The Institute of Chartered Accountants of Bangladesh (ICAB)

Audit and Assurance

Workbook
For CA Professional Level Exams

CA BANGLADESH

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CA OVERVIEW

The ICAB chartered accountancy qualification, the CA, is one of the most advanced learning and professional development programmes available. Its integrated components provide an in-depth understanding across accountancy, finance and business. Combined, they help build the technical knowledge, professional skills and practical experience needed to become an ICAB Chartered Accountant.

Each component is designed to complement each other, which means that students can put theory into practice and can understand and apply what they learn to their day-to-day work.

The four components are:

ICAB constantly reviews the content of the CA qualification to reflect real life business challenges. Today's most urgent business challenges range from sustainability, to rapid changes in technology and the role of ethics in the profession. We work closely with employers, tuition providers, academics and examiners to ensure that the CA equips the chartered accountants of the future with the skills and knowledge they need to meet these challenges and to be successful.

THE CA QUALIFICATION AND SUSTAINABILITY

Finance and accounting professionals need to move beyond simply measuring and reporting the impact of climate change, environmental regulation, supply chain pressure and rising energy costs. They must focus on understanding those implications and integrating them into financial management and business planning. ICAB has been at the forefront of this movement over the past decade and has adapted the CA qualification to reflect that. We see its role as not simply integrating knowledge and understanding the broader implications of environmental, social and governance issues into organisations, but also seeding this thinking into the mindset of our members.

Our syllabus and ethical and professional development framework contribute towards creating ICAB Chartered Accountants who recognise that sustainability is at the core of what they do and are capable of actively using their business skills to analyse how to make the new sustainable economy work for their business.

THE CA QUALIFICATION AND TECHNOLOGY

Rapid growth in technology has automated many compliance elements of accountancy. But, with technology also comes complexity and risk. Accountants need to adapt and develop new skills to manage these technological changes such as data analytics, automation and cyber security.

While there are many new technology capabilities that have broad application across the business and consumer environment, four trends have the greatest potential to transform the accountancy profession: Artificial intelligence, Blockchain, Cyber security and Data (ABCD of technology).

These and other innovations are likely to have a significant impact on the way that accountants access, move and manage business finances.

Technology can provide information more quickly and often more accurately than humans, but it cannot replicate human intelligence and quality decision making. Therefore, chartered accountants hold a key role in data analytics, in validating the source of the data, interpreting and analysing the outputs. Technology provides opportunities for chartered accountants to use their professional skills to add value to their clients and/or the businesses in which they work.

As routine and compliance work reduces, there is greater focus on the development of skills which equip professionals to work with the outputs of automated processes, with other specialists, and in a changing world.

We believe that skills such as analysis, interpretation, professional scepticism, communication, collaboration, adaptability, resilience, and commerciality are essential for tomorrow's business leaders; these are imbedded throughout the CA exams and professional development framework.

THE CA QUALIFICATION AND ETHICS

Culture and values are central to long-term success. How a business adopts an ethical approach towards its staff, shareholders, customers and regulators, as well as within its own operations, has a bigger impact than any performance measure or operational improvement.

Demonstrating a clear commitment to ethical behaviour is one of the main drivers of better performance; it delivers an advantage when recruiting, it adds value to a brand, and it instils trust and confidence in partners, suppliers and others that the organisation is well run and resilient.

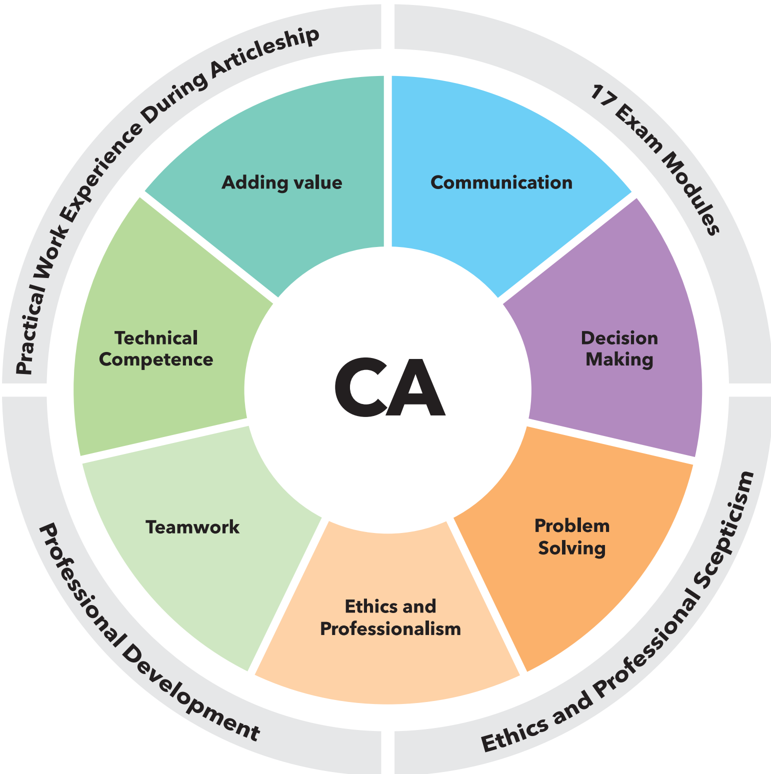
Achieving that is not a matter of simple knowledge. Few ethical challenges will have simple right and wrong responses. They require technical understanding, rigorous appraisal and skillful handling. Accountants must have the necessary skills to apply professional judgement in a given situation, taking into account what has been learned as a CA student about their ethical responsibilities as a Chartered Accountant.

There will be unique ethical challenges throughout any Chartered Accountant's process of learning and career. They serve a variety of masters: senior management, external stakeholders, regulators; and above all the public interest responsibility of their profession. Because of the rigorous and effective training (and continued professional development) chartered accountants can speak up and take a lead.

None of this can happen without one critical element: professionalism. That goes beyond merely knowing the Code of Ethics: it means embodying the right behaviours and having the ability and willingness to push back against those who might compromise the integrity of the business.

That confidence comes from a qualification that prioritises not only technical knowledge of the ethical framework but also challenges accountants with scenarios that accurately reflect the ethical dilemmas a Chartered Accountant may face in business.

PROFESSIONAL DEVELOPMENT



ICAB Chartered Accountants are known for their professionalism and expertise. Professional development prepares students to successfully handle a variety of different situations that they encounter throughout their career. The CA qualification improves students' ability and performance in seven key areas:

- Adding value – add value to the organisation, team or role in order to achieve objectives
- Communication – communicate effectively at all levels, using oral, written and presentational skills to achieve positive outcomes
- Decision making – gather, interpret and evaluate data to make effective decisions
- Ethics and professionalism – behave ethically and sustainably while respecting others to uphold the values of the organisation and the accountancy profession
- Problem solving – analyse a problem, generate options and make recommendations to arrive at appropriate solutions
- Teamwork – work collaboratively as a member or leader of a team to achieve shared goals
- Technical competence – seek, learn and use technology and technical information to support the achievement of organisation or team goals
- There are 17 exams over three levels – Certificate, Professional and Advanced.

CERTIFICATE LEVEL

There are seven exams at this level that introduce the fundamentals of accountancy, finance and business. Students may be eligible for credit for some exams if they have studied a qualification we recognise.

The Certificate Level exams are each 1.5 hours long except Business Laws and Information Technology which are 1 hour long and can be sat four times in the year.

PROFESSIONAL LEVEL

The next seven exams build on the fundamentals and test students' understanding and ability to use technical knowledge in real-life scenarios. The exams are taken in three times in the year.

The Professional Level exams are 3.5 hours long.

The Professional Level exams are flexible and can be taken in any order to fit with a student's day-to-day work. The Business Planning: Taxation & Compliance and Business Strategy and Technology exams in particular help students to progress to the Advanced Level.

The suite of Business Planning: Taxation & Compliance and Business exams is based on the same syllabus structure and skills frameworks, and will give students the opportunity to demonstrate their learning and use this in the context of taxation.

Financial Accounting and Reporting is in the contexts of IFRS Standards.

ADVANCED LEVEL

The Corporate Reporting and Strategic Business Management & Leadership exams test students' understanding and strategic decision-making at a senior level. They present real-life scenarios, with increased complexity and implications from the Professional Level exams.

The Case Study tests all the knowledge, skills and experience gained so far. It presents a complex business issue which challenges students' ability to problem solve, identify the ethical implications and provide an effective solution.

The Advanced Level exams are taken three times in the year.

The Corporate Reporting and Strategic Business Management & Leadership exams are 3.5 hours long. The Case Study exam is 4.5 hours long.

If a student is studying the CA independently, they should consider their future ambitions while selecting which exams to sit.

FLEXIBILITY

There are no regulations stipulating the order in which students must attempt the exams, allowing CA Firms to design Articleship programmes according to business needs. The exception to this rule is the Case Study. For attempting Case Study, students must be attempted the other subjects of Advanced Level.

Students have the unlimited attempts at all levels of exams.

CREDIT FOR PRIOR LEARNING (CPL)

Students with previous qualifications may be eligible to apply for CPL for modules which have been allowed by ICAB. For more information, visit https://www.icab.org.bd/page/credit-for-prior-learning-cpl-exemption.

DATA ANALYTICS

Chartered Accountants are increasingly using more advanced approaches to interrogate client data. To respond to this, ICAB has incorporated data analytics software within the Audit and Assurance and Corporate Reporting modules.

Embedding data analytic techniques within our exams ensures that we continue to reflect the current and future workplace and will also help to develop students' judgement, professional scepticism and critical thinking skills

Audit and Assurance

Module aim

To develop your understanding of the critical aspects of managing an assurance engagement (including audit engagements): acceptance, planning, managing, concluding and reporting.

On completion of this module, you will be able to:

- understand and advise on the regulatory, professional and ethical issues relevant to those carrying out an assurance engagement;
- understand the processes involved in accepting and managing assurance engagements;
- understand how quality assurance processes mitigate risks;
- plan assurance engagements in accordance with the terms of the engagements and appropriate standards; and
- conclude and report on assurance engagements in accordance with the terms of the engagements and appropriate standards.

Method of assessment

The Audit and Assurance exam is 3.5 hours long. The exam will consist of four or five short-form questions and three longer questions. The exam will test each of the three syllabus areas in accordance with the weightings set out in the specification grid .

Ethics and professional scepticism

Ethical thinking is fundamental to the conduct of a sound audit. A specific weighting given to legal and other professional regulations, ethics, accepting and managing engagements and current issues is shown in the table below. In addition to this a separate learning outcome covers planning and performing engagements and the potential risks involved. You will also be required to demonstrate the crucial role of professional scepticism in the judgement they apply.

Specification grid

This grid shows the relative weightings of subjects within this module and should guide the relative study time spent on each. Over time the marks available in the assessment will equate to the weightings below, while slight variations may occur in individual assessments to enable suitably rigorous questions to be set.

	Weighting (%)
1 Legal and other professional regulations, ethics, accepting and managing engagements and current issues	30
2 Planning and performing engagements	50
3 Concluding and reporting on engagements	20

Key resources

Whether you're studying the CA qualification with an employer, at university, independently, or aspart of an apprenticeship, we provide a wide range of resources and services to help you in your studies.

Syllabus, skills development and technical knowledge grids

The syllabus presents the learning outcomes for each exam and should be read in conjunction with the relevant technical knowledge grids and, where applicable, the skills development grids.

Exam support

A variety of exam resources and support has been developed on each exam to help you on your journey to exam success. This includes expert guides, hints and tips, webinars and more.

Past exams and mark plans

Use past exams to practice answering questions. The mark plans will help you check your answers.

Skills within the CA

Professional skills are essential to accountancy and your development of them is embedded throughout the CA qualification.

The level of competency required in each of the professional skills areas to pass each module exam increases as CA trainees progress upwards through each Level of the CA qualification. The skills progression embedded throughout the CA qualification ensures CA trainees develop the knowledge and professional skills necessary to successfully operate in the modern workplace and which are expected by today's forward-thinking employers.

The following professional skills areas are present throughout the CA qualification.

Skill area	Overall objective
Assimilating and using information	Understand a business or accounting situation, prioritise by determining key drivers, issues and requirements and identify any relevant information.
Structuring problems and solutions	Structure information from various sources into suitable formats for analysis and provide creative and pragmatic solutions in a business environment.
Applying judgement	Apply professional scepticism and critical thinking to identify faults, gaps, inconsistencies and interactions from a range of relevant information sources and relate issues to a business environment.
Concluding, recommending and communicating	Apply technical knowledge, skills and experience to support reasoning and conclusion and formulate opinions, advice, plans,solutions, options and reservations based on valid evidence and communicate clearly in a manner suitable for the recipient.

The following provides further detail on the professional skills that you will develop in this particular module.

Assimilating and using information Understand the situation and the requirements

- Identify the needs of customers and clients
- Explain different stakeholder perspectives and interests
- Identify risks within a scenario
- Identify elements of uncertainty within a scenario
- Identify ethical issues including public interest and sustainability issues within a scenario

Identify and use relevant information

- Interpret information provided in various formats
- Evaluate the relevance of information provided
- Filter information provided to identify critical facts
- Identify and interpret information in data analytics software

Identify and prioritise key issues and stay on task

- Identify business and financial issues from a scenario
- Work effectively within time constraints
- Operate to a brief in a given scenario

How skills are assessed: You may be required to demonstrate

- the regulatory, professional and ethical issues relevant to accepting, carrying out and managing assurance engagements;
- how quality assurance processes mitigate risks;
- an ability to identify relevant information in data analytics software in order to suggest actions that need to be taken; and
- an ability to respond to instructions from a line manager, a partner or a client request, making judgements where required and taking ethical considerations into account.

Structuring problems and solutions Structure data

- Identify any information gaps
- Frame questions to clarify information
- Use a range of data types and sources to inform analysis and decision making
- Structure and analyse financial and non-financial data to enhance understanding of business issues and their underlying causes
- Present analysis in accordance with instructions and criteria

Develop solutions

- Identify and apply relevant technical knowledge and skills to analyse a specific problem
- Use structured information to identify evidence-based solutions
- Identify creative and pragmatic solutions in a business environment
- Identify opportunities to add value
- Identify ethical dimensions of possible solutions
- Select appropriate courses of action using an ethical framework

How skills are assessed: You may be required to demonstrate

Requirements will include planning assurance engagements in accordance with the terms of engagement and appropriate standards, taking account of:

- managing audit and other assurance engagements;
- reliance on controls;
- reliance on the work of internal audit or other experts;
- reliance on the work of another auditor;
- extent of tests of control and of substantive procedures, including analytical procedures;
- use of analytical procedures including data analytic routines to identify the risk of misstatement; and
- number, timing, staffing and location of assurance visits.

Applying judgement

Apply professional scepticism and critical thinking

- Recognise bias and varying quality in data and evidence
- Identify assumptions or faults in arguments
- Identify gaps in evidence
- Identify inconsistencies and contradictory information
- Assess interaction of information from different sources
- Exercise ethical judgement

Relate issues to the environment

- Appreciate when more expert help is required
- Identify related issues in scenarios
- Assess different stakeholder perspectives when evaluating options
- Retain an overview of the business issue or scenario
- Appraise the effects of alternative future scenarios
- Appraise ethical, public interest and regulatory issues

How skills are assessed: You may be required to

- Identify business risks and audit risks, including significant risks, from a given scenario, explain their impact on the financial statements, and recommend audit procedures to mitigate the risk of a material error. Requirements will test the ability of students to filter those issues which are more relevant than others in a given scenario.
- Distinguish the quality of data or evidence to be tested in two potential ways. (i) students will need to distinguish between data generated from within an organisation and that generated by a third party, the latter being less susceptible to management bias; and (ii) students will need to appreciate the effect on the quality of evidence that bias caused by specific factors can have, eg, where profits are used to determine a bonus payment to be made to the company's management.
- Identify the impact of specific economic and political factors on a set of financial statements, eg,in the context of dealing with customers or suppliers from overseas that (i) political instability may cause problems which prevent the customer or supplier from trading, ultimately leading to going concern issues for the audited entity; and (ii) economic factors may cause exchange rate fluctuations leading to the risk of misstated balances in the financial statements.
- Evaluate the effect of uncertain future events when describing the procedures to be performed in carrying out an examination of a company's financial forecasts.
- Assess the materiality of a particular matter (eg, an unadjusted error) in the context of a set of financial statements or other financial information. This assessment should then inform the student's judgement as to whether or not to modify the opinion given in a statutory auditor's report or modify the conclusion in a non-audit assurance report.
- Judge the potential independence risks involved in accepting or continuing an audit or other assurance engagement, and the procedures to mitigate those risks; and consideration of the required steps upon the discovery of fraud/money laundering.
- Display the ability to present a structured argument to a client eg, in situations where management is questioning the extent of audit work performed.

Concluding, recommending and communicating Conclusions

- Apply technical knowledge to support reasoning and conclusions
- Apply professional experience and evidence to support reasoning
- Use valid and different technical skills to formulate opinions, advice, plans, solutions, options and reservations

Recommendations

- Present recommendations in accordance with instructions and defined criteria
- Make recommendations in situations where risks and uncertainty exist
- Formulate opinions, advice, recommendations, plans, solutions, options and reservations based on valid evidence
- Make evidence-based recommendations which can be justified by reference to supporting data and other information
- Develop recommendations which combine different technical skills in a practical situation

Communication

- Present a basic or routine memorandum or briefing note in writing in a clear and concise style
- Present analysis and recommendations in accordance with instructions
- Communicate clearly to a specialist or non-specialist audience in a manner suitable for the recipient
- Prepare the advice, report, or notes required in a clear and concise style

How skills are assessed: You may be required to

- advise on the regulatory, professional and ethical issues in carrying out an assurance engagement;
- conclude and report on assurance engagements, including determining whether to modify a report with or without a modified opinion/conclusion; and
- identify deficiencies in financial information systems, their potential consequences and recommendations for improvement.

To help you develop your ability to demonstrate competency in each professional skills area, each chapter of this Workbook includes up to four Professional Skills Guidance points.

Each Professional Skills Guidance point focuses on one of the four CA Professional Skills areas and explains how to demonstrate a particular aspect of that professional skill relevant to the topic being studied. You are advised to refer back to the Professional Skills Guidance points while revisiting specific topics and during question practice.

Chapter 1

Reintroduction to audit and assurance

Introduction

Learning outcomes

- Revise the concept of assurance from your Assurance exam
- Revise the concept of audit from your Assurance exam
- Understand the specific benefits of an audit

Syllabus links

This chapter revises key concepts from your Assurance exam.

Examination context

This chapter is revision of what you have previously been examined on in your Assurance exam.

You will need an understanding of what assurance services are – audit in particular – that will be brought forward from your lower level exam to answer any questions at this level.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	In the recent past, the services provided by accounting practices in the Bangladesh were mainly restricted to accounts preparation, audit and tax. If you are training in practice, you are likely to spend some training time working in an assurance department and being involved in work on audits or other assurance engagements. If you work in industry, you might be involved from the other side.	This chapter is in the main revision of material that was covered in Assurance. You should read over this section and attempt the activity at the end.	This chapter is revision of what you have previously been examined on in your Assurance exam. You will need an understanding of what assurance services are – audit in particular – that will be brought forward from your lower level exam to answer any questions at this level.	1, 2, 3

Topic	Practical significance	Study approach	Exam approach	Self-test questions
2	Formerly, audits were almost the only assurance engagements in existence and nearly all companies required an audit. Consequently, most accountants worked on audits at some point in their careers.	You should read over this section carefully.	The material in this section may be examined in a short form question.	4, 5
3	More recently there have been developments which have tended to split the 'traditional' view that assurance firms provide audit and other services in one 'package'. Factors such as: the restriction on which companies are legally required to have audits; pressure to maintain auditor independence; and the growth in other types of assurance service being requested from, and offered by, accounting practices.	You should read over this section and attempt the activities.	The material in this section may be examined in a short form question.	6

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1. Assurance defined

Section overview

- An assurance engagement is one in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users, other than the responsible party, about the outcome of the evaluation or measurement of a subject matter against criteria.
- Key elements are: three party involvement, subject matter, suitable criteria, sufficient appropriate evidence, written report.
- Different levels of assurance may be given in assurance assignments: reasonable and limited.
- An audit is an example of an assurance engagement giving reasonable assurance.

Definition

Assurance engagement: An engagement in which a practitioner aims to obtain sufficient appropriate audit evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the subject matter information (that is, the outcome of the measurement or evaluation of an underlying subject matter against criteria).

Assurance engagements include primarily audits but also other services such as reports on internal control and review of a business plan.

In recent years businesses worldwide have been publishing sustainability and corporate responsibility reports, in an attempt to demonstrate accountability for the impact of their activities on society and the environment. Such reports may be the subject of assurance engagements that provide limited assurance to management on reported elements such as key performance indicators,adherence to voluntary codes etc.

1.1 The elements

Any assurance engagement needs:

- a responsible party
- a practitioner
- a user of the report
- a subject matter
- criteria
- sufficient appropriate evidence to support the conclusion
- a written report containing a conclusion

The engagement will be governed by its terms of engagement (found in an engagement letter).

The engagement will need to be:

- planned
- performed
- concluded upon
- reported on

1.2 Levels of assurance

The International Federation of Accountants (IFAC) recognises two types of assurance engagement:

- Reasonable assurance engagements, which result in a positive expression of opinion and where the level of assurance given is deemed to be high
- Limited assurance engagements, which result in negative assurance and where the level of assurance given is deemed to be moderate

Engagements could be either type, and this would need to be specified in the terms of engagement.
So for a report on the effectiveness of management's system of internal control, it might be agreed that the report should read as follows:

- "In our opinion management has operated an effective system of internal control"– a positive form of opinion deriving from a reasonable assurance engagement; or
- "Nothing has come to our attention that indicates material internal control weakness" – a negative form of assurance deriving from a limited assurance engagement.

No report on an assurance engagement can ever provide absolute assurance, because of the nature of the evidence available.

Assurance type	Assurance level	Opinion/conclusion	Example
Reasonable	High	Positive	Audit of financial information
Limited	Moderate	Negative	Review of financial information

Professional skills focus: Applying judgement

This issue is connected to that of the expectations gap between users and auditors, which you studied in Assurance. What do you think about the issue? Is the expectations gap a question of users simply misunderstanding the audit, or is audit not fit for purpose?

1.3 Benefits of assurance

A key feature of assurance services is that they are provided by independent professionals who therefore give an objective, unbiased opinion. They give the following benefits to users:

- Enhances the credibility of the information being reported on
- Reduces the risk of management bias, error or even fraud in the information being reported on
- Draws the attention of the user to any deficiencies in the information being reported on

Assurance services also give added credibility to the wider share market:

- They ensure that high quality, reliable information circulates in the market.
- They give investors added faith in the market.
- They improve the reputation of organisations trading in the market.

Context example: Assurance engagement

Predator plc, a large listed company, is considering taking over Target Limited, a small, family owned company.

Predator has asked Talbot and Co, chartered accountants, to carry out due diligence in relation to this prospective purchase. They want them to review the financial statements of the last three years and ensure that they were prepared under IFRSs in Bangladesh . They also want them to review the budgets for the coming 12 months and ensure that they are reasonably and internally consistent.

You can see the elements of the assurance service as these:

- Practitioner: Talbot and Co
- Responsible party: Target Ltd management
- Users: Predator plc management
- Subject matter: Financial statements/budgets
- Criteria: IFRSs/reasonable and internally consistent

Talbot and Co will plan and carry out work to obtain sufficient appropriate evidence to support their assurance opinion, which will be given in a written report.

The benefits of this service to Predator plc are that:

- they are given assurance that the financial statements are in line with IFRSs and therefore are understandable and comparable with other companies they might be considering for takeover;
- they are given assurance that the budgets are reasonable and internally consistent and therefore can be trusted as an indicator of the company's future operating ability; and
- they can therefore make an informed decision about whether to buy Target and for how much.

Interactive question 1: Benefits of assurance

During the night of 7 June 20X3 strong gales caused the brick chimney of the factory to crash through the roof of Hancock Ltd's assembly area. Production was severely disrupted for a period of two months.

In addition to claiming from its insurers for the cost of repairing the premises and for the equipment and inventories destroyed in the accident, the company is also including a considerable claim under the loss of profits provision of its policy. The directors have prepared detailed calculations of the loss of profit and have requested the company's auditors to review this claim and provide an assurance report which they will submit with it to the insurers.

Requirement

What advantages would the directors expect to gain from having this report?

See **Answer** at the end of this chapter.

2 Audit defined

Section overview

- An audit is a key example of an assurance service in the Bangladesh, where many companies are required to have audits by law.
- An audit is an exercise designed to enable an auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
- An auditor usually expresses a conclusion as to whether the financial statements 'give a true and fair view'.
- The 'audit threshold' is the legal qualification for a company to have an audit.

- The benefits of audit are much the same as the benefit of assurance services generally. Users of financial statements subject to an audit are given assurance that the financial statements meet legal requirements as well as accounting ones.

Definition

Audit of financial statements: According to ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* the overall objectives of the auditor in conducting an **audit of financial statements** are as follows:

- To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- To report on the financial statements and communicate as required by the ISAs, in accordance with the auditor's findings.

Context example: How audit is an assurance engagement

The key criteria of an assurance engagement can be seen in an audit as follows:

(a) Three party involvement
- The shareholders (users)
- The board of directors (the responsible party)
- The audit firm (the practitioner)

(b) Subject matter
- The financial statements

(c) Relevant criteria
- Law and accounting standards

(d) Evidence
- The auditor is required by International Standards on Auditing (ISAs) to obtain sufficient and appropriate evidence to support the audit opinion.

(e) Written report in suitable form
- As required by ISA 700, *Forming an Opinion and Reporting on Financial Statements*, the auditor's report is a written report issued in a prescribed form.

2.1 The benefits of being audited

The case for audit for those companies where it is not required by statute usually revolves around the protection of those who, apart from management, nevertheless have a financial interest in the company, for example:

- Banks and other providers of finance
- Minority shareholders

Many would argue (and the auditors of smaller companies have found this to be true) that, in many cases, the audit is valued by management because of the following:

- They value having their business scrutinised by another set of professional eyes.
- It provides additional assurance to third parties such as taxation authorities concerning the reliability of the financial statements.

- A growing business will one day require an audit.
- Audit may have subsidiary benefits, such as the auditors recommending improvements in company systems.

There are, however, some disadvantages relating to having an audit from the entity's point of view. These drawbacks include the following:

- cost
- staff time required in providing information, etc
- disruption to client's business
- time spent on the initial appointment process
- dealing with confidentiality
- expectations gap, particularly surrounding fraud detection
- inherent limitations of audit

Professional skills focus: Applying judgement

As a result of these drawbacks, it is very rare for a company below the audit threshold to have a full audit just for its own sake.

3 Audit and other assurance compared

Section overview

- The earlier sections of this chapter looked at the similarities between audit and other examples of assurance.
- All assurance assignments follow the same basic outline with the key difference being the level of assurance given in the final opinion.
- This has practical implications at various stages of the assignment.

The specific differences relating to agreement of terms and acceptance of appointment are covered in Chapters 6 and 14. The differences in the detailed content of reports are covered in Chapters 13 and 14.

3.1 Nature of work undertaken

In the Assurance exam you studied in detail the sources of audit evidence and the types of procedure that are generally performed on an audit. For other types of assurance assignment, where lower levels of assurance are being provided, the amount and type of evidence required will be less.

The following table compares the main audit procedures as outlined in ISA 500 with those that would be carried out in an engagement to review financial statements following the guidance of International Standard on Review Engagements (ISRE) 2400, and with those that would be carried out in examining prospective financial information under International Standard on Assurance Engagements (ISAE) 3400:

ISA 500	ISRE 2400	ISAE 3400
Inspection of documentation	Inquiry eg, into the accounting principles in	Assessment of assumptions Recomputation
Inspection of assets Observation External confirmation Recalculation Reperformance Analytical procedures Inquiry	place, the accounting systems in use, and concerning material assertions Analytical procedures eg, comparison with prior periods, comparison with anticipated results, and analysis of expected patterns in elements of the financial statements	Written representations

From the above it should be clear that the scope of work differs considerably between ISRE 2400 and ISAE 3400. Under ISRE 2400 the work will be based on historical information that can be tested and, in some instances, verified after the fact. A review under ISAE 3400, on the other hand, will be looking at prospective information. This means that the work will revolve around scrutinising management assumptions and will rely on written representations rather than obtaining evidence by direct testing.

For reviews of interim and historical financial information performed by the entity's own independent auditor, specific guidance is given in ISRE 2410.

3.2 Quality of evidence

It is clear that far less evidence is obtained during a review assignment, and the evidence is generally less reliable as some of the most reliable sources, such as third-party confirmations and evidence generated by the assurance provider, are not required.

In some cases, the nature and quality of the evidence that can be obtained is further affected by the nature of the subject matter of the assignment. If the firm is appointed to carry out a review of forecast figures to be presented to potential lenders then again analytical procedures and inquiry will be employed but the reliability of the evidence will be even lower due to the uncertainties involved. The figures being reviewed relate to transactions and events, some or all of which have not yet occurred at the time the opinion is given. The information is based on subjective estimates.

3.3 Reporting

In both of these cases the assurance provider can give only a low level of assurance and in the case of prospective information, such as the forecast figures, may include additional warnings to readers of the assurance opinion about the nature of the information and the assurance that can be given.

Chapter 14 looks at the content of such reports in more detail.

Interactive question 2: Review and audit compared

The directors of Connelly Ltd are concerned about the reliability and usefulness of the monthly financial management information that they receive.

As a result, the company's auditors have been engaged to review the system and the information it generates, and to report their conclusions.

Requirement

Contrast this assignment with the statutory audit of the company's financial statements with regard to the scope of the assignment and to the report issued.

See **Answer** at the end of this chapter.

Interactive question 3: Benefits of an audit

Acrylics Ltd was established in June 20X0 to produce acrylic products which are used as display units in the retail industry. The shares are owned equally by two executive and two non-executive directors.

The company's revenue increased steadily over the first two years of trading. The results for the first year of trading indicated an operating profit margin of 15%, and the management accounts for the second year of trading indicate that this has increased to 18%. The directors are currently negotiating a contract worth CU600,000 to supply a major retailer which has over 100 outlets throughout Bangladesh. The company will require an increased overdraft facility to fulfil the order.

The finance director of Acrylics Ltd has prepared a business plan for submission to the company's bankers in support of a request for a larger overdraft facility. The plan includes details of the company's products, management, markets, method of operation and financial information. The financial information includes profit and cash flow forecasts for the six months ending 31 December 20X2, together with details of the assumptions on which the forecasts are based and the accounting policies used in compiling the profit forecast. The company's bankers require this financial information to be reviewed and reported on by independent accountants.

Although the company's revenue was below the threshold for a statutory audit for its first year of trading, the company was required by its bankers to have an audit of its financial statements for the year ended 30 June 20X1. Your firm conducted this audit in accordance with auditing standards and issued an unqualified report.

Requirements

3.1 Describe the benefits, in addition to continuance of its overdraft facility, to the company and its directors and shareholders from having an audit of its annual financial statements.

3.2 Explain how and why the level of assurance provided by a report on profit and cash flow forecasts differs from the level of assurance provided by an auditor's report on annual financial statements.

See **Answer** at the end of this chapter.

Interactive question 4: Examination of cash **flow** forecasts

Your firm has been engaged to examine the cash flow forecasts prepared by the management of a company whose principal activity is the installation of electrical systems for customers in the retail, construction and industrial sectors in Bangladesh.

All contracts are fixed-price. Customers pay 95% of the contract on completion of the work and withhold 5% of the contract price for up to six months from the date of completion in case remedial work is required. The materials and components used are bought from suppliers who require payment within 30 days of the invoice date.

As a result of a significant fall in demand for its services the company has closed two of its regional depots and put both premises up for sale. It has also made 25% of its employees redundant.

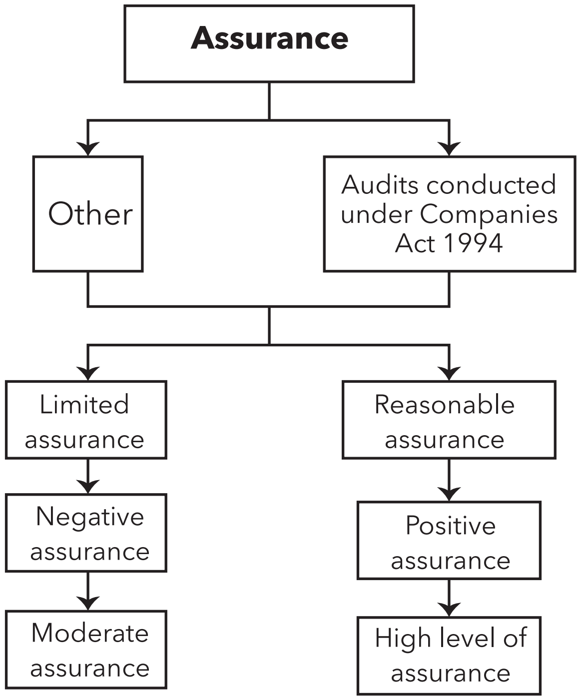
Requirements

4.1 Identify the specific matters you would consider when examining the assumptions underlying the receipts and payments included in the company's cash flow forecasts.

4.2 Explain the level of assurance that will be provided in your assurance report as a result of your examination.

See Answer at the end of this chapter.

Summary


Assurance
Other
Audits conducted under Companies Act 1994
Limited assurance
Negative assurance
Moderate assurance
Reasonable assurance
Positive assurance
High level of assurance

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you explain the levels of assurance that may be given? (Topic 1)	
(2) Can you explain the benefits of audit? (Topic 2)	
(3) What are the principal differences between an audit and a review engagement in respect of the nature of the work undertaken? (Topic 3)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q1	This question tests an area that is basic background knowledge for your examination.	
Q2	This question tests an area that is basic background knowledge for your examination.	
Q6	This question provides a sterner test of your knowledge in this area.	

Once you have attempted these questions, you can continue your studies by moving on to the next chapter, Responsibilities.

Technical reference

1 Audit defined

ISA 200

2 Audit and other assurance compared

N/A

Self-test questions

Answer the following questions.

1 Any assurance engagement requires which of the following elements?

A A user

B A responsible party

C A subject matter

D Criteria

2 Define an assurance engagement.

3 In a reasonable assurance engagement, a negative conclusion is drawn.

A True

B False

4 An audit is a limited assurance engagement.

A True

B False

5 Which of the following is not a potential benefit of having an audit?

A Management may value having their business scrutinised by a set of professional eyes.

B Assurance may be given to parties other than management who have a financial interest in the company.

C An audit is likely to be required in the near future by a growing company.

D Fraud will be uncovered by the auditors.

6 Treetops Ltd

Your firm acts as external auditor for Treetops Ltd, a company whose principal business activity is the manufacture and export of hammocks. Due to recent changes in the ownership form, Treetops Ltd is no longer required by law to have an audit of its financial statements for the year ended 28 February 20X5.

The directors of Treetops Ltd have asked you to set out the main advantages of the company continuing to have a statutory audit and also to provide them with examples of some of the other types of assurance work which your firm may be able to carry out for them.

The company's managing director has also requested a meeting with you. She has recently discovered that her purchase ledger clerk has diverted CU10,000 of company funds into his own bank account. The managing director wants to know why this was not discovered during the course of your audit for the year ended 29 February 20X4. The company's retained profit for that year was CU350,000.

Requirements

6.1 Briefly describe the advantages to the directors and shareholders of Treetops Ltd of continuing to have an audit, when an audit is no longer required under the Companies Act 1994.

(4 marks)

6.2 Provide examples of four other types of assurance engagement where the scope of the work is agreed between the assurance firm and the company. For each engagement identified, briefly set out the nature of the assurance given in the accompanying report and, where applicable, identify potential users of the report other than the company's management.

(8 marks)

Total: 12 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Advantages of report regarding loss of profits:

- Independent opinion from external source
- Enhanced credibility of compilation of claim
- Confirmation that data subjected to review and examination
- Comfort to insurers that risk of inflated claim reduced
- Could accelerate processing of claim

Answer to Interactive question 2

Scope	
This assignment	**Statutory audit**
Agree between parties	In accordance with Companies Act 1994
Restricted to instructions	In accordance with audit regulations
	In accordance with ISAs

Report	
This assignment	**Statutory audit**
Addressed to board	Addressed to members
Format wholly discretionary	On true and fair view
Private report	Format prescribed
	Report in public domain

Answer to Interactive question 3

3.1 Benefits, additional to continuance of overdraft facility, of having an audit:

- Shareholders who are not involved in the day-to-day management of the company (non-executives) will have assurance that their interests are protected (ie, company assets are not abused).
- Financial information is likely to be more reliable, resulting in more informed decisions.
- An audit improves a company's governance – management benefits from:
  (a) assurance that they are complying with their statutory responsibilities (including the prevention and detection of fraud, as the audit may act as a deterrent);
  (b) by-products of the audit, such as the identification of weaknesses and recommendations for improvement; and
  (c) reducing risks and improving performance.

