on a consistent and timely basis, with International Public Sector Accounting Standards (IPSAS) prepared by the IPSAS Board seen as providing "the most complete suite of accrual-based international financial reporting standards developed specifically for the public sector"
 - integrated reporting is also seen as supporting public sector entities in engaging with stakeholders in a more complete and understandable way
- ▶ the provision of assurance through external audit is an essential element of a public sector entity's accountability, whilst internal audit can also contribute to accountability mechanisms



Paper P7

ANSWERS TO EXAMPLES

Chapter 1

Example 1

Undue dependence on a client:

Suggested steps to maintain independence:

1. Prior to accepting a client, estimate the fee and check that it does not exceed 10% of gross practice income for a plc or 15% for a private entity.
2. On an annual basis, review the level of fees from major clients to ensure they do not exceed the thresholds above.
3. On larger clients, a second partner could review the audit files prior to the report being signed.
4. Where clients are approaching or exceed the thresholds, consider resigning from some of the services or passing them to another office of the firm.

Overdue fees

Steps:

1. Request a payment on account prior to commencing the current year's audit.
2. Have a second partner review the files prior to signing the audit report.

Family and other personal relationships

Steps:

1. Obtain details on the employers of staff family and friends. This should be updated regularly.
2. Do not assign the staff member to audits of these businesses or related businesses.

Beneficial interests in shares and other investments

Steps:

1. Obtain details of all share-holdings held by staff and their spouses.
2. Request that staff keep the firm informed of any changes.
3. Do not assign staff to audits of clients in which they have a beneficial interest.

Acceptance of goods, services and hospitality

Steps:

1. Give guidelines to staff on the acceptance of goods and services, maybe setting an upper monetary limit.
2. Advise staff to notify the firm of any significant offers of goods or services prior to acceptance.

Example 2

Benefits of providing other services to audit clients

1. The audit firm will gain a greater understanding of their client's business and this should help with the assessment of risk on the audit.
2. The client will benefit from a close relationship with the adviser rather than having to deal with a number of different advisers.
3. There may be cost savings arising from the use of a single firm.
4. The audit firm benefits from increased fees.



Drawbacks

1. The audit firm may be perceived as lacking independence

How to overcome them

1 Use different staff for the various services.

2 Keep the level of fee under review to ensure it does not become excessive.

3 On large clients, consider having a second partner review the audit files prior to giving the audit opinion.

2. The firm may cross the line between advisory and decision making

1 Ensure that an engagement letter is issued for each service being provided, clearly setting out the responsibilities of the audit firm and the management.

2 Ensure that different departments are used to perform the various services.

Chapter 2**No EXAMPLES****Chapter 3****No EXAMPLES****Chapter 4****Example 1****(a) Fixed fees:**

The ethical implications are:

- the fee agreed may not be high enough and this may lead to insufficient work being performed.
- this would increase the risk of an inappropriate audit opinion being given and would lead to an increased risk of a negligence claim.

(b) Lowballing:

The ethical implications are:

- the fee being set so low means that the audit firm needs to retain the client for a number of years in order to recover its initial losses.
- therefore independence will be impaired as the audit firm will not wish to lose the client in the short term.
- it could be seen as unprofessional because it means that smaller practices cannot compete.

Example 2

The following work would be performed in order to assess the risk attaching to a prospective client:

- Perform an entity search at the Government Registrars to ascertain shareholders, directors, security granted and whether or not annual returns are filed on a timely basis.
- Consult a credit reference agency to review solvency and consider whether the firm's fees are likely to be paid promptly.



- Review the most recent published financial statements for solvency, adequacy of disclosure and to determine whether or not the accounting policies adopted are acceptable to the firm.
- Examine background information to identify industry specific problems, issues, legislation and trends.

Less 'technical' methods such as looking at local newspapers or finding out about the entity's location and reputation in that area may also be undertaken.

The firm may make use of contacts with knowledge of the entity to assess its reputation and that of its owners and managers. Useful sources of information may include trade associations and local chambers of commerce.

Chapter 5

Example 1

Factors indicating a high level of inherent risk:

- lack of integrity among the directors and management
- lack of experience and knowledge within the management and staff
- changes in management during the year
- unusual pressures on management
- a complex business
- high technology inventory being held
- multiple locations
- industry factors such as new competitors entering the market
- a high volume of cash transactions
- poor quality accounting systems

Example 2

Risks:

- Inventory may be unsaleable due to its nature
- Staff may be unreliable
- Sales are on a cash basis
- There are numerous locations

Controls needed:

- Market research to identify trends and reduce the risk of unsold inventory.
- Obtaining character references for staff together with careful interview procedures.
- Regular reports to head office coupled with visits from the internal auditors.
- Staff training on accounting and entity policies.



Chapter 6

Example 1

The following factors influence the sufficiency of audit evidence:

- the assessment of inherent and control risk
- the nature of the accounting and internal control systems, including the control environment
- the materiality of the item being examined
- past experience of the client
- the auditor's knowledge of the business and the industry
- the source and reliability of information available

Example 2

1 Agreement of the bank balance to the entity's bank reconciliation:

This would be considered to be a relatively weak form of evidence. Although the agreement has been performed by the auditor, it is based on information which has been provided wholly by the client. The audit firm would aim to obtain a direct confirmation of the bank balance to strengthen this evidence.

2 Inspection of title deeds:

This will provide evidence that the entity has legal title to the property. By itself, it would not be sufficient evidence. The audit firm should ensure that the property hasn't been used as security for a loan and they also need to confirm that it has not been sold. The keeper of the deeds will be a factor to consider in deciding how appropriate the evidence is.

3 Agreement of an account receivable balance to a circularisation response:

This would be considered to be strong evidence in relation to existence and ownership of the account receivable balance. The receivable corresponds directly with the audit firm thereby ensuring appropriate evidence is obtained. However, the audit firm would need to consider whether the client exerts influence over the receivable and they would need to obtain evidence about the recoverability of the debt.

Example 3

Written representations are an appropriate source of evidence when:

- knowledge of facts is confined to management or
- the matter is one of opinion or judgement

Example 4

Audit procedures to ensure that an accurate and reliable valuation has been provided:

1. Obtain a copy of the valuer's report and determine the identity and qualifications of the valuer. If they are a reputable firm this would normally increase their reliability.
2. From the valuer's report determine the reason for the valuation and the basis of valuation used.
3. Check the register of members to confirm that the valuer is not a shareholder.
4. Check personnel records to ensure that he is not an employee.
5. Review the price of similar properties in the area by reference to estate agents' publications. Compare these to the value placed on Udens' head office.
6. Recalculate the gain on revaluation and check that it has been correctly transferred to a revaluation reserve.
7. Recalculate depreciation on the property to confirm that it is based on the revalued amount.
8. Check the notes to the financial statements to ensure that the details of the revaluation have been disclosed.



Example 5

- last year's file
- discussions with management
- separate written representations for each director
- unusual transactions
- journal
- minutes
- group structure
- shareholders
- other directorships

Chapter 7**Example 1**

The following factors could have lead to the increase.

- Increased credit is being given to all customers due to a change in Tervyseks' terms of trade.
- There are bad debts that need to be written off.
- There is a higher level of slow paying receivables.
- Significant sales may have occurred close to the year end.
- There are cut off errors in sales and/or credit notes.
- There has been a change in sales mix.
- Tervyseks has this year registered for VAT purposes
- The VAT rate may have increased since last year

Example 2

Three examples of subsequent events:

- A receivable going into liquidation after the year end.
- Closure of part of the business where this was not anticipated before the year end.
- Purchase of a new subsidiary.

