

**Improving the application of and compliance with International Financial Reporting and Auditing Standards in Trinidad and Tobago. ATN/MT 8114 TT**

## **Guidance notes on International Standards of Auditing (ISA)**

**Graham Fairclough**

**April 2007**

**Institute of Chartered Accountants of Trinidad and Tobago**

<b>Contents</b>	<b>Page</b>
<b>Summary approach to auditing under ISA</b>	<b>1</b>
<b>Introductory to auditing: Professional codes of ethics and behaviour, rules of professional conduct</b>	
<b>Section 1: ISA 220</b>	<b>Quality Control</b>
<b>Section 2: ISA 210</b>	<b>Terms of Audit Engagements</b>
<b>Section 3: ISA 700, ISA 701</b>	<b>Audit Conclusions and Reporting</b>
<b>Section 4: ISA 315</b>	<b>Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement</b>
<b>Section 5: ISA 570</b>	<b>Going Concern</b>
<b>Section 6: ISA 300</b>	<b>Risk Approach Overview</b>
<b>Section 7: ISA 320</b>	<b>Analytical Procedures and Performance Measurement</b>
<b>Section 8: ISA 300</b>	<b>Audit Risk Model</b>
<b>Section 9: ISA 300</b>	<b>Internal Control</b>
<b>Section 10: ISA 300</b>	<b>Evaluation of Audit Evidence</b>
<b>Section 11: ISA 500</b>	<b>Audit Evidence</b>
<b>Section 12: ISA 320</b>	<b>Interpreting Results</b>
<b>Section 13:</b>	<b>Audit Completion</b>

This is a summary of a suggested general approach to auditing under International Standards of Auditing (ISA). It should be varied in the particular circumstances of the individual audit. It is intended as a checklist to ensure that key areas have been complied with. It does not represent itself to be a guarantee of full compliance with ISA in all circumstances!

<b>Step</b>	<b>ISA</b>	<b>Section in these notes</b>
Ethics: Document reason for believing it's ethical to accept the appointment.	ISA 220	Section 1
Ensure an up-to-date engagement letter is sent to the client and returned signed before work begins. Agree form of audit report will be in accordance with ISA 700/ISA 701.	ISA 210 ISA 701	Section 2 Section 3
Ensure that each member of the audit team has an up-to-date understanding of the client's business.	ISA 315	Section 4
Obtain a draft set of accounts (if available). Document reasons for believing the company is a going concern, or specific reservations about the company's going concern status.	ISA 570	Section 5
Determine a tolerable level of audit risk and document this in an audit planning memorandum.	ISA 300	Section 6
Determine a level of materiality for profit, a level of materiality for balance sheet misclassifications that do not affect profit and any other specific figures with reduced materiality (eg directors' salaries disclosures)	ISA 320	Section 7
Identify and document specific audit risks; ideally split for clarity between inherent risks, control risks and detection risks. Use COMPARE mnemonic for identification of specific audit risks.	ISA 300	Section 8
Document assessment of the control environment at the client. Document initial assessment of how much reliance can be placed on the client's controls to ensure transactions are completely and accurately recorded.	ISA 300	Section 9
Test control procedures of the client and assess in detail if these support audit plan to partially rely on control procedures. This may be done at an interim audit before the year-end. Plan to extend post year-end tests of details if control testing yields unsatisfactory results. Ensure all working papers are reviewed by another audit team member of at least equal experience.		Section 9

<b>Step</b>	<b>ISA</b>	<b>Section in these notes</b>
After completion of the controls testing and/or any interim audit, review the audit plan adequately addressing the risks that appear apparent.	ISA 300	Section 10
Perform tests of details on balances in the financial statements. Conclude on the truth and fairness of each figure. Use "AEIOU" mnemonic for devising audit tests of details.	ISA 500	Section 11
Interpret results. Maintain a scoresheet of observed errors and extrapolated population errors.	ISA 320	Section 12
Request adjustments from the client as necessary to present the most true and fair possible presentation. Outline in clear terms to the client what the consequences are likely to be of each error if the error is not corrected.		Section 12
Obtain signed copies of the financial statements from the client. Ensure that these are the same as those audited!		Section 13
Obtain a letter of representation from the management of the business dated up to the date that the auditor signs the audit opinion.	ISA 580	Section 13
Perform a post balance sheet review for any possible adjusting or non-adjusting events. The auditor is primarily liable for identifying any post balance sheet events from the date the financial statements were approved by the directors to the date of issuance of the audit opinion.	ISA 560	Section 13
Issue the audit opinion. Try to do this on or as soon as possible after the date of approval of the financial statements by the directors.	ISA 700 ISA 701	Section 3
Issue any report on control weakness observed in the audit to management, if this is agreed in the engagement letter. State reason for believing a control to be weak, possible consequences of the weakness and recommendations for improvement.		
Debrief audit team to identify any planning matters that could increase the following year's audit. Produce a memorandum to the following year's audit team of any points that will need to be investigated the following year (eg any litigation known to be in progress at the end of the year).		

Step	ISA	Section in these notes
<p><b>Throughout:</b></p> <p>Raise bills on account frequently to ensure there is no possibility that unpaid fee notes may be seen to influence the auditor's judgement. Ensure that all audit work is documented to a standard to enable an independent auditor to form a concurring opinion.</p>	ISA 230	
<p><b>After the engagement:</b></p> <p>Ensure that all the records of the audit are available for inspection by another independent auditor as part of the firm and the profession's quality control procedures. A "cold review" of the audit files will identify areas for improvement in practice procedures.</p>	ISQC 1	

# Introduction to auditing

## Professional codes of ethics and behaviour, rules of Professional conduct

A professional accountant's (an individual who is a member of an IFAC member body) responsibility is not exclusively to satisfy the needs of an individual client or employer it is also acting in the public interest and a professional accountant should observe and comply with the ethical requirements of the IFAC Code.

## Structure of the Code

The Code is in three parts. Part A establishes the fundamental principles of professional ethics for professional accountants and provides a conceptual framework for applying those principles. The conceptual framework provides guidance on fundamental ethical principles. Professional accountants are required to apply this conceptual framework to identify threats to compliance with the fundamental principles, to evaluate their significance and, if such threats are other than clearly insignificant (a matter that is deemed to be both trivial and inconsequential) to apply safeguards to eliminate them or reduce them to an acceptable level such that compliance with the fundamental principles is not compromised.

Parts B and C of the Code illustrate how the conceptual framework is to be applied in specific situations. The Code provides examples of safeguards that may be appropriate to address threats to compliance with the fundamental principles and also provides examples of situations where safeguards are not available to address the threats and consequently the activity or relationship creating the threats should be avoided.

Part B applies to professional accountants in public practice (a professional accountant, irrespective of functional classification (e.g., audit, tax or consulting) in a firm that provides professional services. This term is also used to refer to a firm of professional accountants in public practice.)

Part C applies to professional accountants in business (A professional accountant employed or engaged in an executive or non executive capacity in such areas as commerce, industry, service, the public sector, education, the not for profit sector, regulatory bodies or professional bodies, or a professional accountant contracted by such entities). Professional accountants in public practice may also find the guidance in Part C relevant to their particular circumstances.

## Fundamental Principles

A professional accountant is required to comply with the following fundamental principles:

### (a) *Integrity*

A professional accountant should be straightforward and honest in all professional and business relationships.

### (b) *Objectivity*

A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

*(c) Professional Competence and Due Care*

A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services (services requiring accountancy or related skills performed by a professional accountant including accounting, auditing, taxation, management consulting and financial management services).

*(d) Confidentiality*

A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.

*(e) Professional Behaviour*

A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

### **Threats and Safeguards**

Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances. Many threats fall into the following categories:

*(a) Self-interest threats*

These may occur as a result of the financial or other interests of a professional accountant or of an immediate or close family (A parent, child or sibling, who is not an immediate family member) member;

*(b) Self-review threats*

These may occur when a previous judgment needs to be re-evaluated by the professional accountant responsible for that judgment;

*(c) Advocacy threats*

These may occur when a professional accountant promotes a position or opinion to the point that subsequent objectivity may be compromised;

*(d) Familiarity threats*

May occur when, because of a close relationship, a professional accountant becomes too sympathetic to the interests of others; and

*(e) Intimidation threats*

These may occur when a professional accountant may be deterred from acting objectively by threats, actual or perceived.

### **Addressing the threats**

Safeguards that may eliminate or reduce such threats to an acceptable level fall into two broad categories:

- (a) Safeguards created by the profession, legislation or regulation; and
- (b) Safeguards in the work environment.

Safeguards created by the profession, legislation or regulation include, but are not restricted to:

- Continuing professional development requirements.
- Corporate governance regulations.
- Professional standards.
- Professional or regulatory monitoring and disciplinary procedures.
- External review by a legally empowered third party of the reports, returns, communications or information produced by a professional accountant.

(IFAC)

### **EXAMPLE 1**

#### **BG**

BG is a multinational firm of accountants. Their managing partner has been requested to appear in court in connection with one of their largest clients, BV, a public limited company. BG carries out the audit and tax work for BV. BV is being investigated for a possible tax fraud, which was linked to the establishment of a secret fund designed to make political contributions. The funds were maintained in a foreign bank, TBL, which was also a client of the audit firm. The existence of the fund had been discovered by the managing partner during the audit of the overseas bank.

The judge had ordered that the audit and tax working papers of BV be submitted to the court. However, the managing partner of BG had refused to submit the tax working papers of BV and copies of letters between BV and their solicitors on the grounds that they contained confidential information that would be damaging to their client.

The manager in charge of the tax affairs of BV was disturbed by the partner's actions and felt that they were ethically wrong as the tax working papers proved that BV was guilty of fraud and he refused to carry on acting for BV. He decided that he was going to submit the tax working papers to the court without the partner's due authority.

- (a) **Explain how the audit firm should have dealt with the discovery of the existence of the "secret fund".**
- (b) **Discuss whether the managing partner of BG was justified on the grounds of confidentiality in not providing the court with all the working papers of BV.**
- (c) **Comment on the position of the tax manager if he submits the tax working papers to the court against the partner's wishes.**

## **Suggested Solution:**

### **(a) Dealing with discovery**

The existence of the secret fund designed to make political contributions came to light because of audit work carried out at a mutual client company, that is, the foreign bank.

The audit firm has acquired information which discredits the information given to it by BV, the public limited company. The audit firm may at this point have considered whether it wished to continue to act for BV.

In this case the audit firm would not be able to reveal its findings to BV as it would be deemed to be a breach of confidence to reveal this information without the permission of the foreign bank. It would be difficult to obtain such permission from the bank without a breach of confidence in respect of BV.

The existence of the fund should be substantiated by reference to the books and records of BV and if this had proved to be impossible the consent of BV should have been received to obtain direct confirmation from the foreign bank of the existence of the fund. If permission is refused, then the auditors should consider qualifying the auditor's report or resigning.

**Tutorial note:** *It appears from the case study that neither of these options appeared necessary.*

### **(b) Confidentiality vs court order**

Confidentiality of information is implied in all contracts with clients. Thus as a general rule auditors should not disclose to other persons information about a client against the client's wishes. It is in the public interest that this confidential relationship is maintained, as without confidentiality clients may be reluctant to seek advice from auditors.