- An audit imposes financial discipline which is useful for growing companies.
- It may be easier to obtain credit, as suppliers and credit rating agencies regard the additional assurance provided by an audit important.

3.2 How and why the level of assurance provided by a report on profit and cash flow forecasts differs from the level of assurance provided by an auditor's report on annual financial statements.

- An audit conducted in accordance with auditing standards provides a high level of assurance which is reasonable but not absolute.
- The delay between the reporting date and the date of the auditor's report means that even items such as provisions/estimates can often be substantiated.
- A review of forecasts is only likely to provide a moderate level of assurance.
- This is because financial statements are based on historical information, and forecasts are based on assumptions which are subject to uncertainty.

Answer to Interactive question 4

4.1 The following matters should be considered when examining the reasonableness of the assumptions underlying the receipts and payments:

Receipts

Trading receipts reflect:

- Potential loss of business following the closure of the two depots
- 95% of the contract price is received on completion and 5% received six months later
- The fact that amounts due may not ultimately be paid

Receipt from sale of premises:

- Realistic proceeds from the sale of the two depots that reflect local property values
  Payments
- Payments for components and raw materials reflect the 30-day credit terms
- Taxes are paid on the due dates
- Redundancy payments are in accordance with legal/contractual obligations
- Ongoing wages reflect reduced workforce following the redundancies
- Any extra costs (eg, transportation costs) involved in servicing contracts from distant depots and a fall in overheads after the sale of the two depots are reflected
- Professional costs (eg, legal and selling agent) involved with the sale of depots are included

4.2 An examination of cash flow forecasts is likely to provide only a moderate level of assurance. This is because forecasts are based on assumptions which are subject to uncertainty.

Answers to Self-test questions

1 Correct answer(s):

A A user

B A responsible party

C A subject matter

D Criteria

All of the elements listed are required, as well as a practitioner and sufficient and appropriate evidence, leading to a written expression of opinion.

2 An assurance engagement is one in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

3 Correct answer(s):

B False

A positive opinion is given in a reasonable assurance engagement.

4 Correct answer(s):

B False

It is a reasonable assurance engagement.

5 Correct answer(s):

D Fraud will be uncovered by the auditors.

Although an audit may act as a deterrent to fraud, it does not certify that one has not occurred. We shall look at the responsibilities of auditors in relation to fraud in the next chapter

6 Treetops Ltd

6.1 Benefits of audit

- The credibility of financial information would be enhanced
- Enhances the value of accounts for business valuation purposes in the event of a sale
- Authorities such as NBR can have more faith in the figures
- Avoids the future cost of extra work by the auditor when audit exemption limits are exceeded
- Avoids a potential future qualification over the opening inventory figure
- Makes it easier to raise finance
- May act as a deterrent to fraud/management abusing assets/reduce risk of management bias
- More reliable information results in more informed decisions
- Provides management/shareholders with assurance that the financial statements are true and fair/prepared in accordance with accounting standards
- By-products of the audit such as identification of weaknesses and recommendations should reduce risk and improve performance (management letter)
- Imposes discipline on management and accounts staff if they know that the figures will be subject to third party scrutiny, and therefore encourages best practice
- Gives management comfort that they are complying with their professional responsibilities/the accounts comply with the Companies Act

6.2 Four other types of assurance engagement Fraud investigation

The conclusion/assurance will be based on the extent of the work carried out. The report will:

(1) identify likely causes of fraud
(2) attempt to quantify the level of fraud

Potential users would be:
(1) potential buyers
(2) investors
(3) banks
(4) internal or external auditors.

Working capital reports/reports on inventory and trade receivables recoverability

The report will state whether:
(1) trade receivables are likely to be received
(2) inventory can be sold profitably in the near future

Potential users would be:
(1) potential buyers
(2) investors
(3) banks
(4) internal or external auditors.

Internal control reports

Such a report would:
(1) comment on the effectiveness of internal controls and highlight weaknesses
(2) make suggestions for the improvement of controls

Potential users would be:
(1) regulatory bodies
(2) shareholders
(3) internal or external auditors

Reports

The assurance given would be negative/limited/moderate ie, 'Nothing has come to our attention'.

The report would state whether:
(1) the business plan/forecasts have been prepared in line with stated assumptions;
(2) nothing has come to light to indicate that the assumptions are not a reasonable basis for the plan;
(3) the accounting policies used are consistent with the annual accounts; or
(4) the plan is consistent with the past performance of the company.

Potential users would be:
(1) bankers
(2) other lenders
(3) external auditor

Chapter 2

Responsibilities

Introduction

Learning outcomes

Legal and other professional regulations, ethics, accepting and managing engagements and current issues

Students will be able to understand and advise on the regulatory, professional and ethical issues relevant to those accepting, managing and carrying out assurance engagements. Students will be able to understand the processes involved in accepting and managing assurance engagements and how quality assurance processes mitigate the risks to those conducting the engagement.

- Identify and advise upon the legal, professional and ethical issues that may arise before accepting or during a specified assurance engagement
- Judge when to raise legal and ethical matters arising from assurance work with senior colleagues for review and possible referral to external parties, including reporting suspicions of money laundering
- Discuss the purposes and consequences of laws and other regulatory requirements surrounding assurance work
- Explain, using appropriate examples, the main ways in which national legislation affects assurance
- Describe the principal causes of audit failure and their effects and the gap between outcomes delivered by audit engagements and the expectations of users of auditor's reports

Planning and performing engagements

Students will be able to plan and perform assurance engagements in accordance with the terms of the engagements and appropriate standards.

- Outline the aspects of law and regulation which are relevant to statutory audit

Syllabus links

The issue of responsibilities is usually clarified in an engagement letter, which was introduced in your Assurance exam.

Examination context

Various areas of auditor responsibility are covered regularly in the short form section of the examination, including fraud, and compliance with laws and regulations.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	It is clearly important that all parties to an assurance engagement understand their responsibilities.	When you read sections 1 and 2 of this chapter, learn the distinction between the responsibilities of assurance providers and management	This area is most likely to come up in the short-form section of the examination.	1
2	Law and professional standards imply a number of responsibilities into general assurance services, and particularly into audits. It is important that all parties understand the nature and extent of these responsibilities, or it could lead to a breakdown in the relationship between parties. **Stop and think** Why might a lack of understanding result in a breakdown in the relationship?	Read through this section and consider how these responsibilities differ from those of management. You should also note the focus on sustainability and climate-related matters and be prepared to consider these from the perspective of both management and assurance providers.	Various areas of auditor responsibility are covered regularly in the short form section of the examination, including fraud, responsibilities with regard to a review of projected information and compliance with laws and regulations.	2, 3
3	The respective responsibilities for error link in with the fundamental concept of an audit – management is responsible for internal control, and the auditor is responsible for determining its efficacy, in order to give an opinion on the financial statements.	Read through this section and make sure you know the information contained in the summary.	This is a key area that could be tested in any part of the examination.	

CHAPTER 2

Topic	Practical significance	Study approach	Exam approach	Self-test questions
4	Responsibility for fraud is a key area of misunderstanding. Auditors are not responsible for detecting fraud as such, but they must take it into account because it could mean the financial statements are misstated.	Read through the section and attempt the activities.	This is an important area that could be tested in any part of the examination.	4, 10, 12
5	Compliance with laws and regulations is a topical area, and links in with the auditor's duties under the *Code of Ethics*.	Read through the section and ensure that you understand the auditor's responsibilities in relation to non-compliance and the money laundering regulation. The sections on bribery and data protection provide examples of laws and regulations of which an organisation might fall foul, and in relation to which the auditor would need to consider their response.	This area is topical and could be tested in either part of the examination.	5, 11
6	Related party transactions are important because, where they are not identified, they may result in serious distortions of the financial statements.	Read through the section and attempt the activity.	Although not particularly topical, this area is capable of being examined directly, most likely as a short-form question.	6

Topic	Practical significance	Study approach	Exam approach	Self-test questions
7	Money laundering is a topical issue, and one which auditors need to have in their mind at all times.	Read through this key section carefully and ensure that you understand the material here.	This examinable area could appear in any part of the examination. Questions in this area may require you to recognise that money laundering could be taking place in a particular situation.	7, 9
8	The expectations gap is a complex issue, because although it exists,it may also sometimes be used by the profession to deflect legitimate criticism. This topic should therefore be approached with care.	Read through this section and consider the connections with other areas – such as the responsibilities of management and the auditor; the auditor's report; and the auditor's duty to remain ethically independent of the client.	This area could be examined directly, most likely as a short form question.	8

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1 Management responsibilities

Section overview

- Management is responsible for the following:
  - Managing the business so as to achieve company objectives
  - Assessing business risks to those objectives being achieved
  - Safeguarding the company's assets
  - Keeping proper accounting records
  - Preparing company financial statements and delivering them to the Registrar
  - Ensuring the company complies with applicable laws and regulations
- It is not the responsibility of the auditors of a company to do any of the above.
- Management needs to actively consider sustainability issues and the impact they have on the business (and vice versa).

The approach adopted in this section is to identify the responsibilities which are either defined by ISAs as being attributable to management, or set out in the Companies Act 1994 as being the responsibilities of the company's directors.

It follows, therefore, that these duties cannot belong to the auditor or assurance firm.

1.1 Managing the company

First and foremost it is the directors' job to manage the business so that its objectives are achieved.This may mean producing suitable returns for shareholders or the achievement of other targets.

It also means **assessing what business risks face the company** and **devising the necessary strategies to deal with them**.

Clearly it is not the auditor's responsibility to set these strategies. However, the auditor does need to understand the risks facing the business and to understand how it will impact on their approach to the audit or other assurance engagement. We will look at this in more detail in Chapters 9 and 10.

1.2 Directors' responsibilities under the Companies Act 1994

The directors' statutory duties primarily come from the responsibilities laid out in the Companies Act. It is important that the directors of a company fully understand these, as in some cases there are criminal consequences for failing to carry them out correctly. The general duties of directors under the Companies Act are to **act in the way most likely to promote the success of the company** for the benefit of its members as a whole.

Safeguarding assets

It is the directors who have the legal responsibility for safeguarding the assets of the company. It is therefore for them to take reasonable steps for the prevention and detection of fraud and other irregularities.

To carry out this responsibility they need to implement systems and controls to safeguard the company's assets and they then need to ensure that the systems and controls operate effectively. Such procedures may include the following:

- The safekeeping of documents of title to land and buildings and other assets
- The setting of authority limits, ie, the limitation of what any one individual can do without consulting someone else

- Implementing other procedures to prevent fraud and reduce the likelihood of error

We looked at internal control systems in your studies for Assurance.

Books and records of the company

It is also the directors who are legally responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the company.

This requires records of the following:

- the cash payments and receipts
- what the payments and receipts relate to
- the assets (including non-current assets and inventory)
- the liabilities

The nature of the books and records is not laid down by statute and can take many forms, including manual books, loose-leaf folders, computer records or even a shoebox full of invoices with an add listing attached.

Preparation and delivery of company financial statements

Company law also places on the directors the obligation to prepare financial statements for each financial period (usually a year). These statements must give a true and fair view of the affairs of the company at the end of the accounting period and of the profit or loss of the company for that period.

In preparing those financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently
- make judgements and estimates that are reasonable and prudent
- comply with applicable accounting standards
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business

Once the financial statements have been prepared, it is the directors' responsibility to ensure that they, together with the auditor's report, are laid before the members of the company in general meeting and delivered to Companies House (RJSC) within the specified time.

Interactive question 1: Directors' responsibilities

You are finalising the audit of a company. The audit highlights memorandum indicates that the company has failed to maintain proper books and records. This is because there is no non-current asset register and it was not possible to draw up a register, as some of the invoices were missing. The director is furious that the audit firm says this makes it impossible to give an unqualified audit opinion. They say that the audit firm prepared the accounts and therefore it is simply a matter of the auditors' incompetence.

Requirement

Explain the directors' responsibilities in relation to the books and records of the company.

See **Answer** at the end of this chapter.

1.3 Compliance with laws and regulations

It is the responsibility of management to ensure that the company complies with the laws and regulations which have an impact on its operations.

This includes laws and regulations concerning the following:

- SEC Regulations, Corporate Governance Guidelines
- Money laundering
- Labour law
- Health and safety
- Public liability
- Employer's liability
- Tax withholding, TDS, VAT and payroll matters

Background

Following the Enron scandal, the Sarbanes–Oxley Act was rapidly passed into US law in 2002. It introduced a number of measures to attempt to improve the quality of financial reporting, includingthe following:

- Having Chief Executive Officers (CEOs) and Chief Finance Officers (CFOs) attest to the veracity of the financial statements
- Much greater disclosure of the amendments made to the financial statements during the audit process

Companies have had to review systems to ensure that CEOs and CFOs can make such attestations, as there are criminal penalties for making them falsely.

1.4 Sustainability and Audit and Assurance (management's responsibilities)

In 1987, the United Nations Brundtland Commission gave us the following definition:

Definition

Sustainability: Meeting the needs of the present without compromising the ability of future generations to meet their own needs.

Globally, there is now much greater awareness of the effects of climate change and the impact an organisation's operations can have on the environment. Here are some of the key global initiatives that summarise the environmental, social and governance guidance, legislation and regulation developments for organisations over the past 20 years.

(a) United Nations Global Impact (2000)

(b) Global Reporting Initiative (2000)

(c) Task Force on Climate-related Financial Disclosure or TCFD (2015)

(d) Sustainable Development Goals (2016)

Environmental, Social and Governance (ESG) issues derive from increasing political and stakeholder concerns. Evolving guidance and regulations aim to ensure organisations should aim for the following:

- **Environmental**: Counter the impact of climate change and reduce an organisation's impact on the environment (sometimes referred to as its environmental footprint).
- **Social**: Consider the well-being and impact of their operations on society and their stakeholders and creating a good working environment for its employees.
- **Governance**: Implement good governance practices from the top down, so it is well positioned to meet environment and social requirements by providing its goods and services in a sustainable way and offers employment with good working conditions in the long term.

Currently there is no mandatory international framework for reporting climate-related risks (although see below for future developments in sustainability reporting from the **International Sustainability Standards Board (ISSB)**). However, there is growing support for climate-related financial reporting generally within the financial statements. Also, given the importance of climate-related risks to investors' economic decision making, entities may need to consider such risks in the context of their financial statements rather than solely as a matter of corporate social responsibility reporting or sustainability reporting.

Chartered Accountants need to recognise that sustainability is at the core of what they do and analyse how to make the sustainable economy work for business, for clients and the public interest.

To achieve this, Chartered Accountants and Assurance professionals need to move beyond simply measuring and reporting the impact of climate change, environmental regulation, supply chain pressure and rising energy costs. They will be expected to focus on understanding those implications and advising on the broader implications of environmental, social and governance ('ESG') issues into organisations.

Sustainability impacts across all modules of the ACA qualification. For Audit and Assurance, this impacts the following three areas.

(a) Risk management

(b) Assurance

(c) Law and regulation

As well as the impact on companies, Chartered Accountants need to work with a wide range of other stakeholders to deliver solutions to the issues related to sustainability, such as, boards of directors, business partners, employees, market analysts, suppliers, customers, governments, lenders, the general public and local communities. From an assurance perspective, in the future, stakeholders may require or be entitled to verified information disclosed by companies, which may need to be audited or undergo a specific assurance engagement.

Risk management

Climate change is clearly giving rise to significant risks for businesses. Whether those risks arise from more frequent and severe weather events or the transition to a net-zero carbon economy, expectations are growing that companies appropriately embed climate-related financial risk into their governance and risk management processes. Scenario analysis is key to better understanding and managing future risks today, as well as supporting the transition to a net-zero carbon economy. The accountancy and assurance profession has a particular interest in the topic of risk, notably the identification, measurement and management of business and financial risk, including reputation risks that may threaten the survival of an enterprise. A mature company is now expected to recognise that environmental and social matters are recognised and integrated into its risk management and reporting infrastructures

Assurance

All types of sustainability and ESG information is affected by the need for credibility when disclosed to stakeholders, for example, for:

- Financial markets, both debt and equity, in attesting information relating to sustainability, and its consequences, and thereby reducing risk for investors
- Government in supporting compliance with laws and regulations by preparing or attesting information relating to sustainability
- Employees, to provide confidence in systems, establish progress against targets and improve confidence

- Specialists, including market analysts, credit rating agencies and listing authorities
- Business partners, to strengthen the supply chain
- Communities, to establish credibility with neighbours and local organisations

Law and regulation

Having had a number of false starts, ESG appears to be on the agenda to stay. There have been commitments with varying degrees of success over the years, including treaties such as the Paris Agreement of 2015. This was signed by around 200 UN member countries and, with the exception of a brief pause in commitment by the Trump administration in 2019, still stands. The knock-on effect of this is continuing commitments from the UN (such as COP 26 in 2021) which has moved ESG further into the legislative sphere.

1.4.1 Expected future developments in sustainability reporting

In 2020, the International Financial Reporting Standards Board (IFRS) established the ISSB to sit alongside the International Accounting Standards Board (IASB).

The intention is for the ISSB to deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions.

At present there are two exposure drafts that have been issued by ISSB:

- IFRS S1, *General requirements for disclosure of sustainability-related financial information* which is designed to provide information about an entity's significant sustainability-related risks and opportunities that support decision making by users of financial statements when considering the value of that entity and whether or not to invest in it.
- IFRS S2, *Climate-related disclosures* focuses on significant climate-related risks and opportunities and the information that an entity needs to disclose in order the satisfy users of financial statements of the impact of such matters on the value of the entity, how such impacts are to be managed and whether the entity is able to adapt if required.

2 Assurance providers' responsibilities

Section overview

- The assurance provider is responsible for the following:
  - Carrying out the assurance service in accordance with professional and ethical standards.
  - Carrying out the assurance service in accordance with the terms of engagement.
- In the case of statutory audit, the auditor is, in addition, responsible for the following:
  - Forming an independent opinion on the truth and fairness of the annual accounts.
  - Confirming that the annual accounts have been properly prepared in accordance with the Companies Act 1994.
  - Confirming that the information contained within the directors' report is consistent with the annual accounts.
  - Confirming that the director's use of the going concern basis of accounting in the preparation of the financial statements is appropriate.
- While the assurance provider does not bear the management responsibilities outlined above, many of them will impact strongly on the audit and, in particular, the risk assessment that the assurance provider carries out.

2.1 General

The responsibility of the external provider of assurance services is determined by the following:

- The requirements of any legislation or regulation under which the engagement is conducted
- The terms of engagement for the assignment, which will specify the services to be provided (you learnt about engagement letters in your studies for Assurance)
- Ethical and professional standards
- Quality management standards

2.2 Statutory audit

The legal requirements are contained in the Companies Act 1994 .

In the case of an audit of annual accounts under the Companies Act 1994, it is the external auditor's responsibility to:

- form an independent opinion on the truth and fairness of the annual accounts;
- confirm that the annual accounts have been properly prepared in accordance with the Companies Act 1994; and
- state in their auditor's report whether in the opinion the information given in the directors' report and strategic report is consistent with the annual accounts.

To achieve these objectives the auditor has to ensure that:

- the audit is planned properly (see Chapters 7, 8, 9 and 10);
- sufficient appropriate audit evidence is gathered (we covered this in detail in Assurance); and
- the evidence is properly reviewed and valid conclusions drawn (see Chapter 13).

In accordance with the law and ethical standards the auditor must maintain independence from the client.

In particular, as stated above, appointment as the Companies Act auditor does not lead to responsibility for the following matters:

- The design and operation of the accounting systems
- The maintenance of the accounting records
- The preparation and accuracy of management information.
- The preparation of the financial statements
- The identification of every error and deficiency in the accounts and the accounting records
- The prevention of fraud in a company
- The detection of immaterial fraud in the company
- Ensuring that the company has complied with the laws and regulations that are relevant to its business (except in so far as it affects the financial statements)

All these remain the responsibility of the management of the company; they have the responsibility to manage and cannot delegate or pass this responsibility on to the external auditor.

All impact on the financial statements to a greater or lesser extent, and systems and controls, impact on the way the auditor conducts the audit. However, it is important to know where these responsibilities lie:

- Business risks
- Fraud and error
- Non-compliance with laws and regulations
- Accounting policies

We shall look at how far auditor responsibilities extend in these areas in the following sections of this chapter.

CA 1994 also grants auditors certain rights to enable them to fulfil their responsibilities. Examples of these rights are as follows:

- The right of access at all times to the company's books and accounts
- The right to obtain any information necessary for the audit from any officer or employee of the company
- The right to attend any general meeting of the company

A person who, knowingly or recklessly, provides the auditor with false or misleading information commits an offence under the Act.

2.3 Non-assurance services

A firm which is engaged by management to provide additional non-statutory and non-assurance services is only responsible for providing the services specifically negotiated with management. Such engagements do not result in the firm taking responsibility for any aspects of the company's operations or procedures.

For example, a firm may be engaged to perform services additional to the audit such as:

- assisting the company with the maintenance of its accounting records
- assisting the company with preparing management information
- preparing the financial statements of the company
- preparing the corporation tax return of the company

The key point is that management retains the overall responsibility for all of these matters; the firm is employed as a support to management, providing expert assistance.

The principles and rules concerning the provision of non-audit services by the audit firm to its audit clients are set out in the BSEC Corporate Governance Guidelines and are dealt with in Chapter 4.

Background

The Sarbanes–Oxley Act, mentioned above in the context of management responsibilities, also has provisions which relate directly to auditors. In particular:

- there is stricter enforcement of the auditor independence rules as a result of the Act
- a Public Company Accounting Oversight Board (PCAOB) has been set up to inspect audit files of US listed and other public interest clients

PCAOB is entitled to inspect the audit files of major subsidiaries of US listed companies, so US domestic law can impact overseas where the subsidiary is not US based. Auditors of subsidiaries of US listed companies must register (for a fee!) with PCAOB and are liable to inspection.

2.4 Sustainability and Audit and Assurance (assurance providers' responsibilities)

In response to current developments in this area, the International Auditing and Assurance Standards Board (IAASB) published a practice alert 'The Consideration of Climate-Related Risks in an Audit of Financial Statements' which focuses on the implications of climate-related risks for audits of financial statements conducted in accordance with ISAs. You will read more about these implications later in this Workbook.

Where climate change impacts the entity, the auditor needs to consider the risk of material misstatement related to amounts and disclosures that may be affected by climate-related risks. Also, auditors need to understand how climate-related risks relate to their responsibilities under professional standards, and applicable law and regulation.

The guidance highlights the auditor's consideration of climate-related risks in respect of those International Standards on Auditing (ISAs) that are likely to be most relevant. These impacts are included in this Workbook where the relevant standard is discussed.

3 Error

Section overview

- Auditors are responsible for obtaining audit evidence that provides reasonable assurance that the financial statements are free of material misstatements, some of which may be caused by error.
- Management are responsible for designing and implementing a system of internal control which is capable of preventing, or detecting and correcting, errors in the financial records.
- Auditors are required to assess the system of internal control as part of their audit in order to determine whether to rely on the system of controls or carry out extended tests of details.
- Auditors are required to report to those charged with governance on significant weaknesses in controls which could adversely affect the entity's ability to record, process, summarise and report financial data potentially causing material misstatements in the financial statements.
- Auditors are responsible for giving an opinion whether the financial statements are free from material misstatement caused by error. This means that they should design procedures that are capable of detecting errors.
- As we set out in your Assurance Workbook, the two types of test generally carried out as part of an audit are tests of control and tests of detail. The more reliance that can be placed on controls (assessed by testing controls), the fewer tests of details may be carried out.

Definitions

Error: An unintentional misstatement in financial statements, including the omission of an amount or a disclosure.

System of internal control: The system designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. For the purposes of the ISAs, the system of internal control consists of five inter-related components: (i) Control environment; (ii) The entity's risk assessment process; (iii) The entity's process to monitor the system of internal control; (iv) The information system and communication; and (v) Control activities. (ISA 315)

Auditor's assessment of internal control

As we also outlined in your studies for assurance, the auditor is required to assess the system of internal control as part of their risk assessment, and determine whether they believe it is capable of preventing or detecting and correcting errors.

If the auditor determines that it is capable of this, it will affect the way that they carry out their audit, as ISA 315, *Identifying and Assessing the Risks of Material Misstatement* requires auditors to:

- obtain an understanding of controls relevant to the audit;
- evaluate the design of those controls; and
- determine whether they have been implemented.

If testing of controls reveals that the system is not only capable of preventing or detecting and correcting errors, but it operates effectively, the auditor will be able to conclude that the system is strong and the risk of the financial statements containing errors is reduced. This, in turn, will result in a lower level of tests of details being carried out.

ISA 330, *The Auditor's Responses to Assessed Risks* requires the auditor to test controls if:

- the auditor plans to test the operating effectiveness of those controls; or
- substantive procedures alone cannot provide sufficient appropriate audit evidence.

Reporting on deficiencies in internal control

ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* sets out that auditors should determine whether audit work has identified any deficiencies in internal control. Where, in the auditor's judgement, those deficiencies are significant, they should be communicated in writing on a timely basis.

A significant deficiency in internal control is one that, in the auditor's professional judgement, is important enough to be brought to the attention of those charged with governance.

Summary

In summary:

- Auditors are responsible for detecting material errors in the financial statements, which they may do by carrying out tests of control or tests of details.
- Management is responsible for internal control systems capable of preventing or detecting error.
- Auditors are responsible for assessing whether that system is capable of preventing or detecting errors.
- If the material weaknesses are found, auditors are responsible for:
  - reporting these to management; and
  - carrying out additional tests of details to uncover any potential errors as a result of the weakness.

4 Fraud

Section overview

- The auditor is responsible for drawing a conclusion as to whether the financial statements are free from material misstatement (which can be caused by fraud).
- The auditor's responsibilities with regard to fraud are set out in ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* and include the following:
- assessing risks of material misstatement
- discussing the susceptibility of the financial statements to material misstatement caused by fraud
- A key issue in relation to discovering material misstatements caused by fraud is professional scepticism.
- When the auditors become aware of possible non-compliance, they should evaluate the possible effect on the financial statements and on other audit evidence obtained and need to make reports to management.

4.1 Definition of fraud

Fraud is a word we normally use to cover a wide range of illegal acts.

For audit purposes, ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, identifies two types of risk of misstatement which can arise from fraud:

- misstatements arising from fraudulent financial reporting; and
- misstatements arising from misappropriation of assets.

In order to have a reasonable expectation of detecting fraud or error, auditors should follow the procedures in ISA 240.

4.2 Responsibilities regarding fraud

ISA 240 sets out management and auditor responsibilities regarding fraud.

Regarding management, the ISA states that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and with management. To fulfil this responsibility, various actions can be taken including the following:

- Demonstrating that management follow a culture of honesty and ethical behaviour and communicating that they expect all employees to adhere to this culture
- Establishing a sound system of internal control
- From the point of view of those charged with governance, ensuring that management implement policies and procedures to ensure, as far as possible, the orderly and efficient conduct of the company's business.

Regarding the auditor, the ISA states that the auditor must obtain reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. The auditor does not therefore offer complete assurance that the financial statements are free from fraud and/or error as audit testing is not designed to provide this assurance.

4.3 Risk assessment

Part of an auditor's work must include assessing the risk of a fraud existing. We will consider risk assessment procedures in more detail in Chapter 9. Appendix 1 to ISA 240 is a very useful document as it gives examples of fraud risk factors.

However, it should not be used as a list to be regurgitated in the examination, as risks are always specific to the client.

ISA 240 sets out that auditors are as follows:

- entitled to accept representations as truthful and records as genuine, unless there is evidence to the contrary; but also
- required to bring professional scepticism (as defined) to the work.

Auditors shall also carry out a discussion of the susceptibility of the entity's financial statements to fraud. This will usually include a consideration of the following:

- Where the company's system is weak and how management could perpetrate fraud
- The circumstances that could indicate earnings management which could lead to fraudulent financial reporting
- The known internal and external factors that could be an incentive to fraud being carried out
- Management's involvement in overseeing employees with access to cash or other assets which could be misappropriated
- Any unusual or unexplained changes in behaviour/lifestyle of management or employees
- The need for professional scepticism
- The type of circumstances that could lead to suspicions of fraud
- How unpredictability will be incorporated into the way the audit is carried out
- What audit procedures might be responsive to fraud
- Any allegations of fraud that have been made
- The risk of management override of controls

Professional skills focus: Applying judgement

Fraud is a difficult area for auditors, because its perpetrators try to conceal their actions and are therefore harder to discover than simple errors. The problem is compounded by the fact that the perpetrators may know their jobs, and the audited entity's financial systems, in more detail than the audit team. Where a fraud is taking place, it is unlikely to be obvious.

Audit trainees therefore need to be alive to the possibility that there will be fraud at the client, but without becoming overly suspicious of everything they encounter.

4.4 Where fraud is suspected

If the auditors identify misstatements which might indicate that fraud has taken place, they should consider the implications of this for other aspects of the audit, particularly management representations which may not be trustworthy if fraud is indicated. This may lead to a limitation in the scope of the audit.

4.5 Written representations

Auditors are required to obtain particular written representations from management that management acknowledges its responsibility to design and implement internal controls to preventand detect fraud and that management has disclosed any known or suspected frauds by management, employees with a significant role in internal control, or any other frauds which might have a material impact on the financial statements to the auditor.

In addition, management confirm in writing that it has disclosed the results of its own assessment of whether the financial statements may be materially affected by fraud.

4.6 Reporting frauds or suspected frauds

The ISA requires that the auditors should discuss suspected or actual fraud with management and those charged with governance and make the appropriate reports, as set out below:

Management	If they actually discover fraud If they suspect fraud
Those charged with governance	Unless all of those charged with governance are involved in managing the entity and the auditor has identified or suspects fraud involving management
Third parties eg, regulatory and enforcement authorities	The auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity

If fraud or error causes the financial statements to not give a true and fair view or there is a fundamental uncertainty, it should be included in the auditor's report in the usual way, **thereby notifying the shareholders.**

Interactive question 2: Fraud

During the course of your audit of Slipstream Ltd the credit controller asks for a private interview with you. During this interview she makes it known that she suspects the chief accountant of misappropriating company funds received from debtors and altering the books.

Requirement

What steps would you take to enable you to assess whether the credit controller's suspicions are reasonable?

See **Answer** at the end of this chapter.

Interactive question 3: Reporting fraud

During the course of the audit you discover that the wages clerk has been defrauding the client through not deleting leavers from the payroll until two months after departure, and was pocketing the money herself.

Requirements

What should you do with regard to:

3.1 Informing the client?

3.2 The auditor's report?

See **Answer** at the end of this chapter.

4.7 Concluding on fraud

Fraud is a major cost for business and the statutory audit is not designed to identify every fraud in an audit, merely those with a material effect. However, many users of accounts expect that the audit process should uncover all instances of fraud in a company. This is a feature of the expectations gap (discussed below in section 8).

From time to time, the issue of whether auditors' duties should be extended in relation to fraud is discussed. It can be argued that the auditors have closer contact with an organisation than any other external advisers and therefore they are in a position to gain a detailed understanding of the organisation and its systems which should lead to an ability to discover all frauds at an organisation.

However, this argument ignores the inherent limitations of the audit process, which you are aware of from your earlier studies in Assurance, and also opens up the possibility that audit becomes seen simply as a fraud investigation and the wider objective of reporting on the financial statements is lost.

Another key issue is the cost to businesses that this would represent, as the level of testing in a fraud investigation would be far more detailed than the sample-based testing required for the purpose of an audit, which most businesses would find prohibitive.

It must be concluded that attempts to make auditors more responsible for discovering fraud also miss the point that management ultimately is responsible for everything within the company, including the prevention and detection of fraud. Management should not be able to hide behind the auditors when fraud is eventually discovered or blame the auditors for not discovering the fraud earlier. Implementing and reporting on the principles of corporate governance is one way to enhance the performance of management in establishing effective systems, managing the risks to the security of the organisation's assets and promoting high standards of conduct by all those within the organisation.

Lastly it must be emphasised that this expectation gap with relation to fraud is generally associated with the statutory audit. If an assurance firm is engaged to carry out a different assurance engagement, or a non-statutory audit, then the terms of that engagement will be set out between the parties and all parties should be very clear what the role of the assurance providers in relation to discovering fraud, will be on that assignment. Bear in mind that the cost of providing a service to uncover frauds might be high and therefore this might be rare in practice. Of course, in order to close the gap in understanding of what the purpose of a statutory audit is in relation to fraud, the auditors' responsibilities are set out in the audit engagement letter. However, this letter is a private matter between the directors and the firm, and therefore this measure does not tackle the issue that the view is widely held in 'society at large' that auditors should detect frauds.

5 Compliance with laws and regulations

Section overview

- Management is responsible for ensuring that the company complies with laws and regulations.
- Auditors are responsible for concluding that the financial statements are free from material misstatements caused by non-compliance with laws and regulations.
- Auditors are required to have a general understanding of the legal and regulatory framework within which the company operates.

5.1 Non-compliance with laws and regulations

Definition

Non-compliance: Acts of omission or commission intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individuals working for or under the direction of the entity, which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity.

Auditors are interested in two categories of law and regulations:

- Those which have a direct effect on the financial statements, for example, the Companies Act
- Those which provide a legal framework within which the company operates

The auditor shall obtain an understanding of the legal framework within which the company operates as part of their understanding of the entity and its environment (discussed in Chapter 8).

Areas of law which affect all businesses will be as follows:

- Employment law (for example, the auditor should note if work on the payroll appears to indicate that the company pays employees less than the minimum wage)
- Social security law (for example, the auditor should ensure that the company appears to be paying over the correct amounts to NBR in respect of Tax, VAT and payments such as maternity pay and paternity pay)
- Health and safety law (for example, the auditor might notice if a company did not have clear safety notices on manufacturing premises and did not display clear fire exit and procedures notifications)

5.2 Risk assessment

As part of their risk assessment procedures, auditors shall consider if there are any indications that the company is not complying with any relevant law or regulation. Risk assessment procedures will be considered in more detail in Chapter 9.

5.3 Evidence about compliance

The auditor is required by ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* to obtain sufficient appropriate evidence about compliance with those laws and regulations that have a direct effect on the determination of material amounts in the financial statements (ISA 250: para. 14).

Auditors shall:

- make inquiries of management; and
- inspect correspondence with relevant licensing or regulatory authorities.

(ISA 250 : para. 15)

The auditors shall obtain written representations that management has disclosed all known instances of actual or suspected non-compliance with laws and regulations.

5.4 Non-compliance suspected or identified

When the auditors become aware of information regarding non-compliance, they shall first obtain an understanding of the non-compliance, together with information to evaluate its effect on the financial statements (ISA 250 : para. 19).

If, after doing this, the auditors suspect non-compliance, then they must discuss the matter with the appropriate level of management unless prohibited by law, for example Anti-Money Laundering Regulations (discussed below in 5.6) (ISA 250 : para. 20).

If the auditors cannot obtain sufficient appropriate evidence about the suspected non-compliance, this might represent a limitation on the scope of the audit, which will result in the auditors not being able to give an unmodified opinion (ISA 250 : para. 21). (We shall look at reporting in more detail in Chapter 13.)

CHAPTER 2

5.5 Communication and reporting of non-compliance

ISA 250 requires the auditors to communicate discovered instances of non-compliance with laws and regulations to those charged with governance (the directors) without delay, and make appropriate reports, as set out below:

Those charged with governance	If the auditors suspect non-compliance with laws and regulations. If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice (ISA 250 :para. 25).
Shareholders	**Only** if non-compliance causes the financial statements to not give a true and fair view or there is a fundamental uncertainty – in which case it should be included in the auditor's report in the usual way (see Chapter 13).
Third parties eg, regulatory and enforcement authorities	The auditor shall determine whether the auditor is required to report the identified or suspected non-compliance to parties outside the entity under law, regulation or ethical requirements.

5.6 Money Laundering Regulations

The auditor must take care not to commit the offence of 'tipping off', where the suspected/identifiednon-compliance could fall within the scope of the Money Laundering Regulations. This means that they must consider the Money Laundering Regulations when they are deciding whether to communicate non-compliance with management or those charged with governance.