Example 3

The impact on a set of financial statements in the event that the going concern assumption does not apply:

- All assets will be classified as current.
- All payables become payable within one year.
- The valuation of assets will be at their "break up" values.
- This will usually result in significant write downs.
- Provisions will be needed for redundancy and other closure costs.
- These write downs and provisions will reduce profits or increase losses.
- Likely change to or increase in net current liabilities and net liabilities position.

Example 4

Indicators of going concern problems: (Any 5 of these!)

- An excess of liabilities over assets
- Recurring losses
- Debt due for repayment where refinancing is necessary for the entity's continued existence.
- Default on terms of loan agreement and potential breaches of covenant.
- Significant liquidity or cash flow problems.
- Fundamental changes in the market or technology to which the entity is unable to adapt.
- Externally forced reductions in operations.
- Loss of key management or staff, labour difficulties or excessive dependence on a few product lines where the market is depressed.



- Loss of key suppliers or customers.
- Major litigation in which an adverse judgement would imperil the entity's continued existence.
- Global economic recession

Chapter 8

Example 1

The limitations of the statutory audit are:

1. There is a time lag between the Statement of Financial Position date and the publication of the audited financial statements.
2. Auditors perform testing on a sample of items only. Therefore the evidence gained is persuasive rather than conclusive.
3. Auditors are required to form judgements on specialised areas which may not be dealt with in International Financial Reporting Standards.
4. Auditors are required to report in a standard format.
5. Auditors are required to form a judgement on estimates which will carry high levels of uncertainty.

Example 2

Factors to consider before accepting standard costs as an appropriate basis for the estimation of cost:

- How often are the standard costs updated?
- Do significant price variances arise?
- Have the standard costs been acceptable in the past?
- What controls are there over the amendment of standard cost data?

Example 3

Audit work on contracts:

1. Agree the contract price to the contract signed by the entity and Chennai Ferries.
2. Costs to date should be agreed to the costs ledger. On a sample basis, select items charged to the ledger and review supporting documentation to ensure that they are legitimate contract costs.
3. Ascertain, record and evaluate the controls which operate over the allocation of costs to contracts. Test that these controls operate properly.
4. Costs to complete should be compared to post year end activity and reviewed for reasonableness. Review completed contracts to determine how accurate Mumbai's estimation processes are.
5. Progress payments received should be agreed to correspondence and to the cash receipts book.
6. The contract is loss making. Confirm to the financial statements that a loss of \$10m has been included.
7. Review correspondence between Mumbai and Chennai Ferries to determine whether any problems have arisen which could give rise to over runs or penalties.
8. Agree the stage of completion to surveyor's reports.
9. Verify the existence of the partially completed ferry to confirm that the estimated stage of completion appears reasonable.
10. Recalculate the turnover, cost of sales and Statement of Financial Position amounts and agree them to those calculated by Mumbai.



Chapter 9

Example 1

The following audit work would be performed before reliance could be placed on the work carried out by the auditors of Anthony plc:

1. Inform the auditors of Anthony of the scope of examination for group purposes and the standards expected. Set up lines of communication with the component auditors.
2. Discuss instructions issued to Anthony plc by Royle Group plc setting out details of deadlines and group accounting policies. Set deadlines for group purposes.
3. Consider the independence of the auditors and any restrictions that may have been placed on their work.
4. Perform analytical review on Anthony's financial statements and discuss the main risk areas with the component auditors.
5. Send a questionnaire to the component auditors in order to determine the work done and the procedures followed.
6. If Anthony plc is material in a group context, the audit working papers of the component auditors might be reviewed to ensure that conclusions are reasonable and justified.
7. Obtain a copy of the management letter sent by Anthony plc's auditors and consider the significance of the contents.

Example 2

The following work would be performed on the fair values:

- (i) Inventory:
The fair value should be based on the lower of replacement cost and nrv. Replacement cost of inventory should be checked to suppliers' list prices on a sample basis. Selling price will be checked to sales invoices or price lists.
- (ii) Accounts payable
The level of payables should be compared with previous years. It may be necessary to circularise accounts payable to ensure that they are not understated.
- (iii) Land and buildings
If an independent valuation has been obtained, check the basis of valuation. If the valuation is based on similar properties in the area discuss the basis with the directors. Consider obtaining a representation from the directors on the basis of the valuation.



Chapter 10

Example 1

- disagreement
- accounting policy
- material
- try to persuade the management to adjust the financial statements
- if they do, and we agree the adjustment, then no affect on audit report
- if they refuse, material disagreement ⇒ "except for"

Example 2

- possibly no effect!
- may be able to gather sufficient alternative evidence
- analytical review
- inventory records
- if there is not sufficient alternative evidence we're faced with a limitation of scope
- it could be material...
- ... or it could be pervasive
- if material, audit report would be an "except for ... might"
- if pervasive, it would be "disclaimer – unable to form an opinion"

Chapter 11

No Examples

Chapter 12

Example 1

Non-financial performance measures (any 5 of these)

- Customer rejects or sales returns
- Customer satisfaction
- Wastage
- Staff morale
- Machine down time
- Documents processed per employee

Example 2

Businesses are exposed to the following risks if their systems are unreliable:

- assets are misappropriated or tampered with.
- systems are damaged and shut down.
- data is tampered with and unauthorised amendments made.
- confidential data is stolen.



Chapter 13

Example 1

The following work would be performed:

- (i) Statement of Comprehensive Income:
 - (1) Compare the forecast sales for the year with those in past years. Any unexpected fluctuations would be discussed with the management.
 - (2) Compare the gross profit margin with that achieved in the past. Significant changes would be discussed with the management and verified to appropriate evidence such as price lists and board minutes.
 - (3) Compare the level of expenses with those in prior year. Certain expenses should be fixed and remain static. Others will vary according to sales levels. Any significant fluctuations would be investigated further.
 - (4) Check that management charges by the parent entity have been excluded.
- (ii) Statement of Financial Position:
 - (1) Check the value of tangible non-current assets to the most recent audited accounts. Additions will be discussed with the directors. Security arrangements should be checked to confirm that it is appropriate to dispose of any assets which appear as disposals in the forecast.
 - (2) Recalculate depreciation for each period and check the accounting policies against those used in previous financial statements.
 - (3) Calculate the age of inventory, accounts receivable and accounts payable and compare them with past financial statements. Any significant variations would be investigated further.

Agree the level of overdraft and loans to agreements with the banks and financial institutions.

Chapter 14

Example 1

- (i) Finance Director

It would be inappropriate for internal audit to report to the finance director, who is largely responsible for internal controls. It may be feasible for him to receive the report as well as the board. Otherwise, the internal audit function cannot be effectively independent as the finance director could suppress unfavourable reports, or could ignore the recommendations of such reports.
- (ii) Board of Directors

A high level of independence is achieved by the internal auditors if they report directly to the board. However, there may be problems with this approach.

 - (1) the members of the board may not understand all the implications of the internal audit reports when accounting or technical information is involved.
 - (2) The board may not have enough time to spend considering the reports in sufficient depth. Important recommendations might therefore remain unimplemented.

A way around these problems would be to have the audit committee deal with internal audit reports.



Example 2

- > 10%
- conflict
- loyalties
- instructions
- independence

Chapter 15**No Examples****Chapter 16****No Examples**

Paper P7

PRACTICE QUESTIONS

1. Breakpass plc

Your firm is the external auditor of Breakpass plc, which has a turnover of \$25 million and a profit before tax of \$1.7 million. The entity operates from a head office at Breakpass and has sales and inventory holding centres in different parts of the country. The directors have decided the entity has reached a size when it needs an internal audit department. As is becoming increasingly common, the directors have asked your firm to provide this service to the entity as well as being the statutory auditor of the entity's annual financial statements.