Generally where an auditor becomes aware that the client has committed an unlawful act, the auditor is under no legal obligation to disclose the information other than to the directors. Thus it could be argued that the managing partner was within his rights to refuse to submit the tax working papers and correspondence between the client and their solicitors. However, auditors must disclose information if compelled by the process of law and a court order constitutes such a due process.

It is in the managing partner's own interest to disclose the information as suspicions about collusion between the partner and the client may be aroused in the event of non-disclosure. Similarly, a criminal charge may be brought against the partner (e.g. for "contempt of court") possibly resulting in a prison sentence. Thus the managing partner should disclose the information to the court both as it may be obligatory under the law and as it is in his own interest.

### **(c) Tax manager vs partner**

The position of the tax manager if he submits the tax working papers is as follows:

The manager considers that the partner has not followed the ethical guidance of IFAC.

In the event of taxation offences, the auditor should:

- in the case of past financial statements, have advised full disclosure to the tax authorities; or if this was not forthcoming;
- have resigned and informed the tax authorities that they were no longer prepared to report on the financial and other documents in the same terms as previously.

Additionally they should inform the tax authorities when they have ceased to act for BV. The auditor is under no duty to indicate in what way the financial statements are defective.

However, the tax manager has no authority to send the tax working papers to the court as the court has ordered the partners of the firm to make these papers available. It is a breach of his professional confidence.

Additionally, the gesture is futile, as the managing partner will be probably forced by law to make the papers available. The tax manager will have created a confrontational situation.

The release of the tax working papers without due sanction cannot be condoned.

The tax manager should have allowed the judicial process to deal with this situation.

## **EXAMPLE 2**

### **Kloser**

You are an audit manager of Kloser, a firm of Chartered Certified Accountants. You are assigning staff to the final audit of Isthmus, a company listed on a stock exchange, for the year to 31 December 2005. You are aware of the following matters:

- (1) Isthmus has recently issued a profits warning. The company has announced that the significant synergies expected from the acquisition of Vanaka, a former competitor company, have not materialised. Moreover, it has emerged that certain of Vanaka's assets are significantly impaired. Your firm's corporate finance department, assisted by two audit trainees, carried out due diligence work on behalf of Isthmus before the purchase of Vanaka was completed in December 2004.
- (2) Mercedes, the assistant manager assigned to the interim audit of Isthmus, has since inherited 5,000 \$1 shares in Isthmus. Mercedes has told you that she has no intention of selling the shares until the share price recovers from the fall to \$1.95 which followed the profit warning.
- (3) Anthony, an audit senior, has been assigned to the audits of Isthmus since joining the firm nearly three years ago. He has confided to you that his father owned 1,001 shares in Isthmus but sold them only days before the profits warning at a share price of \$7.95. You are assured that Anthony did not previously know that his father had the shares.

**Comment on the ethical and other professional issues raised by the above matters and their implications, if any, for staffing the final audit of Isthmus for the year to 31 December 2005.**

## Suggested Solution

### (1) Profits warning

#### **Ethical and professional issues**

The profit warning increases the inherent risk of this assignment. As more work may be needed than for the prior year (e.g. on Vanaka's impaired assets), additional staff may need to be assigned to the audit.

An "advocacy threat" may occur if a dispute (potential legal action) arises between Isthmus and Kloser. For example, if the due diligence work should have recognised the significant impairments.

Kloser should undertake a review of the due diligence work and audit for the year-ended 31 December 2004 to ensure there were no findings which should have alerted them to the problems in Vanaka which precipitated the profit warning.

A "self-review threat" may arise in that the prior year-end audit, which followed the purchase, may have lacked objectivity. For example, the involvement of the corporate finance department in due diligence may have resulted in less audit work being carried out on Vanaka's assets and operating results than would otherwise have been performed.

If Kloser was negligent in undertaking the due diligence work (e.g. because assets were impaired at the time of acquisition and/or the assumptions underlying the expected synergies were unrealistic/hypothetical), to whom will Kloser be liable? To whom was the due diligence work reported? (Isthmus, Isthmus's shareholders, providers of finance for the acquisition?)

**Tutorial note:** *To illustrate that these "model" answers are not exhaustive consider, for example, the trainees' involvement in the audit could be beneficial (to Kloser and/or Isthmus).*

#### **Implications for staffing**

As a safeguard for the provision of the other service (due diligence) the audit personnel seconded to the corporate finance department may not have participated in the audit for the year ended 31 December 2004. Any such "bar" should continue.

If the secondees are involved in the audit, appropriate safeguards would include not assigning them to the audit areas most closely associated with due diligence and close monitoring and review of their work.

More senior/better quality/experienced staff should be assigned to the audit (than would have been necessary had the profit warning not been issued).

### (2) Shares inherited

#### **Ethical and professional issues**

A "self-interest threat" has arisen as Mercedes has a direct financial interest in Isthmus (i.e. she controls the shares). In particular, in wishing the share price to increase Mercedes might be in a position to overlook unrecorded liabilities and losses discovered during the conduct of the audit (say).

Even though Mercedes may have independence of mind and be known to act with the utmost integrity, she cannot have independence in appearance.

This inadvertent violation (i.e. through inheritance) of an independence principle does not impair the independence of Kloser or the audit team providing:

- Kloser's established policies and procedures have resulted in Mercedes having reported promptly her inheritance of the shares;
- Kloser promptly advises Mercedes that the shares should be disposed of; and
- the disposal occurs at the earliest practical date, or she is removed.

Mercedes does not intend to dispose of the shares quickly as she is waiting for the share price to recover.

It is unlikely that Kloser would consider offering her adequate compensation for an earlier disposal (the loss in share value since the fall being  $5,000 \times (\$7.95 - \$1.95) = \$30,000$ ).

Although IFAC's Independence statement requires Mercedes' removal from the audit team, Kloser may require stricter safeguards and prohibit all professional staff from holding direct financial interests. Mercedes may therefore be asked to choose between staying with the firm or disposing of the shares at the earliest practical date.

If any work has been done by Mercedes on the audit of Isthmus since she inherited the shares (e.g. in reviewing interim audit work or planning the year-end or final audit visits) that work should be re-reviewed by another professional accountant.

### **Implications for staffing**

This threat is so significant that Mercedes should be removed from the audit team unless she disposes of the shares before she undertakes any further tasks relating to the audit of Isthmus.

### **(3) Dealing in shares**

#### **Ethical and professional issues**

A self-interest threat would have arisen only if Anthony had known that a close family member (a parent) had shares in Isthmus (but he did not). A self-interest threat cannot now arise as his father has disposed of the shares.

Providing Anthony did not knowingly prompt his father to sell the shares, he has not committed a criminal act (e.g. of insider dealing).

**Tutorial note:** *If he committed such an act he should be instantly dismissed by the firm and any professional body under which he is registered notified for disciplinary action.*

However, if he in some way communicated (e.g. in a careless remark) something that prompted his father to sell the shares, he may be in breach of his duty of confidentiality. This should be investigated and appropriate action taken (e.g. he may be cautioned or given a written warning).

If he unknowingly gave his father price sensitive information, then his father may be guilty of insider dealing (or similar) for having acted on it.

### Implications for staffing

Unless there is any reason to suppose that Anthony has acted improperly (e.g. if he has delayed disclosing the matter) there is no reason why he should not continue his position in the audit team.

However, if his father were to come under suspicion of insider dealing then Anthony should be withdrawn from this assignment.

### Overall

Given the high profile attaching to this listed client it would be timely to have all members assigned to the audit team renew their written declarations of independence and confidentiality.

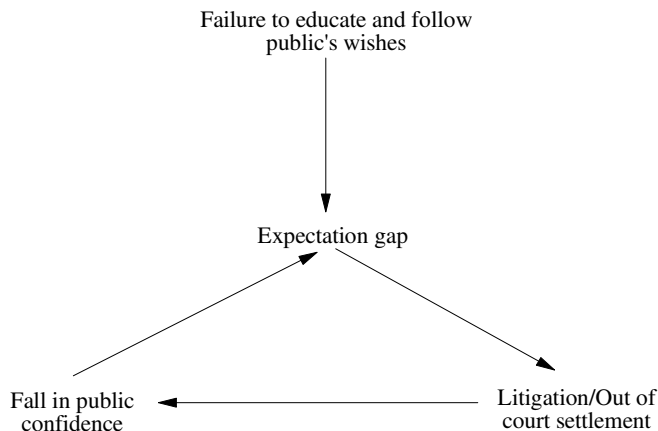
### Importance of audit reporting

- Independent examination gives credibility to financial statements.
- Management produces financial statements which attract inward investment.
- Investors, takeover companies and financial analysts make decisions based on financial statements and therefore rely upon the audit opinion.
- Management needs advice to remove weaknesses (eg in internal controls).

### The audit reporting expectations gap

The *difference* between what the *public* believes the auditor ought to report and what the *audit profession* requires its members to report.

### “Vicious circle”



## Main views

- Reporting gap – the profession's and public's view of *what* should be reported are different
- Performance gap – where auditors perform below existing standards
- Liability gap – the profession's and public's view of *to whom* the auditor is liable are different.

“The future development of auditing” found that 86% of audit report users, 62% of company directors and even 53% of auditors believed that it was the auditor's responsibility to detect fraud.

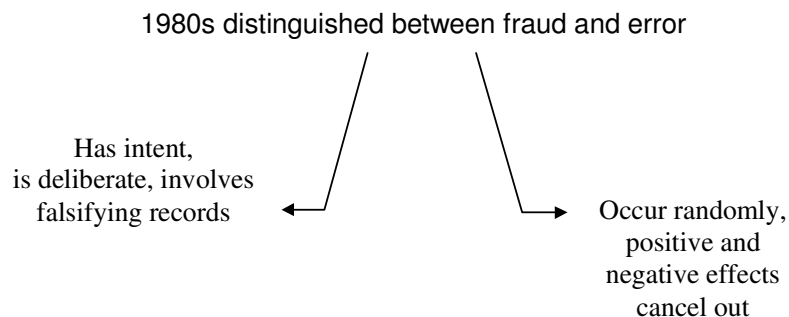
## Viewpoints

	3.3.1 Audit profession	3.3.2 The public
■ Appointment by	<input type="checkbox"/> Shareholders	<input type="checkbox"/> Management
■ Liability to	<input type="checkbox"/> Shareholders	<input type="checkbox"/> Interested parties
■ Financial statements prepared by	<input type="checkbox"/> Management	<input type="checkbox"/> Auditor
■ Examination of	<input type="checkbox"/> Financial statements	<input type="checkbox"/> Statutory requirements
■ Purpose of audit	<input type="checkbox"/> True and fair view	<input type="checkbox"/> Guarantee of correctness $\pm$ existence in future
■ Opinion based on	<input type="checkbox"/> Past evidence	<input type="checkbox"/> Future estimates
■ Testing transactions	<input type="checkbox"/> A sample	<input type="checkbox"/> All

- Fraud detection       Reasonable assurance       Yes
- Procedures followed       Audit standards       Some
- Judge management       In the context of financial statements       At all times
- Advice given       Voluntarily       Statutorily

### Audit profession's expectations of fraud detection

- Public view – fraud *prevention* should be part of auditor's work.
- Fraud *detection* has not been an auditor's objective since the 1940s.



- Currently the auditor designs audit procedures to obtain *reasonable assurance* that those *material* misstatements (whether due to *fraud* or *error*) are detected. But with the issue of the revised standard, ISA 240 (effective for audits of financial statements of periods beginning on or after December 15, 2004) far

greater emphasis is being placed on the risk of fraud and audit procedures (particularly risk assessment and planning). See previous section.