5.7 Sustainability impact

The auditor is required to perform audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements. In the case of climate-related risks, other environment laws and environmental regulations, a breach of such regulations may have a material effect on the financial statements, such as the requirement to recognise a contingent liability for potential litigation and fines or penalties resulting from those regulations. The introduction of reporting climate-related matters in a company's strategic report and elsewhere, depending on the nature of the company, also places a compliance responsibility on the auditor, especially in the context of risk assessment.

5.8 Concluding on reporting non-compliance with laws and regulations

Businesses are faced with ever increasing amounts of legislation across all areas of their activities. It is reasonably asked, "can auditors be expected to become sufficiently expert on every single regulation that exists?"

Many regulations are concerned with matters that are not recorded in accounting systems, for example, issues relating to employment, health and safety and building planning consents. Auditors already face the problem of how to get sufficient and appropriate evidence in relation to their very limited responsibilities, as evidence in this area can be subjective and general. There must be a limit to how much further into the company's total records auditors should be expected to go.

It is possible that it would be better for companies to have a 'regulations audit' carried out by an industry insider who genuinely understands the types of regulations with which the business has to comply and how compliance should occur.

6 Related parties

Section overview

- Accounting standards require that all transactions with related parties are disclosed.
- Auditors need to consider the risk of there being undisclosed related party transactions.
- The auditors should ask the directors for a list of related parties and watch out for transactions with those parties during the course of testing.
- Auditors need to carry out specific tests to seek to identify related parties.
- The auditors need to ensure that appropriate disclosures have been made about related party transactions.
- Written representations about related parties must be obtained from directors.

6.1 The nature of related party transactions

Transactions with related parties may be carried out on terms which may not be the same as in an arm's length transaction with an independent third party. The approach adopted in financial reporting standards is to disclose the relevant amounts and relationships so that the readers of the financial statements can decide for themselves whether such transactions have led to a manipulation of the financial statements.

Related parties are those people or companies that might have, or be expected to have, an undue influence on the company being audited. So as examples (but the full list is much longer), the directors and key management of a company, together with their families, are regarded as related parties of that company, as are other companies controlled by them, other companies in the same group, and so on.

A director might well be in a position to tell an employee to arrange for the company:

- to sell to the director some goods at a cut down price; or
- to buy from another business owned by the director services at above-normal prices.

Because these transactions may not be at the normal market rate, company law and accounting standards require all transactions with related parties, even those conducted at the market rate, to be disclosed. The party that controls the company being audited must also be disclosed in the accounts,even if there are no transactions between them.

ISA 550, *Related Parties* details the audit work required in respect of related party transactions.The work can be split into the three main stages of the audit:

- Planning
- Detailed work
- Review

6.2 The planning stage

The auditor needs to consider the risk of there being undisclosed material related party transactions.This is an extremely difficult area, because the materiality rule for related party transactions is not just the normal one. The normal rule judges materiality by reference to the company being audited, whereas material related party transactions are judged both by that and by reference to the individual related party (which may be much smaller than the company being audited).

ISA 550 recognises that risks of material misstatement are higher where there are related party transactions because of the following:

- The complexity of related party relationships and structures
- Information systems that may be ineffective at identifying related party transactions
- Normal market terms may not apply, for example transactions may be conducted with no exchange of consideration

The auditor will also need to bear in mind that fraud may be more easily committed through related parties, and audit procedures will need to be designed accordingly.

6.3 The detailed testing stage

The auditors should ask the directors, who are, after all, responsible for the proper preparation of the financial statements (which will include full disclosure of related party transactions), for a list of related parties and consider if this is complete. The whole audit team should be aware of the list so that they can keep an eye out for those names when carrying out all of the other audit work needed. For example, an entry in the cash book may give an indication of a related party, so it needs to be picked up by the person auditing cash and bank.

ISA 550 sets out specific procedures that should be carried out:

- Detailed tests of transactions and balances (such as would ordinarily be carried out on audits)
- Reviewing minutes of meetings of shareholders and directors to observe if any related parties or transactions with them become apparent
- Reviewing records for large or unusual transactions or balances, particularly those recognized near the end of the reporting period
- Reviewing confirmation of loans receivable and payable and confirmations from banks (which might indicate guarantor relationships)
- Reviewing investment transactions, for example, when the company has invested in another company

Audit evidence in relation to related parties and transactions with them may be limited and restricted to representations from management. Due to this, the auditor should try carry out procedures such as:

- Discussing the purpose of the transactions with management/directors
- Confirming the terms and amount of the transaction with the related party
- Inspecting information in the possession of the related party
- Corroborating the explanation of the transactions with the related party
- Obtaining information from an unrelated third party if possible
- Confirming information with persons associated with the transaction, such as banks, solicitors, guarantors and agents

Where related party transactions are found the auditor checks that the appropriate disclosures are made in the accounts. Remember that all transactions with related parties need to be disclosed, even if they are at a normal market rate. However, any disclosures should include information that is needed for a proper understanding of the transaction and this would, of course, include whether the transaction was or was not at a market rate.

Professional skills focus: Assimilating and using information

In the case of smaller audits, the audit team may be able to obtain information about related parties while conducting detailed testing, simply by paying attention to the things the client's staff say and talk about.

6.4 The review stage

Written representations should always be requested from directors, who are in the best position to know the identities of related parties. The auditor then reviews the accounts, together with the audit evidence available, in order to reach a conclusion on the appropriate audit opinion.

Interactive question 4: Related party transactions

The training partner in your office is aware that you have covered ISA 550, *Related Parties* in your Professional Stage studies. They have asked you to help them prepare for a training session they are about to give.

Requirements

Prepare notes for a training session for junior staff on how to identify related party transactions. Your notes should include the following:

4.1 A list of possible features which would lead you to investigate a particular transaction to determine whether it is in fact a related party transaction.

4.2 A summary of the general audit procedures you would perform to ensure that all material related party transactions have been identified.

See **Answer** at the end of this chapter.

7 Money laundering

Section overview

- Accountants have substantial responsibilities in respect of suspected or actual money laundering.
- Money laundering is defined as a wide range of activities in relation to criminal property, including using, acquiring, concealing and removing from the country.
- Accountants are required to report a suspicion of money laundering to proper authorities.
- Failure to make a report is a criminal offence.
- There is also an offence called 'tipping off' – making the money launderer aware that a report has been made.

CHAPTER 2

7.1 Background

The auditor's responsibilities in respect of money laundering are substantial. It is not the purpose of these notes to go into all the implications of these responsibilities, but you do need to be aware of the duties laid on your firm and, from your very first day of work as an accountant, on you.

7.2 What is money laundering?

The purpose of money laundering is to:

- disguise the origins of funds derived from illicit sources; and
- enable illicit funds to be used by those who control them.

The definition of money laundering has been expanded to include the following:

- using
- acquiring
- retaining
- controlling
- concealing
- disguising
- converting
- transferring
- removing from the country

Criminal property is also rather widely defined as the **benefits of criminal conduct**.

The definition extends well beyond the 'obvious' examples involving a criminal, say, a drug dealer, passing the takings of their crimes through the books of a 'front' business, such as a restaurant.

Other examples of criminal conduct and criminal property include the following:

- **Tax evasion**
  - This could relate to direct tax such as corporation tax or to indirect tax such as VAT.
- **Offences that involve saved costs**
  - These could result from environmental offences, or from failure to implement health and safety requirements.

7.3 Your responsibilities

The duty to report

The Proceeds of Crime Act and the related Money Laundering Regulations both single out accountants (along with, among others, banks, lawyers, estate agents and casino operators) as having special responsibilities. If an accountant has **grounds for suspicion** that money laundering is taking place at a client, **that accountant must report it**. The exception to this rule is where the accountant is offering advice to a client on areas such as compliance with taxation legislation and the accountant claims Legal Professional Privilege (LPP) and may not therefore be required to make a report. Remember that LPP does not apply to audits.

The regulations override the duty of confidentiality (see the discussion of professional ethics in Chapter 4) towards the client and it is important to note the words '**grounds for suspicion'** – if an accountant waits for incontrovertible evidence, it might be too late.

Accountants do not automatically benefit from any professional privilege under the law. Lawyers do,to some extent, but accountants **generally** do not, unless they are providing legal services, and have always had to tread a fine line of discretion between their duty to their client and the public interest.

An accountant's duty to report money laundering includes reporting actual knowledge or reasonable grounds for suspicion of money laundering. Non-reporting is not an option but mere speculation should not be reported.

Auditors are concerned primarily with the risk of material misstatement of the financial statements, and the audit procedures adopted are designed accordingly. It may be, therefore, that an auditor does not become aware of immaterial matters and there is nothing in the auditing standards to compel the auditor to seek them out. However, if an auditor does come across any misstatement, material or otherwise, this must now be considered from a money laundering perspective.

For non-audit engagements, the terms of engagement will determine whether materiality needs to be considered or not. But here again, any misstatement, regardless of its materiality in whatever context, must be considered for its Proceeds of Crime Act implications.

It would seem that there are considerable amounts of money in the economy which derive from criminal activity – drugs, terrorism, organised crime – and these amounts must go somewhere.

There is therefore a clear ethical imperative (as well as a legal one) to report knowledge or reasonable suspicion of such activity.

If a client is doing well and you do not understand where the money has come from, after exhausting all reasonable lines of enquiry then you have grounds for suspicion and a duty to report without 'tipping off' either:

- the client; or
- anyone who could prejudice an enquiry into the matter.

7.4 Offences and penalties

Failing to report and to comply with the regulations – including the need to provide suitable training are offences under the legislation.

There is also an offence called **'tipping off'** designed to avoid the money launderer being able to escape before the forces of law and order catch up with them.

Professional skills focus: Applying judgement

The audit team needs to be alert to the possibility that something might not be quite right, but they also need to be very careful about who they discuss any suspicions with.

7.5 A paradox

The auditor's responsibility is to form an opinion as to whether the financial statements give a true and fair view. If included in the company's revenue are material amounts resulting from money laundering, it is probable that the financial statements do not, in fact, give a true and fair view. If the auditors modify their opinion, however, they could be accused of tipping off.

7.6 Concluding on money laundering

Money laundering issues affect almost all aspects of an accountant's work and, particularly, due to the privileged position of the auditor, carrying out audit work.

A case has been made to the government by both ICAEW and the Scottish Institute that, due to the professional standards under which their members operate (which we shall look at in the next two chapters) they should be allowed to use their discretion in making reports to NCA.

The government has said broadly: "This is the 'trust me I'm an accountant' argument and past experience of submissions of 'suspicious transactions reports' suggest that not many come from accountants. So we're doing something about it. If you wish to argue to the public that you should have specific rights not to report drugs and terrorist money, go ahead, but we don't think the public will be convinced."

7.7 Money laundering and the audit approach

The introduction of the Money Laundering Regulations(MLR) bring added complications to the auditor's work.

This legislation has regulatory and ethical implications which we have dealt with. Another key principle stressed by the authorities dealing with Money Laundering in worldwide is **KYC – know your client**.

- The firm will need to have checked the client's identity, when they first became a client and will need to keep the evidence on file for five years after they cease to be a client.
- Where does the money come from? Auditors should think about the real nature of the business'sales, but also about the source of the start-up capital and any other equity and loans raised.
- Remember the money launderer wants to overstate income and loves paying tax on the excess,which goes against the grain of the way most auditors think.

Further guidance is available from the CCAB's *Anti-Money Laundering Guidance for the AccountingSector,* which sets out some 'prompts' that clearly illustrate how money laundering suspicions couldarise during the planning and risk assessment phase of an audit, or even during the detailed evidence gathering phase.

a. What is its purpose in entering into any transaction forming the basis of the proposed engagement or its purpose in seeking services where not related to a specific transaction?

b. What are the entity's main trading and registered office addresses? What are its business activities or purposes and sector?

c. Who controls and manages it (ie, has executive power over the entity – this may be directors, shadow directors or others depending on the circumstances)?

d. If the client is audited, were the accounts qualified and, if so why?

e. Name and check that the person(s) purporting to represent the entity is/are who they say they are.

f. Who owns it – ultimate beneficial owner(s) and steps in between (as a minimum for companies provide details of any ultimate beneficial owners of more than 25% – for trusts, supply details of trustees and settlors and details of either beneficiaries with more than 25% interest, or the classes of beneficiary, and or collective investment funds to other similar arrangements provide details of the general partner and/or investment manager together with details of any person with more than 25% interest)?

g. What is its business model/intended business model (ie, the mechanism by which a business intends to generate revenue and profits and serve its customers – in terms of broad principles)?

h. What are the key sources of income (eg, trading, investment etc) and capital (eg, public share offer, private investment etc)?

i. The history and current (also forecast if readily available) scale of its entity's earnings (eg,turnover and profits/losses) and net assets.

j. The entity's geographical connections, so that you are in a position to ask such questions as "Why is it getting so much money from that place?" and "Why is it sending assets to that place?"

k. Has the entity been subject to insolvency proceedings, or is it in course of being dissolved/struck-off, or has it been dissolved/struck-off?

8 Expectations gap

Section overview

- The expectations gap is the gap between the expectations of users of assurance reports and the firm's responsibilities in respect of those reports.
- There are a variety of misunderstandings about the nature of assurance work.
- The expectations gap has been narrowed by the following:
  - Improving the required auditor's report
  - Inserting paragraphs relating to directors'/auditors' responsibilities in the engagement letter
  - The role of audit committees, which liaise with auditors

8.1 What is the expectations gap?

This so-called 'gap' is between the expectations of users of assurance reports, particularly of auditor'sreports under the Companies Act, and the firm's legal responsibilities. For example, users of the financial statements may well expect that an audit engagement involves the checking of every single transaction, while the firm judges that checks on a test basis are sufficient.

This is further compounded by confusion over the meaning of the report that the auditor gives. The misunderstandings made by lay users of financial statements can be summarised as follows:

- Many believe that responsibility for preparing financial statements lies with the auditor, rather than with management.

- It is widely believed by the general public that the auditor's principal duty is to detect fraud, whenin fact the duty is to make a report as to whether or not the financial statements are materially misstated, irrespective of whether such misstatement arises as a result of fraud.
- In most cases the users of the financial statements will also have little perception of the concept of materiality and believe that the auditors check all the transactions that the company undertakes.
- The public generally perceives that an auditor's report attached to the financial statements means that they are 'correct', rather than just meaning that there is reasonable assurance that they give a true and fair view.

8.2 Narrowing the expectations gap

Various steps have been taken to try to reduce the expectations gap.

Expanding the auditor's report

The content of the Companies Act auditor's report has been expanded to do the following:

- Set out responsibilities of auditors and directors
- Explain how an audit is conducted:
  - On a test basis, which implies sampling
  - By assessing significant estimates and judgements
  - So as to give reasonable assurance on the financial statements
  - So as to detect material misstatements – in relation to fraud, error or any other irregularity

In the case of listed companies, the report has been expanded further to explain to the users of the financial statements that the auditors review statements made by the company about its corporate governance procedures, and consider other information included with the financial statements to ensure it is consistent. The revised ISA 700 requires the auditor to report on risks of material misstatements identified by the auditor, and on how the auditor has applied the concept of materiality. The auditor is also required to provide an overview of the scope of the audit, demonstrating how the risks identified have been addressed. This is discussed in more detail in Chapter 13.

Engagement letter

When the firm issues an engagement letter, the letter includes a paragraph reminding the directors of their responsibilities and setting out the firm's responsibilities. Additional detail on the engagement letter can be found in Chapter 6.

Directors' responsibilities

The reporting requirement was extended by the guidance on the preparation of auditor's reports, to include a statement of the directors' responsibilities. This serves to make the respective responsibilities of management and auditors clearer to the users of the financial statements.

Expanding the auditor's report

Various statements on the principles of corporate governance developed for listed companies have recommended that companies should establish an audit committee of the board to liaise with and receive reports from both external and internal auditors. (Internal auditors are people who work for acompany and help the directors to ensure that accounts are properly kept and business risks are minimised. 'External auditors' is the phrase used to describe those involved in the independent Companies Act audit.) The existence of an audit committee serves as a reminder of the division of responsibilities between auditors and management. The disclosures made in the company's annual report about its corporate governance practices should include comments about the operations of its audit committee.

8.3 So why do things still go wrong?

Sometimes companies fail. Sometimes people commit fraud. Sometimes people make genuine mistakes when financial statements are being prepared.

These events are never the fault of the auditor – although as we have seen, the expectations gap means that the users of financial statements do not necessarily understand this.

Sometimes – and these tend to be the most difficult cases – events like this occur, the auditors do not detect them, but no audit failure takes place.

How can this be?

The auditors may not be at fault if:

- the effect is immaterial;
- the accounts, in spite of the event taking place, still give a true and fair view; or
- the auditor's procedures were properly planned, executed and documented but the event couldnot be detected for some reason, perhaps a carefully executed fraud or a sudden, cataclysmic change leading to the company's collapse.

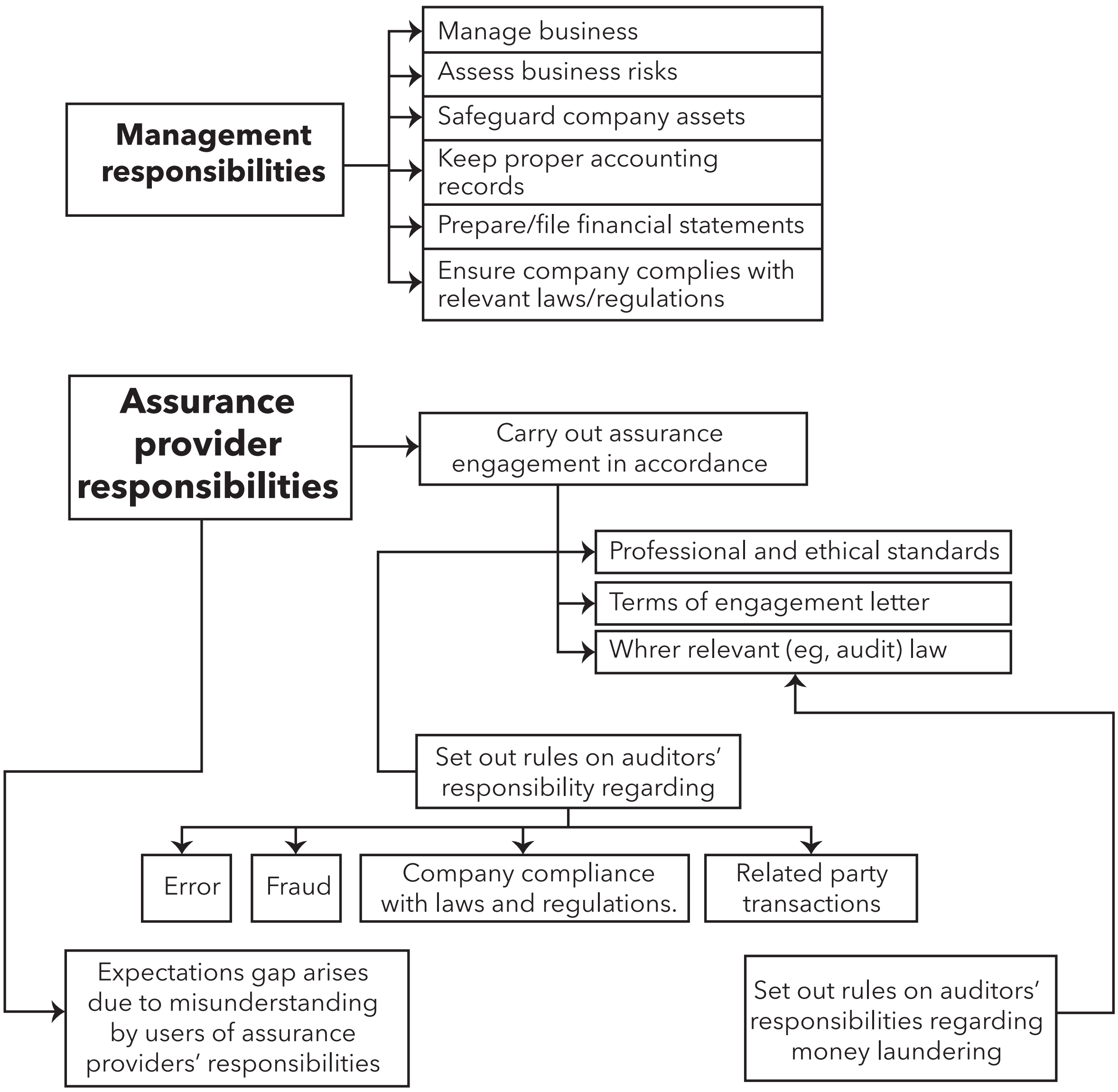
Nevertheless, corporate collapses do happen and the auditors are found to have been negligent in some way. Clearly, in these cases, something must have gone wrong in:

- planning the audit
- performing the audit
- drawing conclusions from the work done

These failures can usually be traced to one of four main causes:

- the failure to assess audit risk properly
- the failure to respond appropriately to audit risk
- the failure to recognise and respond to situations where the auditor's objectivity is threatened
- the failure to recognise and respond to situations beyond the auditor's area of competence

Summary


Management responsibilities
Manage business
Assess business risks
Safeguard company assets
Keep proper accounting records
Prepare/file financial statements
Ensure company complies with relevant laws/regulations
Assurance provider responsibilities
Carry out assurance engagement in accordance
Professional and ethical standards
Terms of engagement letter
Whrer relevant (eg, audit) law
Set out rules on auditors' responsibility regarding
Error
Fraud
Company compliance with laws and regulations.
Related party transactions
Expectations gap arises due to misunderstanding by users of assurance providers' responsibilities
Set out rules on auditors' responsibilities regarding money laundering

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you explain the principal responsibilities of management? (Topic 1)	
(2) Can you explain the responsibilities of assurance providers and auditors, and distinguish these from those of management? (Topic 2)	
(3) Can you explain the responsibilities for error, and the relationship between the auditor and the system of internal control? (Topic 3)	
(4) What are the auditor's responsibilities in relation to fraud? (Topic 4)	
(5) Can you define non-compliance with laws and regulations, and determine what the auditor should do where this is suspected or identified? (Topic 5)	
(6) Can you explain why related parties represent a risk for auditors? (Topic 6)	
(7) Can you define money laundering? (Topic 7)	
(8) Can you explain how the audit profession has tried to narrow the expectations gap? (Topic 8)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q9	This is a topical area, and is typical of the way it could appear in your examination.	
Q11	Another topical area, and one on which you should expect to be examined.	
Q12	This substantial question tests your knowledge and should help give you an idea of what to expect in the examination.	

Once you have attempted these questions, you can continue your studies by moving onto the next chapter, Professional standards.

Technical reference

1 Management responsibilities

Companies Act 1994

2 Assurance provider's responsibilities

Companies Act 1994 ss.210–219

3 Error

ISA 240

4 Fraud

ISA 240

5 Compliance with laws and regulations

ISA 250

6 Related parties

ISA 550

Self-test questions

Answer the following questions.

1 Which one is management not responsible for?

A The safeguarding of company assets

B Keeping proper accounting records

C Preparing financial statements

D Auditing financial statements

2 Auditors have a duty to detect frauds which have a material impact on the financial statements.

A True

B False

3 The Sarbanes–Oxley Act requires CEOs to certify that the accounts are true.

A True

B False

4 Which two of the following are auditors not necessarily required to do?

A Assess the risk of fraud causing material misstatement in the financial statements

B Discuss the risk of fraud causing material misstatement in the financial statements

C Detect instances where fraud has caused a material misstatement in the financial statements

D Report material misstatements caused by fraud to the police

5 Auditors may be required to report instances of non-compliance with laws and regulations to which of the following?

A Shareholders

B Directors

C Regulatory authorities

6 Management is responsible for making appropriate disclosures concerning related parties in the financial statements.

A True

B False

7 An auditor fulfils their duty to report a suspicious transaction in relation to money laundering if they make a report to the money laundering nominated officer in their firm.

A True

B False

8 Which of the following is not a measure designed to close the expectations gap?

A Auditors required to attend company board meetings

B More detailed engagement letter sent to audit clients

C Auditor's report format revised and extended

D Statement of directors' responsibilities included in the financial statements

9 During the course of the audit of Gamma Ltd (Gamma), an employee of the company informed you that a substantial cash deposit was paid into the company's bank account and a month later, the same amount was paid by direct transfer into a bank account in the name of Epsilon, a company based overseas. The employee also informed you that the managing director of Gamma had instructed them not to record the transaction in the accounting records as it had nothing to do with Gamma's business.

Requirement

State, with reasons, what further action you should take in relation to this matter.

Total: 3 marks

10 Your firm is the auditor of Alpha Ltd (Alpha). The managing director of Alpha discovered that the assistant accountant had used company cheques and bank transfers fraudulently to pay her own personal expenses. The expenditure was reported as company expenses in the statement of profit or loss. Although the amounts involved are immaterial in the context of the financial statements, it transpired that this had been going on for several years. The managing director has expressed concern that your firm did not discover this fraud and has requested a meeting to discuss this matter.

Requirement

Using Alpha's fraud as an example, compare and contrast the responsibilities of the auditors in respect of fraud with the expectation of the managing director of Alpha.

Total: 3 marks

11 If brought to their attention, auditors should consider the implications of any breaches by their clients of employment and social security legislation.

Requirement

Outline the consequences of not considering the implications and provide examples of such breaches.

Total: 4 marks

12 Goose Green

You are the auditor of a company with numerous branches spread throughout the Bangladesh. Revenue for the year ended 31 December 20X1 was CU25 million, profit before tax was CU 1,500,000 and net assets were CU 9,500,000. Your auditor's report was signed in March 20X2 without qualification. Your report to management after the audit pointed out that internal controls were weak at the branches due to the small number of staff.

You have been telephoned by the finance director, Ray Gosling, and told that the sales ledger clerk at the Goose Green branch had been caught 'teeming and lading'. His investigations so far show that during the year to 31 December 20X1 the sales ledger clerk had diverted CU 50,000 of receipts from customers to his own bank account. Ray has asked you to attend a meeting with him to discuss the matter. He is particularly concerned as to why the fraud was not discovered during the course of the audit and what the effect on the accounts might be.

At 31 December 20X1 the Goose Green branch had net assets of CU400,000. For the year ended on that date the branch had revenue of CU1,000,000 and made a small loss.

Re-examination of your audit working papers shows that your staff had visited the Goose Green branch, that no grounds for suspicion arose during the audit and that appropriate audit procedures were carried out.

Requirements

12.1 Prepare notes to guide you in your discussions with the finance director.

(6 marks)

12.2 Following the meeting, the finance director has asked you to carry out additional assurance work to establish the extent of the fraud. Outline the main areas to which you would direct your attention in order to establish the extent of the fraud and the loss to the company and state why you would consider those areas.

(6 marks)

Total: 12 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

CHAPTER 2

Answers to Interactive questions

Answer to Interactive question 1

The director's responsibilities include:

- keeping proper accounting records
- disclosing with reasonable accuracy at any time the financial position of the company
- ensuring that the financial statements comply with the Companies Act 1994

Answer to Interactive question 2

You should take the following steps:

- Review and obtain photocopies of documents which have aroused her suspicions
- Enquire into reasons for altered pages in books/documents etc
- Investigate any apparent override/circumvention of company procedure eg, cancelling a sales invoice instead of raising a credit note
- Review previous management letters for any weaknesses facilitating misappropriations
- Consider credit controller's motives for putting chief accountant under suspicion eg, working relationship/job threat
- Take note of chief accountant's standard of living; make enquiries about their lifestyle
- Consider whether past dealings with chief accountant have ever cast doubt on their integrity
- Increase analytical procedures on revenue and receivables eg, monthly revenue/receipts of major customers/extend circularisation if trade receivables collection period has increased
- Discuss with engagement partner, who may wish to discuss with client (eg, board of directors)

Answer to Interactive question 3

3.1 You should:

- Report to appropriate level of management
- If you believe that management or employees with significant roles in internal control are involved or fraud results in material misstatement in financial statements, report to those charged with governance (eg, audit committee)
- If integrity/honesty of management or those charged with governance is in doubt, seek legal advice

3.2 You should:

- If error is corrected, no need to qualify opinion
- If no correction is made and the resulting misstatement is material, then the opinion should be appropriately modified

Answer to Interactive question 4

Notes for a training session for junior staff on how to identify related party transactions

Purpose of the training

To assist junior staff in the application of IAS 24, *Related Party Disclosures* and ISA 550, *Related Parties*, and specifically on how to identify related party transactions.

Related parties

IAS 24 defines related parties as individuals or entities (eg, companies) with more than a simple business relationship with the client. This would be because they are directors, owners or major investors of the client and can include family and close friends of the directors or owners.

At the start of each audit you will be provided with an up-to-date list of known related parties. It is important that if you come across any transactions involving these parties during the audit you should record them on the audit file.

The directors should provide us with a complete list of these related party transactions. However, we need to be certain that their list is complete, and by comparing the transactions you find with the list from the directors we can obtain evidence as to its reliability.

General audit procedures

Unless we determine that the risk of non-disclosure of related party transactions is high, we gain a significant amount of evidence needed from general audit procedures. These are listed in 4.2 below.

Additionally, they may intentionally or otherwise leave out certain transactions from the list they provide and you therefore need to be aware of indicators of potential undisclosed related party transactions. These are given in 4.1 below.

If you notice any such transactions, record them on the audit file. If there is a significant number of such transactions, immediately ask the manager for specific guidance on what action to take.

4.1 List of possible features which would lead you to investigate a particular transaction to determine whether it is a related party transaction.

- Transactions which have unusual terms of trade, eg, unusual prices, interest rates, guarantees and repayment terms.
- Transactions which appear to lack a logical business reason for their occurrence.
- Transactions which are overly complex.
- Transactions which involve previously unidentified related parties.
- Transactions which are processed in an unusual manner.

4.1 Summary of the general audit procedures you would perform to ensure that all material related party transactions have been identified.

- Obtain a list of current known related parties, eg, directors, other companies with common directors, family members of directors, significant private company investments of directors,associate or joint venture companies, key personnel and significant investors (>20%).
- Ensure that the permanent file is updated for related parties.
- If it is the first year of the audit perform company search; otherwise review statutory records to confirm directorships, other directorships and significant investors.
- Discuss the list of related parties as disclosed by the directors as to its accuracy and completeness.
- Enquire of directors as to whether there have been any material transactions with the related party, eg, loans, purchase or sale of assets, consultancy fees.
- List all transactions disclosed by the directors.
- Review the accounting records before and after the year end for any large or round sum amounts; investigate and analyse with reasons.
- Analyse all loans receivable or payable, and seek confirmation of identity of lender or borrower.
- Review board minutes and enquire as to whether the company has provided any guarantees.
- Analyse the details of guarantees given and review the terms.
- Include confirmation of all related party transactions or lack of them within the letter of representation.
- Check the accuracy of disclosure within the context of IAS 24.

Answers to Self-test questions

1 Correct answer(s):

D Auditing financial statements

2 Correct answer(s):

A True

As auditors are giving an opinion whether the financial statements are free from material misstatements, they should plan and perform procedures designed to discover material misstatements even if they result from a fraud.

3 Correct answer(s):

A True

4 Correct answer(s):

C Detect instances where fraud has caused a material misstatement in the financial statements

D Report material misstatements caused by fraud to the police

Auditors are required to plan in a manner that tries to uncover material misstatement caused by fraud, but as fraud is by its nature concealed, they might not necessarily uncover it. They are required to report to directors, but may be precluded from reporting outside the entity by their duty of professional confidence.

5 Correct answer(s):

A Shareholders

B Directors

C Regulatory authorities

Although again, in the case of reporting outside of the organisation, the auditor must take care not to breach their duty of professional confidence.

6 Correct answer(s):

A True

7 Correct answer(s):

A True

8 Correct answer(s):

A Auditors required to attend company board meetings

And in fact, this could be a breach of the auditor's professional duties if the auditor attended in a management capacity for example.

9 Actions

- Check bank statement to confirm employee's assertion
- Report to nominated officer/money laundering officer in firm
- Avoid tipping off

Reasons

- Represents proceeds of crime under money laundering
- Criminal offence if auditor does not report suspicions of money laundering

10 Auditor's responsibilities

- To identify material misstatements in the financial statements
- Plan, perform and evaluate work in order to have a reasonable expectation of detecting material misstatement in the financial statements
- No obligation to prevent fraud although it may act as a deterrent

MD's perception

- Auditor responsible for ALL fraud
- Lacks an understanding of materiality
- Directors often rely on auditors for monitoring they should undertake themselves

11 Failure to comply may result in penalties/fines requiring provision or disclosure Serious breaches may have going concern implications (closure, inability to pay fines) May be indicative of poor control environment

Examples

- Minimum wage and working time directives
- Health and safety at work regulations
- Pension scheme requirement

12 Goose Green

12.1 Notes for meeting re fraud

Before meeting

- Check terms of engagement letter. Were there any special duties agreed with client (specifically, any extra work on branch audits)?
- Schedule responses to this letter from the client.
- Check that the letter contained the usual paragraph re purpose of audit procedures.

Why fraud not discovered

- Remind Ray that the prevention and detection of errors and fraud are primarily the responsibility of management.
- The purpose of audit procedures is not to discover errors and fraud, but to enable the auditor to form their opinion on the financial statements: reasonable expectation of discovering error and fraud.
- Weaknesses were pointed out in the last management letter, covering all branches of similar size, together with suggestions for improvement.
- Discuss management's response – reasons why suggestions not implemented.
- Audit working papers give details of the work done at Goose Green, which was in accordance with ISAs .

Effects on the accounts

- Amount material in context of branch – particularly as it may have turned a profit into a loss
  - but probably not in the general context of the company (3.3% of profit before tax). 20X1accounts do not need adjustment unless fraud found to be more extensive.
- Potential effect of control weaknesses not considered material enough to warrant a qualification in 20X1 accounts, but this matter is reviewed each year.
- Qualification possible this year if there is significant breakdown in controls and/or an actual fraud (has the Goose Green fraud continued into 20X2?).

12.2 Areas to consider to establish extent of fraud/loss and why

Area	Why consider
• How long the particular clerk has worked at the Goose Green (GG) branch • Relationships between staff at the GG branch • Other branches with poor control environments (all?) • Relationships between staff at the GG branch (especially the sales ledger clerk) and staff at other branches • Whether the GG branch manager runs other branches • How the fraud was discovered (chance or management control) • Recoverability of the amount from the clerk • Likelihood of false claims from credit customers (ie, having heard of the fraud, customers claim to have settled their accounts) • Adequacy of fidelity insurance	• To establish how long the fraud is likely to have gone on • Possibility of collusion • To establish general likelihood of fraud at other branches • Could the fraud have been 'sold' to staff at other branches? • Could indicate other branches where fraud might be undetected • If by management control, then provides some comfort that other frauds would be detected and therefore, generally, fraud less widespread • To establish actual monetary loss • To establish any knock-on monetary loss • Is the loss recoverable?

Chapter 3

Professional standards

Introduction

Learning outcomes

Legal and other professional regulations, ethics, accepting and managing engagements and current issues

Students will be able to understand and advise on the regulatory, professional and ethical issues relevant to those accepting, managing and carrying out assurance engagements. Students will be able to understand the processes involved in accepting and managing assurance engagements and how quality assurance processes mitigate the risks to those conducting the engagement.

- Describe the role of the national and international standards
- Explain, in non-technical language, significant current issues being dealt with by the accountancy profession, government bodies, the national standard-setting body and the IAASB

Syllabus links

Some auditing standards were introduced in your lower level Assurance exam. In this exam, you will both build on the knowledge you have gained at the lower level, and be introduced to more standards. The Technical reference pages will direct you to the exact places in the standards where the requirements discussed in the chapter can be found.