In answering the question, you should consider:

- (a) the effects of the ACCA's Rules of Professional Conduct in relation to providing an internal audit service to Breakpass;
- (b) the extent to which your audit firm can rely on the internal audit work when carrying out the statutory audit of Breakpass;
- (c) the arrangements over control of the work and reporting of the internal audit staff:
 - (i) the extent to which the internal audit staff should be responsible to Breakpass, and who should control their work;
 - (ii) the extent to which the internal audit staff should be responsible to a manager or partner of your firm, and whether the same manager and partner should be responsible for both the internal audit staff of Breakpass and the external audit.

Requirements

In relation to your audit firm becoming internal auditors of Breakpass:

- (a) **describe the matters you should consider and the action you will take to ensure your firm remains independent as external auditor of the annual financial statements;**
- (b) **describe the advantages and disadvantages to Breakpass of your firm providing an internal audit service;**
- (c) **describe the advantages and disadvantages to your audit firm of providing an internal audit service to Breakpass.**

2. Caparo

'The Caparo case and the requirement for auditors to have compulsory professional indemnity insurance will result in a lowering of the standards of audits of the financial statements of limited liability entities. Also, the requirement of the Companies Act 2006 for all auditors to be registered is creating a monopoly, which cannot be beneficial to people relying on audited financial statements.'

Note. The Caparo case is Caparo Industries plc v Dickman and Others.

Discuss whether you consider that the factors cited in the statement above will result in a lowering or raising of audit standards.



3. Cd Sales

CD Sales plc was a growth orientated entity that was dominated by its managing director, Mr A Long. The entity sold quality music systems direct to the public. A large number of sales persons were employed on a commission only basis. The music systems were sent to the sales agents who then sold them direct to the public using telephone sales techniques. The music systems were supplied to the sales agents on a sale or return basis and CD Sales plc recognised the sale of the equipment when it was received by the sales agents. Any returns of the music systems were treated as re-purchases in the period concerned.

The entity enjoyed a tremendous growth record. The main reasons for this apparent expansion were as follows:

- (a) Mr A Long falsified the sales records. He created several fictitious sales agents who were responsible for 25% of the annual turnover.
- (b) at the year end, Mr Long despatched nearly all of his stock of music systems to the sales agents and re-purchased those that they wished to return after the year end.
- (c) 20% of the cost of sales were capitalised. This was achieved by the falsification of purchase invoices with the co-operation of a supplier. Suppliers furnished CD Sales with invoices for tangible non-current assets but supplied music systems.
- (d) the directors of the entity enjoyed a bonus plan linked to reported profits. Executives could earn bonuses ranging from 50% to 75% of their basic salaries. The directors did not query the unusually rapid growth of the entity, and were unaware of the fraud perpetrated by Mr A Long.

Mr A Long spent large sums of money in creating false records and paying accomplices in order to conceal the fraud from the auditors. He insisted that the auditor should sign a 'confidentiality' agreement which effectively prevented the auditor from confirming sales with independent third parties, and from examining the service contracts of the directors. This agreement had the effect of preventing the auditors from discussing the affairs of the entity with the sales agents.

The fraud was discovered when a disgruntled director wrote an anonymous letter to the Stock Exchange concerning the reasons for CD Sales plc's growth. The auditors were subsequently sued by a major bank that had granted a loan to CD Sales plc on the basis of interim financial statements. These financial statements had been reviewed by the auditors and a review report issued.

- (a) **Explain the key audit tests which would normally ensure that such a fraud as that carried out by Mr A Long would be detected.**
- (b) **Discuss the implications of the signing of the 'confidentiality' agreement by the auditors.**
- (c) **Explain how the 'review report' issued by the auditors on the interim financial statements differs in terms of its level of assurance from the auditors' report on the year end financial statements.**
- (d) **Discuss whether you feel that the auditors are guilty of professional negligence in not detecting the fraud.**



4. Audit Risk Assessment

Your firm has recently been approached by the finance director of an entity which is considering whether it should change its auditors. The finance director heard about your firm from a business associate. The manager who spoke to the finance director has asked you to help him to assess whether the entity would be a suitable client for your firm.

- (a) **Explain the information you would seek to enable you to reach a conclusion as to the suitability of the potential client.**
- (b) **Explain the factors you would take into account when assessing the level of risk associated with the potential client before deciding whether to accept it as a client.**
- (c) **Summarise the general steps your firm could take to mitigate audit risk on this assignment once the client has been accepted.**

5. • Gasoleum Ltd

Your firm is the auditor of Gasoleum Ltd which operates 15 petrol stations in and around London. You are the senior in charge of the audit for the year ending 31 January 2010, and are engaged on the audit planning.

- Most of the entity's sites are long established and, as well as supplying fuel, oil, air and water, have a car wash and a shop.

Over the last few years, due to the intense price competition in petrol retailing, the shops have been expanded into mini-markets with a wide range of motor accessories, food, drinks and household products. They also sell National Lottery tickets.

Point-of-sale microcomputers are installed in all the petrol stations, linked on-line via a network to the computer at head office. Sales and inventory data are input direct from the microcomputers.

The entity has an internal auditor, whose group function is to monitor continuously and test the operation of internal controls throughout the organisation. The internal auditor will also be responsible for co-ordinating the year-end inventory count.

Prepare notes for a planning meeting with the audit partner which:

- (a) **identify areas of potential risk which will have to be addressed by the audit;**
- (b) **describe the extent to which the work performed by the internal auditor may affect your planning, and the factors that could limit the use you may wish to make of his work; and**
- (c) **detail the analytical review procedures that you would adopt to obtain audit evidence on income and gross profit as part of your substantive testing.**



6. Opening Balances

You have recently been appointed auditor of Lowdham Casting Ltd, an entity which has been trading for about thirty years, and are carrying out the audit for the year ended 30 September 2010. The entity's turnover is about \$1,500,000 and its normal profit before tax is about \$130,000.

- (a) **Discuss your responsibilities in relation to the corresponding amounts included in the financial statements for the year ended 30 September 2010. You should also consider the information you would require from the retiring auditor.**
- (b) **In October 2009 one of the entity's customers went into liquidation and the debt of \$130,000, which is material, is considered irrecoverable. No provision for this debt was included in the financial statements for the year ended 30 September 2009. What audit work should you perform to enable you to decide whether a provision should have been made for this amount in the financial statements for the year ended 30 September 2009?**
- (c) **You have been informed by the retiring auditors that they did not attend the inventory count at 30 September 2009 and you have come to the conclusion that the value of inventory at that date may be materially misstated. Discuss the effect that this would have on your audit report on the financial statements for the year ended 30 September 2010. You should also state the effect that this error has on the Statement of Comprehensive Income and Statement of Financial Position.**

7. Verity

Verity plc has a credit facility with Cranley Bank of \$6 million. The facility is due to expire on 31 December 2010. The overdraft in the recently audited Statement of Financial Position at 30 September 2010 is \$5.5 million. The directors of Verity plc have started negotiations with their bankers for a renewal of the facility and to increase the amount to \$9 million. To support this request the bank has asked Verity plc to provide a business plan for the coming 12 months consisting of a cash flow forecast supported by a forecast Statement of Comprehensive Income and Statement of Financial Position. The management of Verity plc has produced a cash flow forecast for the period 1 October 2010 to 30 September 2011 and, at the request of the bank, have asked their auditors to examine and report on it.