- Auditor is not obliged to provide a guarantee of detection.
- Audit profession carries the illusion of accuracy.

### **Steps to bridge the gap**

1. Auditors to detect (but not guarantee) fraud and company failure
2. Independent body to oversee audit appointments, fee determination, auditing standards, monitoring and discipline, eg auditing committees
3. Independent body to educate public on audit reporting objectives, audit standards etc
4. Independent body to provide a “stand-alone” non-standardised audit report
5. Third party liability to be removed – third parties do not contribute to employment of auditor and audit report is not addressed to them.

## Section 1

### ISA 220

Quality control procedures appropriate to the individual audit should be implemented, in the context of the firm's general policies and procedures under ISQC 1.

- IAS 220 basically takes the requirements of ISQC 1 and applies them in the context of an individual audit.
- For most requirements, the engagement partner is responsible to ensure that ISQC 1 is met.

*Leadership* ⇒ Takes responsibility for the overall quality of the audit engagement

*Ethical requirements* ⇒ Considers whether members of the engagement team have complied with ethical requirements

*Independence* ⇒ Forms a conclusion on the independence of the firm and engagement staff

*Acceptance* ⇒ Satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and specific audit engagements have been followed, and that conclusions reached in this regard are appropriate and have been documented

*Assignment of engagement team* ⇒ Satisfied that the engagement team collectively has the appropriate capabilities, competence and time to perform the audit engagement in accordance with professional standards and regulatory and legal requirements, and to enable an auditor's report that is appropriate in the circumstances to be issued.

*Engagement performance* ⇒ Take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and for the auditor's report that is issued to be appropriate in the circumstances.

⇒ Before the auditor's report is issued, the engagement partner, through review of the audit documentation and discussion with the engagement team, should be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached

and for the auditor's report to be issued.

*Consultation*

- ⇒ Be responsible for the engagement team undertaking appropriate consultation on difficult or contentious matters
- ⇒ Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm
- ⇒ Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are documented and agreed with the party consulted
- ⇒ Determine that conclusions resulting from consultations have been

*Engagement review*

- ⇒ Determine that an engagement quality control reviewer has been appointed
- ⇒ Discuss significant matters arising during the audit engagement (including those identified during the engagement quality control review) with the engagement quality control reviewer
- ⇒ Not issue the auditor's report until the completion of the engagement quality control review

## Section 2

### ISA 210

#### Engagement

Language in the engagement letter should be limiting in its descriptions of services, objectives, and responsibilities. The engagement letter is not the place to embellish or market the firm's capabilities. The practicing firm wants to limit, not expand, its risk exposure in the letter.

The audit engagement letter should also clarify:

- the auditor's responsibility to detect *only* material fraud, and
- the degree of responsibility assumed by the auditor in providing services.

It is also extremely important for practicing accountants to document conversations, advice, decisions, actions, and events. Equally important is the client selection process, an area where "prevention is better than cure".

Practicing accountants can further minimize their exposure to risk by accepting only those engagements they fully understand. As soon as an accountant begins to dabble in specialized areas or offer off-the-cuff advice without thoroughly researching the client's situation, the liability exposure increases significantly.

#### Disclaimers (of responsibility) in audit reports

This is not to be confused with disclaiming an audit opinion!

- In December 2002 PricewaterhouseCoopers announced that its audit reports would, in future, carry a "health warning" that the opinion is provided solely for the benefit of the shareholders.
- PwC's decision was prompted by a case in July 2002, *Royal Bank of Scotland v Bannerman Johnstone Maclay*. RBS sued the Glasgow auditor (BJM) to reclaim a lost loan, which it said it had offered based on information included in the audited accounts. The judge found in favour of RBS. The judge said that a disclaimer would have made it impossible to infer that the auditors had assumed a duty of care to the bank.
- The ICAEW (Institute of Chartered Accountants in England and Wales) issued guidance to all of its members, who wished to manage their risk of liability to third parties, in the use of similar wording to that of PwC.
- The guidance makes it clear that such wording is optional and that each case brought against auditors would still be considered on the individual circumstances. Auditors were advised to seek legal advice where necessary.
- The IAASB have not issued similar guidance to supplement IAS 700. Additional wording in reports depends on the local jurisdiction that the auditors operate under.

## **Wording**

“This report is made solely to the company’s members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we may state to the company’s members those matters we are required to state to them in an auditors’ report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company’s members as a body, for our audit work, for this report, or for the opinions we have formed.”

- The statement would normally be placed in the first or second paragraph of the auditor’s report. It is NOT part of their opinion.

### **Arguments against**

- It may be seen as devaluing the integrity of the accounts.
- It may be misinterpreted as an attempt by auditors to protect themselves in the post-Enron environment.

### **Arguments in support**

- The firm’s responsibilities to its clients will remain unaltered: it will have the same duties and liabilities as it has always had.
- It is to the benefit of shareholders who pay for the audit.
- Clarification of responsibility prevents responsibility from being unintentionally extended to others.

## Section 3

### ISA 700, ISA 701

ISA 700 requires that audit opinions are given in a standard format. This facilitates easier understanding by readers and ensures that the audits appear to have been conducted using consistent methodology.

ISA 700 covers the standard format for an unqualified audit opinion (ie a “clean” audit opinion) and ISA 701 covers how to report where the financial statements are not considered to present a fully true and fair view, or where there has been some material limitation on the auditor’s ability to find sufficient appropriate evidence to form an opinion.

An audit opinion includes the following contents, in this specific order:

1. Title
2. Addressee
3. Introductory paragraph
4. Statement that preparation of the financial statements and maintenance of the records is the responsibility of management rather than the auditor
5. The auditor’s responsibility to form an opinion on the financial statements
6. Methodology used (ie audit conducted in accordance with ISA)
7. Limitations on methodology (ie a limitation on scope modification)
8. Any matters of disagreement (ie any material disagreement modification)
9. Auditor’s opinion (either the financial statements give a true and fair view, or a true and fair view except for the matters above)
10. Any other reporting requirements, such as requirements to report on whether the financial statements comply with local legislation
11. Any “emphasis of matter” paragraph (see below)
12. Audit signature
13. Date of auditor’s report
14. Auditor’s address.

#### INDEPENDENT AUDITOR’S REPORT

To the members of Company Ltd

Report on the Financial Statements

We have audited the accompanying financial statements of Company Ltd, which comprise the balance sheet at 31 Decemeber 20x1 and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

#### *Management’s Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are

reasonable in the circumstances.

#### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

#### *Opinion*

In our opinion, the financial statements give a true and fair view (or "present fairly, in all material respects") the financial position of Company Ltd as at 31 December 20x1 and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

#### *Report on Other Legal and Regulatory Requirements*

{Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.}

{Auditor's signature}

{Date of auditor's report}

{Auditor's address}

### **Modified audit opinions**

There are two forms of modification in an audit opinion which leads to a "qualified" audit opinion. These are where either the auditor has been unable to obtain sufficient appropriate evidence to draw a conclusion, or where all appropriate evidence has been obtained but the auditor disagrees with the presentation in the financial statements. The former of these situations is referred to as a limitation on scope in the audit opinion and the second is an audit modification on grounds of disagreement. The level of disagreement or limitation on scope may be either material or pervasive. Pervasive means that the effect of the limitation on scope or disagreement could affect numerous figures in the financial statements.

	<b>Material</b>	<b>Pervasive</b>
<b>Limitation on scope</b>	“Except for...might” limitation on scope modification	Disclaimer of opinion
<b>Disagreement</b>	“Except for...” disagreement modification	Adverse opinion

In each of these cases, the details of the modification are given before the audit opinion itself, as to give an opinion and then follow with some reservations about that opinion is likely to confuse the reader. ISA 701 gives a number of examples of modified opinions. It is possible to have both a limitation on scope and also disagreement about some matter where all audit evidence has been obtained.

**Example audit opinion: Modified on grounds of limitation on scope and disagreement**

To the members of Company Ltd

Report on the Financial Statements

We have audited the accompanying financial statements of Company Ltd, which comprise the balance sheet at 31 Decemeber 20x1 and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

*Management’s Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

*Auditor’s Responsibility*

Our responsibility is to express and opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as

evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

*Modification on grounds of limitation on scope*

Since we were only appointed as auditor after the balance sheet date, we were unable to attend the inventory count at 31 December 20x1. We are therefore unable to express an opinion on the existence and valuation of inventory at the balance sheet date.

*Modification on grounds of disagreement*

The financial statements include an expense of \$x in respect of operating leases on machinery. In our opinion, to comply with International Financial Reporting Standards these leases should be defined as finance leases, which would increase non-current assets by a figure of \$x, increase liabilities by \$x and reduce the charge in respect of these leases to profit by \$x.

*Opinion*

Except for any adjustments which might prove necessary in respect of inventory values and except for the effect of misclassification of finance leases as noted above, in our opinion, the financial statements give a true and fair view (or “present fairly, in all material respects”) the financial position of Company Ltd as at 31 December 20x1 and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

*Report on Other Legal and Regulatory Requirements*

{Form and content of this section of the auditor’s report will vary depending on the nature of the auditor’s other reporting responsibilities.}

{Auditor’s signature}

{Date of auditor’s report}

{Auditor’s address}

A disclaimer of opinion simply states that we are unable to express an opinion. An adverse opinion states that in our opinion, the financial statements fail to give a true and fair view. It is probably more helpful to shareholders to read a multiple modification, listing all the items which the auditor disagrees with rather than reading a disclaimer, which gives them no information about what the auditor believes the true figure should be. Adverse opinions should therefore be rare in practice.

**Emphasis of Matter Paragraphs**

Sometimes, the auditor will need to draw a particular matter to the attention of the shareholder in order for the shareholder to fully understand the financial statements. This might include a situation where the published financial statements include a statement which is misleading about profit, but where the misleading statement itself is outside the scope of the audit opinion because it is not part of the financial

statements themselves. In this situation, the financial statements may be correct, so it is illogical to modify the audit opinion on the financial statements themselves.

The situation can be remedied by adding an emphasis of matter paragraph after the audit opinion.

### **Example of emphasis of matter paragraph**

(first paragraphs as per unqualified opinion above)

#### *Opinion*

In our opinion, the financial statements give a true and fair view (or “present fairly, in all material respects”) the financial position of Company Ltd as at 31 December 20x1 and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

#### *Emphasis of matter: inconsistent statement*

Without qualifying our opinion above, we draw attention to page 5 of the directors’ report, which refers to the company having made a profit in the period of \$3.2 million. The financial statements show a profit of £2.4 million. This statement is therefore inconsistent with the profit figure we have reported on above.

### **Impact of Going Concern on Audit Reports**

In most situations, going concern will be an uncertainty but it can reasonably be assumed that an entity will continue to trade as a going concern. The auditor is required under ISA 570 to obtain sufficient evidence to support management’s conclusion that the entity can report its financial statements on a going concern basis.

In such a situation, there is no mention of going concern in the audit opinion. There are three circumstances when going concern will be reported in the financial statements:

1. Where the going concern status of the company is fundamentally uncertain but where this fundamental uncertainty is disclosed very clearly throughout the financial statements
2. Where the company has prepared the financial statements on the going concern basis, but the auditor does not believe that the directors have justifiable grounds to believe that the company is a going concern (pervasive disagreement)
3. Where the going concern status of the company is fundamentally uncertain but the financial statements do not make sufficiently prominent disclosure of this fact.