Examination context

While the content of auditing standards will impact on your exam, the details of who issues them and how they are issued are likely to be of less importance, hence the fact that there are few interactive and other questions in this chapter. Ethics, which are covered in the next chapter, are likely to be far more heavily examined in the context of professional standards.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	There is a need for the work of auditors to be transparent and subject to objective, legally binding standards. Increasingly, assurance providers and particularly auditors are being asked to carry out their procedures in a more globally recognised way,	This chapter should be worked through quickly. You do need to know the information here, but it is not as important as some other parts of the Workbook. Read through this brief section, and make sure you can explain why regulations are needed, and what the principal	Read quickly through Chapter 3 which covers a topic less likely to be examined in detail than Chapter 4. This section covers one of the more examinable areas of the chapter, and is most likely to be tested in a short form question in the examination.	1, 3, 5

Topic	Practical significance	Study approach	Exam approach	Self-test questions
	hence the existence of International Standards on Auditing.	regulations are for auditors.		
2	All statutory audits must be conducted in line with ISAs, which are developed first by the IAASB.	Read through this section and make sure you know the information contained in the section overview.	This topic is most likely to be tested in a short form question in the examination.	
3	The IAASB's international ISAs are adapted for the Bangladesh context and issued as ISAs	Read through this section and attempt the activity.	This topic is most likely to be tested in a short form question in the examination.	2, 4
4	Internal control and the management of risk is of crucial importance for the functioning of a business.	Read through this section and ensure that you know and understand the points in the section overview.	This topic is most likely to be tested in a short form question in the examination.	
5	It is important to have a grasp of the issues currently facing the profession, even if they do not directly affect your work at the moment. These are also likely to be examinable areas of the syllabus.	Read through this section and make sure you can explain each of the issues.	This topic is important background, and could form part of a discussion requirement within a longer question.	

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1 The need for professional standards

Section overview

- Professional standards are in the public interest as they add to the quality of assurance services.
- Regulation of audit promotes comparability in the marketplace as all financial statements are audited to common standards.

The benefits of assurance were revised in Chapter 1. A fundamental feature of assurance is that it is provided by independent professionals to particular standards. Users expect assurance providers to be independent and objective (which we shall consider in the next chapter) and competent. They expect an appropriate amount of work to be done to support the conclusion being given. Assurance services are carried out in the public interest. It is important that they are carried out within a context of professional and ethical standards.

In relation to audit, readers **want assurance** when making comparisons of financial statements that **the reliability of the financial statements does not vary from company to company**. This assurance will be obtained not just from knowing each set of financial statements has been audited, but knowing that each set of financial statements has been audited to **common standards**.

Hence there is a need for audits to be **regulated** so that auditors follow the same standards. Auditors have to follow rules issued by a variety of bodies. Some obligations are imposed by governments in law, or statute. Some obligations are imposed by the professional bodies to which auditors are required (by law) to belong.

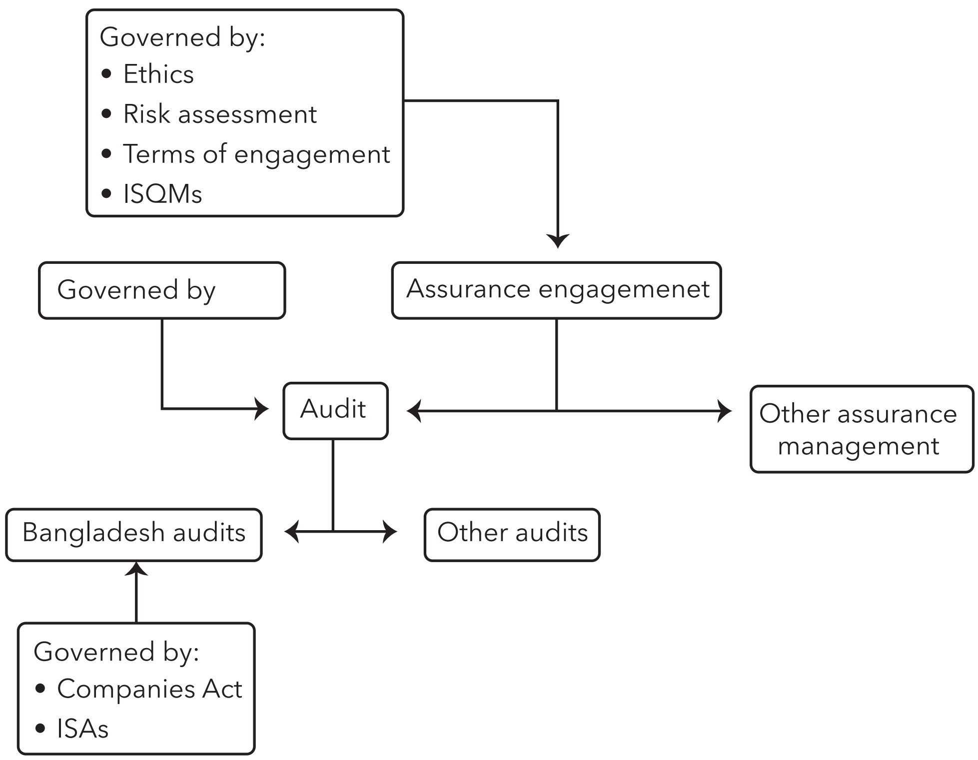


Figure 3.1: Auditing rules

2 The International Auditing and Assurance Standards Board (IAASB)

Section overview

- International standards are developed by IAASB, a subsidiary of the International Federation of Accountants.
- International standards are designed to provide services of a consistently high quality, but they do not override local regulations – although countries are encouraged to develop local systems to comply with these international standards.
- A sub-committee of IAASB works on a particular area and develops an exposure draft which is publicised.
- The exposure draft is revised as a result of comments made by interested parties and sometimes re-exposed.
- When the amendments have been finalised, an international standard is published.

2.1 The International Federation of Accountants (IFAC)

IFAC was set up by the professional bodies representing accountants from around the world. It has over 175 member organisations from over 130 countries. Members from the Bangladesh are as follows:

- ICAB (Chartered accountants)
- ICMAB (Management accountants)

IFAC has established the IAASB – the International Auditing and Assurance Standards Board – to issue professional standards on its behalf.

2.2 The forum of firms

The forum of firms was set up by the largest accountancy practices to cooperate on standard setting and other matters.

2.3 The International Auditing and Assurance Standards Board (IAASB)

IAASB was set up by IFAC, which nominates a majority of its members – others are nominated by the forum of firms – to issue professional standards. It replaced its predecessor body the International Auditing Practices Committee (IAPC). It issues the following standards:

- International Standards on Auditing (ISAs)
- International Standards on Assurance Engagements (ISAEs) (applicable to assurance engagements dealing with matters other than historical financial information)
- International Standards on Review Engagements (ISREs) (applicable to the review of historical financial information)
- International Standards on Related Services (ISRSs) (applicable to other, non-assurance engagements)
- International Standards on Quality Management (ISQMs) (applicable to all engagements carried out under any of the IAASB's standards)

IFAC itself issues Statements of Membership Obligations (SMOs) to assist its members in ensuring high quality performance. SMO1, *Quality Assurance* is to be applied to quality assurance review programmes by members carrying out audits of financial statements.

An explanation of the workings of the IAASB, the authority of the ISAs and so on are laid out in the *Preface to the International Quality Control, Auditing, Review, Other Assurance and Related Services Pronouncements*.

Note: This IAASB publication was issued before the term 'quality control' was changed to 'quality management' but in this instance, you can assume the two terms are equivalent.

The *Preface* restates the goal of IFAC as "developing a set of International Standards and other pronouncements which are generally accepted worldwide" (IAASB *Preface*: para. 2).

In working toward this mission, the Council of IFAC established the International Auditing Practices Committee, precursor to IAASB, to develop and issue, on behalf of the Council, standards and statements on auditing and related services. Such standards and statements improve the degree of uniformity of auditing practices and related services throughout the world.

Within each country, local regulations govern, to a greater or lesser degree, the practices followed in the auditing of financial or other information. Such regulations may be either of a statutory nature, or in the form of statements issued by the regulatory or professional bodies in the countries concerned.

National standards on auditing and related services published in many countries differ in form and content. The IAASB takes account of such documents and differences and, in the light of such knowledge, issues ISAs which are intended for international acceptance.

The *Preface* also lays out the authority attached to ISAs in general.

Authority of International Standards on Auditing

International Standards on Auditing (ISAs) are to be applied in the audit of historical financial information.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the purpose of a procedure. When such a situation arises, the auditor must document justification for the departure.

ISAs do **not** override the local regulations referred to above governing the audit of financial or other information in a particular country.

- To the extent that ISAs **conform** with local regulations on a particular subject, the audit of financial or other information in that country in accordance with local regulations will automatically comply with the ISA regarding that subject.
- In the event that the local regulations **differ from**, or conflict with, ISAs on a particular subject, a professional accountant should not 'represent compliance' with ISAs unless they have done so.

Application to public sector

Considerations Specific to Public Sector Entities are set out at the relevant points in the text of the ISA. Where there are no specific public sector considerations, the ISA is applicable in all material respects to the public sector.

2.4 So where are we now?

ISAs in the Bangladesh are issued by the FRC, and are based on the ISAs first issued by the IAASB. The FRC then modifies these ISAs so that they are appropriate for auditors operating in the Bangladesh.

The system in the Bangladesh works as follows:

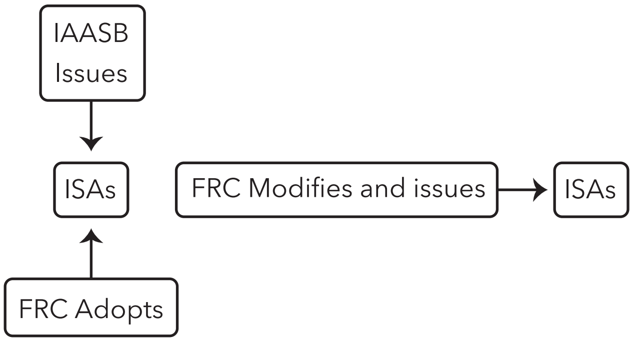


Figure 3.2: Bangladesh system for auditing standards

3 The Financial Reporting Council (FRC)

Section overview

- Supervision of accountancy related issues in the Bangladesh is provided by the Financial Reporting Council.
- The FRC issues auditing standards .
- The FRC adopts International Standards on Auditing.

3.1 The Financial Reporting Council (FRC) objectives and structure

General objectives of the Council

- Determination of financial reporting and auditing professional standards, ethical standards, etc.;
- Qualitative standard development of accounting and auditing services;
- Development of accounting and auditing profession;
- Confirmation of highest standards of the financial reporting and auditing works of the scheduled auditors;
- Enhancement of the credibility financial statements;
- Ensuring the morality, transparency of professional works of financial reporting and auditing and cooperation in capacity building; and
- Encouraging Public Interest entities to produce high quality report of financial and non financial information.

Functional divisions of the Council

- Standards Setting Division;
- Financial Reporting Monitoring Division;
- Audit Practice Review Division; and
- Enforcement division.

3.2 The FRC and auditing standards

The FRC issues the following standards and guidance for auditing:

- auditing standards
- ethical standard
- practice notes etc.

Interactive question 1: The Financial Reporting Council

What are the main functions of the Financial Reporting Council and by what bodies are those functions carried out?

See **Answer** at the end of this chapter.

4 Internal controls

Section overview

- Internal control is an important issue given prominence by the UK Turnbull Report and the US Sarbanes–Oxley Act.
- The issue of providing assurance on internal control is important, particularly as little assurance is given on the effectiveness of internal control by the audit
- Knowledge of the business will be an important factor in providing assurance on internal controls.
- Assurance may be provided on the different stages of the process: identifying the risks, the design of the system, the operation of the system.
- Reports providing assurance on the effectiveness of internal controls should mention the inherent limitations of internal control systems to avoid an expectations gap arising in relation to this issue.

Internal control is an important issue in business. It has been given particular prominence in the Uk by the investigations into corporate governance in the 1990s, notably the Turnbull Report which concentrated on the risks facing companies and the need for directors to manage those risks. In addition, it has been given prominence by the Sarbanes–Oxley Act in the US, and the requirements that places on chief executive officers to give more certification that the financial statements produced are true, by implication, that the systems supporting them are strong and capable of preventing error.

The auditors' responsibilities with regard to internal control were discussed in the previous chapter and in your earlier studies in relation to Assurance. Due to the limitations of the assurance given in relation to internal control as part of an audit, provision of additional or alternative assurances in respect of internal control has become an important issue.

4.1 Providing assurance on internal control

The Briefing Paper draws a clear distinction between two areas of assurance:

- Assurance on the **design** of internal control systems
- Assurance on the **operation** of the internal control system, in accordance with the design

These are two very distinct issues, and the two assignments should be approached very differently.

4.2 Process of internal control

The Briefing Paper recognises the following process in relation to internal controls:

Figure 3.4: Internal control

This figure also illustrates the points of the process where assurance services can be given:

- Risk identification
- Design of system
- Operation of system

In order to carry out an engagement in relation to the internal controls, the practitioners will require sufficient **knowledge of the business** that they can **identify and understand** the events, transactions and practices which will impact on the system of internal control.

4.3 Providing assurance on the operation of the system

The practitioner should establish whether the engagement relates to a period of time or a point of time. The practitioner will only be able to provide a **high level of assurance** on this point if the entity has a detailed description of the design of their system of internal control.

The **report** arising from such an assignment need not be extensive, but is likely to be narrative. This is because practitioners are likely to include such issues as:

- isolated control failures
- observation about the abilities of staff involved in operating the system of control
- potential weaknesses observed which were not contemplated within the design

4.4 Providing assurance on the design and operation of the system

In such an engagement, practitioners will consider two issues:

- the design of the system in addressing a set of identified risks
- the operation of the system (discussed above)

Such an engagement will involve significant **discussions with management** at the outset, to establish matters such as:

- the desired balance between prevention and detection controls
- the balance between costs and benefits
- the importance of specific control objectives

The outcome of these discussions will necessarily be included in the assurance **report**, to provide a context for their conclusions. The following things will also be included in the report:

- the applicable risks
- any framework for design used by either the directors or the practitioners
- a description of the design of the system of internal control

The **level of assurance** given by the practitioners will **depend on several factors**, including the nature of the entity, the knowledge of the business the practitioner possesses and the scope of the engagement. It is likely that the report in this instance would be quite long.

4.5 Providing assurance on the applicable risks and the design and operation of the system

This engagement would include consideration of all three stages of the internal controls process identified above. The identification of risks is likely to involve a **high degree of judgement** as there are no universally recognised criteria suitable for evaluating the effectiveness of an entity's risk evaluation. This means that practitioners are **unlikely to be** able to provide a **high level of assurance** in this area.

The starting point for the practitioner would be the entity's business objectives. The key considerations will include the following:

- the completeness of the applicable identified risks
- the probability of a risk crystallising
- the materiality of the likely impact of the risk
- the time period over which crystallisation is anticipated

In their **report**, the practitioners would have to outline the business objectives of the entity, a description of the risk identification process and the applicable risks.

4.6 Inherent limitations

Internal control systems have inherent limitations, a key one of which is the chance of staff colluding in fraud to override the system. **Any assurance report on internal control** systems should **include a mention of these inherent limitations**, in order to prevent an unnecessary expectations gap.

4.7 Reports

The nature of the individual reports has been touched on above. The discussion paper also includesan example report; however, as it is difficult to issue a standard report for assurance services, which are largely dependent on the scope and nature of the individual assignment, this has not been reproduced here.

5 Current issues

Section overview

- The key current issue for standard setters is the effect of big data on the profession.

5.1 Harmonisation

Harmonisation is the process of aligning international standards for auditing so that companies are audited in a comparable way globally.

5.2 Professional scepticism

Definition

Professional scepticism: "An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence" .

Professional scepticism is crucial to audit. An effective audit cannot be carried out with it.

Following the global financial crisis of 2008 and 2009, a common theme in a number of regulator reports was that professional scepticism could have been more clearly demonstrated by auditors when looking at a number of audit areas. It continues to be at the top of the agenda for regulators and standard setters, including the IAASB in their 2018 update of the IESBA Code of Ethics.

The skills auditors use in making judgements based on evidence, and concludes that no opinion can be expressed on the truth and fairness of financial statements until:

- there has been sufficient inquiry and challenge
- management's assertions have been thoroughly tested
- audit evidence has been critically appraised and deemed to be sufficiently persuasive
- alternative treatments for items in financial statements have been considered

5.3 Big data

Big data is a broad term for data sets that are large or complex. Big data presents both a major challenge to, and an opportunity for, existing standards and training within the audit and assurance profession. Big data technology allows the auditor to monitor very large or complete sets of data, rather than samples, on a more frequent (possibly continuous) basis, and to mine unstructured sets of data, such as email, to identify anomalies for further investigation.

Some accountancy firms are currently investing in data analytics to provide a better-quality audit, and to reduce risk and liability for the auditor. The International Auditing and Assurances Standards Board (IAASB) has set up a Data Analytics Working Group (DAWG) to monitor the various applications of data analytics and the relationship to the audit, such as the effect on risk assessments, testing approaches, analytical procedures and other audit evidence.

The objectives of the Data Analytics Working Group (DAWG) are as follows:

- "Explore emerging developments in the effective and appropriate use of technology, including data analytics, to enhance audit quality; and
- Explore how the IAASB most effectively can respond to these emerging developments via new orrevised International Standards on Auditing or non-authoritative guidance (including Staff publications) and in what timeframe".

The increasing use of technology in the audit will need to be reflected in auditing standards, so that audit data analytics techniques are incorporated into the framework.

The use of data analytics as part of the audit approach is discussed further in Chapter 10.

5.4 Future of audit

Recent years have seen three major reviews into the audit profession:

- The Kingman review (2018), into the regulator of the profession, the FRC (UK)
- The CMA (UK) market study (2019), into the audit market
- The Brydon Report (2019), into the quality and effectiveness of audit

In addition to these, the UK government published in 2021 a policy white paper on 'Restoring trust in audit and corporate governance'. Consultation on this white paper ran from March to July 2021, during which time the UK government sought feedback from stakeholders on how auditing could be improved. At the time of writing, the government is still analysing this feedback, so the recommendations of the Brydon Report (see below) are still just recommendations. In March 2022, the FRC (UK) published their three-year plan which indicated that ARGA would be fully operational by 2025. For the purposes of your exam though, you can assume that the FRC (UK) is still in existence.

This is therefore a developing area that is in some considerable flux.

Kingman review

In the wake of the Kingman review, the UK government announced the abolition of the FRC (UK) and its replacement with a new **Audit, Reporting and Governance Authority (ARGA)**.

It is anticipated that the new ARGA will for the first time be able to:

- directly regulate the biggest audit firms
- impose greater sanctions in cases of corporate failure
- require rapid explanations from companies
- publish reports about a company's conduct and management

The Kingman review took place in the wake of a spate of high-profile corporate collapses (Carillionplc, BHS, Quindell and others). Rachel Reeves MP commented that "audits appear to be a colossal waste of time and money, fit only to provide false assurance" (Parliament UK, 2018).

Michael Izza, the Chief Executive of the ICAEW, had the following to say in response to Kingman:

Sir John Kingman's Review has far-reaching implications for audit, and it is right that his recommendations are scrutinised from all quarters, not just within the accountancy sector, but also by business and wider society.

We are pleased that the government wants to act swiftly, but must consider how Kingman's recommendations will work alongside the findings from the Competition & Markets Authority's market study, and the output from Sir Donald Brydon's review into the quality and effectiveness of audit. Taken together, these must constitute a coherent and comprehensive programme of reform, which will reinforce the role of audit in sustaining a strong economy, and cement the reputation of the UK as a great place to do business.

Brydon Report

The *Independent review into the quality and effectiveness of audit* (December 2019), known as the Brydon Report, took place against the backdrop of a lack of public trust in audit, and the need for change in order to help restore this trust. In the report, Lord Brydon called for urgent reform of the audit profession, recommending nothing less than a total reconfiguration of the relationship between audit and corporate reporting generally – with the separation of the audit profession from the accounting profession.

The key recommendations included (*Brydon Report*: para. 2.0.6):

- A **redefinition of audit and its purpose**: Brydon claimed that the purpose of audit was not clear, and proposed that the following new definition be passed into law: "The purpose of an audit is to help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements" (Brydon Report: para. 2.1.1). The idea here is that audit needs to be useful, and should provide users of audit reports with information that helps them to make decisions; Brydon considers that in order for audit to be useful, it must be a public interest function that goes beyond merely testing compliance with laws and rules.
- The creation of a corporate auditing profession governed by principles. Rather than audit merely being an "adjunct to the accountancy profession", Brydon wants it to be a whole profession by itself, focusing on more than just the statutory audit alone. This would involve the introduction of new principles around openness, independence, challenge and the public interest (Brydon Report: paras. 2.2.1-5). Key here is that the new regulator, ARGA, should "revisit the existing definition of professional judgment".
- Changes to the audit opinion, replacing 'true and fair' with "present fairly, in all material respects"(Brydon Report: para. 2.3.2). The aim here is to emphasise fairness of presentation over simple truth or untruth, although Brydon does consider that the audit opinion itself should still be 'binary'(Brydon Report: paras. 2.3.2-7).

- **Directors** to present to the shareholders a three-year rolling Audit and Assurance Policy – the ideahere is to 'frame' the work of the auditors within the company itself. Brydon also proposes that directors should publish a statement of principal risks and uncertainties before determining the scope of each year's audit.
- The directors' Going Concern and Viability statements would be replaced by a single '**Resilience Statement**', and the directors would present an annual '**Public Interest Statement**' explaining the company's obligations to the public interest.
- **Shareholders** to be encouraged to influence the audit:
  - To establish a formal process for **shareholders to propose matters for the audit** to cover
  - Company's General Meeting to include a standing item to permit members (shareholders) to question the Audit Committee Chair and the auditor
- **Stakeholders** to be covered by way of the 'public interest' – the audit is legally for the shareholders, but auditors to be required to report on the already-existing duties of directors inrelation to the public interest (in s.172 of the Companies Act).
  - **Employees** to be asked about matters to be included in the audit
  - Existing information about **supplier payment performance** to be brought into annual reportand reported on by auditors
- **Fraud**: Directors to report on their actions to prevent and detect fraud, and auditors to report on this. Further, **auditors to be trained in forensic accounting and fraud awareness**. (Brydon Report: s.2.7)
- Brydon has things to say about **internal controls** where these are relevant to fraud (Brydon Report:s.2.8):
  - CEO and CFO to report to the Board on internal control effectiveness, based on new principles to be developed by ARGA
  - Companies to disclose when there has been a material failure of internal controls
- **Capital maintenance**: where directors propose a dividend, they would make a statement that this in no way threatens the existence of the company within, say, two years (Brydon Report: para. 2.8.5).
- **Auditor transparency**: there are a number of proposed measures here (Brydon Report: para. 2.9.1):
  - Separation between audit team and team negotiating the audit fee
  - Audit firms to disclose profitability of audit work, and remuneration of audit partners
  - Audit report to disclose hours spent on the audit by each grade of staff
  - Clear reasons to be given for resignation, dismissal or not re-tendering
- Other recommendations made by Brydon include:
  - BEIS and ARGA to develop policies around audit firm use of client data to improve audit
  - Auditors to explain in the auditor's report any sampling techniques used
  - Any Alternative Performance Measures reported by a company should be subject to audit
- Suggestions to inform the work of BEIS on internal controls and improve clarity on capital maintenance.

It remains to be seen exactly how the Brydon report will be implemented in the future, but the report itself recommends that a further review be conducted in 2025 to consider how its recommendations have been implemented.

Restoring trust in audit and corporate governance

In March 2021 the UK government published a white paper on 'Restoring trust in audit and corporate governance' in which it set out its proposals for a way forward. The government stated that it agreed with the findings of the Kingman and Brydon reviews, and made proposals for reform in several areasas summarised below.

Consultation on this white paper ran from March to July 2021, during which time the UK government sought feedback from stakeholders on how auditing could be improved. At the time of writing, BEIS is still analysing this feedback, so the recommendations of the Brydon Review are still just recommendations. In March 2022, the FRC (UK) published their three-year plan which indicated that ARGA would be fully operational by 2025. **For the purposes of your exam, you can assume that the FRC (UK) is still in existence**.

Directors

In order to combat directors who 'neglect their reporting responsibilities' (Restoring trust: p15), the government proposes new reporting and attestation requirements covering internal controls, dividend and capital maintenance decisions, and resilience planning, designed to sharpen directors'accountability in these key management areas within the largest companies (Restoring trust: p16).

There are also proposals to ensure that the regulator has effective investigation and civil enforcement powers to hold to account directors of large businesses which are of public importance for breaches of their duties in relation to corporate reporting and audit.

Audit, auditors and audit firms

The government considers that audit has not developed sufficiently in the last several decades, and that the idea that audit should simply be a report to shareholders on compliance with accounting standards is outdated. The government is also of the view that there is not enough competition in the audit market (with 97% of FTSE 350 audits undertaken by just four firms).

It is proposed – in line with the Brydon report – to create a new, stand-alone audit profession, underpinned by a common purpose and principles – including a clear public interest focus – and with a reach across all forms of corporate reporting, not just the financial statements. There are to be new regulatory measures to increase competition and reduce the potential for conflicts of interest, by providing new opportunities for challenger audit firms and new requirements for audit firms to separate their audit and non-audit practices.

Shareholders

The white paper states that "Shareholders, as the owners of companies, have a vital role to play in the corporate governance framework" (Restoring trust: p17), and that institutional investors in particular have a stewardship role to "create long-term value for their clients through oversight of the companies in which they are invested" (Restoring trust: p17). The problem is that asset managers do not do this enough and do not 'sufficiently prioritise audit' in relation to this stewardship role.

This is interesting because it implies that institutional shareholders may have a soft duty to the publicas a whole to oversee the creation of long-term value in companies.

The government therefore proposes for companies to be required to set out their approach to audit through publication of an audit and assurance policy on which there would be an advisory shareholder vote. Shareholders would also have a formal opportunity to propose to the audit committee areas of emphasis to be considered within the auditor's annual audit plan. The aim here appears to be to facilitate shareholder interest in stewardship and the audit process.

The audit regulator

The FRC(UK) is to be replaced by the ARGA, and the government proposes steps such as new statutory objectives and functions. The government is also proposing to give the regulator competition powers and new powers to strengthen its corporate reporting review function and its oversight of audit committees, and to enforce the corporate reporting duties of directors (Restoring trust: p18).

Joint audit

In a joint audit, more than one auditor is responsible for the audit opinion. The audit is performed jointly, and a joint auditor's report is issued. The audit firms would be jointly liable in the event of any litigation.

The Competition and Markets Authority (CMA) has proposed the introduction of mandatory joint audits. This is part of its intention to increase the capacity of firms outside the biggest audit firms, which it believes will eventually contribute to an intensification of **competition**, and thus to higher quality, in the audit market as a whole. The background to this is the dominance of the audit market –particularly for larger listed companies – by the biggest firms, and the capacity of smaller firms to perform these audits. Being involved in joint audits of larger companies would help these firms to build up their ability to audit them.

Joint audits have been the subject of extensive discussion in recent years, and are a source of controversy. The CMA's advocacy of them relates to the specific problem of competition in the audit market, but there is more to the issue than just this. One of the major criticisms of joint audits is that they may be expensive. This is likely true, but if the two firms have organised the work between them properly the difference can be minimised. Further, an increase in the fees may be justified by improved services, not least because the two firms of accountants are likely to work as efficiently as possible.

5.4.1 Climate change and sustainability

Climate change is a central concern across many sectors, and the audit profession is no different. In November 2020, the FRC (UK) published a review of company and auditor responses to climate change.

The FRC found the following:

- It is the board's responsibility to consider climate-related issues, but there is little evidence that business models and company strategy are influenced by integrating climate considerations into governance frameworks.
- An increasing number of companies are providing narrative reporting on climate-related issues. While minimum legal requirements are often being met, users are calling for additional disclosure to inform their decision making. Some companies have set strategic goals such as 'net zero', but it is unclear from their reporting how progress towards these goals will be achieved, monitored or assured.
- Consideration and disclosure of climate change in the financial statements lag behind narrative reporting. We identified areas of potential non-compliance with the requirements of International Financial Reporting Standards (IFRS).
- The quality of support, training and resources provided to the audit practice varied considerably across firms. Firms also need to do more to ensure that their internal quality monitoring has appropriate regard for climate change considerations.
- Audits reviewed indicated that auditors need to improve their consideration of climate-related risks when planning and executing their audits.
- UK professional bodies, and audit regulators in the Crown Dependencies, are responding to climate change, but approaches differ in terms of substance and granularity regarding references to climate-related reporting and the impacts of climate change.
- Investors support the Task Force on Climate-related Financial Disclosures framework, but also expect to see disclosures regarding the financial implications of climate change. Investors are themselves facing a changing regulatory environment.

Since the UN COP 26 in 2021, there has been a shift in the relationship between companies, stakeholders and auditors regarding sustainability and climate-related disclosures. One of the key outcomes of COP 26 was the formation of the **International Sustainability Standards Board (ISSB)** which signalled the IFRS Foundation laying down a marker for sustainability disclosures. At the time of writing, there are two exposure drafts under consultation which deal with these disclosures.

In the UK, the Companies Act has been amended to require certain aspects of an entity's sustainability and climate-related risks and opportunities to be disclosed, a measure that has been matched by the listing authority for most large UK companies. Underpinning all of these disclosures is the methodology from the Task Force for Climate-related Financial Disclosures (TCFD) which uses the categories of governance, strategy, risk management and metrics and targets.

All that remains to be concluded is the degree of credibility of such information, as it is not currently subject to audit. However, the pace of change seen in relation to disclosures, coupled with the obvious sense of urgency for action in this area, suggests that some form of assurance is inevitable.

5.4.2 Technological advances

Technological development continues apace, in many cases disrupting the finance profession in ways that were unforeseen just a few years ago. Four main types of technology are most relevant:

- Robotic Process Automation
- AI & Cognitive Computing
- Blockchain
- Advanced Analytics & Visualisation, which was covered in the section on 'Big data' earlier in this Chapter

Robotic Process Automation (RPA)

RPA refers to software used to capture and interpret existing applications for the purpose of automating activities across multiple technology systems.

Robots can perform recurring processes just like their human counterparts. They mimic human actions, examples of which you can read below. RPA does not mimic human judgement and intelligence though – this is something which can only be performed using cognitive technologies.

Robots can perform a range of actions, some simple and some more complex. Simple actions include opening emails, or copying and pasting files; complex actions include making calculations, extracting data from documents or scraping data from the web.

The decision whether to use RPA should take into account a number of criteria, including: the extent to which a process is standardised (with unambiguous rules); the number of exceptions to rules; the amount of manual work involved (large amounts are ripe for RPA); or the number of systems used (ideally more than one system).

AI & Cognitive Computing

Artificial intelligence (AI) is a term used to describe any computer program which does something that we would normally think of as intelligent in humans.

The tasks that computer systems are able to perform have changed over time, and so the meaning of 'AI' has also evolved. As these shifts occurred, other terms, such as Cognitive Computing and Machine Intelligence, have also been introduced to refer to smart technologies.

AI seeks to copy human cognitive activities, such as:

- Learning: Learning from historical data or responses to determine the correct response to a question
- Understanding: Interpreting images or speech – recognising objects in images or words in speech
- Interacting: Interacting in a natural way
- Perceiving: Gathering information from surroundings, eg, through hearing or sight
- Reasoning: Form hypothesis to recognise patterns in underlying data

Common areas of application within finance include:

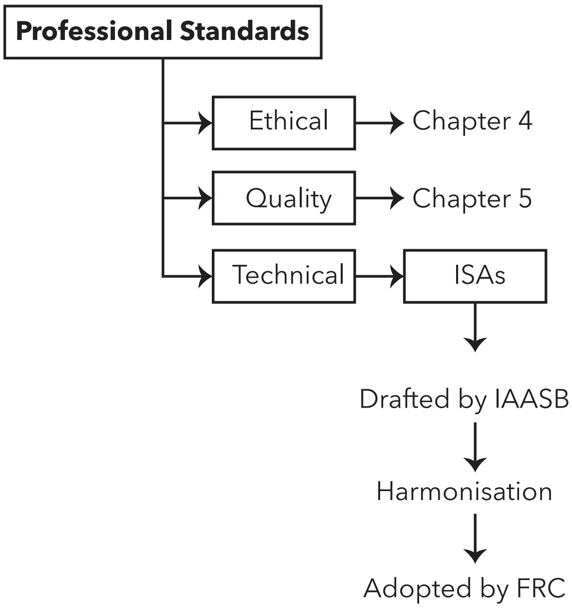
- Cognitive automation: For example, to automate the cash matching process
- Cognitive engagement: For example, using a virtual assistant to resolve common queries or requests
- Cognitive insight: For example, providing visibility of the entire cash process, allowing finance to proactively resolve disputes

5.4.3 Blockchain

A blockchain is "a distributed ledger that allows digitals assets to be transacted immutably and in real time". In contrast to a traditional record or ledger, which is stored in only one place, a blockchain involves the storage of information across all multiple computers. The information is more secure because it is public.

Whilst the technology itself is not brand new, the application of blockchain within business is still emerging. As such, the vision for the benefit it can bring is still being proven. For finance, there are a number of benefits that are expected to flow through from the application of blockchain to wider business processes. Some CFOs and finance teams are seeking to play a key role in driving forward the blockchain agenda to ensure that these benefits are realised. Others may simply be recipients of the change. Regardless, this change has the potential to be transformative for finance.

Summary



Professional Standards
Ethical
Chapter 4
Quality
Chapter 5
Technical
ISAs
Drafted by IAASB
Harmonisation
Adopted by FRC

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. It not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you explain why markets need audits to be conducted in accordance with professional standards? (Topic 1)	
(2) Can you explain which body issues ISAs and which body issues ISAs ? (Topic 2)	
(3) Can you identify the two principal bodies which report to the FRC Board? (Topic 3)	
(4) What are the two main areas of assurance that may be provided on internal control? (Topic 4)	
(5) Can you explain the potential impact of big data on the audit profession? (Topic 5)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q2	This question tests a point of knowledge that you should be able to answer well.	
Q3	This question tests a point of knowledge that you should be able to answer well.	
Q5	This question gives a taste of how this topic could appear in the examination.	

Once you have attempted these questions, you can continue your studies by moving onto the next chapter, Professional ethics.

Technical reference

1 The need for professional standards

n/a

2 The International Auditing and Assurance Standards Board (IAASB)

Preface to the International Quality Control, Auditing, Review, Other Assurance and Related Services Pronouncements

3 Internal controls

ISA 315.12(m) and 19

4 Current issues

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Self-test questions

Answer the following questions

1 Auditing is regulated by the government in the Bangladesh.

   A True

   B False

2 The Financial Reporting Council issues auditing standards which auditors are required to follow.

   A True

   B False

3 Why are professional standards important?

   A

4 Discuss the advantages and disadvantages of accounting and auditing standards to auditors and the consequences of such standards being enforceable by statute.

Total: 4 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed forthis chapter.

Answers to Interactive questions

Answer to Interactive question 1

General objectives of the Council

- Determination of financial reporting and auditing professional standards, ethical standards, etc.;
- Qualitative standard development of accounting and auditing services;
- Development of accounting and auditing profession;
- Confirmation of highest standards of the financial reporting and auditing works of the scheduled auditors;
- Enhancement of the credibility financial statements;
- Ensuring the morality, transparency of professional works of financial reporting and auditing and cooperation in capacity building; and
- Encouraging Public Interest entities to produce high quality report of financial and non financial information.

Functional divisions of the Council

- Standards Setting Division;
- Financial Reporting Monitoring Division;
- Audit Practice Review Division; and
- Enforcement division.

Answers to Self-test questions

1 Correct answer(s):

B False

Option	Debrief
False	It is regulated by the FRC.

2 Correct answer(s):

A True

Option	Debrief
True	Auditors face discipline by ICAB if they do not.

3 It is in the public interest that assurance services are carried out to professional standards.

4 The major **advantages** of accounting standards and auditing standards can be summarised as follows:

Accounting standards

- They reduce the areas of uncertainty and subjectivity in accounts.
- They narrow the areas where different accounting policies can be adopted.
- They increase the comparability of financial statements.
- They codify what is considered in most circumstances to be best accounting practice.
- They give an indication of the interpretation of the concept 'true and fair' in many circumstances.

Auditing standards

- They give a framework for all audits around which a particular audit can be developed.
- They help to standardise the approach of all auditors to the common objective of producing an opinion.
- They assist the court in interpretation of the concept of 'due professional care' and may assist auditors when defending their work.
- They increase public awareness of what an audit comprises and the work behind the production of an auditor's report.
- They provide support for auditors in a dispute with clients regarding the audit work necessary.

The possible **disadvantages** include the following:

Auditing standards

- They give a framework for all audits around which a particular audit can be developed.
- They help to standardise the approach of all auditors to the common objective of producing an opinion.
- They assist the court in interpretation of the concept of 'due professional care' and may assist auditors when defending their work.

CHAPTER 3

- They increase public awareness of what an audit comprises and the work behind the production of an auditor's report.
- They provide support for auditors in a dispute with clients regarding the audit work necessary.