The audit manager, who has recently completed Verity plc's audit, has been asked to make a preliminary examination of the cash flow forecast and supporting material and she has noted the following observations.

- (a) The cash flows from sales are based on the assumption of an overall increase in sales of 24% compared with the previous financial year. Analysis shows that this is based on an increase in selling price of 5% and an increase in the volume of sales of 18%. Just over a quarter of all Verity plc's sales are made to overseas customers.
- (b) The cost of sales in the recently audited Statement of Comprehensive Income to 30 September 2010 was 80% of sales revenue, giving a gross profit of 20%. In the forecast Statement of Comprehensive Income for the year to 30 September 2011 the cost of sales has fallen to 72%, giving a gross profit of 28%. Manufacturing costs are made up of approximately one third each of materials, labour and production overheads.
- (c) The accounts receivable collection period used in the forecast cash flow to 30 September 2011 is 61 days. In the year to 30 September 2010 this period averaged 93 days. Management has stated that it is its intention to inform all customers of a new standard 60 day credit period. In addition an early settlement discount of 1% will apply to customers who settle their account within 30 days of the statement.



Conversely the credit period for trade payables has been extended from an average of 45 days in the current year to 90 days in the forecast.

- (d) The forecast cash flow showed that the maximum credit required during the period would rise to nearly \$9 million in August 2011.

(a) **Describe the general matters an auditor should consider before accepting an engagement as a reporting accountant on forecast financial information.**

(b) **Detail the procedures that the reporting accountant should undertake in relation to the cash flow forecast of Verity plc for the year to 30 September 2011.**

(c) The negotiations with Cranley Bank resulted in a renewal of Verity plc's existing credit facility of \$6 million, but the bank would not agree to increase it to \$9 million. As a result of this Verity plc issued a circular to its existing shareholders inviting them to subscribe for a new \$3 million issue of debentures. The purpose of the circular was to show the intended use and the future benefits from the debenture issue. It was supported by the same forecast financial information, including the accountant's report, that had been provided to Cranley Bank. However the directors of Verity plc had removed all references to its original purpose and restricted distribution.

The trading results of the first half of the year to 30 September 2011 showed that the forecast information was proving to be over optimistic and that Verity plc was beginning to experience cash flow difficulties.

Discuss the basis on which a reporting accountant should form an opinion on forecast information, and consider whether the reporting accountants of Verity plc may be liable to:

(i) **Cranley Bank; and**

(ii) **the investors who subscribe for the new debentures.**

Note. You are to assume that the accountant's report had expressed an unqualified opinion on the statement of cash flow.



8. Haskins Ltd

You are in charge of the audit of Haskins Ltd, an advertising agency with two subsidiaries, for the year ended 31 July 2010.

During the course of the audit you have ascertained the following information which is considered material:

- (1) Non-current asset investments include \$500,000 in respect of the cost of a 20% holding in Telpro Ltd, a small television programme production entity. The investment was made on the incorporation of Telpro on 15 September 2009. Telpro Ltd's loss for the period ended 31 July 2010 was \$220,000.
- (2) During the year, Haskins demolished some store rooms in its offices and converted the space into a 30-seat high technology theatre for making presentations to clients. The costs of rebuilding and equipping the area have been capitalised to buildings, \$110,000, and plant and machinery, \$250,000. Depreciation has been provided at the standard rates of 2% and 20% respectively.
- (3) Accounts payable include \$180,000 in respect of payments received on account. This represents the initial fee from a client in Spain on a contract for an advertising campaign to be mounted during August and September 2010.

State the matters you would consider, and the evidence you would seek, in order to reach a conclusion on the accounting treatment of the above items in the financial statements of Haskins Ltd for the year ended 31 July 2010.

9. Tern Limited

Described below are situations which have arisen in three audits. The year end in each case is 30 September 2010.

- (1) Tern Ltd provided a bridging loan of \$50,000 for one of its directors in July 2010. The loan was repaid, with interest, in August 2010. The directors refuse to disclose the loan in the financial statements in view of its sensitive nature.

The pre-tax profits of Tern Ltd for the year ended 30 September 2010 were \$350,000 and the net assets at 30 September 2010 amounted to \$3 million.

- (2) Auk Ltd was notified that a receiver was appointed on 10 October 2010 at Kite Ltd, a customer with a balance outstanding of \$14,500. The directors refuse to make a provision for the debt on the grounds that the receiver was appointed after the Statement of Financial Position date.

The pre-tax profits of Auk for the year ended 30 September 2010 were \$840,000 and accounts receivable at 30 September 2010 amounted to \$4 million.

- (3) Egret Ltd has not provided for depreciation on its freehold buildings as the directors consider that the current market value is in excess of net book value. You estimate that depreciation for the year of \$25,000 should be charged.

The pre-tax profits of Egret Ltd for the year ended 30 September 2010 were \$250,000 and tangible non-current assets at 30 September 2010 amounted to \$2.5 million.

- (a) **State what is meant by, and explain, the relationship between the concepts of**

- (i) **materiality; and**
- (ii) **true and fair.**

- (b) **Discuss briefly each of the situations outlined above, referring to materiality considerations and where appropriate, relevant accounting principles. For each situation state, with reasons, what kind of audit qualification (if any) would be appropriate.**



Paper P7

PRACTICE ANSWERS

1. Breakpass

- (a) The auditors should consider the following factors when assessing their independence.
- (i) The level of fee income from Breakpass should not exceed 15% of the practice's total income. If Breakpass is listed, the fees should not exceed 10%.
 - (ii) The non-audit fees received by the audit firm should be disclosed in Breakpass's financial statements.
 - (iii) As external auditors, the firm will be reviewing the work of internal audit; if the same staff were acting as external and internal auditors, they would be judging their own work. This obvious threat to objectivity can be lessened by different staff carrying out the detailed work, and different partners and managers being in charge of providing both services.
 - (iv) There is a specific threat to independence if preparing Breakpass's financial statements is part of the desired internal audit service. If Breakpass is a listed entity, the audit firm's staff should not be involved in preparing the financial accounting records unless their work is of a mechanical nature. Even if Breakpass is not listed, it must still accept responsibility for its financial statements and accounting records, and the practice must carry out sufficient audit work on the records.
 - (v) Similarly there is a threat to independence if the internal auditors become involved in the management of the entity because, as external auditors, the audit firm is reporting on the stewardship of management. However part of the internal audit service could be making recommendations about the design of systems and controls. The audit firm should thus ensure that the directors take responsibility for implementation of any recommendations, and their decisions are clearly recorded in board minutes.
 - (vi) Internal audit staff may be particularly likely to breach other independence guidelines that are applicable to them as employees of the firm carrying out the external audit. They should be reminded that they should not own shares in the client, accept a loan from the client, or obtain goods or services on more favourable terms than are offered to Breakpass's own staff.
 - (vii) If Breakpass fails to pay fees, there may be a greater danger of the amounts owing being similar to a loan because of their size and because they are amounts owed for a continuing service rather than an annual audit.
 - (viii) The engagement letter should set out clearly the respective responsibilities of the audit firm and Breakpass. It should separately identify the work that the audit firm should carry out as external and internal auditors, and how fees will be calculated for each service. It should make clear to whom the audit firm's internal audit team will report.
 - (ix) The firm should consider as part of its annual review of independence whether it is still sufficiently independent to be able to continue to act as external auditors.
- (b) The advantages for Breakpass of having the external auditors provide internal audit services are as follows:
- (i) The audit staff will be qualified or partly qualified accountants who are subject to professional standards and guidelines.
 - (ii) Training costs will be saved as the audit firm, not Breakpass, will be responsible for staff training.