In the first scenario, the going concern problem has been adequately disclosed and preparation of the financial statements on a going concern basis is justifiable. This would be reported on by adding an emphasis of matter paragraph (see above) to the audit opinion.

In the second and third scenario, the financial statements are either actively misleading (scenario 2) or have serious potential to be misleading. In both of these situations, an adverse opinion would be appropriate, since the financial statements fail to give a true and fair view. ISA 701 is not prescriptive in the third scenario and it might be that a modification on grounds of material disagreement (inadequacy of disclosure notes) would be possible whilst still complying with ISA 701. An adverse opinion is probably the safer option for the auditor however, since it may be possible for a reader of the financial statements to fail to appreciate the importance of the problem if the modification is “watered down” to a material disagreement.

## Section 4

### ISA 315

#### **Understanding the Entity and its Environment and assessing the Risks of Material Misstatement**

- Identify risks arising from the entity and its environment, including relevant controls, by:
  - understanding the entity and its environment; and
  - consider the impact on transactions (eg sales, expenses), account balances (eg non-current assets, payables) and disclosures (eg related party transactions) in the financial statements.
- Relate the risks that have been identified to what can go wrong:
  - at the assertion level (eg completeness, occurrence, accuracy, existence and valuation of transactions, account balances and disclosures); and
  - at the overall financial statement level (eg where many assertions are impacted thus risk is pervasive throughout the financial statements); and
- Consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.
- Consider the likelihood that the risks could result in a material misstatement of the financial statements.
- In other words:
  - understand the business, its environment and controls to establish what could go wrong (in that the financial statements contain a material error); then
  - identify the ways in which material errors could arise and devise a work programme to test to see if they have (ISA 330 and ISA 500).

## UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

### Basic principles

- The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to:
  - identify and assess the risks of material misstatement of the financial statements (whether due to fraud or error) at the overall statement level and at the assertion level;
  - plan, design and perform appropriate audit procedures; and
  - reach an audit opinion
  
- Understanding internal control means considering the design and implementation of relevant internal controls, over the financial statement assertions, to assess the potential risk of material misstatements.

### Methods

- Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit.

- To obtain the necessary level of understanding, auditors must, for example:
  - make inquiries of management and others within the entity (eg business objectives, governance, internal audit, key employees);
  - carry out analytical procedures (eg on internal and external generated information);
  - observe (eg activities and operations) and inspect (eg business plans, strategies, internal audit risk assessments, records, procedure manuals);
  - read reports prepared by management (eg monthly management accounts) and those charged with governance (eg board minutes);
  - carry out other procedures (eg visit premises and facilities, walk through systems relevant to financial reporting, review external sources of information).

- Prior year information, eg organisational structures, control environment, management attitude and actions to control breaches, can be used so long as it is up to date, ie check and update as required.
- Information obtained from client acceptance procedures and other client engagements (eg review of interim financial statements) may also be relevant in obtaining an understanding of the entity.

## **Audit team**

- Discussions are held amongst the engagement team about the susceptibility of the financial statements to material misstatement.
- By holding such discussions;
  - the more experienced engagement team members, eg the engagement partner and manager, brief other members and share their knowledge and audit experience of the entity;
  - members of the engagement team obtain a better understanding of the potential for material misstatements of the financial statements resulting from fraud or error in the specific areas assigned to them; and
  - understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing, and extent of further audit procedures
- Team members exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement.
- The discussion should also emphasise the need to:
  - address the application of the applicable financial reporting framework to the entity's facts and circumstances;
  - maintain professional scepticism throughout the engagement;
  - be alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred; and
  - be rigorous in following up on such indications.
- Audit assistants must have sufficient understanding of the entity to enable them to perform the work delegated to them.

## **Using the understanding**

To establish a framework within which the audit is planned and professional judgment exercised in assessing risks of material misstatement and responding to those risks throughout the audit.

- To assess various components of audit and business risk.
- To develop the audit strategy and audit plan.
- To determine materiality levels and judge if they remain appropriate as the audit progresses.
- Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's

use of the going concern assumption, or considering the business purpose of transactions.

- Developing expectations for use when performing analytical procedures.
- Designing and performing further audit procedures to reduce audit risk to an acceptably low level.
- To evaluate the sufficiency and appropriateness of audit evidence including, for example, management representations .
- To recognize conflicting information, unusual circumstances and effectively apply professional scepticism.
- To make informed enquiries and assess the reasonableness of responses.
- To appraise the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures.
- To provide a better service to clients and be responsive to their needs.

## **NEW AUDITS**

### **Information needs**

- An understanding of the nature of the entity, relevant industry, regulatory, and other external factors including the applicable financial reporting framework, must be obtained by the auditor.

### **Selection and application of accounting policies**

- How does the entity select and apply accounting policies. Are they appropriate for its business and consistent with the financial reporting framework and accounting policies used in the relevant industry. In particular:
  - the methods the entity uses to account for significant and unusual transactions;
  - the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus; and
  - the way changes in the entity's accounting policies are dealt with must be understood.

### **Objectives, strategies and related business risks**

- As well as information about the way the entity operates and its environment, the auditor will also need to understand how the management of the business deals with business risk that may result in material misstatement of the financial statements.
- Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies.
- Just as the external environment changes, the conduct of the entity's business is also dynamic and the entity's strategies and objectives change over time.
- Examples of business risks to be managed include:
  - Industry developments, eg that the entity does not have the personnel or expertise to deal with changes or increased complexity in the industry (or does not recognise the need for change)
  - New products and services, eg that there is increased product liability or that the product may fail.
  - Expansion of the business eg that the demand has not been accurately estimated, the market incorrectly analysed.

- New accounting requirements, eg incomplete or improper implementation of a new IFRS, or increased costs.
- Regulatory requirements, eg that there is increased legal exposure.
- Current and prospective financing requirements, eg the loss of financing due to the entity's inability to meet requirements.
- Use of IT, eg the loss of e-commerce facilities due to a failure within the system.

## EXISTING CLIENTS

### Updating

- In the case of entities audited in prior years, historic key information required for planning will be available in the working papers ("WPs") and other files (eg computer knowledge bases).
- But as entities are adaptive and dynamic and operate in a dynamic environment, the auditor must consider events, transactions and practices that will have changed during the financial year.
- Basically, where were we; what has changed within the business and its environment to change the nature of risks; where are we now.
- Where changes are identified, their impact on the entity, its business and financial reporting environment must be understood, eg when and how the entity dealt with such changes.
- Changes that will impact the business in a future financial period cannot be ignored. What business risk is there to the entity arising from these changes? Does that risk impact the current financial statements? For example, future changes in regulations may create a going concern risk.
- Reasons for changes in the selection of, or method of applying, accounting policies must be ascertained. Any change must be appropriate and consistent with the requirements (including disclosure) of the applicable financial reporting framework, eg IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

## **Section 5**

### **ISA 570**

#### **Going Concern**

IAS 1 states that it is a fundamental assumption in preparing financial statements that the entity concerned is a going concern, unless it is clearly stated otherwise. Going concern means that the entity is reasonably expected to continue trading without going out of business, or very significantly curtailing its business, in the near future.

Where a company is not a going concern, the financial statements will need to be prepared on a break-up basis. This will have a fundamental and pervasive effect on the financial statements. For example, all non-current assets and liabilities will need to be reclassified as current, as there is not reasonably expected to be a period of more than one year from the balance sheet date to recover assets' values or repay creditors. In the event that there is a limited time to recover receivables, the entity's debtors may not pay the amounts in full that they owe. It is also likely that inventory will only be sold for a reduced value, since it will be necessary to offer discounts to sell all inventory quickly, typically in a "closing down sale" situation.

Both management and the auditor must be satisfied that the entity is a going concern and that there is sufficient evidence to support this.

#### **Positive and negative assurance**

Positive assurance: "I believe this is true".

Negative assurance: "I've no reason to believe this is not true".

Traditionally, going concern has been something that has been considered to be an issue in an audit by exception. This means that entities have been considered to be going concerns unless there is strong evidence to the contrary. This has historically meant that auditors have been poor at identifying where serious going concern uncertainties exist and reporting on this accordingly in their audit opinion.

To counter this, there is a strong move towards taking a positive assurance approach to going concern. A positive assurance approach means that the auditor must be positively assured that the company is a going concern in order to avoid going concern featuring in the audit opinion. The auditor must use his/ her professional scepticism to initially assume that the entity is not a going concern until the auditor has seen sufficient evidence to satisfy himself/ herself that the going concern status is appropriate.

Negative assurance, by comparison, simply means that making no mention of the company's going concern status means that nothing has specifically come to the auditor's attention to suggest that the company is not a going concern.

The current version of ISA 570 largely takes a negative assurance approach to going concern but it is very likely that this will be replaced soon by a revised ISA 570 which requires a positive approach. To avoid audit error, it is best practice in any event to take a positive assurance approach.

#### **Respective responsibilities of management and auditor**

It is the principal responsibility of management to perform an active review of the company's position each period before deciding that the financial statements can be appropriately prepared on a going concern, rather than a breakup, basis. The auditor is required to review the assessment of going concern made by management and must be reasonably assured that the company appears to be a going concern for the coming period of not less than 12 months from the date of signing the audit opinion. If there are any specific indicators that the company will cease to be a going concern after 12 months, then the appropriate basis of preparation of the financial statements is a break-up basis. The minimum period where the auditor should seek positive assurance that the company is probably going to continue to trade as a going concern is 12 months, however, unless something specific comes to the auditor's attention which would properly require extension of this period.

### **Indicators of going concern problems**

#### *Financial*

- Net liability or net current liability position
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by debtors and other creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

#### *Operating*

- Loss of key management without replacement.
- Loss of a major market, franchise, license, or principal supplier.
- Labour difficulties or shortages of important supplies.

#### *Other*

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied.
- Changes in legislation or government policy expected to adversely affect the entity.

### **Impact of going concern on audit opinion**

Going concern is an inevitable uncertainty in all situations, since companies cannot be certain that something drastic is not going to occur that would cause the company to stop trading. In these normal circumstances, the appropriate audit opinion is an unqualified audit opinion.

Where there is an elevated level of going concern which suggests that there is a fundamental uncertainty about the company's going concern status, such as ongoing negotiations with a provider of finance where the outcome of negotiations is uncertain, the company must make very prominent disclosure of this elevated uncertainty such that no reader of the financial statements could fail to be aware of the elevated uncertainty. This probably means making reference to the disclosure note that gives full and frank disclosure of the uncertainty on the heading of each of the financial statements.

If this conspicuous disclosure has been made and the auditor's opinion is that it is truly uncertain whether the company is a going concern or not, the appropriate opinion is to issue an unqualified opinion with an emphasis of matter paragraph in accordance with ISA 701.

If the auditor believes that there is an elevated level of uncertainty about going concern, but this is not disclosed with sufficient prominence to be reasonably sure that no reasonable reader of the accounts will miss the disclosure, the auditor must make clear disclosure of the uncertainty in the audit opinion. This opinion will then be modified, either on grounds of material disagreement (inadequate disclosure to provide a full understanding) or an adverse opinion (pervasive disagreement, as going concern may affect all figures in the financial statements). It is a matter of judgement which of these opinions an auditor would issue, but an adverse opinion is clearly the safest in terms of defending in litigation since it is the strongest warning the auditor is able to give the reader of the audit opinion. In reality, this situation should be rectified by ensuring more prominent, repeated disclosure of the elevated level of uncertainty.