The possible **disadvantages** include the following:

Accounting standards

- They are considered to be too rigid in some areas and too general in others, making their application difficult in some circumstances.
- They can be onerous for small companies to adopt.
- Their proliferation could be said to increase proportionately the number of qualified auditor's reports thereby reducing the impact of such qualifications.
- They can create divisions within the profession of those who agree and those who disagree with a particular standard.
- They would be difficult to change once they become statutory as alterations to company law can take years rather than months to enact.

Auditing standards

- It may appear that they impinge on, rather than assist, professional judgement.
- They are considered by some to stifle initiative and developments of new auditing methods.
- They may create additional and unnecessary work and thus raise fees, particularly on the audit of small companies.

If either type of standard were to be enforceable by statute it would mean that there would be government intervention in areas currently controlled solely by the profession itself. This might ultimately lead to a diminished role in self-regulation. To be enforceable by statute the standards would have to be applicable to all circumstances and thus need to be very general and broad in their instructions. This might reduce their usefulness to the auditors. Auditors might spend unnecessary time ensuring that they have complied with the law rather than considering the quality of their service to their clients.

Finally, it should be considered whether full statutory backing for standards would force auditors into narrow views and approaches which might gradually impair the quality of accounting and auditing practices.

Chapter 4

Professional ethics

Introduction

Learning outcomes

Legal and other professional regulations, ethics, accepting and managing engagements andcurrent issues

Students will be able to understand and advise on the regulatory, professional and ethical issues relevant to those accepting, managing and carrying out assurance engagements. Students will be able to understand the processes involved in accepting and managing assurance engagements and how quality assurance processes mitigate the risks to those conducting the engagement.

- Identify and advise upon the legal, professional and ethical issues that may arise before accepting or during a specified assurance engagement
- Recognise the professional and ethical issues that may arise during an assurance engagement, explain the relevance and importance of these issues and evaluate the relative merits of different stand points taken in debate
- Judge when to raise legal and ethical matters arising from assurance work with senior colleagues for review and possible referral to external parties, including reporting suspicions of money laundering
- Discuss the purposes and consequences of laws and other regulatory requirements surrounding assurance work

Syllabus links

This topic was covered in detail in Assurance.

Examination context

As this is an important practical area, you can expect it to be examined regularly.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	All members of ICAB, and trainees, are required to comply with the ethical rules of ICAB. **Stop and think** Why are professional ethics important?	This section is fairly straightforward and can be read through quickly.	The material here is unlikely to be examined directly, although you should continue to have an awareness of the current issues surrounding sustainability.	

Topic	Practical significance	Study approach	Exam approach	Self-test questions
2	Professional ethics are important to all ICAB members and trainees, regardless of what field theywork in.	This chapter is all revision from Assurance, but you should ensure that you are very certain of the rules of professional ethics and be prepared to apply them to situations in the exam. You should read this section carefully and attempt the activity.	The material in this section is of fundamental importance and could be tested anywhere in the examination.	1, 4
3	As a trainee, you are unlikely to need to consider the details of this ethical guidance in your job; however, it may be important further on in your career.	You should read this section carefully and attempt the activities.	The material in this section is of fundamental importance and could be tested anywhere in the examination.	6, 7, 8
4	This section covers confidentiality, which is a key issue for trainees working in audit.	Read through this section carefully and attempt the interactive question.	This material could be tested in either part of the examination.	2, 3, 5

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1 The need for professional ethics

Section overview

- The importance of professional ethics is that in order for accountancy services to be meaningful, the public must trust accountants.
- Trust is built by the knowledge that accountants are bound by a professional code of ethics.
- Independence and objectivity (key features of the Code of Ethics) are fundamental to the provision of assurance services.
- The topic of sustainability is increasingly being linked to ethical behaviour.

The accountancy profession has a paradoxical image. On the one hand accountants are seen as pillars of society, providing reliable financial information in their working lives and acting as treasurer for the local church in their spare time.

The other side of the coin is the image of aggressive tax schemes, financial scandals and money laundering.

Yet accountants believe that financial information is important. It is necessary for governments, shareholders, trading partners, management and any number of other stakeholders, that the financial and other reports and information provided by accountants are reliable and can be used by others as they go about their daily lives. So, the work that accountants and other assurance providers do has benefit for the public interest.

It follows from this that, if the profession is to survive and thrive, and if its members are to maintain their position there has to be a code of conduct so that the public are able to feel that they can trust accountants.

The profession needs a code of professional ethics.

When a good deal of the profession's income comes from audit and other assurance services, where the users of those services are seeking to gain additional confidence in the reliability of information, it is no exaggeration to say that the profession's income actually depends on accountants' reputation for ethical behaviour.

You have already studied professional ethics in relation to assurance services in your earlier studies for your Assurance exam.

Consider the difference between professional ethics and ethics in a more absolute sense; what is the difference between the two?

Professional skills focus: Applying judgement

It is said that former US President, Coolidge once returned from church to be asked by his wife what the subject of the sermon was. 'The preacher spoke about sin,' he said. 'What did he say about it?' asked his wife. 'He said he was against it,' replied Coolidge.

Professional ethics could be considered an attempt to avoid this problem by fleshing out the general imperative to act ethically with specific guidance on how to do this in different situations.

1.1 Sustainability impact

The adoption of any new disclosure approach inevitably brings uncertainty over how far such disclosures should go and the extent to which scrutiny should extend. In the case of financial reporting, due to the connection between a company's financial position, performance and prospects, the involvement of investors' funds and the remuneration of the company's board and management, assurance over the financial statements is necessary to address the agency problem. Should the same need for trust and credibility be extended to sustainability disclosures?

Previously, whenever items of an ESG nature have been reported in an annual report or equivalent, there has always been an element of scepticism over just how much to trust this information and whether it is merely serving the purpose of greenwashing.

Definition

Greenwashing: A PR tactic used to make a company or product appear environmentally friendly,without meaningfully reducing its environmental impact

The ethics of deliberate misstatement of such issues are complex and the determination of both victim and beneficiary are not always apparent. Clearly the environment suffers if a company is not operating in as sustainable a manner as it claims to be, but as many of the consumers such disclosures are aimed at are also exposed to the adverse effects of unsustainable corporate behaviour, they ultimately become victims too. However, a company that continues to operate in an unsustainable manner will preserve employment opportunities for its workforce, ongoing income for its suppliers and returns for its investors.

The disclosure framework for ESG issues, including those climate-related and sustainability risks and opportunities that will need to be reported under the proposed ISSB standards . This means that there is now a more robust methodology set out by the Task Force for Climate-related Financial Disclosure (TCFD) that must be followed, including the connection between governance, strategy, risk management and metrics and targets.

Some organisations are exempt from this, and in other cases, the disclosures are only subject to a comply or explain approach. Assurance of these disclosures is not required either, leading to criticisms that the system currently does not go far enough. However, before the adoption of the TCFD was even being discussed, there has always been a control in place to encourage companies to be open and transparent about all their disclosures: professional ethics. The fundamental ethical principles of integrity and objectivity go back to the terms true and fair and should still be in force today whatever the contents of and approach to the company's communication with its stakeholders.

2 Code of Ethics

Section overview

- The International Ethics Standards Board (IESBA) is one of the standard setting boards of IFAC.
- IESBA issues a *Code of Ethicsfor Professional Accountants*, with which you should be familiar.
- The IESBA *Code* has been used as the basis for developing ICAB codes, in particular, compliance with the ICAB *Code* ensures compliance with the IESBA *Code*.

2.1 IESBA *Code of Ethics* – fundamental principles

The fundamental principles are:

- **Integrity** – to be straightforward and honest in all professional and business relationships.
- **Objectivity** – not to compromise professional or business judgements because of bias, conflict of interest or undue influence of others.
- **Professional competence and due care** – to:

- attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organisation receives competent professional service, based on current technical and professional standards and relevant legislation; and
- act diligently and in accordance with applicable technical and professional standards.

- **Confidentiality** – to respect the confidentiality of information acquired as a result of professional and business relationships.
- **Professional behaviour** – to comply with relevant laws and regulations and avoid any conduct that the professional accountant knows or should know might discredit the profession.

(IESBA Code of Ethics: para. 110.1 A1)

2.2 Code of Ethics – threats to objectivity and independence

The IESBA *Code of Ethics*, the ICAB *Code of Ethics* all work on the basis that an assurance firm's integrity, objectivity and independence are subject to various threats and that the firm must have safeguards in place to counter these threats.

The threats are as follows:

- **The self-interest threat**

  All firms face the self-interest threat, simply because the client pays the fee, and to lose a client may be painful.

  The risk is increased for audit engagements, because, although technically the auditor is appointed by and reports to the shareholders, in practice the appointment depends on the client's management. The auditor may be tempted to allow inappropriate accounting treatments in order to keep the client.

- **The self-review threat**

  It may be difficult for the firm to maintain its objectivity if any product or judgement made by the firm needs to be challenged or re-evaluated at a later date.

  Examples might be brand or company valuations or aggressive tax schemes. If the firm has valued a client's new subsidiary at a price which is questioned when it comes to the audit, there may be some embarrassment, or the temptation to gloss over the differences in values.

  Where the auditor also carries out accounting work on behalf of the client, this may seem innocent enough. Indeed there may be perceived ethical advantages, because the accountant should be able to prepare the accounts 'properly'.

  There will be a self-review threat where the accountant prepares financial statements and then acts as auditor, effectively reviewing their own work. The auditor may not want to report mistakes that they, as accountant, had made. Where accounts are prepared by auditing firms, another department always carries out the audit to remove this threat. In some jurisdictions, auditors are not allowed to prepare financial statements for a client, removing this threat completely.

  But consider the position where the use of different accounting policies may give very different results, or where different interpretations can be placed on treatments required by accounting standards.

- **The management threat**

  A management threat arises when the audit firm undertakes work that involves making judgements and taking decisions, which are the responsibility of management.

- **The advocacy threat**

  The advocacy threat occurs where the professional adopts a stance arguing for or against the client's point of view, rather than taking a balanced (objective) position.

The advocacy threat is difficult to deal with because, surely, the professional adviser wants to give the client the best possible support.

In a tax case, for example, is it not the tax consultant's job to win on behalf of the client at all costs?

- The familiarity or trust threat

  This recognises that, if the professional gets to know the client too well, objectivity may be threatened because the auditor becomes too trusting of the client and professional scepticism is impaired.

  This is also quite a difficult area. As we shall see in Chapter 8 the auditor needs to understand the client's business well. Changing the engagement partner may or may not enhance objectivity, but if it does, it may open up greater audit risks due to lack of familiarity with the client's business.

- The intimidation threat

  This threat may range from the effective hijacking of the auditor's professional qualification by clients with criminal tendencies – something which the Government is concerned about, as demonstrated by the anti-money laundering regime they have introduced – to the bullying behaviour of a dominant personality who insists on getting their own way. The situation may go as far as threatening the auditor with removal if a modified auditor's report is produced.

2.3 Code of Ethics – safeguards against the threats

There are a number of general safeguards against the threats which come from the environment in which the professional accountant operates:

- training
- ICAB also offers support systems for its members and students – a local and central counselling service and helpline

The quality management systems in place at engagement, firm and profession levels including:

- planning, supervision and review procedures
- hot and cold file reviews
- regulatory inspections

Procedures envisaged under the *Ethical Standard* include the following:

- The overall control environment at the firm which ensures a professional approach towards ethical issues
- The segregation of duties between those engaged on audits and those providing non audit services
- Rotation of engagement partners and staff
- Consulting the ethics partner
- Procedures for evaluating the integrity of potential new clients
- The formal process of reviewing the appropriateness of the firm's continuing in office before its name is allowed to go forward for reappointment
- Staff recruitment procedures
- Regular completion of 'fit and proper' and independence declarations by partners and staff
- Staff training, development and performance appraisal
- Monitoring and evidencing the firm's own systems

Interactive question 1: Fundamental principles

Set out the ethical fundamental principles which should be followed by members of the profession.

See Answer at the end of this chapter.

Interactive question 2: Fee income

Aitken and Waterman have been asked by a long-standing client, Lewis plc (a quoted company) to perform a special assignment. This would take the total fees received by Aitken and Waterman from this client to CU55,000. Gross practice income is CU500,000.

Requirement

Comment and reach a conclusion on the above situation.

See **Answer** at the end of this chapter.

Interactive question 3: Threats to objectivity

Your firm is the auditor of Alpha Ltd and Beta Ltd.

(1) It provides quarterly VAT services to Alpha Ltd, which involves completing the VAT return for submission by management from information extracted from the company's records.

(2) It is also the auditor of Beta Ltd's largest customer.

Requirement

What potential threats to objectivity do each of these situations pose to your firm, and what safeguards should be in place to address them?

See Answer at the end of this chapter.

3 ICAB Code of Ethics

Section overview

- The ICAB Code covers independence and objectivity .
- Accountants are required to keep information obtained in the course of professional work confidential.

3.1 ICAB *Code of Ethics* Con**fidentiality**

Due to the nature of their work, chartered accountants find themselves in a privileged position in that they gain access to books and records and have access to information and explanations from the directors of the company that they would otherwise not be party to.

This is particularly true of the Companies Act auditor, but does apply to all members. So the Institute's guidance is designed to reinforce to all members that information that comes into their possession as a result of the work they are completing should remain confidential.

The Code of Ethics states that the principle of confidentiality is not only to keep information confidential, but also to take all reasonable steps to preserve confidentiality. The professional accountant should assume that all unpublished information is confidential, however it is gained . Perhaps the greatest risk to the principle of confidentiality comes from accidental disclosure. This is particularly pertinent to trainees, who may not be accustomed to taking care of confidential information.

Professional skills focus: Applying judgement

Disclosure of information

The Code of Ethics identifies three circumstances where the professional accountant is or may be required to disclose confidential information :

- Disclosure is required by law, for example:
  (1) Production of documents or other provision of evidence in the course of legal proceedings; or
  (2) Disclosure to the appropriate public authorities of infringements of the law that come to light;
- Disclosure is permitted by law and is authorised by the client or the employing organisation
- There is a professional duty or right to disclose, when not prohibited by law:
  (1) To comply with the quality review of a professional body;
  (2) To respond to an inquiry or investigation by a professional or regulatory body;
  (3) To protect the professional interests of a professional accountant in legal proceedings; or
  (4) To comply with technical and professional standards, including ethics requirements [this could include making disclosures to the concerned authorities of actual or suspected money laundering offences]

In making such a report, an auditor is not deemed to have broken the confidence of the client. It is normally addressed by setting out the auditor's right to disclose in the engagement letter.

ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements,* ISA(250, *Consideration of Laws and Regulations in an Audit of Financial Statements* *and Regulators of Other Entities in the Financial Sector* also provide guidance on this issue.

ISA 240 and ISA 250

What the ISAs require is that when the auditors become aware of suspected or actual frauds or instances of non-compliance which should be reported to the relevant authority, they should:

- report to management
- report to those charged with governance
- report to regulatory and enforcement authorities, where appropriate

Obviously, if they suspect management of being involved in the non-compliance etc, they should report the matter directly to those charged with governance or, if appropriate, to a higher authority such as the audit committee.

Anti-money laundering legislation requires auditors to report suspected money laundering activity. In doing so auditors need to be mindful of the offence of 'tipping off' possible suspects and prejudicing any investigation.

Auditors should also consider whether (having taken legal advice) any matters should be reported in the public interest.

In addition, professional accountants may also be entitled to disclose confidential information for the purpose of defending themselves.

Improper use of information

A professional accountant acquiring or receiving confidential information in the course of their professional work shall neither use, nor appear to use, that information for their personal advantage or for the advantage of a third party.

Examples of particular circumstances are:

- On a change in employment, professional accountants are entitled to use experience gained in their previous position, but not confidential information acquired there.
- A professional accountant should not deal in the shares of a company in which the member has had a professional association at such a time or in such a manner as might make it seem that information obtained in a professional capacity was being turned to personal advantage ('insiderdealing').
- Where a professional accountant has confidential information from Client 1 which affects an assurance report on Client 2, they cannot provide an opinion on Client 2 which they already know, from whatever source, to be untrue. If they are to continue as auditor to Client 2 the conflict must be resolved. In order to do so, normal audit procedures/enquiries should be followed to enable that same information to be obtained from another source. Under no circumstances, however, should there be any disclosure of confidential information outside the firm.

Informants

The majority of confidentiality issues relate to the professional accountant's treatment of confidential information belonging to the client or employer. However, the accountant may also be approached in confidence with information about alleged illegal or improper acts on the part of employees or management of the business for which the informant works. This information must be treated sensitively, particularly as it is likely that the informant has approached the accountant on the basis that they are someone that the informant can trust. In this situation the professional accountant should:

- advise the informant to pass on the information to their employer in accordance with company procedures
- protect the identity of the informant to the extent that this is possible
- take care in the way that this information is used, if at all

3.2 ICAB *Code of Ethics* conflict of interest

Situations are frequently perceived by clients as 'conflicts of interest' where in reality they involve no more than concerns over keeping information confidential (or even simply a self-interest threat to independence). Hence the issues of confidentiality covered above and conflicts of interest are related.

3.2.1 General principles: conflict of interest

The *Code of Ethics* states that a professional accountant shall take reasonable steps to identify whether any conflicts of interest exist, and to take all reasonable steps to determine whether any conflicts are likely to arise in relation to new assignments involving both new and existing clients .

If there is no conflict of interest, firms may accept the assignment. If there is a conflict of interest, but it is capable of being successfully mitigated by the adoption of suitable safeguards, firms should record those safeguards.

There is nothing improper in a firm having two clients whose interests are in conflict provided that the activities of the firm are managed so as to avoid the work of the firm on behalf of one client adversely affecting that on behalf of another.

Where a firm believes that a conflict can be managed, sufficient disclosure should be made to the clients or potential clients concerned, together with details of any proposed safeguards to preserve confidentiality and manage conflict. If consent is refused by the client, then the firm must not continue to act for one of the parties.

Where a conflict cannot be managed even with safeguards, then the firm should not act.

3.2.2 Conflict between the interest of a professional accountant or their firm or a client

A self-interest threat to the objectivity of a professional accountant or their firm will arise where there is or is likely to be a conflict of interest between them and the client, or where confidential information received from the client could be used by them for the firm's or for a third party's benefit.

The test to apply is whether an objective, reasonable and informed observer would perceive that the objectivity of the member or their firm is likely to be impaired. The member or their firm should be able to satisfy themselves and the client that any conflict can be managed with available safeguards.

Safeguards might include the following:

- Disclosure of the circumstances of the conflict
- Obtaining the informed consent of the client to act
- The use of confidentiality agreements signed by employees
- Establishing information barriers
  - Ensuring that there is no overlap between different teams
  - Physical separation of teams
  - Careful procedures for where information has to be disseminated beyond a barrier and for maintaining proper records where this occurs
- Regular review of the application of safeguards by a senior individual not involved with the relevant client engagement
- Ceasing to act

Social media can be really beneficial for both individuals and practices if used appropriately and if the fundamental principles contained within the ICAB *Code of Ethics* are adhered to. Social media continues to be popular and members and practices should understand the opportunities and risks associated with social media. One of the difficulties involved is that social media tends to blur the boundaries between a professional accountant's personal and professional lives.

The benefits of social media include the ability to share experiences and to engage in debate, or to raise an individual's profile.

Members should bear in mind, however, that the principles of the *Code of Ethics* will apply to their use of social media. It is recommended that members check the privacy settings of any social media accounts, in order not to make the mistake of believing public posts to be private. It will also be necessary to check and act in line with an employer's social media policy, where one exists.

The ICAEW publication *Using social media* notes the following key pitfalls:

- **Confidentiality** – care should be taken not to disclose confidential information, even inadvertently.
- **Criticism and defamation** – it is acceptable to write robustly, but this should not stray into criticism or defamation.
- **Acting with integrity and professional behaviour** – Abusive commentary must be avoided, and professional accountants should not make use of pseudonyms in order to provide such commentary.
- **Inappropriate language or offensive posts** – Robust exchanges are ethically acceptable, but there comes a point where the language or sentiment may spill over into the unacceptable and abusive.
- **Inappropriate behaviour** – Posting to social media examples of individuals (or the accountant themselves) behaving inappropriately may breach the fundamental principle of

professional behaviour if they are linked to the professional accountant who is known or identified as such.

- **Adversarial stances** – such a stance in relation to prevailing laws is acceptable.
- **Committing illegal or offensive acts** – committing such an act is likely to be a breach of the *Code of Ethics*.

Interactive question 4: Confidentiality

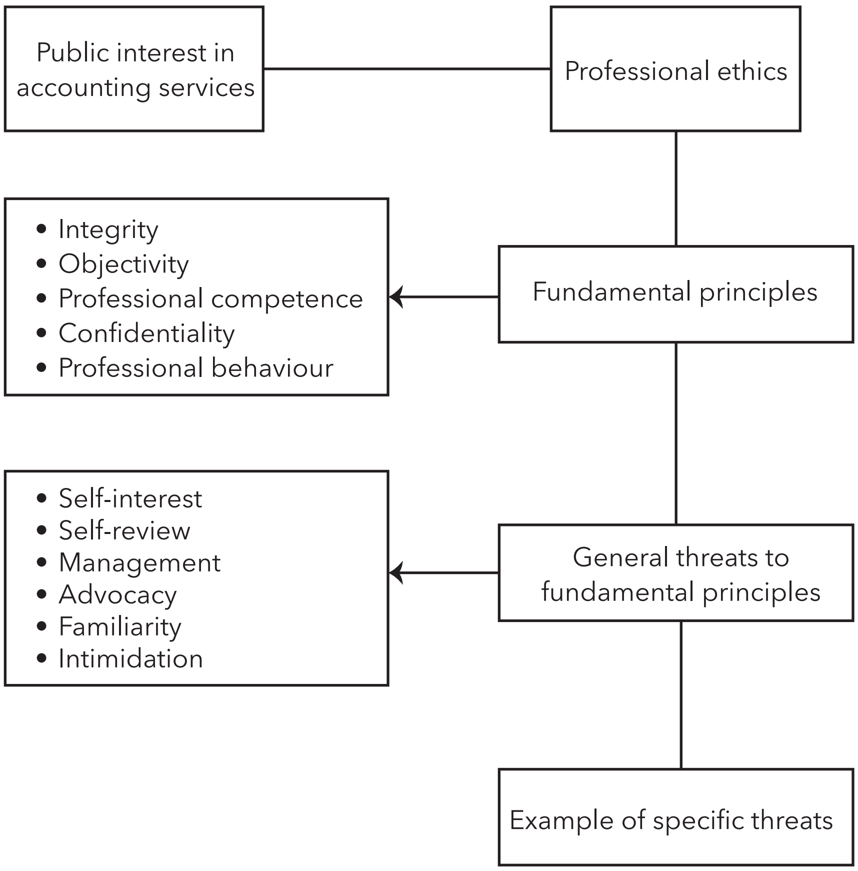
You are in the middle of an audit with a tight deadline, the manager is due to visit you at the client tomorrow and you need to be home early to meet the builders at your new flat. You are considering taking the sales ledger and the cash book home with you to finish the trade receivables section ready for the manager to review tomorrow.

Requirement

What must you consider before you remove any client files from their offices?

See **Answer** at the end of this chapter.

Summary


Public interest in accounting services
Professional ethics
Fundamental principles
Integrity
Objectivity
Professional competence
Confidentiality
Professional behaviour
General threats to fundamental principles
Self-interest
Self-review
Management
Advocacy
Familiarity
Intimidation
Example of specific threats

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you explain why there is a need for professional ethics? (Topic 1)	
(2) Can you give an example of each type of threat? (Topic 2)	
(3) What should an auditor do if they suspect that management has not complied with laws or regulations? (Topic3)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q6	This substantial question tests your knowledgeand should help give you an idea of what to expect in the examination.	
Q7	This substantial question tests your knowledgeand should help give you an idea of what to expect in the examination.	
Q8	This substantial question tests your knowledgeand should help give you an idea of what to expect in the examination.	

Once you have attempted these questions, you can continue your studies by moving onto the next chapter, Quality management.

Technical reference

1 The need for professional ethics

Greenpeace (2022) *Greenwash: what it is and how not to fall for it* [Online]. Available at: https://www.greenpeace.org.uk/news/what-is-greenwashing/ [Accessed 28 June 2022]

2 Code of Ethics

IESBA Code of Ethics for Professional Accountants

3 ICAB *Code of Ethics*

ICAB *Code of Ethics*

Self-test questions

Answer the following questions.

1 What are the six general threats to integrity and objectivity?

2 Give three examples of when auditors are entitled to make a disclosure in breach of the duty of confidence.

3 As auditor of Northend Ltd you prepare quarterly management accounts for the company, and these are passed on to the company's bankers. Northend Ltd's overdraft is close to its limit and the bank manager has contacted you to discuss the high level of bad debts disclosed in the latest management accounts.

Requirement

What considerations will determine the extent you divulge information to the bank manager?

Total: 2 marks

4 Three situations have arisen with audit clients of your firm.

(1) Due to cash flow difficulties, overdue fees from Doe Ltd have built up to include all bills submitted by your firm in the last 12 months.

(2) The engagement partner of Ray Ltd has acted for the company for many years.

(3) To express her gratitude for the quality of service she has received from your firm, the managing director of Mee Ltd has invited all partners and staff involved with her affairs for a golf day and dinner at an exclusive club one weekend.

Requirement

State the threats to objectivity that these matters represent and how the threats could influence objectivity.

Total: 4 marks

5 Your firm has been invited to tender for the audit of East Ltd. Your firm has not previously acted in any capacity for this company but does act for West Ltd, which is East Ltd's major competitor.

Requirement

Identify and explain the principal ethical issue relating to this situation, and state the procedures you would implement to address this issue.

Total: 3 marks

6 Examples of situations when the auditors' independence may be impaired include the following.

(1) Providing taxation services to the company and its directors.

(2) Providing accountancy services, including preparing periodic management accounts and annual financial statements.

(3) Providing management consultancy, including advice on new computer systems and systems of internal control.

(4) Preparing confidential reports to the company's bank and other lenders on the financial position of the client. The conclusions of these reports are not made available to the audit client.

Requirement

Describe how each of the situations listed above may compromise auditors' independence, and the ways in which an audit firm can minimise the effect which the provision of other services has on independence.

Total: 13 marks

7 You have recently come across the following professional issues.

(1) During the audit of a listed company on which you were involved, you overheard the finance director on the telephone to a family friend asking her to buy shares on her behalf, prior to an announcement about a new product which you know is likely to increase the share price significantly. The finance director is a chartered accountant.

(2) During a night out at the pub following your exams one of your fellow students told you in strictest confidence that he had tampered with his degree certificate on his computer to improve the classification. He explained that he had done this to satisfy the minimum requirements to secure a job at his firm, one of your main rivals. He boasted about how easy it was with new computer technology currently available.

(3) One of the audit clients you recently worked on was so impressed with your courtesy towards her staff members that she wanted to make you a gift of tickets to the World Cup football final, along with an overnight stay in a hotel.

Requirement

Set out the problems inherent in each of the above situations and the action that you should take.

Total: 10 marks

8 You are a sole accountancy practitioner. The following situations have arisen.

(1) At the request of Ace Ltd (an audit client), you have agreed to provide advice on the preparation of a tender for a very large contract. Subsequently, client Black & Co (a partnership for whom you prepare accounts and provide a wide range of advice) also asks for your assistance in preparing a tender for the same contract.

(2) Whilst carrying out the final audit of the accounts of Club Ltd (deadline one month after the reporting date), you discover a substantial trading debt due from another client, Diamond Ltd. Although it has not been made public, you are aware that Diamond Ltd is in serious financial difficulties and the bank is considering appointing a receiver. The directors of Club Ltd have made no allowances for irrecoverable or doubtful receivables against the amount due from Diamond Ltd.

Requirement

Explain the action you would take in each of the above circumstances.

Total: 10 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Members should:

- behave with integrity in all professional and business relationships
- strive for objectivity in all professional and business judgements
- not accept or perform work beyond own competence (unless obtain adequate advice and assistance)
- carry out work with due care, skill and diligence and follow expected technical and professional standards
- respect the confidentiality of information acquired
- act professionally and comply with relevant laws and regulations

Answer to Interactive question 2

Comments

- Total fee income received from Lewis plc > 10% of gross practice income of firm as a whole; therefore there is a risk that perception will be that objectivity impaired
- Need to determine whether regular fees will exceed 5% threshold

Conclusion

Assignment may be accepted. Ethics partner should be consulted and those charged with governance informed of the situation.

Answer to Interactive question 3

Alpha Ltd

Threats to objectivity and safeguards:

- Self-interest threat
- Self-review threat
- Firm may be susceptible to pressure for fear of losing work
- Lack objectivity when checking VAT
- Different staff should be used for VAT work and audit

Beta Ltd

Threats to objectivity and safeguards:

- Self-interest threat
- Advocacy threat
- Either company may be uncomfortable with arrangement and exert pressure
- Beta could exert pressure re your knowledge of customer
- Separate audit partners
- Separate audit teams

Answer to Interactive question 4

The auditor must obtain the client's permission before removing any files from the client's offices.

Answers to Self-test questions

1 General threats:

- Self-interest
- Self-review
- Management
- Advocacy
- Intimidation
- Familiarity

2 Three examples:

- Reporting of suspected money laundering
- Reporting of terrorist offences
- Defending oneself against negligence charges

3 The following considerations:

- Whether Northend Ltd's permission has been obtained to discuss matters freely with bank
- Extent to which information has already been divulged by the bank to Northend Ltd's management
- Terms of engagement with Northend Ltd and/or bankers for preparation of management accounts
- Duty/responsibility to bankers

4 **Threats**

Threat	How influence objectivity
Self-interest	Auditor may worry that fees will not be paid if report is qualified or going concern doubts disclosed
Familiarity	Partner may be reluctant to upset or be too reliant on representations from 'friend'
Self-interest	Partners and staff may be reluctant to appear ungrateful or hope for further hospitality

General

- Proper audit may not be carried out
- Inappropriate opinion may be give

5 Principal ethical issue

- Confidentiality
- East and West may perceive a threat in respect of disclosure/use of information
- Conflict of interest

Procedures to address

- Procedures to ensure staff are aware of confidentiality issues and such issues have been brought to attention of staff (eg, Chinese walls)
- Staff to certify awareness of these procedures
- Obtain informed consent of clients
- Use of different partners and teams
- Independent review of arrangements for ensuring confidentiality maintained

6 Compromises to auditors' independence:

(1) Taxation services

Many audit firms prepare tax computations for their client companies and this should not normally compromise independence.

Where taxation services are provided to the company, a conflict of interest could arise in dealing with the tax affairs of the directors (eg, if any of the directors are also shareholders, they may have preferences as to dividends or bonuses, which are not in the best interests of the company's tax or cash flow position).

There may also be independence issues in relation to tax advisory work. For example, the firm may have difficulty in giving an independent view on the acceptability of a scheme to the Revenue or Customs and Excise if the firm designed the scheme itself in the first place.

As a safeguard, a tax manager (or partner) independent of the audit function should be assigned todeal with individual director's tax affairs.

(2) Accountancy services

For many audit clients it is common to provide a range of accountancy services including participation in the preparation of accounting records. For listed or other public interest clients, an audit firm should not participate in the preparation of the company's accounts and accounting records.

Preparing periodic management accounts may draw the auditor, inadvertently, into performing management functions.

Safeguards for non-listed companies include the following:

- The client accepting responsibility for the records as its own
- The auditor not assuming an operational role
- Conducting appropriate audit tests on records processed/maintained by the auditor

(3) Management consultancy

An auditor's independence may be compromised if a course of action is recommended to an audit client. For example, if the auditor advises on a new computer system which is then found to be unreliable, the auditor may be reluctant to report the weaknesses to management.

As a safeguard auditors should lay the facts before the directors and let them make the decision. It is important that the auditor is not seen to be acting as part of the management function.

The additional guidance on best practice has also now provided that services involving the design and implementation of financial information technology systems (FITS) should not be provided unless:

- management accept overall responsibility in writing;
- management do not rely on the FITS work as the primary basis for determining the adequacy of internal controls and financial reporting systems; and
- the design specifications are set by management.

In any case separate engagement teams are likely to be necessary to mitigate the potential threat to independence.

(4) Preparing con**fidential** reports

Auditors are not prevented from producing confidential reports for banks and other lenders, provided they have obtained the client's authority to do so.

A 'clean' confidential report recently issued to a lender may be borne in mind when forming the audit opinion. This may increase pressure not to qualify the audit opinion (to add credibility to the confidential report) when qualification is justified.

A partner other than the audit engagement partner should be responsible for the confidential reports. Unless confidentiality is absolutely necessary, the client should be made aware of the reports to lenders. The quality of these reports may be enhanced by consideration of management's views on matters included.

7 Inherent problems and actions:

Share purchase for FD

Problems

- This constitutes insider dealing which is a criminal offence, as the financial director is benefiting financially from an inside knowledge of the business.
- All chartered accountants and trainees, whether in business or practice, are required to comply with the *Code of Ethics*. This states that members should act with integrity at all times and not act to bring the profession into disrepute.

Actions

Inform the audit partner but do not approach the finance director directly yourself.

- This constitutes insider dealing which is a criminal offence, as the financial director is benefiting financially from an inside knowledge of the business.
- All chartered accountants and trainees, whether in business or practice, are required to comply with the *Code of Ethics*. This states that members should act with integrity at all times and not act to bring the profession into disrepute.

Exam certificates

Problems

- The student is guilty of obtaining an employment position under false pretences and by deception. This is not appropriate behaviour for a future chartered accountant.
- It is unlikely that the firm would have taken the student if it had known the class of degree.

Actions

- No duty of confidentiality to their friend.
- Encourage the friend to admit to his employer.
- If not, the matter should be discussed with your own partner, who would make contact with the staff partner of the other firm.

Accepting a gift from an audit client

Problems

- Firm's independence on the audit may be called into question; need to consider.
- Size and availability to all employees of the client company. (Generally gifts from clients should only be accepted if value modest and available to all employees.)
- Whether own firm's regulations may prohibit this.

Actions

Discuss with partner and only accept if firm's permission is given.

8 Suggested actions:

(1) Tender preparation

Additional service

The decision to provide advice and assistance in connection with the tender is not unethical provided it is made clear to the directors that any tender ultimately remains their responsibility. The directors should be sent a supplementary engagement letter, distinguishing the nature of an audit from other work and clarifying the extent of the advice to be given.

Ace Ltd

The decision to provide advice and assistance in connection with the tender is not unethical provided it is made clear to the directors that any tender ultimately remains their responsibility. The directors should be sent a supplementary engagement letter, distinguishing the nature of an audit from other work and clarifying the extent of the advice to be given.

Black & Co

Independence may also be affected by a conflict of interest between two clients. With Ace Ltd and Black competing by tender for the same contract, it is likely that detailed inside information of both businesses would be obtained which would be of considerable value to the competitor.

Although there is, in theory, nothing improper in having two clients whose interests are in conflict, it must be possible to manage the activities of the firm so that the work on behalf of one client does not adversely affect that on behalf of the other. However, in this case the auditor is a sole accountancy practitioner so safeguards such as 'Chinese walls' which could be put in place in a large firm are unlikely to be feasible.

To advise both clients would not therefore appear to be independent. It would be difficult to be objective and avoid influencing one or other of the tenders unfairly.

It would be preferable to advise only one of the two clients – probably Ace Ltd as already agreed – and thereby avoid conflict. However, the knowledge of Black & Co's business may be seen to impair objectivity, and Black & Co might well object to assistance being provided to Ace Ltd.

It may therefore be best to advise neither client but to explain the predicament to both and suggest that each consults another independent firm of accountants.

(2) Confidentiality

To inform the directors of Club Ltd that the accounts will not give a true and fair view unless an allowance for doubtful receivables is made against the debt due from Diamond Ltd would be a breach of confidentiality. It could also have the undesirable effect of precipitating the collapse of Diamond Ltd since the directors of Club Ltd would take steps to obtain payment from Diamond Ltdas soon as possible.

To ignore the information about Diamond Ltd's financial position (since it is not publicly available) and give an unqualified auditors' report, in a situation where the accounts are known (by the auditor) not to give a true and fair view, would be *prima facie* a breach of an auditor's statutory duty under the Companies Act 1994 and in breach of Confidentiality of the Code of Ethics.

If the auditor is to continue to act for Club Ltd the conflict must be resolved. To do so normal audit procedures should be followed and enquiries made to enable the information about Diamond Ltd to be obtained from another source. It may be possible to delay forming an opinion until the situation crystallises. Under no circumstances must there be any disclosure of confidential information outside the firm.