- (iii) The audit firm may be able to provide a range of expertise which would not be available to Breakpass without incurring considerable extra costs.
- (iv) The efficiency of external audit would be enhanced, and hence its costs lowered, because internal auditors are using the same procedures to record and assess systems. Therefore external auditors would not have to spend time checking whether appropriate work has been performed.

The disadvantages for Breakpass of using the internal auditors are as follows.

- (i) Breakpass may want to use internal audit for a variety of tasks on the non-financial areas of its business, and the audit firm may not have staff with the expertise necessary in these areas.
- (ii) The ACCA's independence requirements place limitations on the work that the internal auditors can carry out as a result of their firm also acting as external auditors.
- (iii) The audit firm may not be able to guarantee continuity of internal audit staff. There may be regular staff changes as staff leave or are involved in other work, and the learning curve for new staff may add to the costs of internal audit.
- (iv) The audit firm may not be able to provide the staff that Breakpass wants at the time Breakpass needs them because of commitments to other clients.
- (v) The costs of the audit firm's staff will be higher than if Breakpass employed its own internal audit staff, because the audit firm will be charging Breakpass a mark-up on the staff's time as well as their salaries.
- (vi) There may be conflicts over the reporting arrangements for internal audit staff. Breakpass would want to maintain control over their activities, but there has to be a mechanism for reporting to the audit firm as well, because the external firm is responsible for the staff's professional development and hence will need to assess how staff have performed.

(c) The advantages for the audit firm of carrying out both the internal and external audit are as follows.

- (i) The audit firm will be able to gain greater assurance from their own staff's work as internal auditors than they are likely to be able to gain if the internal audit staff were employed by Breakpass. The firm will know that its staff have the necessary levels of competence and independence. It will also not have to spend time assessing the methods used to record and evaluate controls.
- (ii) The extent of the work done by internal audit is likely to go beyond that necessary to support an external audit opinion, so the firm will have more evidence available than it would aim to have if it was just carrying out an external audit.
- (iii) Working on a variety of internal audit tasks will enhance the professional development of the audit staff concerned.
- (iv) The internal audit work might be able to be carried out at times of the year when the amount of other work is low, and thus staff will be used more efficiently.
- (v) There will clearly be an increase in the firm's fee income

The disadvantages for the firm of carrying out both services are as follows.

- (i) The firm may have problems exercising control over the internal audit staff, because of their responsibility to report to the client.
- (ii) Problems over the internal audit work may jeopardise the firm's role as external auditors.

The potential problems discussed in (a) in guaranteeing independence may prove insurmountable.



2. Caparo

Implications of Caparo

The decision in the Caparo case limited the extent of auditors' potential liability to third parties. The conclusion by the Law Lords was that, whilst the auditors owed a duty of care to the members of the entity as a body, no duty was owed to existing or potential investors who relied on the financial statements for the purposes of an investment decision.

Hence the decision in this case, whilst limiting auditors' liability to a wide range of third parties who may wish to rely on financial statements, does not lessen the auditors' duty to use skill and care because they are still fully liable for negligence to the entities they audit and the shareholders as a body.

Indemnity assurance

The purpose of requiring auditors to have compulsory profession indemnity insurance is to ensure that where a claim for negligence is successful against the auditor, there is the likelihood of the claimant being paid the damages awarded to him without endangering the continuation of the audit firm in business (assuming the claim falls within the insurance limit). Whilst it might appear that the existence of such insurance may result in a lowering of standards as the auditors can be confident that any negligence claims will be met, the following considerations would prevent this.

- (i) the auditors' reputation will suffer if they are found liable for a succession of claims.
- (ii) their insurance premiums would rise substantially and ultimately they might find it impossible to obtain cover so forcing them out of business.

3. Cd Sales

- (a) There are various key audit procedures which would have uncovered the fraud perpetrated by Mr A Long. Note that the first two tests would bring to the attention of the auditors the substantial inherent and control risk surrounding the financial statements of CD Sales, thus increasing their perceived audit risk, and putting them on their guard.

Analytical review

The auditors should perform analytical procedures in order to compare the entity's results with those of other entities in the same business sector. In particular, the auditors should look at sales growth rates and gross profit margins, but also inventory levels, tangible non-current assets and return on capital. This should indicate that the entity's results are unusual for the sector, to a great extent.

Review of service contracts

The auditors should examine the directors' service contracts. It is unusual for all directors to be paid such substantial bonuses, although the payment of bonuses of some sort to directors is common business practice. It is the size of the bonuses in proportion to the directors' basic salaries which is the problem here. It increases both the inherent and control risk for the auditors because it reduces the directors' objectivity about the performance of the entity. Audit risk is thus increased.

Testing of sales, purchases and inventory

- (i) The main audit test to obtain audit evidence for sales would be to require direct confirmations from the sales agents. These confirmations would also provide evidence for the balance owed to CD Sales at the year end and the inventory held by the agent at the year end. Replies to such confirmations should be sent direct to the auditors who would agree the details to the entity's records or reconcile any differences. Where replies are not received alternative procedures would be carried out which might include visits to the agents themselves to examine their records.



- (ii) A selection of agents should, in any case, be visited at the year end to confirm the inventory held on sale or return by physical verification. The auditors should count such inventory and consider such matters as obsolescence and damage.
- (iii) Fictitious agents might be discovered by either of tests (i) and (ii), but a further specific procedure would be to check authorisation of, and contracts with, all the sales agents. Correspondence could also be reviewed from agents throughout the year.
- (iv) The practice of 'selling' all the inventory to the agents and then repurchasing it after the year end should be detected by sales and purchases cut-off tests around the year end. All transactions involving inventory items returned after the year end should be examined.

Testing of tangible non-current assets

Tangible non-current asset testing should help to identify inventory purchases which have been invoiced as tangible non-current assets.

- (i) Samples of additions to tangible non-current assets can be checked to the tangible non-current asset register and to the asset itself.
- (ii) Physical verification will ensure that an asset is being used for the purpose specified, and this should be relatively straightforward to check as the computers will each have individual identification codes.
- (iii) Where the assets cannot be found, then it may be possible to trace the asset to inventory, perhaps via the selling agents' confirmations, or to sales already made.

Related parties review

The level of collusion with suppliers makes detection of fraud difficult, but the auditors may be put on their guard if they discover that the suppliers are related parties to CD Sales plc. A related party review would normally take place as part of an audit.

- (b) The type of 'confidentiality agreement' signed by the auditors of CD Sales plc has reduced the scope of the audit to such an extent that it has become almost meaningless.

While it is understandable that entities would wish to protect sensitive commercial information, the auditors have the right to any information they feel is necessary in the performance of their duties. This agreement clearly circumvents that right. Moreover, such information would still be protected if released to the auditors, because the auditors themselves are under a duty of confidentiality to their client.

In reducing the scope of the audit to this extent, the agreement prevents the auditors obtaining sufficient appropriate evidence to support an audit opinion. The audit report should therefore be qualified on the grounds of limitation of scope, possibly to the extent of a full disclaimer.

In failing to issue such a qualification, the auditors may well have acted negligently and even unlawfully in signing such an agreement.

- (c) A review of interim financial statements is very different from an audit of year end financial statements. In an audit report a positive assurance is given on the truth and fairness of the financial statements. The level of audit work will be commensurate with the level of the assurance given, that is it will be stringent, testing the systems producing the financial statements and the year end figures themselves using a variety of appropriate procedures.