If the auditor's opinion is that it is more likely than not that the company will not be a going concern, then there is a serious disagreement about the basis of preparation of the financial statements. In such a case where the auditor believes that management are arguably guilty of wishful thinking, the safest opinion for the auditor to give is to give full details of the auditor's belief that the company is not a going concern and then provide an adverse opinion.

## Section 6

### ISA 300

#### Risk Approach overview

##### Audit risk

The risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.

- An audit in accordance with ISAs is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement.
- The concept of “reasonable assurance” implies that there is a risk that the audit opinion will be inappropriate when the financial statements are materially misstated.
- This risk may be reduced to an acceptable level by designing and performing audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base an audit opinion.
- Audit risk therefore considers two base risks:
  - that the financial statements were materially misstated prior to audit;
  - and that the auditor will not detect such material misstatement – detection risk.

##### Business risk

- Business risk is the risk that the entity will not be able achieve its objectives and execute its strategies.
- Such risks result from the way the entity is managed, its operating environment, products, customer base, employee base, ownership, legal and regulatory regimes and the very fact that it operates in a dynamic and adaptive environment.
- Management should have risk assessment procedures in place to be able to recognise business risks and take appropriate action (eg through risk management procedures and controls) to minimise the impact of such risks.

##### Relationship of audit risk to business risk

- Business risk is much broader than the risk of material misstatement of the financial statements, but as most business risks will eventually have

financial consequences, there will be a 'cascading' impact on the financial statements and consequently, audit risk.

- Embodied within business risk controls will be those controls that directly, or indirectly, relate to financial reporting, operations and compliance.
- Audit risk takes into account the risks that are inherent within the entity, how such risks are managed and their impact on the financial statements.

### **Audit risk models**

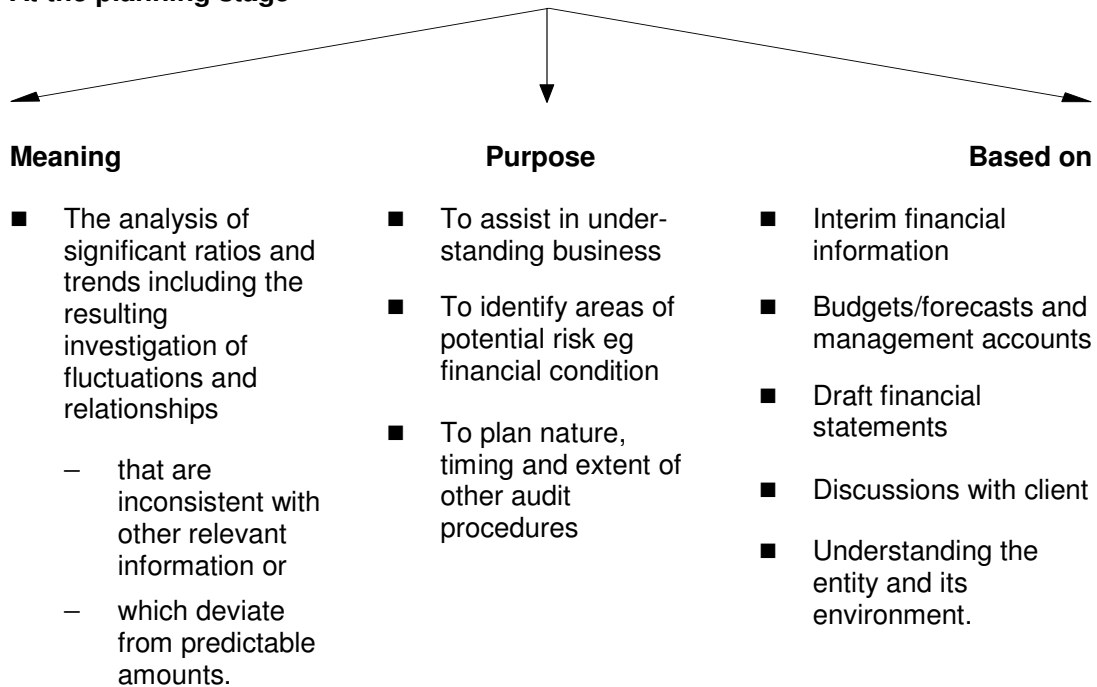
- There are a number of audit approaches (audit risk models) used within the auditing profession. However, whatever form of model is used, it is critical that the audit process involves the exercise of professional judgment in designing the audit approach through:
  - focusing on what can go wrong (ie what are the potential misstatements that may arise); and
  - performing audit procedures in response to the assessed risks in order to obtain sufficient appropriate audit evidence on which to base the audit opinion.
- What is of paramount importance is the application of the "Risk Standards", *ISA 315 Understanding the Entity and its Environment and assessing the Risks of Material Misstatement*, *ISA 330 The Auditor's Procedures in Response to assessed Risks* and *ISA 500 Audit Evidence*
- It is clear that the need for the auditor to make appropriate risk assessments is much more important than the different approaches by which they are made.

## Section 7

### ISA 320

#### Analytical procedures and performance measurement

##### At the planning stage



##### Ratio analysis

- Considering one set of ratios for the current year may not, by itself, be sufficient. Comparison should be made with at least the prior year equivalent ratios, if not at least a three year trend.
- For example:
  - The deterioration of short-term and/or long-term financial ratios potentially increases the risk of the entity not being a going concern.
  - An increase in receivable days may, for example, indicate credit control risk and a potential increase in bad and doubtful debts.
  - A decrease in gross profit % may indicate, for example, inventory shrinkage, poor cut-off procedures or an increase in competition (such that prices were reduced or increased costs unable to be passed onto the customer).

## **Expectations and performance measures**

- By understanding the entity, its environment, performance measures and in performing analytical procedures at the planning stage (as risk assessment procedures) the expectations are noted about plausible relationships that are reasonably expected to exist.
- When such expectations are not founded, eg with recorded amounts, ratios developed from recorded amounts or audit test results not meeting original expectations, the audit plan is reviewed in identifying risks of material misstatement.
- Performance measures may be internal or external, eg meeting budgets, cash flows, reported profit forecasts, share price targets. Professional scepticism must apply when, for example, the auditor is aware of the potential for pressure to be placed upon management to meet expected performance measures.
- For example, following discussions with management over the course of the year, a review of the management accounts and an understanding of the business environment in which the entity operates in, the auditor is expecting the results of the entity to be lower than the previous year. Instead, not only is turnover up, but gross profit % has also improved.
- This would place the auditor on guard that the financial statements may contain material errors. If combined with other known factors, eg performance-based incentive remunerations (bonus, share options) the risk of management manipulation through, for example, profit smoothing, inappropriate revenue recognition or deferral of expenses, is higher.

## Section 8

### ISA 300

#### AUDIT RISK MODEL

##### Assessing risk of material misstatement

- Through obtaining an understanding of the business and its environment, including relevant controls, and considering the classes of transactions, account balances and disclosures in the financial statements, the auditor must now consider the risk of material misstatement at the:
  - overall financial statement level; and at the
  - transaction, balance and disclosure level.
- No one model for doing this is proposed within ISA. The key points are:
  - the auditor is concerned with material misstatement within the financial statements;
  - audit risk is reduced to an acceptably low level by the exercise of professional judgement;
  - and audit procedures are designed to ensure that audit risk is at an acceptable level.

##### Basic principles

- Inherent risk, control risk and detection risk are the components of audit risk.
- Inherent risk and control risk, although separately defined, are often subject to a combined assessment to assess the risk of material misstatement. Detection risk is then referred to as 'residual risk'.
- It is irrelevant what names and approaches are used, so long as the model follows the basic principles required by ISAs.

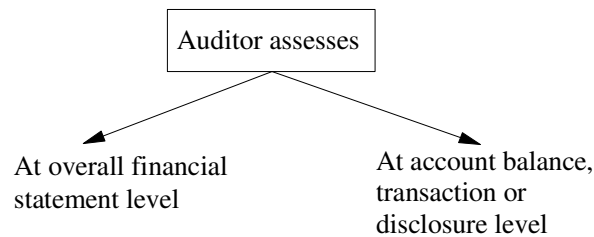
##### Inherent risk

###### Definition

The susceptibility of an assertion to misstatement that could be material (individually or in aggregate) assuming no related internal controls.

*Note the assumption – if it not assessed as less than high, it is assumed to be high – this is also true of control risk (see below).*

## Financial statement v's assertion levels



## Control risk

### Definition

The risk that a misstatement that could occur (at the assertion level) and be material will not be:

- prevented; or
- detected *and* corrected on a timely basis;

by the internal control system.

*i.e. given that risks arise (IR), CR is the risk that they are not dealt with by the client's systems*

### Preliminary assessment

- An understanding of the design and implementation of internal control will have been obtained through understanding the entity and its environment.
- From this understanding, controls that are key to assessing the risk of material misstatement at the assertion level will have been identified.
- Where the controls are suitably designed to prevent, or detect and correct, a material misstatement, tests of the operating effectiveness of the controls can be carried out if considered to be efficient to do so.

### Measuring control risk

- Control risk is assumed to be high (i.e. high risk of material misstatements in the financial statements) unless:
  - internal controls which are likely to prevent/detect/correct material misstatement relevant to the assertion are identified; and
  - tests of the operating effectiveness are planned to be performed to support the assessment.
- Control risk will be assessed as high when:
  - internal control is not assessed to be effective; or
  - evaluating the operating effectiveness of controls would not be an efficient audit approach; or
  - sufficient audit evidence can be obtained purely from substantive testing.

- There will always be some control risk because of the inherent limitations of any system of internal control.

## Detection risk

### Definition

That the auditor will not detect a misstatement that exists (in an assertion) that could be material.

- The level of detection risk relates directly to the auditor's substantive procedures.
- Inherent risk and control risk assessments influence the nature, timing and extent of substantive procedures to be performed to reduce detection risk (and therefore audit risk) to an acceptably low level.
- Some detection risk would always be present even if examining 100% of an account balance or class of transactions.

Methods of varying detection risk	Examples where inherent/control risk are high
1 Change <i>nature</i> of audit work	⇒ Direct tests toward independent parties rather than documentation within entity. ⇒ Use tests of detail in addition to analytical procedures.
2 Change <i>extent</i> of audit work	⇒ Use a larger sample size.
3 Change <i>timing</i> of audit work	⇒ Perform a procedure at the period end rather than at an earlier (interim) date.

### Basic principles

*these should be evident from the preceding analysis*

- Some substantive procedures should always be carried out for *material* account balances and classes of transactions.
- More evidence should be obtained from substantive procedures the higher the inherent and control risk assessments.
- A qualified opinion (or a disclaimer of opinion) should be expressed if detection risk cannot be reduced to an acceptable level.

## Significant risks

- What ever risk model is used, care must be taken to identify “significant risks”, ie those risks that relate to significant non-routine transactions and judgemental matters, where there is for example;
  - greater ability for management intervention re accounting treatment;
  - greater ability to use manual override with IS collection and processing of data;
  - complex calculations (eg fair value, provisions, estimates) or accounting policies open to different interpretations;
  - subjective judgement based on a significant measurement uncertainty, eg a range of values; and
  - the nature of the transactions make it difficult to implement effective controls over the risks.
- A full understanding of such risks and the management’s internal control and risk assessment procedures must be obtained by the auditor.
- Note that any risk that relates to potential fraud is considered to be a significant risk.