Note: Notice how practical this question is. Your answer should not merely be a repetition of the ethical guide but should apply it to the specific circumstances given. Part (2) is really 'unanswerable'and what is required is simply a sensible discussion of the possibilities. In any question on ethics, try to use common sense and come up with practical suggestions, and bear in mind that there may be no 'right' answer.

Chapter 5

Quality management

Introduction

Learning outcomes

Legal and other professional regulations, ethics, accepting and managing engagements and current issues

Students will be able to understand and advise on the regulatory, professional and ethical issues relevant to those accepting, managing and carrying out assurance engagements. Students will be able to understand the processes involved in accepting and managing assurance engagements and how quality assurance processes mitigate the risks to those conducting the engagement.

- Identify the sources of liability (including professional negligence) arising from an assurance engagement and their impact upon the conduct of the engagement
- Formulate the approach suitable for management of the assurance engagement
- Explain the principles and purposes of quality management of assurance engagements
- Demonstrate how quality management processes improve the quality of assurance work
- Describe how quality can be monitored and managed through procedures external to the organisation

Syllabus links

Your understanding of quality management issues will be necessary at the Advanced stage.

Examination context

This is an area of the syllabus that is likely to be examined in conjunction with other issues such as client acceptance or ethics. It has featured as a part of long questions and also as short-form questions.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	If you work in practice, you will be subject to a system of quality management as set out in this chapter, as this is a requirement of audit firms. Stop and think Why is it important that audit firms have aquality management system?	Read through the section attempt the activity. ISQM 1 and ISA 220 are important documents and you should know the difference between them.	This section lends itself best to a short-form question in the examination.	2

Topic	Practical significance	Study approach	Exam approach	Self-test questions
2	Quality management could seem like a peripheral concern, but ISQM 1 places it at the centre of what the firm does. The purpose of the firm may be to turn a profit, but it is also to do this while complying with professional standards and law.	Read through this section. The important thing here is to be familiar with the term 'SOQM' (System of Quality Management) as it will be useful to draw upon in exam answers.	This section is mainly background for exam questions.	
3	The SOQM has a number of elements, in relation to each of which the firm must establish quality objectives.	Read through this section.	This section is unlikely to be examined directly but could form part of a short- form question.	
4	The risk assessment process is applied to each element of the SOQM. The idea of risk and the management of risk is very important in the real world, and is at the centre not just of the audit process but of the managementof organisations in general terms.	Read through this section and consider the risks that might be present for your firm. Try to fit these risks into the relevant part of the SOQM.	This section maynot be examined as knowledge, but risk assessment is likely to be at the core of exam questions in this area.	
5	Quality should be part of a firm's culture. **Stop and think** Consider whether the leadership of the companies you have worked in have prioritised quality. What tone was set?	Read through this section.	This section is unlikely to be examined directly but could form part of a short- form question.	3

Topic	Practical significance	Study approach	Exam approach	Self-test questions
6	It may seem obvious, but it should be considered before acceptance whether doing so would compromise a member's professional ethics.	Read through this section.	This section is unlikely to be examined directly but could form part of a short- form question.	
7	Engagements should only be accepted if they are for appropriate clients. Stop and think Consider what an inappropriate client might look like. Clearly this would include clients who are involved in crime;what about clients who value profit over integrity?	Read through this section.	This section is unlikely to be examined directly but could form part of a short- form question.	
8	Quality in the context of particular engagements is the outcome of the factors discussed in the previous sections. Stop and think Have all of the assignments you have worked on been of the same quality level, or have they varied? What were the factors involved in determining the quality of the engagements?	This section is at the core of this chapter, so it should be read very carefully.	This material could be tested anywhere in the examination.	5, 6, 7, 8

Topic	Practical significance	Study approach	Exam approach	Self-test questions
9	The engagement quality review is not something that is likely to come up in your work as a trainee,but can be seen as an adaptation of the review process that is applied in the normal course of your work to a higher and more formal purpose.	Read through this section. It is important that you understand when such a review takes place, and are able to describe how it would happen in practice.	This section could form part of a short-form question.	
10	A focus on quality will also express itself in a firm's attitude to its resources.	Read through this section.	This section is unlikely to be examined directly but could form part of a short-form question.	4
11	This section deals with the way information is managed within the firm, which includes a consideration of the firm's culture. **Stop and think** How would you describe the culture of your firm, and in particular the sharing of information between individuals and teams? What good things are present in your firm? What couldbe improved.	Read through this section carefully.	This section is practical in nature and could easily be examined as part of a longer question.	
12	Firms are required to take certain actions here. Can you think of any instances where you have been involved in theseat work?	Read through this section carefully.	This section could form part of a short-form question.	

Topic	Practical significance	Study approach	Exam approach	Self-test questions
13	If you work in practice, you will soon be accustomed to the types of quality management procedures on individual assignments. Your work will be supervised and reviewed by the people superior to you on the assurance team, for example. You might also be involved in more general controls, such as confirming that you do not own any shares that would cause a barrier to independence in relation to a particular client.	Read through this section carefully.	This section could form part of a short-form question.	9
14	The person responsible for the SOQM must provide an opinion on whether it is effective.	Read through this section.	This section could form partof a short-form question.	
15	Listed clients (which apply the BSEC Corporate Governance Code) are required to consider the quality of the external audit.	Read through this section.	This section could form partof a short-form question.	
16	The audit opinionis the outcome of the audit. This means that where the factors contributing to quality are not paid sufficient attention, then there is a risk the auditor will suffer the consequences of giving the wrong audit opinion.	Read through this section carefully, paying particular attention to the material on limiting liability.	This material could be tested any where in the examination.	1

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1 The need for quality management

Section overview

- Quality management is essential to ensure that an acceptable job is carried out by the assurance firm, and assurance engagement risk is reduced to an acceptable level.
- An engagement could go wrong due to client-based problems, or assurance firm based problems, for example that the engagement team has insufficient knowledge of the business or are badly directed and supervised.
- Audit quality is monitored by the FRC (public interestentities and certain other entities) or by ICAB under its Quality Assurance Board (QAB).
- There are eight key components of a system of quality management (which we shall look at in turn in the next sections of this chapter):
  - The firm's risk assessment process
  - Governance and leadership
  - Relevant ethical requirements
  - Acceptance and continuance of client relationships and specific engagements
  - Engagement performance
  - Resources
  - Information and communication
  - Monitoring and remediation process

Throughout this chapter, we will use these eight components from ISQM 1 as a structure to help you navigate the technical content of the standard more easily.

The main reason the end user wants to have an assurance report prepared is to reduce the risk of making a wrong decision. As a result of this, someone is prepared to pay an assurance firm a fee.

Quality management is connected to the **public interest** vocation of the audit and accountancy profession. One would expect a Chartered Accountant to act ethically, and in the same vein one would also expect such an accountant to give of their best in every engagement that they perform.

As you know (and we shall look at this in more detail in Chapter 9) the amount of work the firm does is dictated by the need to reduce **assurance engagement risk** to an acceptable level. If the firm does not do this, it has not carried out a job which is acceptable when judged against professional standards.

The firm should ensure that the quality of its work does not fall short by implementing its own quality management procedures.

The ultimate aim of any quality management system is to improve the quality of work conducted by firms and by the profession as a whole. Relevant findings from engagement quality reviews are fed back into firms' processes and methodologies in order to foster continuous improvement. They are also used to guide future regulatory developments by the standard setting and other bodies.

1.1 What could go wrong?

Context example: Need for quality

Take a moment to think about what the areas of risk are for the firm. The list you came up with might look something like this.

The terms 'auditor' and 'audit' are used here, because audits are a common form of assurance engagements but the same principles will apply to any assurance engagement.

Let us start, as it were, from the bottom up.

The client

- Could be incompetent
- Could be negligent
- May mislead the audit team

The individual auditor

- May not have adequate understanding of the client's business
- May not perform the right work to an adequate standard
- May not record the work done adequately

The supervisor

- May not have an adequate understanding of the client's business
- May not brief and direct the staff properly
- May not carry out sufficient supervision so that the wrong work is done by the audit team
- May fail to deal with issues raised adequately
- May fail to communicate the issues arising to the engagement partner

The engagement partner

- May have insufficient knowledge of the client and its environment
- May fail to pass knowledge of the business on to the audit team
- May select the wrong team for the audit
- May not adequately brief and supervise the team
- May not consult sufficiently with colleagues and outside experts
- May not review the work carried out by the team with sufficient care
- May fail to deal with issues raised adequately
- May not draw the correct conclusions from the evidence available

1.2 The consequences of quality failure

As we have seen assurance engagements, including audits, do not offer the end user absolute assurance about the subject matter of the assurance report. At best, they offer **reasonable assurance**,a **high** level of assurance.

As a consequence, the firm needs to have quality systems and procedures, primarily to ensure that its work is of a sufficiently high standard so that failures simply do not happen.

In the event of a complaint, the firm will have a defence, providing it has followed suitable procedures.

ICAB firms carrying out audit work have been subject to regulatory inspections for some time, and the ICAB is responsible for carrying out regulatory reviews of listed and non-listed company audits. Audits of public interest entities are reviewed by the team of the Financial Reporting Council.

During this review, which is designed to be constructive rather than disciplinary in tone, the consultants working on behalf of ICAB will examine files and procedures in all the firm's departments. They will compare what they find with standards set out by ICAB, and, where appropriate, make recommendations for improvement.

Clearly, if a firm's working practices were found to be inadequate, there could be disciplinary consequences, but the overall thrust of the scheme is intended to be supportive – in effect to provide the firm with access to consultancy. All members of the ICAB who hold a practising certificate will be included in the programme of visits.

Audit failures revealed by such visits may result in disciplinary action being taken against the firm. This can lead to fines or, possibly, suspension of the firm's authorisation to carry out audits.

The consequences of failure can be catastrophic, with major audit firms having collapsed in the past in the wake of audit failures (such as the then 'Big Five' firm, Arthur Anderson, after the Enron audit). But even a complaint which is successfully defended can absorb huge amounts of time and expense,so it really is sensible to avoid getting into the situation in the first place.

1.3 Approach to quality management

Quality management is the subject of three standards, all of which have been issued or revised only recently:

- ISQM 1, *Quality Management for Firms That Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*
- ISQM 2, *Engagement Quality Reviews*
- ISA 220 , *Quality Control for an Audit of Financial Statements*

All three of these are examinable for *Audit & Assurance*. The two ISQMs are applicable to all engagements – both audits and reviews – and deal with quality at **firm level**, whereas ISA 220 is an auditing standard and applies only to audits at **engagement level**.

Interactive question 1: Benefits of quality management procedures

Your manager has been asked to brief your department on the new system of quality management that the firm has introduced. Your manager has asked you to prepare a list of the benefits of the system of quality management in a firm, which he can use as part of his presentation.

See Answer at the end of this chapter.

2 Objective of quality management

Section overview

- Quality management requires a risk-based approach.
- Objectives relate to how the engagement team should act and what they need to deliver.

Quality standards require the firm to apply a risk-based approach to quality management. This is a point of different from the technical guidance that preceded them, which spoke of having 'quality control procedures'. Instead of firms performing the same generic procedures for each client, the risk-based approach requires them to think about the specific quality risks for the firm (the subject of the ISQMs) and for its individual engagements (the subject of ISA 220).

At the centre of the risk-based approach is the **system of quality management** (SOQM). The SOQM is the source of reasonable assurance that the firm meets its quality objectives.

The quality **objectives** are:

(a) The firm and its personnel **fulfil their responsibilities** in accordance with **professional standards** and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements.

(b) **Engagement reports** issued by the firm or engagement partners **are appropriate** in the circumstances.

(ISQM 1: para. 14)

3 System of quality management (SOQM)

Section overview

- The SOQM is the means by which the objectives of quality management are achieved.
- Responsibility for the SOQM needs to be assigned to appropriate individuals within the firm.
- The SOQM consists of a number of components which are covered by ISQM 1.

ISQM 1 defines the SOQM as follows.

Definition

System of quality management: A system designed, implemented and operated by a firm to provide the firm with reasonable assurance that:

(a) The firm and its personnel fulfil their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements.

(b) Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.

This definition largely repeats the quality objectives of the firm – the SOQM is the means by which these objectives are achieved.

The firm's managing partner (or equivalent) is ultimately responsible for the SOQM, but operational responsibility may be delegated (ISQM 1: para. 20). The firm needs to explicitly assign this responsibility to individuals within the firm.

The SOQM is perhaps best understood by considering its components, which form the main subject matter of this chapter. There is considerable overlap between these components and the ordinary operating structure of an ICAB firm. The idea of the SOQM, then, can be thought of as a way of understanding the way such a firm should be structured if it is to perform engagements of the required level of quality. Viewed in this way, the most novel aspect of ISQM 1, and the part which asks the most of firms implementing it, is the risk assessment process. It is to this that we now turn.

4 Component 1 – The firm's risk assessment process

Section overview

- The risk assessment is central to the SOQM.
- ISQM 1 specifies six areas to be covered by objectives, risks and responses.

The conceptual structure of the risk assessment is as follows.

Establish quality objectives → Identify risks → Respond to risks

First the firm establishes its quality objectives, then it considers risks/threats to these, and finally it responds to these risks.

These objectives don't just come from nowhere – they relate to the following elements of the SOQM:

- Governance and leadership
- Relevant ethical requirements
- Acceptance and continuance
- Engagement performance
- Resources
- Information and communication

Much of the content of ISQM 1 then consists of details of the quality objectives that a firm is required to establish in each of these areas.

5 Component 2 – Governance and leadership

Section overview

- ISQM 1 details the quality objectives for governance and leadership to support the SOQM.
- This must be instigated by the leaders of the firm, that is, the partners.

The ISQM requires quality objectives to be established in the following areas.

- The firm's culture should recognise and reinforce:
  - serving the **public interest**
  - the importance of professional ethics, values and attitudes
  - that quality is the responsibility of **all personnel**
  - the emphasis on quality in the firm's strategic decisions, and operational priorities
- **Leadership is responsible** and accountable for quality
- Leadership demonstrates a commitment to quality through their **actions and behaviours**

- The **organisational structure** supports the SOQM
- **Resource needs** are planned for, and appropriate resources are provided

(ISQM 1: para. 28)

A key concern of ISQM 1 is that quality does not come second to commercial considerations. Indeed, the articulation of a coherent picture of a professional accounting firm which includes both of these things is part of the standard-setters' vision. Put simply, it is expected that professional accountants make their money by acting professionally, performing a public service which delivers value to the economy, rather than by cutting corners to make a quick buck.

The firm's culture may seem unimportant when set next to more tangible items, such as books of procedures to be followed or rules to be obeyed. Against this, however, it may be claimed that culture is actually crucial to the establishment of quality – indeed, the ISQM describes it as the environment which supports the SOQM. It is a fact that organisations have cultures, so it follows that if a firm's culture does not emphasise quality then this will affect decisions and behaviours at all levels. A good firm, for example, might expect audit team members to take professional pride in doing a good job; a less good firm might simply emphasise increasing sales revenue but without really believing quality to be important.

The firm must consider the risks that might arise here. The IAASB's example is of a firm with multiple offices, in which situation there may not be one single culture throughout the firm, and hence not only single set of attitudes toward quality.

Assessment focus point

Exam questions on quality management can be either knowledge-based or applied in nature.

It will help you to be able to refer to the 'System of Quality Management' in your answer, and to be able to analyse situations first in terms of its components, and then in terms of the quality objectives, risks and responses within each area. So that if, for example, you come across a scenario featuring an ICAB firm with a poor culture, you would not only point this out but also be able to write of the deficiency of the Governance and Leadership component of the System of Quality Management, perhaps mentioning the quality objectives that are at risk but to which the firm may not have responded appropriately.

6 Component 3 – Relevant ethical requirements

Section overview

- The quality objective in this area is for the firm and its personnel to understand and fulfil their ethical responsibilities.

We saw in the previous chapter how important ethics are to assurance providers, as they underpin the public trust required to make assurance services viable.

It is clear that individuals have to apply the principles of the *Code of Ethics*, but what does this mean for the firm? It means that the firm must ensure that these ethical requirements are satisfied. It does this by establishing the following quality objectives in this area.

The firm and its personnel:

a) Understand the relevant ethical requirements

b) **Fulfil** their ethical responsibilities

(ISQM 1: para. 29)

The firm may need to establish sub-objectives to ensure that these quality objectives are met. The first point here would entail ensuring that personnel receive sufficient training, so that they are aware of the ethical duties that are placed upon them. A sub-objective might then be for all audit department staff to receive ethical update training every six months (for example).

The second part may also include sub-objectives, for example that the audit staff do not accept gifts from clients (even where the value is trivial and inconsequential). In this case, the firm might establish policies and procedures prohibiting the acceptance of gifts from clients.

As part of the SOQM, the firm would need to consider **risks** relating to these objectives. Here the IAASB gives as an example a firm with a strategic goal to grow its tax practice, which could create a risk of breaching ethical rules concerning the provision of tax advice to audit clients. In this situation,the firm would need to respond to this risk, for example by clarifying the strategic objective so that it refers only to tax clients that are not already audit clients.

Context example: Policy in respect of employees' shareholdings

Freshfields & Co is a large accountancy practice. It has a number of assurance clients. At the beginning of every year it circulates a memorandum to all staff employed in the assurance division requesting that they disclose any shareholdings in a list of named assurance clients. It further emphasises the need for disclosure of such shareholdings should they arise in the year. Every staff member joining the assurance department during the year is also asked to make the disclosure.

Professional skills focus: Assimilating and using information

Take a moment to consider other areas in which a firm might have ethical policies and procedures.

7 Component 4 – Acceptance and continuance of client relationships and specific engagements

Section overview

- The firm must establish quality objectives to ensure that only appropriate clients are accepted in the first place and retained.

The acceptance or continuance of an engagement is an important point at which a firm needs to make sure it does not sacrifice quality or professional ethics for commercial gain. It is clear that the ISQM regards the pursuit of money to be a key risk to quality and to ethical compliance.

The quality objectives here are as follows.

(a) To base acceptance decisions on:

(1) Whether the **client has integrity and ethical values**

(2) Whether the firm is **able to perform the engagement** to the required standard (ie, in line with ISAs and other required professional standards)

(b) The firm's financial/operational priorities should not lead to it accepting or continuing engagements that should not be accepted

(ISQM 1: para. 30)

The big risk here is that the firm may accept a client – because it wants the fee – that it should not accept. It is noteworthy here that the firm must not only consider its own ethics, but also those of the client, since being involved with a client whose integrity is questionable can be considered a risk to the firm's own ethics. The firm would need to respond to this risk with procedures to assess the integrity of clients, for instance looking into the reputations of its management and their attitudes.

The situation becomes complex when the firm starts to consider whether it is actually able to perform the engagement. This has two sides. On one side, one can imagine a firm being tempted by a fee for an engagement that it does not have the expertise or the resources to perform; in this case, ethics must trump self-interest and the engagement should be declined. On the other side, it may be that the client is offering a fee that is actually too low to cover the costs that would be involved – if the engagement were accepted, then it may not be possible to devote to it the time that would be needed to do a good job. In this case, the firm would either need to argue for a higher fee, in order to cover its reasonable costs (thus standing up for its own monetary interest), or else decline the engagement and lose the potential fee.

8 Component 5 – Engagement performance

Section overview

- ISQM 1 gives guidance on how the engagement team should work together while performing engagements.
- Key issues are supervision, direction, review, consultation and resolution of disputes.

This section of the ISQM focuses on the **engagement team** (the audit team), and the different roles or functions that need to be fulfilled within it. When reading this section, it should be borne in mind that the guidance relates to the way the firm performs and organises engagements in general terms, rather than to the performance of specific engagements. These would be covered by technical standards, such as the ISAs, with the purpose of the ISQM being to help ensure that the detailed requirements of these standards are complied with by the firm.

A point of focus of the ISQM here is that, in line with the IAASB's ISAs, the **partner** should be involved throughout the engagement. Gone are the days when partners deal only with winning new business and signing auditor's reports – they are now required to be properly involved throughout the audit process.

The following quality objectives should be established.

(a) Engagement teams must understand and fulfil their responsibilities (including the partner's overall responsibility for the engagement).

(b) The nature, timing and extent of **direction, supervision and review** is appropriate.

(c) Engagement teams exercise appropriate professional judgement/scepticism.

(d) Consultation is undertaken on difficult or contentious issues.

(e) **Differences of opinion** (within the engagement team) are brought to the firm's attention and **resolved.**

(f) Documentation is assembled on a timely basis (and then retained), and is appropriate to comply with relevant standards and laws.

(ISQM 1: para. 31)

The firm must evaluate risks to these objectives, and then put in place responses to these risks. The IAASB gives as an example of a risk the characteristics and management style of leadership; if management has a dominant style of leadership, then this could give rise to a quality risk that personnel do not bring differences of opinion that involve leadership to the attention of the firm. The firm would need to design a response to this, such as involving someone who is independent of leadership to handle differences of opinion.

8.1 Direction, supervision and review

Direction is largely the responsibility of the engagement partner, who controls how the assurance engagement should be conducted, but this duty will be delegated to the most senior team member on site at the engagement, who will direct the engagement in accordance with the overall strategy.

ISQM 1 gives some guidance on how an engagement should be directed, supervised and reviewed.

Direction and supervision may include (ISQM 1: para. A76):

- Tracking the progress of the engagement
- Considering whether the engagement team:
  - understands instructions
  - is working in line with the plan
- Addressing matters that arise, and modifying the planned approach where necessary
- Identifying matters for consultation with more senior team members

Good supervision can be a difficult skill to master:

- If it is too close it can stifle initiative and waste the time of supervisor and assistant alike.
- If it is too loose, mistakes may be made or time wasted in ineffective work.

Work performed by staff is reviewed by other more senior staff or the engagement partner. The purpose of the review is to consider whether the work done is in line with the audit strategy.

A **review** may consider whether:

- work is in line with the firm's policies, and relevant standards/law
- significant matters have been consulted on
- there is a need to revise the work that is planned
- the work performed supports the conclusions drawn, and is appropriately documented
- evidence obtained is sufficient and appropriate to support the report
- the objectives of procedures have been achieved

The engagement partner must be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions in the auditor's report.

8.2 Documentation and review

You should remember from your studies for the Assurance exam that ISA 230, *Audit Documentation* requires that audit documentation should contain the following:

What would be necessary to provide an experienced auditor, with no previous connection with the audit, with an understanding of the nature, timing and extent of audit procedures, the results of audit procedures, and the audit evidence obtained, and significant matters arising during the audit and conclusions reached thereon?

One of the key purposes of the documentation of audit procedures is to enable the reviews described above to be carried out. Adequate documentation is also essential to allow the firm to implement overall monitoring of quality.

8.3 Consultation

When difficult or contentious issues arise, the assurance team must consult properly on the matter and the conclusions drawn as a result of consultation must be properly recorded.

The ISQM states that, "An environment that reinforces the importance and benefit of consultation and encourages engagement teams to consult may contribute to supporting a culture that demonstrates a commitment to quality" (ISQM (1: para. A79).

8.4 Differences of opinion

Any differences of opinion must be resolved prior to the assurance report being issued. This may mean that a person independent of the engagement (such as the engagement quality reviewer, or another firm) may have to be involved in resolving the difference of opinion.

9 ISQM 2, Engagement quality reviews (EQR)

Section overview

- This review process is an extension of the firm's existing review process and is only required for certain engagements
- EQRs are mandatory for listed companies and can be undertaken for other engagements where it is considered necessary to manage a specific issue or is a suitable response to address quality risks.
- The EQR is conducted using ISQM 2 and will require a suitable engagement quality reviewer to be appointed

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The engagement quality review (EQR) is the subject of another ISQM, ISQM 2, *Engagement quality reviews*. It is included here because it could be understood as an extension of the firm's own internal processes of review, but is important to realise that the EQR is a different process from the internal reviews that take place on every engagement.

The EQR is not a requirement for every audit, and is a quality procedure that is applied only:

- for audits of public interest entities (eg, listed companies) – this is a legal requirement so the EQR is mandatory
- where the audit engagement partner has determined that an EQR is needed, for example as an ethical safeguard

ISQM 1 para. 34(f)(iii) states that an EQR is also required for: "Audits or other engagements for which the firm determines that an engagement quality review is an appropriate response to address one or more quality risk(s)."

What factors might make an auditor choose to perform an EQR for an audit client, even though there might be no legal requirement for such a review?

ISQM 1 para. A134 provides the examples of conditions, events, circumstances, actions or inactions giving rise to one or more quality risk(s) for which an EQR may be an appropriate response
– these are summarised below:

- Engagements requiring a high level of complexity or judgement (such as those where there is a high degree of estimation uncertainty or the underlying subject matter requires specialist knowledge or skills)

- Engagements which have a history of control deficiencies or regulatory intervention
- Anomalies encountered during engagement acceptance and continuance procedures
- Engagements which contain the use of information required for subsequent purposes (such as prospectuses)
- Higher risk entities that fall outside the scope of listed or public interest entities may still require an EQR as a result of the nature of their business model (such as those in emerging industries or those with unusual amounts of assets held on behalf of others)

Once the EQR has been triggered, however, there are rules about how it should be conducted, and this is the subject of ISQM 2.

For listed entities, and those other entities determined by the firm, an engagement quality review is conducted by a suitably qualified partner or other person in the firm not otherwise involved in the engagement or by an external consultant. The purpose of this independent review is not to reperform the other reviews in the audit process but to provide an additional safety check about the validity of the firm's opinion on the financial statements.

Indeed, the ISQM notes that the EQR is not a review of a whole audit, but only of the significant judgements made. These might be the issues that become 'Key Audit Matters', which will be covered in Chapter 13 on the auditor's report (in brief, listed companies are required to include, in the auditor's report, information about the most important matters on the audit).

The engagement quality reviewer is **not a member of the engagement team**. They are independent of the team, and their role is to review the **significant judgements** made on the engagement. The fact that an EQR has been conducted does not change the fact that the engagement partner is responsible for the engagement as a whole – so that if something goes wrong, they cannot share their responsibility with the reviewer.

The ISQM contains guidance about the **appointment** of the engagement quality reviewer. Usually the reviewer will be another partner within the firm, although the review may be done by someone outside the firm (eg, another firm, or a partner of another firm).

The reviewer must:

(a) have the **competence and capabilities**, **including sufficient time**, and the appropriate authority to perform the EQR;

(b) **comply with relevant ethical requirements**; and

(c) comply with provisions of law and regulation, if any, that are relevant to the eligibility of the engagement quality reviewer.

(ISQM 2: para. 18)

The ISQM stipulates a cooling-off period of at least two years for partners who were previously responsible for the engagement (ISQM 2: para. 19).

The reviewer must:

- Understand the **nature and circumstances** of the engagement
- Discuss with the partner the **significant matters and judgements**
- **Review** the **documentation** underlying these significant matters and judgements
- Evaluate the partner's assessment of **ethical independence**
- Evaluate consultation and conclusions on **difficult or contentious matters**
- For audits, evaluate whether the partner has been sufficiently involved throughout the audit

For **audits**, the following matters should be considered (there is some overlap here with the above list):

- The **independence** of the firm from the entity
- The **significant risks** and the measures that the partner has taken to manage them
- The **reasoning** of the partner in relation to **materiality** and significant risks

- Any request for advice to external **experts**
- The nature and scope of corrected and uncorrected **misstatements**
- The subjects **discussed with the audit committee**
- Whether **documents support the opinion** as expressed in the draft of the auditor's report

(ISQM 2: paras. 25)

10 Component 6 – Resources

Section overview

- There must be a quality objective that the SOQM has sufficient resources.
- Resources are human, technological and intellectual.

The firm needs to devote resources to the performance of engagements, and also to the SOQM generally. The firm must ensure that resources are available 'in a timely manner' for all of the quality management procedures that are required, such as for the firm's risk assessment process in general and the establishment of the SOQM itself.

The most important resource for engagements is likely to be **human resources**, but the ISQM includes technological resources, intellectual resources and service providers too.

10.1 Human resources

The firm must have the right **personnel**. The means that personnel are hired with the competence and capabilities to:

- consistently perform quality engagements
- perform activities in relation to the SOQM (the SOQM must have resources)

Personnel are required to demonstrate a commitment to quality. Where the firm does not have these personnel, then it must obtain them from external sources (eg, from network firms). Not having the right people is not an excuse for not being able to operate the SOQM as required.

The ISQM requires the firm to give engagement team members **sufficient time** to consistently perform quality engagements. This is an important issue in practice, where time pressure on engagements can sometimes have a negative effect on quality. It should be noted, however, that the ISQM does not simply advocate for more time for engagements without an upper limit, but rather requires sufficient time for someone of the required level of competence to perform their role in the team (ISQM 1: para. 32(d)-(e)).

10.2 Technological resources

Appropriate technological resources should be available to enable the operation of the SOQM and the performance of engagements.

The ISQM does not it self take a view on the technology that firms need to put in place (there is no requirement around the use of modern data analysis, for example). This is up to firms, but whatever IT solutions a firm uses must allow it to perform engagements that comply with ISAs (or other relevant standards).

10.3 Intellectual resources

Intellectual resources must be sufficient to enable the SOQM to operate.

But what are intellectual resources? The term is not defined in ISQM 1, but the application guidance states that: "Intellectual resources include the information the firm uses to enable the operation of the system of quality management and promote consistency in the performance of engagements" (ISQM 1: para. A102).

For an audit, this will mean having access to audit programmes, firm methodologies, ISAs, or subscriptions to websites that provide industry guides.

10.4 Service providers

Any of the above types of resource may be obtained from an external service provider (ISQM 1:para. 32(h)).

11 Component 7 – Information and communication

Section overview

- The SOQM requires information to be used appropriately to achieve the firm's quality objectives.
- This includes how the firm uses and stores information and how it communicates both internally and externally.

The ISQM makes certain requirements in relation to information. Relevant information needs to be communicated properly both within the firm and externally.

- The **information system** identifies, captures, processes and maintains relevant and reliable information that supports the system of quality management.
- The **culture of the firm** recognises and reinforces the responsibility of personnel to exchange information with the firm and with one another.
- **Relevant and reliable information is exchanged** throughout the firm and with engagement teams.
- Relevant and reliable information is communicated to **external parties**.

(ISQM 1: para. 33)

It can be said that two things at play here – technical factors to do with the information systems and the way information is held and shared within the firm; and human factors to do with the culture of the firm and the individuals living and working within it.

In many cases, where an audit fails this is often not the result of problems not being known about, but stems from this information not being communicated properly and hence not acted upon.

An important problem here is the presence of communication barriers, or of a firm culture that works against information from being shared. This might be the case where a firm's culture includes competition between individuals or teams, who might not want to share information with internal competitors. Similarly, certain information may be deemed unwelcome by individuals within the firm – such as the existence of doubts over a client or its financial statements – and could thus be repressed. A plethora of situations of this sort can exist, all of which are harmful to the quality of the engagements being performed.

The firm will need to ensure that its **information system** is adequate to the task of facilitating the documentation and communication of information within the firm. This would include the use of email, most likely alongside other IT systems, such as audit software and general office software for teamworking.

12 Specified responses

Section overview

- The SOQM will require certain responses in certain circumstances, including those of an ethical and compliance nature.

'Specified responses' here means responses to risks that do not arise from the firm's own risk assessment, but which are mandatory because the risks they respond to are significant and are present in every firm.

The following responses are **mandatory**:

- Policies and procedures for identifying, evaluating and addressing **ethical threats**, and reporting ethical breaches
- The firm must obtain, annually, a **documentation of compliance** with ethical requirements from all relevant **personnel** (ie, all relevant personnel must sign a form stating that they comply with ethical requirements)
- Policies and procedures for dealing with **complaints** about failure to comply with standards and regulation, and failure to comply with the SOQM
- Policies and procedures for dealing with situations where:
  - the firm has already accepted an engagement, but then becomes aware of something that would have made them decline it (eg, a lack of integrity from the client)
  - the firm is legally obliged to accept an engagement (ie, irrespective of whether doing so complies with ethical requirements)
- Policies and procedures regarding communication with audit clients about the SOQM
- Policies and procedures regarding the conduct of EQRs and compliance with ISQM 2

(ISQM 1: para. 34)

13 Component 8 – Monitoring and remediation process

Section overview

- The firm must have policies in place to ensure that their quality management procedures are adequate and relevant, that they are operating effectively and are complied with.
- Management of the assurance firm (that is, the partners) should receive an annual report on the outcome of monitoring activities.
- The most important issues will be systematic or repetitive deficiencies.

Monitoring and remediation means monitoring engagements that have been completed, and fixing (remediating) any problems that are discovered.

The firm must establish a monitoring and remediation process to:

- provide information about the SOQM
- take actions to remedy problems with the SOQM

(ISQM 1: para. 35)

The information obtained about the SOQM must be timely, relevant and reliable, and the actions must be appropriate and timely.

This used to be called just 'monitoring', but the ISQM now includes 'remediation' to make it clear that it is not enough just to monitor the SOQM but do nothing to fix any problems. Problems unearthed by the monitoring process must be remedied.

Monitoring and remediation have the following elements (ISQM 1: paras. 36-47):

- **Designing and performing monitoring activities.** The aim is not just to monitor for its own sake, but to identify deficiencies – so the firm should focus on the areas where these are most likely. The firm should take into account complaints/allegations about **poor quality work** when deciding which engagements to monitor. The ISQM requires the firm to **monitor all partners** over time, "selecting at least one completed engagement for each engagement partner on a cyclical basis" (ISQM 1: para. 38c). The individuals performing the monitoring activities (reviewing completed engagements) should have **competence and capabilities**, as well as the time, to do this. They must also be **independent** of the engagements being monitored.
- **Evaluating findings and identifying deficiencies.** The findings of the monitoring process must be evaluated to determine whether there may be deficiencies in the engagements.
- **Evaluating identified deficiencies.** The severity and pervasiveness of the deficiencies is evaluated. Consideration should be given to their root cause and their effect on the SOQM.
- **Responding to identified deficiencies.** Remedial action is taken to address the deficiencies. This action must be effective at addressing the deficiency but also its **root cause**.
- **Ongoing communication related to monitoring and remediation.** The results of monitoring should be communicated to the person responsible for the SOQM.

It should be borne in mind that what is being checked here is the operation of the SOQM, rather than substantive failures of the engagements themselves. The monitoring process should be designed to test whether the SOQM has operated effectively to mitigate quality risks. Failures at the engagement level would, however, suggest that something has gone wrong with the SOQM so they are taken into account in this respect.

Monitoring might take place by ongoing evaluation of the system and also by periodic review of selected engagement files to assess whether policies and procedures were put into place during the engagement.

13.1 Monitoring (or cold review)

Cold reviews are designed to be a continuing part of the SOQM and take place after the assurance assignment has been completed.

They are usually conducted either:

- as a process, where by partners in a firm review each other's work;
- by a team specifically constituted to conduct such reviews – usually under the direction of a partner, but the work is usually carried out by suitably qualified and experienced managers; or
- by a suitably qualified external consultant.

The review team should also develop appropriate courses of action where failures are identified, including the following:

- communication of the findings within the firm
- additional training and professional development
- changes to the firm's policies and procedures
- disciplinary action against those who repeatedly fail to comply with the firm's standards.

Professional skills focus: Applying judgement

A 'hot' review is sometimes referred to as a 'pre-issuance review', because it takes place before the auditor's report is issued. Likewise, a 'cold' review can be referred to as a 'post-issuance review'.

Interactive question 2: Quality management issues on an engagement

You are an audit senior working for the firm Addystone Fish. You are currently carrying out the audit of Wicker Ltd, a manufacturer of wastepaper bins. You are unhappy with Wicker's inventory valuation policy and have raised the issue several times with the audit manager. She has dealt with the client for a number of years and does not see what you are making a fuss about. She has refused to meet you on site to discuss these issues.

The former engagement partner to Wicker retired two months ago. As the audit manager had dealt with Wicker for so many years, the other partners have decided to leave the audit of Wicker in her capable hands.

Requirement

Comment on the situation outlined above. See **Answer** at the end of this chapter.

14 Evaluating the system of quality management

Section overview

- The SOQM is subject to an evaluation of whether it is achieving its objectives or whether further action is necessary to manage quality risks.

The individual who is ultimately response for the SOQM must evaluate it, at least **annually** (ISQM 1: para. 53).

The individual is then required to come to a conclusion, which should be documented. The conclusion is a little bit like an audit or assurance opinion about the effectiveness of the SOQM, and can take one of three possible forms.