In the case of a review of interim financial statements, the auditors are giving only a negative assurance, that they have not found any indication that the interim financial statements are materially misstated. The level of audit work will be much less penetrating, varied and detailed than in a full audit. The main audit tools used to obtain evidence will be analytical procedures and direct enquiries of the entity's directors.

- (d) It is not the duty of the auditors to prevent or detect fraud. The auditors should, however, conduct their audit in such a way that they expect to detect any material misstatements in the financial statements, whether caused by fraud, error or other irregularity. At the planning stage, the auditors should assess the risk that fraud is occurring and plan their procedures



accordingly. Where fraud is suspected or likely, the auditors should carry out additional procedures in order to confirm or deny this suspicion.

Even if a fraud is uncovered after an audit, the auditors will have a defence against a negligence claim if they can show that they followed auditing standards and that at no time did they have any indication that a fraud was taking place.

Application of principles to this case

In this particular case, Mr A Long has taken a great deal of trouble to cover up his fraudulent activities, using accomplices, bribing people and creating fictitious documents. When such a high level fraud is carried out, the auditors might find it extremely difficult to uncover the true situation or even to realise anything was wrong. The auditors are also entitled to accept the truth of representations made to them and documents shown to them which purport to come from third parties.

On the other hand, the auditors should have a healthy degree of professional scepticism. They should be aware of the risks pertaining to the entity and they should recognise that controls can be overridden by collusion or by management actions. The suspicions of the auditors should have been aroused by the rapid growth rate of the entity and fairly standard audit procedures on cut-off and tangible non-current assets should have raised matters which required explanation.

Where the auditors have been most culpable, however, is in signing the confidentiality agreement. This restricted the scope of the audit to such an extent that the auditors should have known that they had insufficient evidence to support their opinion. The auditors will therefore find it difficult to defend a negligence claim successfully.

4. Audit Risk Assessment

(a) Information needed to reach a conclusion on the suitability of a potential client

- Details of the industry that the client is involved in.
- Do we audit any other clients in the same industry/markets that may cause conflicts of interest?
- Do any partners or staff hold shares in the entity?
- Do any partners or staff have personal relationships with the entity that would preclude them from acting on the audit?
- Do we have the necessary skilled staff with experience in the same industry as the potential client?
- Where is the client located and how many offices do they have?
- Are the most recent financial statements qualified?
- Size of the client.
- When is the year end?

(b) Factors to take into account re level of risk

The following factors should be taken into account with respect to the level of risk associated with the potential client before deciding whether to accept it as a client:

- Who are the management and shareholders? If they are of good reputation, the client is likely to be lower risk.
- Were the most recent financial statements qualified in any respect?
- Is the entity quoted on any stock exchange? Listed entities are subject to more scrutiny and are therefore higher risk clients.
- What industry/market is the client involved in and what are the inherent risks in that industry?



- Why is the entity wishing to change its current auditors?
- Disagreement on accounting policies?
- Level of fees?
- Growing too large for their current auditors?
- How long the entity has been in existence?
- The financial standing of the entity.
- Whether the entity is part of a group or not
- Reporting deadlines. Tight deadlines increase audit risk unless they are well managed.
- Level of controls within the business

(c) General steps to mitigate audit risk

Steps that could be taken include:

- Attempt to book staff with experience in client's industry to ensure detection risk is reduced.
- Perform thorough planning prior to the commencement of the audit, focusing on points raised in the most recent report to management.
- Review engagement letter annually to ensure that responsibilities are clearly defined.
- Plan for early pre year-end visit if possible to document and evaluate systems and do preliminary analytical review to identify areas of risk.
- Audit plan to be approved in writing by reporting partner before work commences.
- All work needs to be adequately supervised and reviewed by senior staff.
- Perform an annual review of the client taking into account their financial viability and level of risk to decide whether to accept re-appointment

5. Gasoleum

(a) Areas of potential risk to be addressed by the audit

Income

A substantial proportion of sales made at the stations will be cash based therefore making completeness of income difficult to establish.

Sales records are updated via an on-line computer ie records are updated automatically and instantly. Any weakness in the operation of the computer be it manual input or systematic error will directly impact income. The key risk is however weak control over manual input.

Income could be missed via weak controls over the sale of car wash and air tokens.

Misclassification of income would render management financial statements meaningless for analytical review purposes.

Inventory

The nature of inventory ie petrol requires an unusual method to quantify - dipping of tanks. This increases the risk that the value is inaccurate.

All goods within the mini markets are potentially desirable to both staff and customers. They are also easily moveable and thus inventory losses could occur. If this remains undetected, year-end inventory and thus profit will be overstated.

Goods are also perishable. There is therefore a risk of inventory valuation being overstated where no provision/write off is made.

National lottery outlet

There is a potential risk that income from sales of tickets is inappropriately included within the entity's income.

Outlets receive commission per ticket sold. There is a risk of inappropriate classification and also overstatement if weak controls exist over the handling and storage of lottery tickets.



Inherent risk due to price competition

Intense price competition could significantly reduce margins which could in turn lead to management manipulation of financial information ie potential overstatement of income and understatement of expenses.

Multi-locations

With there being 15 service stations to audit, there is increased risk of not detecting error as it is more complicated to control and co-ordinate the audit.

- (b) The work performed by the internal auditor would impact planning to the extent that:
- (1) The results of his work on the entity's internal controls during the year could reduce the risk attached to particular parts of the audit and thus reduce the extent of our detailed testing on it.
For instance, evidence that the microcomputer has operated satisfactorily during the year would provide us with increased assurance as to the completeness and accuracy of both income and inventory records and thus allow a modification in the nature, timing and extent of our work. This is obviously only the case if the audit work was done thoroughly and competently.
 - (2) Once we have determined that his work can be relied upon, the knowledge that he was responsible for co-ordinating the year-end inventory count would again increase our confidence in inventory quantity figures, provided we are satisfied that he is suitably independent of the service station personnel and of the normal inventory control procedures.

Before deciding to make use of his work we would first need to establish its relevance and the reliability.

Relevance – has he been engaged in projects whose results are of interest to us. Given what we have been told about his duties it would appear that we have some common objectives.

Reliability – his work is ultimately only reliable provided he is competent at what he does, carries out his work with due professional care and is suitably independent.

Once these have been determined, other factors would also need to be considered:

- (1) Do management within the entity act upon the results of his work?
- (2) The materiality of the area would need to be ascertained. For instance any work on the controls surrounding the sale of car wash and air tokens could reduce our testing to just a review of his working papers, whereas work on the operation of the on-line micro computers would give us confidence but not negate the need for some systems work to be done by our computer audit department.

- (c) Analytical procedures on income and GP margin:

Income

- (1) Obtain an analysis of income per petrol station and perform inter-branch comparisons to identify any branch with unusually high/low total income.
- (2) Obtain an analysis of income per source for each station and again carry out inter-branch comparisons to identify any branch with an unusual mix/split of income.
- (3) Compare income per source and per branch to last year. Are changes in line with our expectations and industry norms?
- (4) Obtain management financial statements and do a month by month review of sales comparing with both previous years and other branches.
- (5) For all the above we need to discuss fluctuations with management, follow up any discrepancies and confirm any statements made by the directors.

Gross profit

- (1) Perform a comparison of gross profit percentage per station.
- (2) Compare gross profit percentage this year to last year and against budget.