## Risk assessment procedures

- Under **ISA 315 *Understanding the entity and its environment and assessing the risks of material misstatement*** the auditor is required to carry out a risk assessment. In particular, this includes a risk assessment of the possibility of material misstatement caused by fraud.

## Inquiries of management

- Inquiries of management are made regarding their assessment of the risk of fraud and the controls in place to prevent and detect it, eg:
  - their (management’s) assessment of the risk that the financial statements may be materially misstated due to fraud;
  - the process for identifying and responding to the risks of fraud in the entity;
  - the involvement of those charged with governance regarding the processes for identifying and responding to the risks of fraud; and
  - the involvement of employees regarding management’s views on business practices and ethical behaviour.
- The way management approach the prevention and detection of fraud, and the actions taken should fraud occur, are indicative of management’s attitude to internal control.

- Discussions should also be held with management about their knowledge of actual, suspected or alleged frauds and the action they took. When holding such discussions, the auditors should apply professional scepticism and consider evidence obtained from other areas of their risk assessment.

### **Inquiries of those charged with governance**

- Those charged with governance (eg the audit committee) play an active role in the oversight of the entity's assessment of the risks of fraud and of the internal control established to mitigate specific risks of fraud that the entity has identified.
- As management are in a key position to be able to override internal control, understanding the role of those charged with governance enables the auditor to assess the strength of the oversight procedures and the susceptibility of the entity to management fraud.
- As the oversight procedures are in effect part of the entity's internal control, the auditor should consider observing the governance process by attending appropriate meetings, reviewing reports and discussing matters directly with, for example, the audit committee.
- As with management, enquiries should be made of those charged with governance about their knowledge of actual, suspected or alleged fraud. The response received can then be compared to those of management and where inconsistencies arise these must be investigated.

### **Inquiries of others**

- Would include:
  - internal audit;
  - direct and indirect (of the finance function) operating personnel;
  - those employees who deal with complex or unusual transactions;
  - internal and external legal services; and
  - any employee who is designated responsible for ethics and/or specific laws and regulations (eg the MLO – money laundering officer).

### **Consideration of risk factors**

- In understanding the entity (as well as throughout the audit process) the auditor should be aware of potential fraud risk factors (for both financial reporting and misappropriation of assets):
  - events or conditions that indicate an incentive or pressure to commit fraud;
  - provide the opportunity to commit fraud; and
  - the attitude/environment that rationalises the fraud.

### **Risk factors relating to fraudulent financial reporting**

- Incentives and/or pressure arising from:
  - negative impact on financial stability or profitability due to political, economic, social, technological, industry, or entity operating conditions, (basically PEST risk factors);
  - external third parties, eg investment analysts, banks, credit rating agencies, putting significant pressure upon management to, for example, meet forecasts;
  - the entity's poor financial performance placing management under personal financial pressure, eg personal guarantees of entity debt;
  - those charged with governance placing management under pressure to meet financial targets, including sales or profitability incentive goals (includes pressure on operating personnel from management).
  
- Opportunities arising from:
  - the nature of the industry, the entity's operations and methodologies of financial reporting, eg dominant position to be able to dictate trading terms and conditions, use of significant estimates involving subjective judgments, use of tax havens without any clear business logic;
  - ineffective monitoring of management, eg poor oversight of the board by those charged with governance or of the CEO by the board;
  - a complex or unstable organizational structure, eg rapid turnover of new senior employees and those charged with governance, opaque management structure with unclear lines of responsibility or knowing who is the ultimate reporting party;
  - deficient internal control components, eg lack of monitoring, lack of understanding (especially complex computer information processes and systems) and high turnover of key control staff.
  
- Attitude and rationalisation through:
  - ineffective communication of high ethical values (or the communication of poor ethical values) by management;
  - failure by management or those charged with governance to take appropriate action for breaches of the entity's rules and regulations, eg fraudulent expense claims, inappropriate use of company assets;
  - known history of violations of laws and regulations;
  - a need to maintain key performance indicators, eg market capitalisation of the business, earnings trends;
  - a need to minimise corporate taxation;
  - failing to correct known ineffective material internal controls;
  - no distinction between personal and business transactions;
  - strained relationships between management and the current and/or predecessor auditor, eg frequent disputes over material matters, constraints placed on the auditor, attempts to dictate the scope of the audit;
  - strained relationships between management and those charged with governance, eg withholding of board information and explanation of board actions, attempts to dictate governance procedures.

### **Risk factors relating to misappropriation of assets**

- Incentives and/or pressure arising from:

Management or employees with financial problems, eg debts, divorce, drugs.

Deterioration of employee/employer relationship, eg expected or known redundancy, expected or actual negative changes in remuneration and benefits, expectations on promotions and benefits not met.

■ Opportunities arising from:

the type of assets controlled by the entity, eg large volumes of cash, easily convertible assets (bearer bonds, diamonds, computer chips, precious metals), assets in high external demand;

poor internal control environment, eg inadequate segregation of duties or independent checks and ....

inadequate control of senior management expenditures, eg travel and other re-imbursments;

inadequate oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations;

inadequate job applicant screening of employees with access to assets, eg no references taken or probing of employment 'gaps' when employing a cashier who has committed fraud at previous employers;

inadequate recording, tracking and physical reconciliation of assets;

inadequate system of authorization and approval of transactions, eg purchasing and asset disposals;

inadequate physical safeguards over cash, investments, inventory, or fixed assets;

lack of mandatory vacations for employees performing key control functions, eg minimum of two weeks and preferably over at least one month end control period;

inadequate management understanding of, and controls over, information technology, eg a programmer is able to change a program and misappropriate company property;

inadequate management understanding of complex processes carried out by employees, eg derivative trading.

**Attitude and rationalisation through:**

ignoring the need for monitoring or reducing risks related to misappropriations of assets;

lack of respect for internal control over misappropriation of assets, eg ability to overriding existing controls, attitude of 'controls are only for others, not for me';

changes in behaviour or lifestyle that may indicate assets have been misappropriated;

tolerance of petty theft, eg stationery, scrap metal, use of company systems for private gain;

following the lead of others, eg 'what is good for the management is good for us'.

**Analytical review and other information**

- Any unusual or unexpected relationships identified when using analytical review (in understanding the entity and throughout the audit process) may indicate risks of material misstatement due to fraud, eg fictitious sales.

- All information received about the entity should be considered for the risk of material misstatement due to fraud, eg information obtained during client acceptance procedures, any interim engagements.

## Significant risks and revenue recognition

### Significant risks

- Having identified potential fraud risk factors, any risk of material misstatement at the financial statement level and the assertion level (for transactions, account balances and disclosures) due to those factors, must be identified and classified as significant risks.
- ISA 315 requires that the design of controls, control activities and whether the controls have been implemented **MUST** be audited for all significant risks (if not already covered in the auditor's normal work on understanding the entity and its control environment). Likewise, ISA 330 requires substantive procedures to be specifically designed for those risks designated as significant risks.

### Revenue recognition

- Such is the involvement of revenue recognition (eg recognising before it is earned or carrying forward to another period) in financial statement fraud, revenue recognition is **ALWAYS** considered to be a significant risk.
- The types of revenue, revenue transactions and revenue assertions that may give rise to the risk of fraud must be considered.
- In the event that revenue recognition is not considered to give rise to a risk of material misstatement due to fraud, the reasons for this must be clearly documented.

### Response to risk of material misstatement due to fraud

- Responses to the risk of material misstatement due to fraud include:
  - considering the overall audit approach;
  - the nature, timing and extent of substantive audit procedures;
  - specific audit procedures to consider the risk of management override of controls.
- Depending on the nature of the entity and the risk identified, the planned audit procedures may be sufficient or they may need to be revised when the risk is considered.

### Overall audit approach

- Increased professional scepticism, eg when selecting documentation, making enquiries and corroborating management explanations.
- Ensuring the audit team includes personnel with specialised knowledge and/or sufficient experience of the potential risk areas, eg specialist IT or forensic auditors.

- Increasing the level and detail of supervision.
- Increased alertness to management's application of accounting policies, particularly those related to subjective measurements and complex transactions, e.g. are the policies being interpreted and applied in order to deceive financial statement users by influencing their perceptions as to the entity's performance and strength.
- Altering the nature, timing and extent of audit procedures to incorporate an element of unpredictability (from the entity's management view point) to reflect the fact that management may be familiar with prior audit approaches, eg:

different sample selection procedures;  
different locations visited;  
unannounced audit visits;  
full year end inventory count for perpetual inventory systems;  
some final audit work carried out at the inventory count visit.

### **Audit procedures to respond to risk of material misstatements caused by fraud**

- The nature of audit procedures may need to be changed to obtain audit evidence that is more reliable and relevant or to obtain additional corroborative information. For example:

physical inspection of at risk assets, rather than acceptance of third party confirmation;  
computer-assisted audit techniques, including data-mining, to gather more evidence about data contained in significant accounts or electronic transaction files;  
embedded audit procedures within an entity's system, eg continuous monitoring and recording of data that may not be available at the year end;  
circularisation of receivables balances plus sales agreement terms, eg to confirm when a sale can be recognised under the agreement, returns policies, 'special' discounts;  
specific physical attention paid to cut-off procedures at the year end (say during the inventory observation or) on "at risk" sales and purchase accounts, eg inspection of despatch and inventory items for those accounts;  
seeking information from a different external source if the original external source is suspected to be party to the risk of fraud, eg early acceptance of volume purchase discounts agreed between the entity buying manager and supplier sales manager;  
reviewing journal adjustments at specific times of the year, eg quarter and interim periods, after the last audit was completed (to see what adjustments went through after the auditors had left);  
using more sophisticated analytical review procedures, eg data mining, linear regression analysis;  
closer involvement with subsidiary auditors and experts where their work is material;  
inquiries of non-financial personnel involved within the risk area;  
retrospective analysis, eg consider the approach taken by management, under similar circumstances, in prior years and the outcome of that approach.
- Timing of the procedures may need to be modified, eg:

specific functions usually carried out by the client at various times throughout the year, requested also to be carried out at the year end, eg continuous inventory counting with a full inventory count and reconciliation at the year end;  
greater detail of substantive testing conducted between the interim audit and the year end, eg full transaction and control testing in that period rather than, say, analytical review and reconciliation.

- Changing the extent of audit procedures reflects the assessment of the risks of material misstatement due to fraud, eg

increasing sample sizes;  
performing analytical procedures at a more detailed level;  
using computer-assisted audit techniques for extensive testing of electronic transactions and account files.

### **Management override of controls**

- Management are in a unique position to be able to override controls that they, themselves, would have implemented.
- **ISA 240** requires that in addition to overall responses to address the risks of fraud, the following areas are specifically considered:

Journal entries and other adjustments;  
Accounting estimates;  
Business transaction rationale.

### **Journal entries**

- Obtain an understanding of the controls over journal entries.
- Evaluate the design of those controls and determine whether they have been implemented.
- Make enquiries and review to determine if there have been any inappropriate or unusual activities (volumes, values and timing) relating to journal entries.
- Select journal entries and other adjustments for testing to appropriate supporting evidence or auditor recalculation.