Either:

(a) the SOQM **provides the firm with reasonable assurance** that the objectives of the SOQM are being achieved;

(b) the SOQM provides the firm with reasonable assurance that the objectives of the SOQM are being achieved **except for specific matter(s) identified**; or

(c) the SOQM **does not provide the firm with reasonable assurance** that the objectives of the SOQM are being achieved.

15 BSEC Corporate Governance Code requirements

Section overview

- Audit committees have a role in monitoring the effectiveness of the audit process.

The Corporate Governance Code requires audit committees of listed entities to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements.

Many firms discharge this responsibility by the use of questionnaires conducted with members of the audit committee, executive directors, senior management and internal audit. Participants are asked to rate the external auditor on factors such as:

- independence and objectivity
- audit planning and execution
- conduct and communication
- audit findings and feedback
- quality of reports
- expertise and resourcing
- business understanding
- continuity and experience of personnel
- cost effectiveness/value for money

16 Getting the assurance opinion wrong

Section overview

- Getting the auditor's opinion wrong could lead to:
  - being sued for professional negligence
  - prosecution and fines
  - disciplinary proceedings from ICAB
  - loss of reputation, clients, key staff
  - assurance firm collapse
- In the context, quality management procedures are important.
- Risk is another key issue associated with getting the opinion wrong – are some clients too risky to accept?

Think for a moment about the possible cost of getting the audit opinion wrong:

- If someone can demonstrate that you owed them a duty of care and they suffered loss by relying on the financial statements, they could sue you under the tort of negligence, as you saw previously whilst studying for the Law exam.
- You as auditor may not be the only person responsible for their loss – the directors, who are responsible for preparing financial statements which give a true and fair view, probably had a hand in it somewhere – but you could find yourself solely liable.

- As a member of the ICAB you could also face disciplinary proceedings, fines and penalties.

Audit firms must carry professional indemnity insurance, which means that any settlement will be paid out by the insurance company, but there is quite a long list of audit firms which no longer exist –ranging from Spicer and Oppenheim as a result of the British and Commonwealth/Atlantic

Computers failure to Andersens, the former auditor of Enron – as a result of the collapse of an audit client.

To some extent the final cost of the settlement is only a part of the overall cost. Lawyers do not come cheap, particularly good corporate lawyers, and the time of partners and staff taken up with defending such an action can also represent a huge cost.

There is a further substantial, but intangible cost, resulting from the damage to a firm's reputation following its involvement with a client collapse. This is the loss of other clients and often key members of staff who no longer want to be associated with the firm.

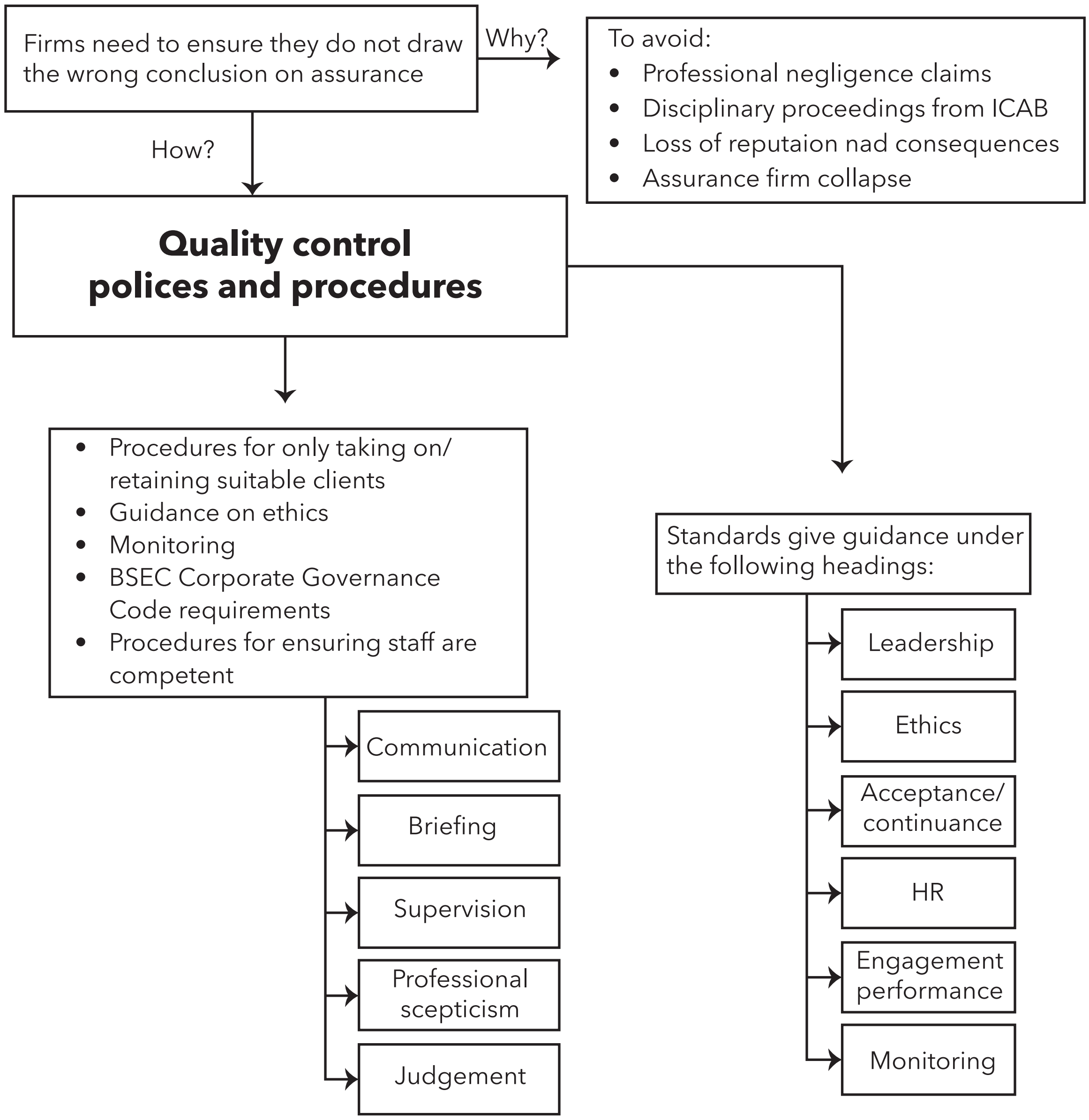
Remember that many assurance firms operate as partnerships whose partners have unlimited and joint and several liability (which you also will remember from your law studies). If one partner gets it wrong, all the partners could be found liable.

Clearly in this context, quality management policies and procedures, which help to ensure that the wrong opinion is not given, are very important. However, it is not just a question of quality. As you saw in your studies for Assurance, and as we shall look at in more detail in the next chapter, it is a question of risk. Increasingly, assurance firms are concluding that there are some clients which are too risky to take on, leaving companies required to have an audit under the law unable to appoint an auditor.

This situation has needed resolution. One way of trying to restrict liability has been to look at the business vehicles through which many assurance firms operate. As a result, many have incorporated in a limited way, becoming Limited Liability Partnerships (LLPs), which were introduced into UK lawback in 2001.

However, there has also been a need to review the whole concept of who is to blame when things go wrong. The profession has favoured a scheme of 'proportional liability', whereby the assurance provider only pays for its share of the blame when things go wrong.

Summary


Firms need to ensure they do not draw the wrong conclusion on assurance
Why?
To avoid:
• Professional negligence claims
• Disciplinary proceedings from ICAB
• Loss of reputaion nad consequences
• Assurance firm collapse
How?
Quality control polices and procedures
• Procedures for only taking on/ retaining suitable clients
• Guidance on ethics
• Monitoring
• BSEC Corporate Governance Code requirements
• Procedures for ensuring staff are competent
Communication
Briefing
Supervision
Professional scepticism
Judgement
Standards give guidance under the following headings:
Leadership
Ethics
Acceptance/ continuance
HR
Engagement performance
Monitoring

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you identify the six elements of a system of quality management? (Topic1)	
(2) Can you identify the elements of a firm's risk assessment process? (Topic 4)	
(3) Can you explain the means used by a firm to ensure it does not fall foul of ethical guidance? (Topic 6)	
(4) Can you explain the quality objectives relating to the acceptance and continuation of engagements? (Topic 7)	
(5) Can you identify the quality objectives relating to resources? (Topic 9)	
(6) Can you identify the purposes of reviewing the work performed by audit staff? (Topic 6)	
(7) Can you identify who conducts a cold review? (Topic 7)	
(8) What must listed companies consider in relation to their external audit?(Topic 14)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q5	This question focuses on one particular area, but you need to know much of this chapter in this level of detail.	
Q8	This subject of this question is important both practically and for your examination.	
Q9	This substantial question tests your knowledge and should help give you an idea of what to expect in the examination.	

Once you have attempted these questions, you can continue your studies by moving onto the next chapter, Accepting engagements.

Technical reference

1 The need for quality management
ISQM 1 and ISA 220

2 Objective of quality management
ISQM 1, para. 14

3 Governance and leadership
ISQM 1, para. 28
IAASB *First-time implementation guide* to ISQM 1: p25–26

4 Relevant ethical requirements
ISQM 1, para. 29
IAASB *First-time implementation guide* to ISQM 1: p25

5 Acceptance and continuance of client relationships and specific engagements
ISQM 1, para. 30

6 Engagement performance
ISQM 1, para. 31
IAASB *First-time implementation guide* to ISQM 1: p25

7 Engagement quality reviews (EQRs)
ISQM 2

8 **Resources**
ISQM 1, para. 32

9 **Information and communication**
ISQM 1, para. 33

10 Specified responses
ISQM 1, para. 34

11 Monitoring and remediation
ISQM 1, paras. 35–47

12 **Evaluating the system of quality management**
ISQM 1, paras. 53–56

13 **Corporate Governance Code requirements**
BSEC Corporate Governance Code

Self-test questions

Answer the following questions.

1 Establishing a system of quality management, as required by ISQM 1, will constitute a good defence against allegations that the firm has been negligent.

A True

B False

2 ICAB's practice assurance scheme is primarily disciplinary.

A True

B False

3 Which **one** of the following statements about formal leadership is incorrect? Partners should ensure that:

A Commercial considerations do not override the quality of work performed.

B Sufficient resources are allocated to developing quality management policies and procedures

C Staff prioritise the system of quality management over ethical considerations for listed clients.

D The firm's policies in relation to remuneration should reflect the importance of quality.

4 Explain an ICAB member's responsibility with regard to CPD.

5 List four items the engagement partner should ensure the assurance team are aware of prior to commencing an engagement.

6 Define 'hot' review.

7 You are about to start work on an assignment. What would you expect the role of your senior to be interms of supervising you and explaining your role on the audit?

Total: 2 marks

8 A qualified senior and you are due to start work on an assignment. They will review your work before the file is passed on to the manager.

Requirement

What would you expect them to consider as part of their review?

Total: 2 marks

9 Jog Ltd

Your firm has recently been appointed as auditor of Jog Ltd ('Jog'), a company operating within the sports and leisure sector. Your audit manager has arranged a meeting with the company's finance director for early next week and she has asked you to assist her, in advance of this meeting, with the audit planning for the year ending 30 June 20X6. Your audit manager has also asked you to carry out some preliminary analytical procedures on the year-end financial statements of Jog when these become available.

Jog's business can be split into the following three divisions:

- Sports equipment retail outlets: 35 sports equipment retail outlets located in 'out of town' retail parks
- Fitness clubs: 15 fitness clubs, each offering a fully equipped gym together with yoga, aerobics, and circuit training classes
- Machine manufacture: A manufacturing unit in which running machines and rowing machines are assembled using components sourced from overseas.

Further information:

Sports equipment retail outlets

The retail outlets are all located close to major towns and cities throughout the whole of the Bangladesh. Each outlet stocks a standard range of products which are supplied from a central warehouse operated by Jog. Salaries for the core staff at the outlets are paid by Jog's head office by direct bank transfer.
Each outlet is run on a day-to-day basis by a manager who is responsible for hiring casual staff to cover peak periods. These casual staff members are generally paid using cash from the till.

Jog received some bad publicity during the year following its inclusion in a television documentary which revealed that one of its non-BD sports shoe suppliers was making its employees work long hours for very low wages. In an attempt to manage this adverse press attention, Jog has now had to source these products from alternative suppliers based in Bangladesh.

Fitness clubs

Jog's 15 fitness clubs are all located directly above existing Jog retail outlets. Each club has its own on-site manager and is operated independently of the adjacent retail outlet. Customers of the fitness clubs pay by one of three methods: on a 'pay per session' basis over the fitness club counter; by monthly direct debit paid into Jog's head office bank account; or by annual subscription to head office. Customers are then issued with a membership card which enables them to gain access to the club.

The company operates a bonus incentive scheme for the managers at both its retail outlets and fitness clubs. The size of the bonus is linked to the profitability of their individual operation.

Machine manufacture

During the year Jog started to manufacture its own running machines and rowing machines. It sources the machine components from China. These components are assembled in Bangladesh at Jog's factory for sale both in Jog's own stores under their own 'Jog' brand and also to independent sports shops under the 'Iron Champ' brand. The latter accounts for approximately 80% of Jog's total production of both running and rowing machines. Sales to independent sports shops achieve a gross profit margin of 50%, whereas sales to Jog's own shops are made to that division at cost plus 10%.

Jog is invoiced by its non-BD component suppliers in their respective local currency. The components are sent by sea, which means that Jog's typical lead time for components from the placing of an order to delivery in Bangladesh is three months. Jog is required to pay its suppliers 50% withorder and 50% upon receipt of the components in Bangladesh.

Quality management

In line with your firm's system of quality management, procedures were conducted prior to accepting Jog as an audit client, to ensure that it was appropriate to accept such an appointment. Your audit manager has asked you to consider the other objectives of a system of quality management and why they may be particularly relevant to Jog.

Requirements

9.1 State the objectives of a system of quality management within an audit firm.

9.2 Identify, with reasons, which of the above objectives are likely to be particularly relevant to your audit of Jog.

Note: An additional two parts of this question will be included in Chapter 7. Note that much of the information given in this question relates to these parts, but has been left in so that you can use any relevant information for the purposes of answering the above questions.

Total: 8 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

The benefits of a system of quality management include:

- Standard of all audit work completed is high and consistent
- Registered auditors are regarded as professionals who follow standards
- Quality of the work completed can be measured against a standard
- Individuals within firms know if the work they have completed is acceptable

Answer to Interactive question 2

Several quality management issues are raised in the scenario:

Engagement partner

An engagement partner must be appointed to each audit engagement undertaken by the firm, to take responsibility for the engagement on behalf of the firm. Assigning the audit to an experienced audit manager is not sufficient.

The lack of an audit engagement partner also means that several of the requirements of ISA 220, about ensuring that arrangements in relation to independence and directing, supervising and reviewing the audit, are not in place.

Conflicting views

In this scenario the audit manager and senior have conflicting views about the valuation of inventory. This does not appear to have been handled well, with the manager refusing to discuss the issue with the senior.

ISA 220 requires that the audit engagement partner takes responsibility for settling disputes in accordance with the firm's policy in respect of resolution of disputes required by ISQM 1. In this case, the lack of engagement partner may have contributed to this failure to resolve the disputes. In any event, at best, the failure to resolve the dispute is a breach of the firm's policy under ISQM 1. At worst, it indicates that the firm does not have a suitable policy concerning such disputes as required by ISQM 1.

Answers to Self-test questions

1 Correct answer(s):

A True

2 Correct answer(s):

B False

Although disciplinary action may be taken as a result of a review if required.

3 Correct answer(s):

C Staff prioritise the system of quality management over ethical considerations for listed clients.

4 Every member is required to certify that they have carried out appropriate professional development annually.

5 Four from:

(1) What work they are supposed to be doing

(2) The nature of the entity's business

(3) Any risks relevant to the engagement

(4) Problems that might arise during the engagement

(5) The detailed approach to the engagement

6 A 'hot' review is a review carried out by a partner not otherwise involved in the engagement or an external consultant before the auditor's report is signed.

7 Supervision

- Inform you of your responsibilities
- Explain the objectives of the work you are carrying out
- Explain the nature of the entity's business
- Highlight possible accounting and auditing problems which may affect the procedures you carry out

8 Review of work:

- Work properly conducted in accordance with plan/programmes
- Working papers to a standard/evidence recorded
- Conclusions valid
- Matters identified for further consideration
- Working papers headed, initialled, dated

9 Jog Ltd

9.1 Objectives of quality management

The objectives of an audit firm's system of quality management are to ensure that the auditor performs the right work to a high standard and adequately records the work done. It involves selecting the appropriate team, supervising staff, consulting sufficiently with colleagues and outside experts and reviewing the work carried out by the team with sufficient care.

A system of quality management will also ensure that the auditor draws the correct conclusions from the evidence available, forms the appropriate audit opinion and deals adequately with issues raised including reporting to management.

Quality management is also designed to protect the auditor from risks arising as a result of incompetence or negligence of the client's staff and will protect the firm from the risk of litigation.

9.2 Objectives relevant to the audit of Jog

Jog operates out of many locations and because it has a number of diverse activities, the audit firm may not have staff with relevant expertise. It is therefore particularly important that a team with appropriate skills and experience is selected for the audit and that the work is supervised closely.

As Jog is a new audit client and because its business is diversified it is particularly important that the audit team has an adequate understanding of the business. The risks arising from the client's staff being incompetent or negligent are particularly relevant to Jog as the auditor does not yet know the client very well.

Chapter 6

Accepting engagements

Introduction

Learning outcomes

Legal and other professional regulations, ethics, accepting and managing engagements andcurrent issues

Students will be able to understand and advise on the regulatory, professional and ethical issues relevant to those accepting, managing and carrying out assurance engagements. Students will be able to understand the processes involved in accepting and managing assurance engagements and how quality assurance processes mitigate the risks to those conducting the engagement.

- Discuss the issues which underlie the agreement of the scope and terms of an assurance engagement (new or continuing)
- Explain the main ways in which national legislation and other regulations affect the scope and nature of the audit and the appointment and removal of auditors (including the relationship between the law and auditing standards)

Syllabus links

Many of the considerations set out in this chapter have already been introduced in the Assurance exam. In this exam, you are required to consider the matters at a higher level, and be able to explain and discuss the matters in more detail.

Examination context

You may be asked to apply the principles discussed in this chapter to a scenario question in the exam.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	It is of practical significance to both companies and assurance firms how assurance engagements are obtained and the processes that assurance firms go through when determining whether to accept engagements. This is because companies need assurance services, particularly audits	Chapter 6 is another chapter which builds on the basic knowledge you obtained in your Assurance exam. Read all the sections carefully to note the higher level points. Read through the section carefully. At its most basic level, you need to know what a tender is (effectively a bid for an audit), and	You may be asked to apply the principles discussed in this chapter to a scenario question in the exam. This topic could come up in any part of the examination.	4, 2

Topic	Practical significance	Study approach	Exam approach	Self-test questions
	which are a statutory requirement in many cases and because assurance firms need to generate income. If you work in practice, you may become involved in the tender process for a new client in some way at some stage during your training. If you work in industry, you may be responsible for evaluating audit tenders and recommending who to appoint as auditors.	what it would include.		
2	A key issue for firms to consider, as raised in the previous chapter, is the risk associated with that client or potential client in terms of getting the opinion wrong. In addition, they need to consider ethics and resources. Companies should bear in mind when seeking auditors that audit firms generally prefer to take on clients which appear to	Read through the section carefully, paying particular attention to the worked example.	This topic is examinable, and could come up in any part of the examination.	3, 8, 9

Topic	Practical significance	Study approach	Exam approach	Self-test questions
	have integrity and commitment to internal control. **Stop and think** What can a company do to make its audit attractive to assurance firms and why might it do so?			
3	Since it is a legal requirement for companies to have an audit (as long as they are not exempt), there are also legal requirements relating to the appointment of auditors.	Read through the section carefully and attempt the activity.	This is an examinable area that could be tested anywhere in the examination, but perhaps most likely as a short form question.	1, 5
4	The terms of a new audit will be negotiated as part of the tender process. The engagement letter itself then confirms the basis of the audit with the client.	Read through the section carefully and attempt the activity.	This topic could come up in any part of the examination.	6, 7

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1 Tendering

Section overview

- An assurance firm might be invited to accept an engagement or to tender for an engagement.
- A tender is in effect a 'bid' for an engagement.
- The firm will set out the reasons why it is best placed to provide the engagement and the fee at which it can do it.
- Lowballing may occur during a tender process, and while this is not ethically wrong, it may require ethical safeguards to be put in place.

An assurance firm might obtain an engagement by the following methods :

(a) Is asked by a potential client to replace another accountant

(b) Considers tendering for an engagement held by another accountant

(c) Considers undertaking work that is complementary or additional to that of another accountant

In practice, the most common method of obtaining an audit is by tender. In a tender process, several assurance firms are in effect asked to 'bid' for the engagement, by setting out the attributes their firm possesses that makes them the best placed to carry out the engagement, and, sometimes very importantly, by indicating the level of fee that they are likely to charge. The company seeking auditors then considers the bids (which may be written or presented orally or both) and invites the successful party to accept the audit.

Although the price of the proposed engagement can be very important, it is not the only consideration for the company in a tender process. Other important considerations are as follows:

- The quality of the service the prospective auditors are likely to provide
- The knowledge of the business they possess
- The experience of the industry they have
- The proposed personnel on the audit team
- References obtained about the audit firm

An issue to consider briefly in the context of tendering is lowballing. Lowballing is the name given to the practice of charging less than the 'market rate' for the audit. In other words, say five comparable-sized firms were tendering for an audit, it is likely that their proposed fees would be similar. If one were significantly lower than the others, then it might be that the firm was quoting at a low rate in order to obtain the engagement on those grounds, in other words, lowballing.

The ICAB *Code of Ethics* states that a firm might quote whatever fee is considered appropriate. In other words, the practice of lowballing is not unethical in itself. However, ethical safeguards should be considered as lowballing does increase the self-interest threat of not being able to complete the audit to the appropriate standards in a commercial way.

The *Code of Ethics* suggests that the basis for fee computation shall be disclosed to and discussed with the client/potential client as soon as possible, so this would probably be incorporated into a tendering document. It states that fees should be determined with reference to the following:

- The seniority and professional experience of the persons necessarily engaged on the work

- The time expended by each
- The degree of risk and responsibility which the work entails
- The nature of the client's business, the complexity of its operation and the work to be performed
- The priority and importance of the work to the client
- Together with any expenses properly incurred

Giving the client such details about the basis of the fee will help the client determine if they are getting value for money, particularly in comparison with other tenders.

Professional skills focus: Applying judgement

The issue of low fees is connected to the need for a firm to have a culture of integrity. If fees are routinely set too low to allow for sufficient work to be done, then this communicates to staff that quality is unimportant.

2 Risk analysis

Section overview

- Firms carry out risk analysis prior to accepting engagements.
- This is in order to ensure that the risk of giving an inappropriate opinion on the engagement is not too high.
- Matters to consider are whether the directors appear to have integrity, the company has a good financial record and prospects, the attitude to internal control and the nature of the client's transactions.

As you learnt in Assurance, assurance firms will carry out a risk analysis before accepting clients. This is partly to determine what fee they think is appropriate for the engagement (the higher risk the client, the greater the benefit that the firm will want from undertaking the engagement) but also tolay foundations for understanding the risks associated with the engagement if it is taken on and the amount of work that will have to be undertaken to reduce assurance risk to an acceptable level for that assignment. As noted in Chapter 5, it may be that an engagement is too risky for a firm to risk taking on.

Context example: Two clients

Imagine two clients of a similar size, in the same industry:

Client A

You have never had to make any adjustments to client A's financial statements, which are produced by their qualified chief accountant and the accountant's experienced and competent staff from proprietary software, which both you and they know and understand well. The company's chief executive is a stickler for deadlines, but takes a genuine interest in the financial statements so that accurate numbers are produced on time on a regular basis.

Client B

The chief executive of client B is a 'seat of the pants' person, who has little time for accountants and the financial statements they produce. The accounts department is understaffed, those working there are unqualified and using an accounting package on which they have received no formal training.

Every year you go through a lengthy process of correcting the trial balance before you can even start to think about analytical procedures and audit work proper. You are always under pressure to finish the engagement on time and there is always an argument about the fee.

Which of these clients presents the higher risk?

Clearly client A is better organised than client B on the accounting front. Client A therefore starts out as a lower risk proposition than client B, based on the firm's experience of client A, its organizational culture and its reliable systems.

After the financial statements for both clients are finalised, however, you may feel more confident about the figures for client B because you had analysed them in more depth.

Another question

Would you prefer to be operating client A or client B if:

- you were a fraudster, hoping to inflate the value of your company so that a venture capital fund would invest, or a bank would continue with finance, or a large multinational would purchase it; or
- you were a money launderer wanting to introduce the profits from your drug smuggling and dealing activities into an otherwise legitimate business.

You could argue that things are so chaotic at client B that no one would notice a few stray transactions.

Or you might think that the auditors have to spend so much time on the detail that they would have quite a good chance of picking something up.

Perhaps the well organised, reliable client A, where the auditors don't seem to do very much detailed checking, might be a better bet.

The most that can be said therefore is that the assessment of risk is something of a balancing act between your judgement of how reliable the information coming from the client is likely to be and the things you can actually do.

The example illustrates that such judgements are not simple, but generally speaking when carrying out risk analysis prior to accepting a client, assurance providers will be seeking to determine:

- Whether the directors/management of the company appear to have integrity: this can be assessed by looking at the accounting policies of the company (are they prudent and conservative or imprudent?) and the qualifications of the finance director it employs, or by obtaining references for key personnel from parties known to the assurance firm, such as bankers or solicitors, or the previous auditors
- Whether the company has a good financial record, resources and outlook: this can be assessed by looking at recent financial performance and reports and by making enquiries (with permission) from its bankers
- Whether the company appears to have good internal control, or, at minimum, a good control environment: this might be indicated by the existence of an internal audit department, or assessed through inquiries of management
- Whether the company has unusual transactions: this can be assessed by reviewing published financial statements

In general terms, if the directors appear to have integrity, the financial record is strong and prospects look good, there is a good attitude to internal control in the company and it has few unusual transactions, then it is lower risk than a company for which those things are not true.

Remember, that if a firm determines that a company is a high risk client, this does not necessarily mean that the firm will not accept the engagement, but this preliminary assessment of risk will be incorporated into the audit procedures when risk assessment identification and procedures are carried out on the engagement.

Another area constituting risk to the auditor, as indicated in the example above, is the risk that the client may be money laundering. As you know, accountants are required to report suspicions of money laundering and failure to report a suspicion is a criminal offence. The auditors are also required to carry out client due diligence with respect to money laundering at the start of an engagement. This was all set out in your manual for Assurance, and you should refer back to it for the details.

3 Acceptance and legal issues

Section overview

- Auditors must consider:
  - the results of risk analysis
  - any ethical barriers to acceptance
  - whether the firm has the resources to undertake the assignment
  - legal issues

When deciding whether to accept an assurance engagement, the auditors need to consider the following:

- the results of risk analysis (discussed above)
- whether there are any ethical issues which prevent acceptance (discussed in Chapters 4 and 5)
- whether the firm has sufficient experience and resources (mainly staff who are appropriately qualified, experienced and available) to undertake the engagement
- for an audit engagement, whether all the legal requirements associated with the appointment of the incoming auditors and the removal or resignation of the outgoing auditors have been met

3.1 Ethical issues

The ICAB *Code of Ethics* sets out the following points in relation to changes in professional appointment.

3.1.1 Prospective auditors

When a prospective auditor is first approached by a prospective client or nominated, they shall seek to communicate with the existing auditor. (This may be mentioned in replying to requests to submit tenders.)

The client should give the existing auditor written authority to discuss the client's affairs with the prospective auditor.

The prospective auditor should then write to the existing auditor, seeking information which could influence their decision as to whether or not they may properly accept appointment.

If the existing auditor fails to respond within a reasonable time, the prospective auditor should write to the existing auditor by recorded delivery stating an intention to accept the appointment in the absence of a reply within a specified period. The existing auditor's silence would imply that there were no adverse comments.

Once the prospective auditor has received confirmation that there are no reasons not to act, or has become satisfied that they can properly act, and are prepared to accept nomination/appointment, they should inform the client.

3.1.2 Existing auditor

The existing auditor should get written authority from the client to communicate with the prospective auditor. In the absence of specific instructions by the client, an existing auditor should not ordinarily volunteer information, as they are bound by confidentiality.

The existing auditor or adviser should quickly answer the communication from the prospective auditor. However, care must be taken in situations where the existing auditor knows or suspects that their client is involved in money laundering as it is a criminal offence to 'tip off' a money launderer.

If there are no matters of which the latter should be aware, the existing auditor should write to say that this is the case.

If there are such matters, they should inform the prospective auditor of those factors within their knowledge of which, in their opinion, the latter should be aware. It is not sufficient to state that unspecified factors exist.

Matters may include:

- unlawful acts by the client
- unpaid fees
- differences of opinion between the auditor and the client

The fact that there are issues that should be brought to the attention of the prospective auditor doesnot preclude them from accepting appointment; it merely identifies issues that need to be considered.

This communication between the prospective and existing auditors should also provide evidence to the prospective auditor of both the identity and integrity of the client. This is additionally valuable in the light of new requirements on accountants to verify the identity of clients to guard against money laundering.

3.1.3 Client refuses permission to contact previous auditors

If the client fails or refuses to grant the existing auditor or adviser permission to discuss the client's affairs with the proposed auditor, the existing auditor or adviser should report that fact to the prospective auditor or adviser, who should carefully consider the impact of this on their decision whether to accept the appointment/nomination or not.

3.1.4 Additional work

A professional accountant invited to undertake work which is additional to and related to continuing work carried out by another professional adviser should notify that other professional adviser of the work they have been asked to undertake.

It is generally in the interest of the client that the existing auditor or adviser be aware of the nature of the additional work being undertaken.

The existing adviser will be provided with the opportunity to communicate with the professional accountant to provide information, lack of which might otherwise prevent the additional work from being carried out effectively.

Additionally, such notification could affect the way an existing auditor or adviser discharges their continuing responsibilities to their client.

Notification should always be given unless the client advances reasons which persuade the firm that, in all the circumstances, the existing adviser should not be informed.

An example of such a situation might be where a client disagrees with the proposed audit opinion of its auditors and engages a second accountant to give them a second opinion on the matter. A key danger in this situation is that the second accountant does not have all the information necessary to give an appropriate second opinion, thus communication is vital. Auditors should always be wary of giving second opinions as they may compromise the position of the first auditor, trying to give an appropriate, independent opinion.

3.2 Legal issues

3.2.1 Appointment of auditors by the members

In order to carry out the audit of a company, the auditor first needs to be appointed by ordinary resolution.

The members (ie, shareholders) of a company appoint the auditor at an annual general meeting (AGM), or other general meeting of the company at which the financial statements are put forward for approval by members.

3.2.2 Appointment of auditors by the directors

The exception to the above rule is where the directors appoint the auditor either to:

- fill a casual vacancy, for example when the existing auditor resigns during the year; or
- appoint the first auditor between the date of incorporation and the first AGM or if the company qualifies to require an audit, before the next AGM.

As noted above, however, in both cases the members must then reappoint the auditors at the next AGM, by ordinary resolution.

3.2.3 Removal of auditors

If the members of the company wish to remove the existing auditor and appoint a new one, they can do so by ordinary resolution with special notice at a general meeting.

Where this happens the auditors must make a statement of circumstances (see below) and they have certain rights, which include the right:

- to receive notice, attend and speak at the meeting where they would have been appointed, or the proposed new auditor is appointed
- to have a written representation of a reasonable length circulated to all members. Such a representation might explain why they should not be removed as auditors

In practice, it tends to be the directors who decide that they would like the existing auditor removed, but to achieve this they must put up a resolution for the members to vote on.

One of the possible reasons why directors might wish to make this change is because they have had a disagreement in principle with the existing auditor over the accounting treatment of an item in the financial statements, but have no such disagreement with the new auditor. (Finding auditors who are more acquiescent is a process known as 'opinion shopping'). It is to protect the existing auditor (by giving them a right to argue their case) that company law provides for an auditor being removed to make written representation to members and to speak at the meeting at which the resolution is voted on.

3.2.4 Resignation of auditors

If the auditor resigns during their year of office, they must submit written notice to the company at the company's registered office. The auditor must also send a statement of circumstances (see below).

The auditor has certain rights here, which include the right:

- to request that the directors convene a general meeting of the company so that the auditor can explain the circumstances connected with the resignation
- to require the company to circulate the statement of circumstances in advance of:
  - the general meeting requested by the auditor
  - any general meeting at which the auditor's term of office would otherwise have expired or at which it is proposed to fill the vacancy caused by the resignation

On receipt of the auditor's resignation the company must then notify:

- the Registrar of Companies
- anyone entitled to receive a copy of the company's accounts.

As an alternative to resignation the auditor may simply not seek reappointment, or the company may decide against reappointment. In either of these two circumstances, the auditor is still required to prepare a statement of circumstances or confirm in writing that there are no circumstances of which members should be aware.

Interactive question 1: Disagreement with directors

You have recently had a serious disagreement with the directors of one of your major audit clients who, as a result, have threatened to recommend another firm of auditors for appointment at the next AGM.

Requirement

What statutory rights do you have if they carry out their threat?

See **Answer** at the end of this chapter.

4 Terms of an audit engagement

Section overview

- As part of engagement acceptance, the assurance providers will negotiate the terms of the engagement. For assurance engagements, this will include the following:
  - the scope of the engagement
  - the subject matter of the engagement
  - the criteria by which the subject matter is being judged
  - the level of assurance required and therefore the type of opinion to be given
  - the timings associated with the engagement
  - any restriction in liability
  - the fee for the engagement

With regard to audits, the scope of the engagement is determined by law and professional standards, but the auditors must ensure that these terms are understood by the client. In addition,the following matters will need to be agreed:

- the fee or the basis by which the fee will be determined
- the limited liability agreement, that is, the cap on the auditors' liability for the engagement (discussed in the previous chapter)

4.1 Audit engagement letters

You were introduced to the concept of an engagement letter in your studies for Assurance. Engagement letters are required under ISA 210, *Agreeing the Terms of Audit Engagements*. As you may remember, it is a requirement of this standard that the terms of the engagement are put in writing.

The form and content of an engagement letter will vary, but should cover the following matters:

- The objective and scope of the audit of financial statements (including reference to applicable legislation, regulations, financial reporting framework and auditing standards)
- Management's responsibilities (including responsibility for the financial statements and the company's system of internal control)

The auditor's responsibilities:

- The form and content of reports and communications that will arise from the audit
- The fact that due to the test nature and other limitations of an audit, there is an unavoidable risk that some material misstatement may remain undiscovered
- The fact that auditors are entitled to unrestricted access to records, documents and other information requested in connection with the audit

There is an expectation that management will provide written representations.

The letter may also cover practical matters, such as arrangements relating to planning, using the work of experts, liaising with the internal audit department, the fee and restriction of auditor liability.

Professional skills focus: Assimilating and using information

The engagement letter is one of the ways that the auditor can try to narrow the expectations gap, by clarifying the responsibilities of management and the nature of the audit. As far as management, but not the public, is concerned, the engagement letter is not on the public record.

4.2 Recurring audits

When the audit is a recurring audit, it is not necessary to issue a new letter each year. However, the auditors should consider every year whether a new letter is required. The following factors may indicate a new letter is required:

- indications that the client misunderstands the terms of the engagement
- revised or special terms of the engagement
- a recent change in senior management or directors
- a significant change in ownership of the company
- a significant change in the nature or size of the company
- legal or regulatory requirements
- a change in the financial reporting framework adopted in the preparation of the financial statements
- a change in other reporting requirements

4.3 Changes in engagement

If the auditor is asked to change the engagement to one which provides a lower level of assurance then they should consider the appropriateness of doing so. Obviously, if the audit is a statutory audit,the auditor must provide an appropriate audit as required by law, that is one giving reasonable assurance on the truth and fairness of the engagement.

If the terms are changed, the auditor and the client must agree the terms. If the auditor and the client cannot agree, the auditor should withdraw from the existing arrangement.

4.4 Disclosure of the terms of agreement

The Companies Act 1994 makes provision for potential future regulations requiring disclosure of the terms of the audit engagement. Currently there are no such regulations in place.