- (3) Review aged inventory analysis between this year and last for slow moving products, to identify any overstatement of closing inventory and thus gross profit.
- (4) Compare percentage of inventory written off after inventory counts branch by branch and investigate branches with low gross profit percentages.
- (5) Compare margins on petrol to industry norms.
- (6) Consider the impact that fluctuations in oil prices would have on profits made.
- (7) Again, for all of the above we would need to discuss fluctuations, follow up any discrepancies and confirm any statements made.

6. Opening Balances

- (a) Consideration of the financial statements of the preceding period is necessary in the audit of the current period's financial statements in relation to three main aspects.
 - (i) Opening position. Obtaining satisfaction that those amounts which have a direct affect on the current period's results or closing position have been properly brought forward.
 - (ii) Accounting policies. Determining whether the accounting policies adopted for the current period are consistent with those of the previous period.
 - (iii) Comparatives. Determining that the corresponding amounts are properly shown in the current period's financial statements.

The auditor's main concern will therefore be to satisfy himself that there were no material misstatements in the previous year's financial statements which may have a bearing upon his work in the current year.

The new auditor does not have to 're-audit' the previous year's financial statements, but he will have to pay more attention to them than would normally be the case where he had himself been the auditor in the earlier period. A useful source of audit evidence will clearly be the previous auditor and, with the client's permission, he should be contacted to see if he is prepared to co-operate. Certainly, any known areas of weakness should be discussed with the previous auditors and it is also possible that they might be prepared to provide copies of their working papers (although there is no legal or ethical provision which requires the previous auditor to co-operate in this way).

- (b) To decide whether the debt in question should have been treated as an adjusting event and provided for in last year's financial statements it would be necessary to consider what proportion of the debt was outstanding at 30 September 2009 and whether or not, at that date, the liquidation of the customer could have been foreseen. The details of the balance could be ascertained by examining the customer's ledger account and the likelihood of a bad debt materialising could be considered by studying both the way in which the account had been conducted and also any correspondence between the entity and the customer. Any part of the debt which arose after the year end should be dealt with in the current period although if material, as seems likely, it should have been detailed by way of note as a non-adjusting event.
- (c) If the closing inventory figure at 30 September 2009 was materially misstated, it would affect both this year's and last year's financial statements. The new auditor would need to qualify his report on the current year's financial statements on the grounds of a limitation of scope. It is probable that the qualification would be seen as material but not pervasive, and so an 'except for' rather than a 'disclaimer' of opinion is likely to be appropriate. The qualification should detail the nature of the uncertainty and its cause, and indicate that it would affect the reported profits of both this year and the previous year.



7. Verity

(a) The factors that will affect the accountants' decision on whether to accept appointment are as follows:

- (i) Previous experience of client
The accountants should draw on their knowledge of the client as gained during the audit. In particular they will be interested in the willingness of the client to provide information, the integrity and knowledge of the directors, and the reliability of the forecasts prepared for financial accounting purposes, for example in the assessment of going concern or deferred tax.
- (ii) How prepared
The accountants will need to consider how the forecast is being prepared, in particular:
 - (1) how the forecast was compiled, and the staff who compiled it;
 - (2) the extent to which the forecast is based on assumptions consistent with past events. The details given suggest that a more optimistic view is being taken than is warranted by the entity's record in recent years;
 - (3) whether the forecast represents management's best estimate of achievable results, or whether it represents hopeful targets or is based on certain hypothetical events taking place;
 - (4) how the forecast takes account of factors which may invalidate the assumptions made;
 - (5) the level of detail available supporting the forecast,
- (iii) Terms of report
The accountants will need to consider the exact terms within which they are reporting, as this could have a bearing on their liability. This is discussed further in (c) below.
- (iv) Users
The accountants should consider carefully the use to which the report will be put, and potential users.

(b) A major concern of the reporting accountant will be the assumptions on which the report is based. The level of evidence required will depend on the terms of the accountants' report, but some evidence will be required on the major assumptions made in the forecast.

- (i) Sales
It might be expected that the price increase would result in some lost sales, so extra sales will be needed from other customers to make up for the sales lost as well as achieving the planned increase. The auditors will need to focus on the plans to achieve that increase. Increases might be a result of a change in the sales mix or new products or customers; if these changes have already occurred, the accountants should consider what effect they have already had. Increased marketing and promotional activity may also be necessary, and this would need to occur rapidly in order to achieve the desired effect. This activity will probably be reflected in increased costs, and the accountants will need to check that these have been included in the forecast.
- (ii) Cost of sales
The accountants will need to consider whether economies have been planned to improve margins, whether these economies are likely to be achieved, and whether there will be consequential other costs that need to be reflected in the plan. For example reduction in the labour force is likely to mean redundancy costs, and investment in more up-to-date plant and machinery will involve capital investment costs.
- (iii) Accounts receivable
The accountants should consider whether the decrease in settlement period is likely to be achieved. They should consider whether emphasising new credit limits and prompt settlement discounts will help achieve the required target, and also the effectiveness of



any other measures the entity takes, for example tighter checks on new customers and more rigorous pursuit of slow payers. In particular the accountants will need to review the position of overseas customers, as they may be less flexible in reducing settlement periods. The accountants should also check that the consequences of the prompt settlement discount, a reduction in amounts received, have been reflected in the forecast. For overseas customers, the accountants should also check that any exchange rate effects have been reflected in the forecast.

(iv) Accounts payable

The accountants should check that the increase in creditor days will not breach terms of business with suppliers, leading to possible supply problems or withdrawal of credit terms and demands for immediate cash payments. They should also check that the forecast reflects other possible consequences of the increase, for example a loss of early settlement discounts.

(v) Maximum finance

The accountants should check whether the estimated increase in finance is reasonable or whether other sources will be required, either because the \$9 million is an underestimate or because other existing sources of finance will need to be repaid. The accountants should check that the consequences of the increase, particularly an increased interest burden, have been reflected. They should consider also whether the forecast shows that the entity will be able to make the repayments comfortably, or whether the forecast margins are tight.

The accountants should also check that the forecast is internally consistent, for example that increased sales correspond with increased purchases, and reflects all non-trading cash flows. Consistency with forecasts made for other purposes, for example management accounting budgets, should also be checked.

(c) Liability will depend partly on the following general factors.

Extent of assurance

In this assignment accountants are focusing on uncertain future events, as opposed to an audit, where the report is based on verification of data relating to past events. Therefore the level of assurance that can be given on this type of report is lower.

The exact level of assurance will depend on the form of the opinion given. A common form of reporting is for accountants to report whether the forecast has been properly compiled on the basis of the stated assumptions, the financial statements and records, and other information known to the accountants. The report may state that nothing has come to the accountants' attention to suggest that the assumptions and forecast are unrealistic. The accountants may go further and make a positive report on the assumptions or, less probably, give a report on the achievability of the forecasts. If the report gives more positive assurance, this may increase the expectations of the report's readers as to the assurance given.

Other report issues

Whatever the exact terms of their opinion, the accountants should mention other matters in their report that will clarify for users what the accountants have done and hence what they are offering:

- (i) the accountants should state why and for whom the report is being prepared;
- (ii) reference should be made to the work done, and whether the work has been done in accordance with any published standards;
- (iii) the report should state that the directors are responsible for the assumptions made;
- (iv) the accountants may be able to include specific disclaimers on the assumptions made and achievability of the forecasts. Even if they do not, they should make a statement about the uncertainty of the forecast, and the probability that the actual outcomes will differ from what is predicted.



Cranley Bank

The accountants were on notice that the forecast was being prepared for the purposes of the bank, and thus the degree of proximity that the law relating to professional liability requires has been established. If a claim arises, the courts will consider whether the forecast was properly prepared and based on reasonable assumptions that took account of the information that should have been known at the time of the forecast. If it was not, the court would then consider whether the accountants should have drawn the conclusion that they did or allowed themselves to provide some degree of implicit assurance on the forecast because of their association with it.