Risk factors include journals that are:

made to unrelated, unusual, or seldom-used accounts;  
made to accounts that contain complex, unusual or unrelated transactions;  
made to accounts that contain significant estimates and period-end adjustments;  
made by individuals who typically do not make journal entries;  
recorded at the end of the period or as post-closing entries that have little or no explanation or description;

made either before or during the preparation of the financial statements that do not have account numbers;  
containing round numbers or consistent ending numbers; and  
processed outside the normal course of business.

### **Accounting estimates**

- Basic audit work requires auditors to establish estimates and compare to those of management. Even if the differences are individually reasonable, a consistent bias (eg understatement in estimates relating to liabilities) may indicate a risk in which case the auditor reconsiders the estimates taken as a whole.
- Carry out a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year to the actual outcome after the year end and audit. The objective of the review is to determine whether there is an indication of a possible bias on the part of management.
- Where a possible bias in accounting estimates is identified, does the bias show a risk of material misstatement due to fraud, eg an attempt to smooth earnings or to achieve a designated earnings level.

### **Business rationale of significant transactions**

- A lack of business logic for significant transactions would indicate that the transactions may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.
- The approach to evaluating the business logic includes considering if:
  - the form of the transactions appear overly complex, eg involves multiple entities within a consolidated group or multiple unrelated third parties;
  - management has discussed the nature of and accounting for such transactions with those charged with governance of the entity, and whether there is adequate documentation;
  - more emphasis is placed on the need for a particular accounting treatment than on the underlying economics of the transaction;
  - transactions that involve non-consolidated related parties, including special purpose entities, have been properly reviewed and approved by those charged with governance of the entity;
  - the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity itself.

## Section 9

### ISA 300

#### Internal control

The process designed and effected by those charged with governance, management, and other personnel, to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

- Internal control is designed and implemented to address identified business risks that threaten the achievement of any of these objectives.
- Five elements of internal control need to be considered:
  - the control environment, eg attitude, awareness and actions of management and those charge with governance;
  - the entity's risk assessment procedures, eg identifying and assessing business risk;
  - the entity's information systems, including the related business processes relevant to financial reporting and communication;
  - the control activities, eg authorisation, performance review, information processing, physical controls and segregation of duties;
  - the entity's process of monitoring controls, eg are they operating as intended; if not, why not and changes to be made.

#### Understanding internal control

The auditor should obtain an understanding of internal control relevant to the audit (ie of the five elements noted above).

They must also obtain an understanding of the way that the management monitors that internal control, i.e. over financial reporting and the way corrective action is taken.

- Professional judgement has to be used to identify those controls (which may be in any of the five elements noted above) that relate to;
  - the entity's objective of preparing financial statements that give a true and fair view; and
  - the management of risk that may result in a material misstatement within the financial statements.

For example, controls to prevent unauthorised ordering of materials, or the curtailment of the supply of essential material, will be relevant to the audit.

Controls to prevent the excessive use of material within the manufacturing process are unlikely to be relevant.

- To be able to understand internal control, the design of a control and its implementation must be ascertained by the auditor.
  - Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements.
  - Implementation of a control means that the control exists and that the entity is using it.

A poorly designed control may result in a material weakness in the entity's internal control, regardless of the fact that it is being used.

- Methods of obtaining evidence (risk assessment procedures) on the evaluation and implementation of controls include:
  - previous experience of entity – there will be a need to update understanding where changes have occurred in the current year;
  - inquiring of entity personnel, eg management, internal audit, those charged with governance, operating personnel;
  - observing the application of specific controls;
  - inspecting documents and reports, eg entity's risk strategy, assessment and response, internal control procedure manuals, management reports, system error reports, internal audit testing programmes (including report to management and management response); and
  - tracing transactions through the information system relevant to financial reporting, eg walkthrough to see that internal control is as described.

Inquiry alone is not sufficient to evaluate the design of a control relevant to an audit and to determine whether it has been implemented.

- Understanding these controls helps the auditor to:
  - identify the types of potential misstatements;
  - consider factors that affect the risks of material misstatement; and
  - design the nature, timing, and extent of further audit procedures.

This may, or may not, include testing the operating effectiveness of the controls, as after understanding the controls, the auditor decides that sufficient, appropriate audit evidence can be obtained from other procedures.

On the other hand, the testing of controls may be the only way that sufficient, appropriate evidence can be obtained, eg in fully automated computer based systems where transactions are initiated by the system.

### **Management monitoring of internal controls**

- Typically management monitoring may be through internal audit reviewing and testing internal control. Reports produced by internal audit and the resulting action taken by management may form a suitable basis for the auditor to understand the management monitoring process of internal control.
- Regular management and supervisory activities, eg checking that control activities take place, and review of external information, eg regulatory reports and complaints from customers, are all indicators of management monitoring of internal control.
- Where the information used by management for monitoring internal control is produced by the system (eg exception reports, variance analysis) the auditor must obtain an understanding of how that information is produced and the basis for management believing it to be sufficient for monitoring purposes.

|

## Section 10

### ISA 300

#### Interpreting results of internal control testing

The auditor will test a sample of internal controls that have operated throughout the period. The aim of doing this is to confirm that the control has operated as designed and thus can be partially relied upon to ensure that:

- The entity has maintained proper books and records
- The chance of material error or fraud is within tolerable limits.

At the start of the audit, the auditor will have documented an assessment of control risk. The testing of controls should confirm that this control risk is as expected.

If the controls are operating better than expected, control risk will be lower than expected. This means that a reduced level of substantive testing is required as detection risk can be relatively high.

Conversely, if controls testing reveals that controls cannot be relied upon as the proportion of times when a control did not operate properly is above tolerable limits, then the auditor must revisit his assessment of control risk. Recognising a higher level of control risk will mean that detection risk must reduce. This means more direct substantive testing of items in the balance sheet and income statement will be needed.

Controls testing is often performed before the year-end as part of an interim audit. This enables the auditor to have a good understanding of actual risks at the client before the year-end, enabling appropriate resources to be planned for the year end audit and the expected level of substantive testing.

As part of an interim audit, the auditor will also develop a further enhanced understanding of the client entity's business. This may mean that further inherent risks will be identified.

The auditor should therefore perform a full review of the initial audit plan after completing the interim audit to ensure that the audit plan contains the best possible identification of all relevant risks.

## Section 11

### ISA 500

Audit evidence

#### **Aims of Work Programmes**

An audit work programme is a list of audit objectives (financial statements assertions) and specific steps that the auditor will undertake in order to obtain sufficient appropriate evidence to conclude that each item in the financial statements gives a true and fair view.

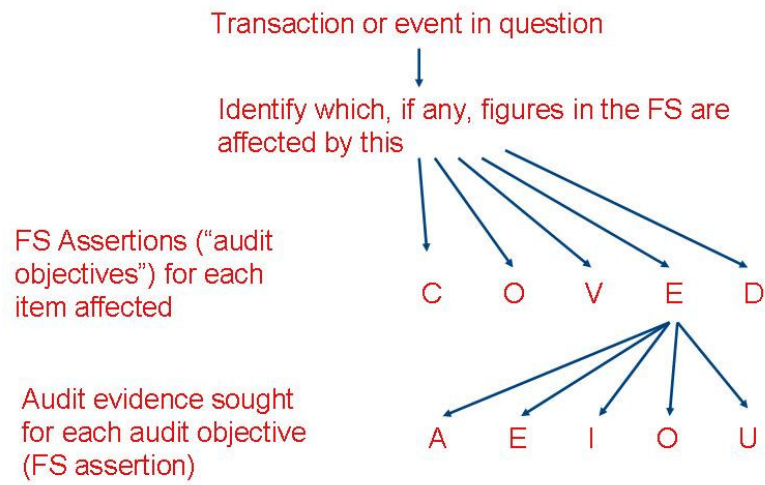
In practice, work programmes are often time consuming to write, so are often used year upon year at the same client. To promote efficiency, standard work programmes often exist and these are often tailored to the needs of a particular client's business.

The ACCA produces standard work programmes on CD-ROM and these can be a very time saving device when devising a standard work programme for a client for the first time.

Work programmes provide a logical flow for any person reviewing a file to see what work has been planned and what steps have been taken to address those risks.

Work is often performed by less experienced members of the audit team and so to enable them to improve their understanding of the audit process, each audit test should be documented carefully to state as precisely as possible what work they should perform and what the purpose of this work is. This links closely to the flow from financial statement assertions (audit objectives) to types of audit evidence.

# Summary approach



## Layout of audit programmes

A sample of an ACCA CD-ROM standard audit programme is given at the end of this section. If working with more junior, less experienced staff, the more precise that you are able to be in the instructions the better. This is consistent with the requirement in ISA to properly delegate work using three stages of direction (in advance of work being done, normally using an audit programme), supervision (while the work is being done) and concurring review (after the evidence seeking is completed). When instructing staff on what evidence to actually seek and recording what work has been done, it is often a good approach to use the verbs given in ISA 500, being:

- Analyse
- Enquire (external in writing, external orally, internal in writing, internal orally)
- Inspect
- Observe
- Reconfirm.

Avoiding using somewhat vague verbs such as “check” and “ensure” is likely to increase the chance of junior members of staff understanding what they are trying to do. This will increase the quality of their work.

Each audit programme and the working papers that come from it should really contain:

- An audit objective (ie what the test is trying to discover)
- A record of how sample sizes have been determined
- Clear statements of precisely what work is to be done
- Conclusions from each test.

The summary sheet at the start of each section of the audit file should have an overall conclusion on whether that item in the financial statements appears to be fairly stated.

# SAMPLE AUDIT PROGRAMME ON PAYABLES

## PAYABLES

- 1 Approach summary
- 2 Lead schedule

### **Audit tests and working papers**

- 3 To consider the items that have been covered through accountancy work
- 4 To form an opinion as to whether all payables existed at a given date and belonged to the client at that date, and whether all payables have been included and reflected at their proper value
- 5 To form an opinion as to whether all payables represent bona fide liabilities of the company
- 6 To form an opinion as to whether there are any other unrecorded payables
- 7 To form an opinion as to whether all payables have been allocated to the correct accounting period
- 8 To form an opinion as to whether all payables have been disclosed, classified, valued and described in accordance with the applicable reporting framework
- 9 (Any other objectives identified, which are specific to the client's business...)

[Index](#)

Completed by:	Date:	Ref: <a href="#">L1</a>
Reviewed by:	Date:	

### PAYABLES – APPROACH SUMMARY

As a result of the issues considered during the planning, note here the specific and business risks associated with the audit of this section:

Consider the best approach from the table below to be adopted to ensure that the objectives have been achieved:

Assertion	Tests of control	Analytical procedures	Substantive procedures	Sample size
Existence				
Rights and obligations				
Completeness				
Valuation and allocation				
Classification and understandability				
Accuracy and valuation				

Tests of control in respect of business risks identified ([PAF](#)):

Tests of control to be applied, based on the findings of the controls checklist ([PAF](#)):

Completed by:	Date:	Ref: <a href="#">L1</a>
Reviewed by:	Date:	

**PAYABLES – APPROACH SUMMARY continued**

Substantive analytical review procedures:
Other substantive audit procedures to be adopted:
Tolerable error level: #..... Other key items:

**Planning conclusion:**

<b>Risk:</b>	<b>Low</b>	<b>Medium</b>	<b>High</b>
--------------	------------	---------------	-------------

Prepared by: \_\_\_\_\_ Date: \_\_\_\_\_

Reviewed by: \_\_\_\_\_ Date: \_\_\_\_\_

**Final conclusion:**

Prepared by: \_\_\_\_\_ Date: \_\_\_\_\_

Reviewed by: \_\_\_\_\_ Date: \_\_\_\_\_

[Back to B3](#)

[Index](#)

Completed by:	Date:	Ref: <a href="#">L3</a>
Reviewed by:	Date:	

## WORKING PAPER – PAYABLES

	Reviewer's comments/ reference
<b>Test objective:</b>  To consider the items that have been covered through accountancy work	
<b>Work performed:</b>  <ol style="list-style-type: none"><li>1. Consider the assessments of risk and materiality performed at the planning stage, and document the impact of any changes in these assessments due to evidence coming to light since the planning was performed</li><li>2. Agree opening balances to last year's accounts</li><li>3. Obtain and check, or prepare, a lead schedule for the current year's figures</li><li>4. Enquire into and make notes of reasons for any major variations from expectations, including consideration of missing suppliers</li><li>5. Prepare or review a list of accruals and compare to previous years</li><li>6. Record details of any related party balances and ensure that they have been properly disclosed, confirmed and are complete</li></ol>	
<b>Risk:</b>	
<b>Summary and evaluation of results</b>	
<b>Conclusion</b> (include comment on impact on report where necessary)	

[Index](#)

Completed by:	Date:	Ref: <a href="#">L4</a>
Reviewed by:	Date:	

## WORKING PAPER – PAYABLES

	Reviewer's comments/ reference
<p><b>Test objective:</b></p> <p>To form an opinion as to whether all payables existed at a given date and belonged to the client at that date</p> <p><b>And</b></p> <p>To form an opinion as to whether all payables have been included and reflected at their proper value</p>	
<p><b>Work performed:</b></p> <ol style="list-style-type: none"><li>1. Verify the completeness of the list being used to select the sample using analytical review, for example:<ul style="list-style-type: none"><li>• comparing the list of trade payables with that of the previous year end</li><li>• reviewing the activity report for the last quarter, and confirming that balances are present in respect of the major suppliers</li></ul></li><li>2. Reconcile payable balances to suppliers' statements or other evidence of existence and completeness (such as a payables circularisation)</li><li>3. Agree other payables to supporting documentation to ensure that they are valid liabilities of the company</li><li>4. Review significant payments after the year end, and ensure that all liabilities existing at the year end have been included in the financial statements</li></ol>	
<p><b>Risk:</b></p>	<p><b>Sample size:</b></p>
<p><b>Method of sample selection:</b></p>	
<p><b>Summary and evaluation of results</b></p>	
<p><b>Conclusion</b> (include comment on impact on report where necessary)</p>	

[Index](#)

Completed by:	Date:	Ref: <a href="#">L5</a>
Reviewed by:	Date:	

**WORKING PAPER – PAYABLES**

	<b>Reviewer's comments/ reference</b>
<b>Test objective:</b>  To form an opinion as to whether all payables represent bona fide liabilities of the company	
<b>Work performed:</b>  1. Review for large and unusual items in each category of payables, and verify to supporting documentation	
<b>Risk:</b>	
<b>Summary and evaluation of results</b>	
<b>Conclusion</b> (include comment on impact on report where necessary)	

[Index](#)

Completed by:	Date:	Ref: <a href="#">L6</a>
Reviewed by:	Date:	

**WORKING PAPER – PAYABLES**

	<b>Reviewer's comments/ reference</b>
<b>Test objective:</b>  To form an opinion as to whether there are any other unrecorded payables	
<b>Work performed:</b>  1. Review invoices posted after the year end, and ensure that all significant year end liabilities (including accruals) have been accounted for in the correct period	
<b>Risk:</b>	
<b>Summary and evaluation of results</b>	
<b>Conclusion</b> (include comment on impact on report where necessary)	

[Index](#)

Completed by:	Date:	Ref: <a href="#">L7</a>
Reviewed by:	Date:	

**WORKING PAPER – PAYABLES AND ACCRUALS**

	<b>Reviewer's comments/ reference</b>
<b>Test objective:</b>  To form an opinion as to whether all payables have been allocated to the correct accounting period	
<b>Work performed:</b>  1. Review purchases around the period end and ensure that they have been accounted for in the correct period with reference to inventory movements  2. Use the cut-off details obtained during the inventory check attendance to confirm that the last receipt of inventory in the accounting period was invoiced before the year end and included in trade payables, and the first receipt of inventory after the year end was excluded	
<b>Risk:</b>	
<b>Summary and evaluation of results</b>	
<b>Conclusion</b> (include comment on impact on report where necessary)	

[Index](#)

Completed by:	Date:	Ref: <a href="#">L8</a>
Reviewed by:	Date:	

**WORKING PAPER – PAYABLES**

	<b>Reviewer's comments/ reference</b>
<p><b>Test objective:</b></p> <p>To form an opinion as to whether all payables have been disclosed, classified, valued and described in accordance with the applicable reporting framework</p>	
<p><b>Work performed:</b></p> <ol style="list-style-type: none"><li>1. Ensure that payable balances have been correctly classified and disclosed as long or short term</li><li>2. Ensure that there is correct disclosure of any security or guarantees provided by the client (in accordance with GAAP)</li><li>3. Ensure that any related party transactions and balances have been adequately disclosed</li><li>4. Ensure that there has been no inappropriate setting off of debit balances against credit balances (or vice versa)</li><li>5. Consider the need to accrue for interest in respect of overdue payables</li></ol>	
<p><b>Risk:</b></p>	
<p><b>Summary and evaluation of results</b></p>	
<p><b>Conclusion</b> (include comment on impact on report where necessary)</p>	

|

## Section 12

### Interpreting Results of Testing

An audit sample is inevitably going to contain errors. It is normal for the auditor to keep a record of errors noted, other than errors which are of such small size that they are very unlikely to contribute to a net material error in the financial statements.

For example, if an auditor has sampled receivables with a value of \$50,000 from an overall receivables balance of \$500,000, the auditor has substantively tested 10% of the total balance. This testing might be by writing to a sample of receivables to ask them to confirm their balance, looking at receipts of cash after the year-end and various other substantive procedures using the "AEIOU" mnemonic above.

If this sample shows a net overstatement of \$1,500, the auditor may extrapolate from this sample to draw a conclusion about the population as a whole. In this case, the auditor may conclude that the projected misstatement of receivables as a whole is \$15,000 ( $\$500,000 \times \$1,500/\$50,000$ ).

If this projected error is material to the financial statements, it would be normal to extend testing to determine if the error in the sample is unrepresentative. If the auditor has chosen an appropriate sample however, this should not be the case.

If the projected error is immaterial but not completely insignificant (say 10% of more of the materiality figure), then it is normal to keep a cumulative record of all immaterial errors noted. This is normally done using a "scoresheet" list of proposed journals to correct the errors. The client will be asked to correct all errors noted in the scoresheet, with the aim of providing the most accurate picture possible.

The auditor will also add up all the errors noted in the scoresheet in order to make sure that errors which are individually immaterial do not collectively exceed the materiality figure. For example, if a number of errors exist which individually are below materiality but all of which overstate profit, they may collectively produce a material error. If the client refuses to correct all such errors if the effect is material, this will produce a material disagreement "except for" modification in the audit opinion.

## Section 13

### Audit Completion

Once most of the audit work has been completed and there are provisional conclusions on each account balance in the financial statements, a number of steps remain before the auditor is able to issue an audit opinion, including:

- Obtain a management representation letter
- Perform an overall review of the financial statements (analytical review)
- Update going concern review
- Perform a post-balance sheet events review
- Arrange a date to sign the audit opinion as soon as possible after the directors have signed the financial statements.

Many audit firms find that the costs on an audit after the audit “fieldwork” has been completed are often around on third of the total audit costs. This should be avoided by careful planning at the start of the audit for what matters remain to be covered, since this stage of the audit often involves the greatest amount of effort from the most senior staff. Careful planning and communication can do much to reduce inefficiencies at this stage.

### Management Representation Letters: ISA 580

A management representation letter is a written confirmation that management understand their responsibilities for preparation of the financial statements. It also has the following purposes:

- To confirm the auditor’s understanding of key explanations and other representations given to the auditor orally by management during the audit. This minimises the risk of management denying something they said or the auditor having misunderstood a statement made by management.
- To provide evidence where no other sources of evidence are available. For example, an intention to hold an asset for the long-term means it must be classified as a non-current asset rather than as a current asset. ***The auditor should consider a written representation from management to be sufficient, appropriate evidence only where no other source of evidence on that matter can be expected to exist.***

- There is some evidence that fraudulent management are less likely to be willing to actively mislead an auditor in writing than passively not in writing.

Although it is normal for the auditor to draft the representation letter for management, the letter should be sent from management to the auditor, be presented on the entity's headed paper. It should also be given to the auditor and dated as close as possible to the date that the management approve the financial statements. This, in turn, should be the same date that the auditor signs the audit opinion.

Management representations are not a substitute for other forms of evidence. If there is no other form of evidence available, the auditor should consider qualifying their audit opinion on grounds of limitation on audit scope.

If management refuse to provide a management representation letter, ISA 580 states that the auditor should consider issuing an audit opinion which is modified:

- For material limitation on scope (an "except for ... might" modification),  
or
- A disclaimer of opinion.

It is worth considering the fact that the purpose of an audit is to lend credibility to the financial statements by providing an independent opinion. If the only evidence available on a matter that would be very significant to a shareholder is a management representation, the auditor is not adding much value. Hence management representations must not be used as a short cut to obtaining more reliable evidence.

### **Overall review of financial statements**

Prior to issuing the audit opinion, a final analytical review should be performed on the financial statements, with each adjustment requested put through the financial statements.

This may reveal unusual inter-relationships between figures that would appear to suggest that one or more of the adjusted figures is not correct. In effect, this is a final reasonableness test.

It is often at this stage that uncorrected errors are identified, so it should not be rushed. The greater an auditor's familiarity with the client's business and the industry in which the client operates, the greater the benefit of this stage of the audit.

### **Update going concern review**

This is part of the post-balance sheet review below, but it is wise to ensure that going concern has been specifically considered and that the auditor feels that there is sufficient appropriate evidence to take a positive assurance view of going concern.

### **Perform a post-balance sheet events review**

The directors remain primarily liable for identifying and reporting any events after the balance sheet date, in accordance with IAS 10. Once the management has approved the financial statements however, they have completed their responsibilities for that year's accounts and so the primary responsibility for identifying any post balance sheet events shifts from the management to the auditor after this date. For this reason, the auditor should normally arrange to sign the audit opinion on the same date that management approve the financial statements.

IAS 10 requires that the figures in the financial statements are adjusted where evidence comes to light after the date of the balance sheet that gives further insight into conditions that existed at the balance sheet date. These are often called adjusting post balance sheet events.

Non-adjusting events are material events that were not in progress at the balance sheet date, but which must be disclosed for the reader of the financial statements to obtain a full understanding of the financial statements.

If any post balance sheet events come to light after management approved the financial statements, they must be disclosed in the audit opinion. This would not interfere with a true and fair view at the date that the management approved the financial statements, so it would not necessarily result in a qualified audit opinion.

### **Arrange a date for issuing the audit opinion**

In light of the above, it is wise for careful administrative arrangements to be made for the audit opinion to be signed on the same date that the directors authorise the financial statements.

Since the financial statements do not legally exist until they have been approved by management, the auditor is unable to issue an audit opinion dated before the date that management approved the financial statements.