Certainly some of the assumptions made would appear to be doubtful and the bank may have a case against the accountants. However if the entity fails to meet the forecast, it may well be difficult to assess how much this was due to factors that could have been predicted, and how much it was due to factors that could not have been forecast when the forecast was made.

The debenture holders

The accountants will probably not be liable to the debenture holders, The accountants stated in their report that it was prepared solely for the bank. The fact that the directors omitted this statement makes no difference to the accountants' liability, although it may render the directors liable. In addition had the report been prepared for the purposes of obtaining debenture finance it would have been prepared on different assumptions.



8. Haskins Ltd

MATTERS TO CONSIDER

PROCEDURES

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|--|---|
| <p>(1) Whether the cost of \$500,000 is correct.</p> <p>Whether the holding is 20% and the entity benefits from it</p> <p>Whether there has been an impairment in the value of the investment</p> | <ul style="list-style-type: none"> – Agree the values to the relevant contract, bank statements and shares certificates – Review share certificates for details of the investment held. – Review the register of members to confirm that Haskins owns the shares. – Request a copy of the latest audited financial statements of Telpro Ltd to establish the most recent net asset value of the entity. – Review the period subsequent to the date of the Statement of Financial Position to establish the latest information about Telpro Ltd's financial position and future. – Discuss with the directors the future plans and prospects of Telpro Ltd. – If necessary obtain written representations from management to support the financial statement values and disclosures. |
| <p>(2) Whether the costs are completely and accurately recorded</p> <p>Whether the theatre and equipment exists</p> <p>Whether the equipment and theatre are included at an appropriate valuation in the financial statements.</p> | <ul style="list-style-type: none"> – Obtain an analysis of the rebuilding and equipping costs of \$110,000. – Agree key elements of the expenditure to contractor bills and invoices. Trace payments to bank statements. – Ensure costs relate to the construction of the theatre through invoice review. Check that any revenue expenditure is written off to the Statement of Comprehensive Income. – Physically inspect the theatre and the equipment. – Ascertain the depreciation policy and check it is consistent with the policy used on similar assets. – Recalculate this period's depreciation charge. – Review the guarantee period for the equipment to gain some indication of useful life. – Review the value of insurance cover to gain some evidence of valuation. Investigate any significant differences between this and the value in the financial statements. |



- | | |
|--|---|
| (3) Whether \$180,000 is accurately recorded | <ul style="list-style-type: none"> – Trace \$180,000 to bank statements and sales invoices. – Recalculate the translation from euros to dollars |
| Whether the monies are in relation to a future campaign | <ul style="list-style-type: none"> – Review the details of the sales invoice for description of services to be provided |
| Whether any of the monies should have been included in this period's Statement of Comprehensive Income | <ul style="list-style-type: none"> – Discuss with management the extent of work completed up to the 31st July 2010 in relation to this campaign. – Consider if some of the income relates to this period. |
| Whether the campaign has taken place | <ul style="list-style-type: none"> – Review the period subsequent to the Statement of Financial Position date to determine if the campaign has gone ahead as planned. |
| Whether payment in advance is normal practice | <ul style="list-style-type: none"> – Discuss with management the reasons for the advance payment – Consider similar transactions in the past and how they were treated. – Compare the policy to industry norms to assess reasonableness. |

9. Tern Limited

- (a) When conducting an audit, the auditor will have regard to the concepts of materiality and truth and fairness.

Materiality

The auditor must be concerned with identifying material errors and omissions when planning an audit.

A matter is material if its inclusion, omission or misstatement would reasonably influence the decisions of a user of the financial statements.

True and Fair

This is a legal term. UK law states that the auditor's report must include an opinion on whether a true and fair view of the financial statements has been presented by the directors. The phrase is not defined by statute but can be interpreted as follows:

True

Information is not false but factual and conforming with reality. In addition the information conforms with required standards and law. In practical terms the financial statements have been correctly extracted from the books and records.

Fair

Information is free from discrimination and bias and in compliance with expected standards and rules. Practically the financial statements should reflect the commercial substance of the entity's underlying transactions.

The two concepts are necessarily interrelated. The concept of truth and fairness is invoked only when material issues arise. Matters which are not material (whether by nature or amount) have no impact on the truth and fairness.



(b) Tern Ltd

Situation/Materiality Considerations	Relevant accounting and legal principles	Audit Qualifications/Reasons
<p>The directors refuse to disclose a bridging loan to a director, as required by UK law. Materiality in this case should be measured not in relation to the profit for the year or the Statement of Financial Position position but in relation to the requirements of the law. This item is therefore by its nature material.</p>	<p>Tern Ltd is in non-compliance with statute. In law, the following should be disclosed:</p> <ul style="list-style-type: none"> • name of director • opening and closing balance • maximum outstanding at any point in the year • amounts repaid • interest waived 	<ul style="list-style-type: none"> • As the loan has been repaid, there appears to be no need to qualify as to the true and fair view given on the Statement of Financial Position and Statements of Comprehensive Income • However, there is non-compliance with regard to statute. • The auditor would need to qualify on the grounds of disagreement as to disclosure of loans in the financial statements. • An 'except for' wording would appear before the concluding sentence of the audit opinion paragraph. <p>Note:</p> <ul style="list-style-type: none"> • The auditor would be required to include in the report the fact that loans have been made and to disclose the amounts involved.



Auk Ltd

Situation/Materiality Considerations	Relevant accounting and legal principles	Audit Qualifications/Reasons
<p>The entity appears to have received further evidence concerning a year end customer balance in the period subsequent to the date of the Statement of Financial Position. By not providing against this debt, pre-tax profits are overstated by 1.7%.</p> <p>The impact on net assets is uncertain but, in relation to accounts receivable, failure to provide does not have a material effect (< 1/2%)</p> <p>However, the matter might be material when taken together with other adjustments identified.</p>	<p>The directors' grounds for not providing against the debt are not in accordance with accounting principles. The receipt of evidence subsequent to year end relating to conditions existing at the date of the Statement of Financial Position is an adjusting subsequent event.</p> <p>The directors' refusal could be justified if it could be established that the appointment of a receiver occurred as a result of an event arising after 30 September 2010. This seems unlikely.</p>	<ul style="list-style-type: none"> • In relation to pre-tax profits, the matter is not material. No qualification is required.



Egret Ltd

Situation/Materiality Considerations	Relevant accounting and legal principles	Audit Qualifications/Reasons
<p>The entity has not depreciated freehold buildings.</p> <p>Pre-tax profits are overstated by an estimated 10% and tangible non-current assets by an estimated 1%.</p> <p>Profits would appear to be materially overstated.</p>	<p>IFRS requires all tangible non-current assets having a finite useful economic life to be depreciated.</p> <p>The current value of a tangible non-current asset in excess of book value is not relevant in the requirement to match the cost of an asset over the period in which the asset is used to generate revenues.</p> <p>Depreciation should be charged on tangible non-current assets unless the amount would be immaterial.</p> <p>Under alternative accounting rules, the directors are permitted to hold assets at valuation but these must also be depreciated.</p>	<ul style="list-style-type: none"> • Failure to provide represents a material disagreement. An 'except for' wording would precede the true and fair opinion on the financial statements. • Although an entity does not have to provide depreciation if it is immaterial (an impairment review would need to be carried out), it would appear that from the auditor's work depreciation is necessary.