Interactive question 2: Engagement letter

Mr Angry of Gonzo Animations Ltd has approached your audit firm to undertake the audit of his company. When the partner held the initial meeting with Mr Angry, the client refused to sign the engagement letter as he said that it was merely a means of the firm abdicating its responsibility for the audit.

Requirement

Your partner has asked you to draft a letter to the client explaining the need for a letter of engagement.

See Answer at the end of this chapter.

Summary

How do assurance firms obtain clients? → Usually by tendering for the engagement →

Issues:
- Fees (lowballing)
- Firm's experience
- Firm's reputation
- Proposed personnel

How do assurance firms determine whether to accept clients? →

Ethical considerations →

Issues:
- Is the firm independent?
- Communication with the previous auditors

Legal considerations →

Issues:
- Have the previous incumbents been removed/resigned properly

Risk analysis →

Issues:
- Will it be possible to give an appropriate opinion?
- What fee should be charged?
- Consider director integrity, financial record, internal controls, types of transactions

How do assurance firms confirm the scope of the engagement? → Engagement letter →

Issues:
- Set out scope/responsibilities
- Update when necessary
- Consider appropriateness of changing level of assurance provided if requested
- Disclosure of terms

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you identify the issues in relation to which fees should be determined? (Topic 1)	
(2) Can you explain the four main things that an auditor will seek to determine when assessing a potential client's risk profile? (Topic 2)	
(3) Can you explain the four main things that an auditor must consider when deciding whether to accept an audit? (Topic 3)	
(4) Can you explain the matters that should be included in the audit engagement letter? (Topic 4)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q7	The contents of the engagement letter are an examinable topic.	
Q8	This substantial question is broadly representative of the way in which this topic could be examined, and provides a good test of your work on this chapter.	
Q9	This substantial question is broadly representative of the way in which this topic could be examined, and provides a good test of your work on this chapter.	

Once you have attempted these questions, you can continue your studies by moving onto the next chapter, Planning.

Technical reference

1 Tendering

ICAB Code of Ethics 320–330

2 Risk analysis

n/a

3 Acceptance and legal issues

ICAB Code of Ethics 320, CA 1994

4 Terms of an audit engagement

ISA 210.9–10

Self-test questions

Answer the following questions.

1 If the client refuses the existing auditor permission to communicate with the prospective auditor, the prospective auditor should decline the appointment.

A True

B False

2 List four issues that ICAB states should be referred to when determining fees.

3 Define lowballing.

4 Why do firms undertake risk analysis?

5 An auditor can be appointed by which of the following methods?

A Ordinary resolution by shareholders

B By directors to fill a casual vacancy

C By directors to appoint first auditor

D By the government

6 If a client requests that an auditor reduce the level of assurance offered on a statutory audit, an auditor may agree and reduce procedures accordingly.

A True

B False

7 Acer Ltd is a client of your firm and is seeking funding in order to expand the business. The directors have prepared profit and cash flow forecasts for the next three years ending 30 June 20X9 in support of the request for funding. The company's bankers require this information to be reviewed by independent accountants and the board of directors has requested that your firm undertakes this review.

Requirement

Set out the matters that you would include in the engagement letter in relation to the respective responsibilities of the directors and the reporting accountant.

Total: 2 marks

8 Wrapper Ltd

Your firm, which has six partners, has been invited by Ms Packer, the managing director and majority shareholder of Wrapper Ltd, to accept appointment as auditor of the company and also provide assistance with the preparation of the financial statements and the corporation tax computation.

The principal activity of Wrapper Ltd is the production of paper carrier bags, serviettes, coffee cups and lids which are sold to customers operating in the fast food sector. Wrapper Ltd was incorporated on 1 October 20X4 and the financial statements will cover the 15-month period to

31 December 20X5. Although the company's revenue and assets are below the thresholds for statutory audit purposes, the company's bankers require the annual accounts to be subjected to a full audit.

Ms Packer started the business using a combination of money inherited from her grandfather and a bank loan. The loan agreement includes a covenant specifying that the company's debt equity ratio should not exceed parity (ie, 1:1).

The accounting records are computerised and the company uses software which was developed by IT Systems Ltd, a company owned by Ms Packer's brother. The software has been customised to integrate inventory control with receivables and payables. IT Systems Ltd also provides support for the company's computer systems. The accounting records are maintained by Mrs Carlton, assisted by Mr Biggs who works one day a week and is responsible for payroll processing.

Requirements

8.1 State, with reasons, the matters to be considered and procedures to be performed prior to your firm accepting and commencing the audit of Wrapper Ltd for the period ending 31 December 20X5.

(8 marks)

8.2 Identify, from the information provided above, the factors which should be taken into account when assessing the risk of misstatement in the financial statements of Wrapper Ltd and explain why such factors should be taken into account when conducting the audit.

(10 marks)

Total: 18 marks

9 Harmony Ltd

The directors of Harmony Ltd ('Harmony') have approached you with a view to your firm accepting appointment as its auditor for the year ending 31 July 20X6. Harmony manufactures satellite navigation systems which it supplies to many of the major motor car manufacturers with UK-based factories.

Harmony has a wholly owned subsidiary undertaking located overseas which manufactures 'high-end' audio systems for locally based motor car manufacturers. The subsidiary, which is of a similar size to Harmony, is located in a country where there is no audit requirement for companies whose shares are not publicly held. Harmony prepares consolidated financial statements.

The shareholders of Harmony are actively involved in the day to day running of the business and that of the wholly owned subsidiary.

The directors of Harmony have told their existing auditors that they will not be reappointed at the company's forthcoming annual general meeting. They have not given them a reason for this, but the existing auditors suspect that it is due to a dispute that arose during the audit of last year's financial statements. At 31 July 20X5, Harmony was carrying inventory totalling CU375,000 in respect of a cancelled order for a satellite navigation system from a motor car manufacturer that had gone into liquidation. During September 20X5, modifications were made to the inventory, at a cost of CU75,000, to enable them to be sold to another customer for CU195,000 that same month. The directors of Harmony were concerned at the effect that any allowance to reduce inventory to NRV in the financial statements would have on their distributable profits for the year. The directors accordingly insisted on including the inventory in the financial statements at CU375,000, which gave rise to a modified auditor's report.

In addition to your appointment as auditor, the directors of Harmony have also requested:

(1) that you, as the proposed engagement partner, attend the company's monthly board meetings; and

(2) that your firm be appointed to provide an IT service to Harmony.

Your firm has seven partners in total and has an office in each of three cities in the south of England.

Requirements

9.1 Outline the reasons for and against the subsidiary of Harmony having an audit on its own basis despite being owner managed.

(6 marks)

9.2 Set out the key issues specific to Harmony that may prevent you from accepting the appointment solely as its external auditor, and state what action you could take to resolve these issues.

(6 marks)

9.3 Discuss the potential threats to objectivity caused by the provision of the additional services requested by Harmony and describe what safeguards could be put in place to mitigate those threats.

(8 marks)

Total: 20 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Rights:
- To receive notice of the resolution to appoint another auditor
- To have written representations circulated to all members, or read out at the meeting
- To attend the meeting
- To be heard at the meeting

Answer to Interactive question 2

To: Mr Angry

Engagement letters

We are required by International Standards on Auditing to send you a formal engagement letter before conducting the audit. All firms of auditors should abide by this procedure.

The letter is there as much to protect the client, as it is the auditor, and we would suggest that legal advice is taken prior to you accepting the terms.

Purpose of engagement letter

The purpose of the letter is to:
- define clearly the extent of our responsibilities, and your responsibilities
- minimise the possibility of any misunderstanding between ourselves and Gonzo Animations Ltd
- provide written confirmation of our acceptance of appointment, the scope of the audit and the form of the report

We believe that it is important for both parties to clearly understand their roles within the external audit function.

Contents of engagement letter

The contents of the letter are set out below, together, where necessary, with the justification of the inclusion of the section.
- Our respective relevant statutory and professional responsibilities (to avoid misunderstanding).
- An explanation of the scope of the audit (so that we inform you of what we will do). This covers a number of issues.
  - The audit will be carried out in accordance with the International Standards on Auditing issued by the Financial Reporting Council.
  - We need to obtain an understanding of the accounting system in order to assess its adequacy as a basis for the preparation of the financial statements.
  - We need to obtain relevant and reliable evidence sufficient to enable us to draw reasonable conclusions therefrom.
  - The nature and extent of our procedures will vary according to the assessment of the accounting system and, where we wish to place reliance upon it, the system of internal control.
  - We will endeavour to plan the audit so that we have a reasonable expectation of detecting material misstatements in the financial statements or accounting records resulting from fraud, error or non-compliance with law or regulations but that the examination ought not to be relied upon to disclose all frauds, errors or instances of non-compliance which may exist (as some

may be immaterial).

- Due to the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that even some material misstatement may remain undiscovered.
- An explanation that management representations may be required in writing during the audit (this will only be in the case of audit areas where we have to rely on your representations).
- The fact that we may send a letter of comment, adding value to the audit, by outlining ways in which we discussed the business may be improved.

- Other matters such as:
  - our billing arrangements
  - any arrangements in the future concerning the involvement of:
    - other auditors and experts
    - internal auditors
    - previous auditors
  - management's responsibility to detect and prevent fraud
  - your complaints procedures
  - a proposed timetable for the engagement (which will vary each year).

I hope this clarifies the need for the letter. Except for the timetable, we will only send out such letters in future where absolutely necessary.

Yours sincerely
A Accountant

Answers to Self-test questions

1 Correct answer(s):

B False

Not necessarily, although this might be an indicator that the auditor should have concerns about director integrity.

2 Four from:

(1) the seniority and professional experience of the persons necessarily engaged on the work

(2) the time expended by each

(3) the degree of risk and responsibility which the work entails

(4) the nature of the client's business, the complexity of its operation and the work to be performed

(5) the priority and importance of the work to the client

(6) together with any expenses properly incurred

3 Lowballing is the practice of charging less than the market rate for assurance services.

4 Reasons firms undertake risk analysis:

- To ensure that the assurance provider believes an appropriate conclusion can be drawn
- To assist in determining an appropriate fee (that reflects the risk of the assignment)

5 Correct answer(s):

A Ordinary resolution by shareholders

B By directors to fill a casual vacancy

C By directors to appoint first auditor

D By the government

All of them.

6 Correct answer(s):

B False

A statutory audit provides a reasonable level of assurance.

7 Directors

Responsible for:

- forecasts including the assumptions on which they are based
- cooperating with the reporting accountant by making available records, documents and personnel

Reporting accountant

- Forecast is properly prepared on the basis of the assumptions made
- Provide negative assurance that nothing has come to reporting accountant's attention to cause them to believe that the assumptions do not provide a reasonable basis for the forecast

8 Wrapper Ltd

8.1 Matters/procedures prior to acceptance of audit

(a) Check adequacy of resources to enable:
- work to be completed to a high standard on a timely basis/use of competent staff
- provision of tax/accountancy services without compromising independence (ie, safeguards can be put in place) eg:
  - use of separate personnel to perform accountancy and tax
  - review by an independent partner/senior staff member with appropriate expertise if tax computation prepared by audit team
  - review of the audit by an audit partner who is not involved in the audit engagement

(b) Establish/document existence of informed management – to ensure auditor does not take management role

(c) Consider relationships/familiarity threat – to ensure independence/objectivity not impaired

(d) Consider potential conflicts of interest (eg, competing clients) – to ensure act in the best interest of clients

(e) Consider integrity of client – to reduce risk of misstatements due to fraud/misrepresentation

(f) Client identification procedures – to reduce exposure to money laundering/comply with money laundering requirements

(g) Send letter of engagement – to ensure client understands nature and scope of the work to be undertaken/narrow expectations gap

8.2 Factors to take into account:

Factors	Why taken into account
New client	Lack of familiarity – may not identify events and transactions which have an impact on the financial statements/higher detection risk
Start-up	Going concern risk Doubts/material uncertainty will require disclosure in the financial statements Lack of going concern status will require financial statements to be prepared on a break-up basis
Lack of prior year figures	Lack of comfort/corroboration from use of analytical review procedures Require more extensive use of tests of details (substantive tests)
Bank covenant	Risk that profits may be overstated in order to preserve the debt equity ratio
Trading with IT Systems Ltd	Need to ensure complete disclosure of related party transactions
Customised accounting software	May not be reliable, resulting in errors
Lack of segregation of duties	Misstatements may not be prevented or detected and corrected on a timely basis/higher control risk Determine the audit approach which is likely to be substantive based

9 Harmony Ltd

9.1 Arguments for Harmony's subsidiary having an audit

An audit requires all similar-sized companies to be treated the same, regardless of ownership. It provides assurance that the company has complied with the Companies Act and accounting standards. Many would consider that an external audit is a fair price to pay for limited liability.

There are more stakeholders in a company than simply its shareholders who can use the assurance generated by the audit work. The tax authorities can place more reliance on the financial statements and an audit affords some measure of protection to creditors that the company is not trading whilst insolvent. It also means potential investors can place similar reliance on the financial statements whether or not the company is listed.

Arguments against Harmony's subsidiary having an audit

Harmony's shareholders are actively involved in the management of the subsidiary and therefore an audit will be of little value to them. The auditor's report will be addressed to shareholders and therefore contribute little to their knowledge and understanding of the business. Furthermore, an audit can cause unnecessary red tape and expense.

9.2 The audit of Harmony will include the results of the subsidiary, which are material as the subsidiary is the same size as Harmony. The audit firm must consider whether it has adequate resources to audit the overseas subsidiary itself and whether it has the required level of competence. Harmony should appoint a local audit firm and undergo an audit of its subsidiary voluntarily. This local firm would use the firm's audit packs and the firm would review the work of the local auditor in detail.

The dispute with the previous auditors may also cast doubt over the integrity of management and whether accepting the appointment will put the firm at risk of management intimidation. In an attempt to resolve this issue, permission should be sought to speak with the outgoing auditors and enquire of them whether there are any other issues of which the incoming auditor should be aware.

The engagement partner assigned must ensure that members of the audit team have appropriately consulted on difficult or contentious issues. It is also recommended that an independent second partner review of the audit file is undertaken in the first year, before the auditor's report is signed.

9.3 Threats to objectivity

In some cases, for example when management representations are discussed, it may be desirable for the auditor to attend board meetings. However, an auditor must not under any circumstances make management decisions. Attending board meetings is allowed if the auditor is acting in an advisory capacity only or is reporting the results of audit work.

Safeguards

To safeguard against this threat, the auditor should ensure that there is 'informed management' at the company. The auditor should inform the directors that they alone are responsible for decision making and they should get their written confirmation of agreement to this. In the interests, however, of being 'seen to be independent' it may be best to decline the offer of attendance at monthly board meetings.

Threat to objectivity

The provision of an IT service causes a self-review threat to the auditor as the audit staff members may place too much reliance on IT systems that their firm designed or implemented.

Safeguards

An IT service cannot be provided to an audit client if it will be important to the accounting system or to the financial statements.

Where the IT service is not related to the accounting system then safeguards include using separate teams and partners from the audit, and subjecting the audit to an independent engagement review in relation to the information technology work.

Chapter 7

Planning

Introduction

Learning outcomes

Planning and performing engagements

Students will be able to plan and perform assurance engagements in accordance with the terms of the engagements and appropriate standards.

- Assess the impact of risk and materiality on the engagement plan of assurance procedures to be performed on historical and prospective information, including the nature, timing and extent of assurance procedures, for a given organisation
- Discuss the benefits and limitations of analytical procedures (including data analytics) at the planning stage
- Specify and explain the steps necessary to plan, perform, conclude and report on the audit of the financial statements of a non-specialised profit-oriented entity in accordance with the terms of the engagement including appropriate auditing standards

Syllabus links

You have studied these matters for your Assurance exam, so much of the technical detail covered here is revision. It is important at this Professional stage to be able to explain and apply the techniques outlined in the chapter.

Examination context

A question which deals with planning in the exam is also very likely to deal with risks, which we shall look at in more detail in the next chapter, hence the question practice given in this chapter is limited and more practice will be given in the next chapter.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	Planning is an important aspect of the quality management processes relating to an assurance assignment and it is key in determining whether the work carried out is	Read through the section and attempt the interactive question at the end. This chapter is largely revision so read through it fairly quickly	A question which deals with planning in the exam is also very likely to deal with risks, which we shall look at in more detail in the next chapter, hence the	1

Topic	Practical significance	Study approach	Exam approach	Self-test questions
	capable of supporting a correct conclusion. It is therefore of crucial importance. If you work in practice, you may become involved in planning assignments, particularly as you progress, if you have worked on a client in the previous year and acquired a degree of knowledge of the business. If you work in industry, you may be involved in the other side of planning, providing auditors with necessary planning information, such as budgets and draft financial information. **Stop and think** Why does planning an audit increase the chances of the correct conclusion being drawn?	trying all the activities to apply your knowledge.	question practice given in this chapter is limited and more practice will be given in the next chapter.	

Topic	Practical significance	Study approach	Exam approach	Self-test questions
2	The distinction between the audit strategy and the audit plan is of key importance. The strategy is general and abstract; the plan then contains the detail needed to implement the strategy.	Read through the section carefully.	This section is partly background but could be examined directly in a short-form question.	2
3	Materiality is one of the most important concepts in auditing, but it affects all accountants whether they work in practiceor in industry.	Read through the section carefully. You need to know the materiality thresholds.	This material is examinable and could form part of a question in any part of the exam.	3, 6
4	Analytical procedures are becoming increasingly important with the expansion of the role of data in auditing. It is crucial that you do not just know how to calculate the ratios, however, but that you understand what they are telling you.	Read through the section carefully and attempt the activities.	This material is examinable and could form part of a question in any part of the exam.	4, 5, 7
5	Going concern is a topical area, and is relevant to accountants working in practice and in industry.	Read through the section, paying particular attention to the indicators and to the audit procedures.	This material is examinable and could form part of a question in any part of the exam.	

Topic	Practical significance	Study approach	Exam approach	Self-test questions
6	The risk profile of an audit needs to be assessed.	Read through the section carefully, including the worked example.	This material in this section is not likely to be examined directly, but could come up as part of a question.	7

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1 The need to plan

Section overview

- Audits are planned so that auditors know what to do so that the appropriate conclusion can be drawn.
- It is a requirement of ISA 300, *Planning an Audit of Financial Statements* that audits are planned.

Audits (and other assurance engagements) are planned because if they are not:

- time might be wasted doing the wrong work
- the really important work might not be done at all
- ultimately, the wrong conclusion might therefore be drawn

Planning an engagement is a key aspect of the quality management associated with that audit. If an audit is planned, then the right work is done, it is easier to supervise and review that work, and therefore it adds to the quality of the whole engagement.

In addition, as you know from your studies for Assurance, audits are planned because it is a requirement of auditing standards. ISA 300, *Planning an Audit of Financial Statements* requires audits to be planned so that they can be carried out 'effectively'.

Much of the material we look at in this chapter you have covered in your lower-level studies. In this area, you need to be able to apply your knowledge to the scenarios presented in the exam.

In summary, planning helps the auditor know:

- what to do
- how much to do
- where to focus resources
- what the important matters that need dealing with

Interactive question 1: The need to plan

State the reasons why auditors need to plan audits. See Answer at the end of this chapter.

2 Overall audit strategy and audit plan

Section overview

- The key planning document is called the overall audit strategy.
- It covers matters such as materiality, risk, audit approach, use of experts/internal audit, timings,team, budget and deadlines.
- Many audit firms have 'audit packs' containing example audit strategies and plans, but care should be taken when using them.
- The other key document in audit planning is the audit plan.

2.1 Key planning documentation

As you know from your studies for Assurance, the key planning document is called an overall audit strategy. This covers the main general areas of planning: materiality, risk, audit approach, use of experts and internal audit, timing, team, budgets and deadlines.

The technical details of many of these issues will be covered in later chapters.

Most audit firms have 'audit packs' which have a specific planning section and set out the key areas that auditors must consider when planning an audit. However, care should be taken when using any standard forms, as there is a risk that matters particular to the client might be forgotten. It is important to tailor the plan to the client, not the other way around. Identifying key issues relating to the client and then adjusting the audit approach will be necessary. This is why understanding the business (Chapter 8) and risk assessment (Chapter 9) are very important.

The overall audit strategy should be updated as necessary during the course of the engagement.

As you also know from your earlier studies, the other key document in audit planning is the audit plan, which is more detailed that the audit strategy, and sets out the nature, timing and extent of planned audit procedures (including risk assessment procedures) to fulfil the requirements of the overall audit strategy and auditing standards.

The audit plan should be updated as necessary during the course of the engagement.

2.2 Automating the audit process

Many audit firms use some form of automated process during the planning stage of the audit and when carrying out audit fieldwork, with the aim of improving audit quality and reducing costs.

During the planning stage, automation can help with bringing information forward from the previous audit and populating checklists, identifying resource requirements, generating working paper templates and identifying information required from the client prior to any site visit.

During the fieldwork phase automated templates help to ensure that all areas are covered in sufficient detail, enable electronic sign-off to take place and can feed into the auditor's report and into any report to management on deficiencies identified.

As with audit packs, it is important that any generic documentation is customised to fit the specific audit needs of each client.

3 Materiality

Section overview

- An item is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
- Items might be material by value or nature.
- Materiality is a matter of auditor judgement.

You learnt about materiality and the principles of ISA 320, *Materiality in Planning and Performing an Audit* in your studies for Assurance. The following is therefore revision.

Definitions

Material: Information is **material** if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Performance materiality: An amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole or, if applicable, for a particular class of transaction, account balance or disclosure.

Auditors should consider materiality when determining the nature, timing and extent of audit procedures.

Items might be material due to their:

- amount/value/quantity
- nature/quality

The Standard does not specify a methodology for determining materiality for the financial statements as a whole. In practice, however auditors will set a computed level of materiality, often based on the following ranges:

Profit before tax	5%
Gross profit	0.5%–1%
Revenue	0.5%–1%
Total assets	1%–2%
Net assets	2%–5%
Profit after tax	5%–10%

In addition, some matters might be material by nature, for example:

- The CU1 that turns a profit into a loss might be considered very important by some companies/shareholders.
- The CU1 that changes the thresholds the company operates in (for example, becoming a medium-sized rather than small company) might also be very important.
- Some matters are automatically material, such as matters relating to directors, or related parties because these matters have to be disclosed in financial statements regardless of their value.

Performance materiality should be set so that misstatements which are in themselves immaterial, but which in aggregate could cause the financial statements to be materially misstated, are unlikely to remain undetected. In other words, the probability of such misstatements remaining undetected should be reduced to an acceptably low level. Performance materiality can be one or more amounts, and it should be revised as the audit progresses, if the auditor becomes aware during the audit of information that would have caused a different amount to be set in the first place.

Auditors should always bear in mind that materiality is a matter of professional judgement. Materiality is also important at the completion stage of an audit, when the auditors are evaluating the effect of discovered misstatements. We shall look at this in Chapter 12.

3.1 Sustainability impact

Climate-related risks may affect the auditor's determination of materiality and performance materiality in accordance with ISA 320. Given that some investors have specifically identified climate-related risks as being used in their economic decision making, auditors of entities that are affected by climate-related risks may need to take that into account when determining materiality.

When considering whether misstatements in qualitative disclosures could be material, one of the factors that the auditor may consider is whether the qualitative disclosures are important to users of the financial statements. Climate-related risk disclosures may be considered to be important and the auditor may need to consider how management has evaluated climate-related risks and disclosures based on judgements made by the directors in relation to the recognition or measurement of climate related items in the financial statements.

4 Analytical procedures

Section overview

- Analytical procedures must be used in risk assessment.
- The benefits of analytical procedures in planning are the 'overall' perspective, the use of information outside of the accounting records and the comparison of different elements of the financial statements.
- The limitations of analytical procedures in planning are:
  - Substantial knowledge of the business is required for results to be meaningful (therefore experienced staff may be required to carry them out).
  - They can be performed mechanically.
  - The relevant information may not be available.

You looked at analytical procedures in some detail in your studies for Assurance. You should be able to explain what analytical procedures are and carry out basic analytical procedures.

ISA 315, *Identifying and Assessing the Risks of Material Misstatement* states that the auditor should use analytical procedures in risk assessment in order to obtain an understanding of the entity and its environment. We shall look at this in detail in the next chapter.

In this syllabus you are required to be able to discuss the benefits and limitation of analytical procedures at the planning stage.

Professional skills focus: Concluding, recommending and communicating

Performing analytical procedures well illustrates in microcosm the skills of a professional accountant.To do so requires an understanding of the numbers (what the particular equation is calculating) but also an ability to understand and explain the meaning of those numbers, connecting them to the qualitative processes that are taking place within the entity.

Interactive question 2: Benefits and limitations of analytical procedures

Analytical procedures must be carried out at the planning stage of an audit to help identify risk are as requiring extra work.

Requirement

Set out the benefits and limitations of using analytical procedures to identify risk areas during audit planning.

See Answer at the end of this chapter.

These are the ratios students need for applying analytical procedures.

Heading/Ratio	Formula	Purpose
Performance		
Return on capital employed	$\frac{\text{Profit before interest and tax}}{\text{Equity + net debt}}$	Effective use of resources
Return on shareholders' funds	$\frac{\text{Net profit for the period}}{\text{Share capital + reserves}}$	Effective use of resources
Gross profit percentage	$\frac{\text{Gross profit} \times 100}{\text{Revenue}}$	Assess profitability before taking overheads into account
Cost of sales percentage	$\frac{\text{Cost of sales} \times 100}{\text{Revenue}}$	Assess relationship of costs to revenue
Operating cost percentage	$\frac{\text{Operating costs / overheads} \times 100}{\text{Revenue}}$	Assess relationship of costs to revenue
Net margin/operating margin	$\frac{\text{Profit before interest and tax} \times 100}{\text{Revenue}}$	Assess profitability after taking overheads into account
Short-term liquidity		
Current ratio	Current assets : Current liabilities	Assess ability to pay current liabilities from current assets
Quick ratio	Receivables + Current Investments + cash : liabilities	Assess ability to pay current liabilities from reasonably liquid assets
Long-term solvency		
Gearing ratio	$\frac{\text{Net debt}}{\text{Equity}}$	Assess reliance on external finance
Interest cover	$\frac{\text{Profit before interest payable}}{\text{Interest payable}}$	Assess ability to pay interest charges
Efficiency		
Net asset turnover	$\frac{\text{Revenue}}{\text{Capital employed}}$	Assess revenue generated from asset base
Inventory turnover	$\frac{\text{Cost of sales}}{\text{Inventories}}$	Assess level of inventory held
Inventory days	$\frac{\text{Average inventory} \times 365}{\text{Cost of sales}}$	Assess the average inventory-holding period
Trade receivables collection period	$\frac{\text{Trade receivables} \times 365}{\text{Revenue}}$	Assess ability to turn receivables into cash
Trade payables payment period	$\frac{\text{Trade payables} \times 365}{\text{Credit purchases}}$	Assess ability to pay suppliers

Context example: Analytical procedures

A distribution and warehousing company is seeking to increase its overdraft and the bank has requested to review its audited financial statements. The company's contracts cover periods of between three and five years. Invoicing takes place after the service has been provided and terms of trade require payment in 30 days. Revaluation of land and buildings has occurred during the financial year. The company owns its own vehicles and trailers.

The following information has been extracted from the financial statements for years ended 31 May:

Extracts from the statement of profit or loss

	Draft 20X8 CU'000	Actual 20X7 CU'000
Revenue	25,417	23,867
Cost of sales	(21,895)	(20,924)
Gross profit	3,522	2,943
Administrative expenses	(2,205)	(2,011)
	1,317	932
Loss on sale of vehicles and trailers	(232)	–
Profit from operations	1,085	932
Finance cost	(345)	(302)
Profit before tax	740	**630**

Extracts from the statement of financial position	CU'000	CU'000
Non-current assets		
Property, plant and equipment	7,987	6,528
Current assets		
Trade receivables	3,156	2,681
Non-current liabilities		
Borrowings – bank loan	3,000	2,500
Current liabilities		
Trade payables	1,553	1,922
Borrowings:		
Overdraft	499	454
Bank loan	500	250

From this information the auditor may wish to highlight the following factors, and to consider the audit risk that they pose:

- Revenue has increased by 6.5% which may be indicative of overstatement due to early recognition of income or cut off errors.
- There has been a significant increase in the gross margin from 12.3% to 13.8%. This may be indicative of inflated sales or unrecorded purchases.
- There is a significant loss in sales of vehicles which may be indicative of inappropriate asset lives and consequently overstatement of carrying amounts.
- The revaluation of land and buildings may have been undertaken in order to inflate the assets figure.
- There has been an increase in trade receivables days from 41 to 45 days. This is greater than the normal terms of trading of 30 days and may be indicative of overstatement. This may be due to inclusion of sales invoices relating to the next accounting period or unrecoverable debts.
- There has been a reduction in payables days from 33.5 to 25.9 days, which may be indicative of understatement. This may be due to a failure to record all supplier invoices relating to the period.

5 Going concern

Section overview

- The question of whether an entity is a viable going concern is an important consideration for the auditor at the planning stage of the audit.
- A number of indicators can alert the auditor to possible problems with the going concern assumption.
- In times of economic uncertainty, additional doubts over going concern may be highlighted.
- There are specific risks that need to be borne in mind at the planning stage of the audit.

ISA 570, *Going Concern* deals with the assumption of going concern as applied to the preparation of financial statements. The risks of the client not being a going concern will need to be considered and planned for at the planning stage.

Going concern is a very prominent area of the audit, in the wake of a string of high-profile corporate failures in recent years. As a result of this, ISA 570 was revised in 2019, imposing more onerous requirements on auditors in this area.

Management is responsible for preparing the financial statements on the going concern basis of accounting, in line with the requirements of IFRS. Management must therefore have assessed whether the going concern assumption is valid. The responsibility of the auditor is then to obtain evidence regarding (ISA 570: para. 6):

- whether a material uncertainty related to going concern exists; and
- the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

The auditor must therefore perform procedures to obtain evidence in relation to management's assessment of going concern. This will firstly involve performing risk assessment procedures, to obtain an understanding of the entity and its environment, the financial reporting framework and its system of internal control including how it identifies and addresses business risks which have a bearing on going concern (ISA 570: para. 10).

The auditor is specifically required to consider whether there is a risk of **management bias**, in relation to the preparation of the financial statements in general and in relation to going concern in particular. Management bias is defined as "a lack of neutrality by management in the preparation of information", and may be indicated by eg, management choosing assumptions that give a favourable outcome.

A list of possible symptoms of going concern problems is given in ISA 570: para. A3. The auditor should consider these indicators when evaluating management's assessment of going concern. The list is reproduced here.

- **Financial indications**
  - 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 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 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 indications**
  - Management intentions to liquidate the entity or to cease operations
  - Loss of key management without replacement
  - Loss of a major market, key customer(s), franchise, license, or principal supplier(s)
  - Labour difficulties
  - Shortages of important supplies
  - Emergence of a highly successful competitor
- **Other indications**
  - Non-compliance with capital or other statutory requirements
  - Pending legal proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy
  - Changes in law or regulation or government policy expected to adversely affect the entity
  - Uninsured or underinsured catastrophes when they occur
  - Substantial decreases in share price

ISA 570 also says that the auditors have to discuss the going concern issue with the client's management, with an emphasis on the following:

- To test the assumptions they have made to ensure they are justified
- To obtain written representations from management about the things they are intending to do in the future to ensure that the going concern basis is appropriate
- To review that disclosures made in the financial statements relating to going concern are sufficient to give a true and fair view

If, in making their assessment, the directors have used a period of less than a year from the date of approval of the financial statements the auditor shall ask management to extend its assessment. If management refuse, the matter shall be discussed with those charged with governance. If the assessment is still not extended, this represents an inability to obtain sufficient, appropriate audit evidence and the auditors must consider the implications for the auditor's report.

In the present circumstances of economic uncertainty, the availability of credit and the costs of borrowing may be factors that the auditor identifies as specific events or conditions that raise doubts over going concern. If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall perform additional audit procedures that may include the following:

- analysing and discussing cash flow, profit and other relevant forecasts with management
- analysing and discussing the entity's latest available interim financial statements and management accounts with management
- reading the terms of debentures and loan agreements and determining whether any have been breached
- reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financial difficulties
- reading minutes of meetings of management, and, where applicable, those charged with governance and correspondence between the entity and providers of finance
- inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications

Audit procedures to evaluate management's assessment may include the following.

- confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds
- evaluating the entity's plans to deal with unfilled customer orders
- performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern
- confirming the existence, terms and adequacy of borrowing facilities
- obtaining and reviewing reports of regulatory actions
- determining the adequacy of support for any planned disposals of assets

6 Risk factors

Section overview

- A number of potential risk factors need to be considered at the planning stage of the audit:
  - management manipulation of the accounting records
  - inappropriate or unauthorised journal entries
  - incorrect revenue recognition
- Audit data analytics (ADA) can be a useful tool for identifying risks at the planning stage.

We shall now consider some of the specific risk factors that auditors need to be aware of during the planning stage of the audit.

6.1 Management override

ISA (240) uses this term to refer to the unique ability of management to manipulate the accounting records and therefore produce misleading financial statements. Reasons for management override are many and varied, for example financial gain, tax avoidance, or the enhancement of personal or business performance. The risk of management override is present in every audit assignment.

Auditors need to assess the risk of management override during the planning stage of the audit, and to design appropriate audit procedures in response. Those procedures should include the following:

- testing journal entries to ensure they are appropriate
- review of accounting estimates to judge whether management bias has been applied
- scrutinising significant and unusual transactions

6.2 Journals

Fraudulent activities can be perpetrated by inappropriate or unauthorised journal entries, especially in organisations where internal controls are poor. When selecting journal entries for testing, auditors should include the following:

- entries made to unrelated, unusual or seldom-used accounts
- journals put through by individuals who do not normally make journal entries
- journals recorded at the end of the period or after closure, with little or no explanation or description
- journals made without account numbers
- round number entries

Auditors may also wish to look at journals made outside normal office hours and postings to and from suspense accounts.

6.3 Revenue recognition

Auditors should be aware of the risks of material misstatement due to incorrect revenue recognition.The risk of this is greater in organisations where management reward is linked to revenue or profit. Revenue may be misstated by, for example, premature recognition or recording fictitious revenue.

Audit procedures in response to the risks relating to revenue recognition may include the following:

- analytical procedures including revenue streams and month by month comparisons
- customer confirmation
- review sales near the end of the accounting period and any unusual terms and conditions
- observe goods being despatched
- sales and revenue cut-off procedures
- tests of controls over electronic revenue transactions

6.4 Audit data analytics (ADA)

With the growth of big data (see Chapter 3) there is scope for auditors to exploit new sources of data when planning audit engagements. Such data sources include the following:

- the internet for actual transactions and sites visited
- cloud computing
- social media

- mobile technology and location tracking
- open data from the public sector

The development of new audit techniques and processes are predicted to have a significant impacton how audits are carried out in future. At the planning stage, ADA methods can be used to identify patterns, correlations and deviations from expected outcomes. This information can be used to enhance the auditor's knowledge about the client and the risks that are specific to the client's environment and activities.

6.5 Cloud computing

Definition

Cloud computing: A model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (eg, networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction.

(US Department of Commerce, National Institute of Standards and Technology)

Recent years have seen increased adoption of cloud computing services. This is because cloud computing offers greater flexibility for users, but also significant cost savings in comparison with traditional on-site IT storage facilities. Cloud computing offers organisations the ability to access their data quickly from any location in the world, which can be extremely valuable for some entities.

Cloud computing does bring risks as well as advantages. The key risk is that the entity relinquishes control of its data, handing it over to the entity providing the cloud-based service. Data may be in danger of being lost, corrupted or stolen. These risks are not absent from internal, on-site data storage, but where data is held on-site the entity itself at least has the opportunity to put in place sufficient cyber security measures to keep the data secure. Where cloud computing services are used, the security of the data is entirely dependent on controls at another entity (the service provider); it is therefore crucial that proper consideration is given to whether the service provider's controls are reliable.

6.6 Cyber security

Definition

Cyber security: The protection of systems, networks and data in cyberspace.

This definition can be extended to include the protection of data from unauthorised modification, disclosure or destruction, and the protection of the information system from the degradation or non-availability of services – in other words, system failure.

The widespread use of IT/IS throughout the world presents organisations with the increasingly complex challenge of keeping the systems and data they hold safe from a range of constantly evolving risks. This has made cyber security a major issue for most organisations. Cyber security is directed towards protecting IT systems from risks which predominantly feature some degree of human involvement.

Although by no means definitive, the list below details some of the most significant cyber risks an organisation's IT systems might encounter:

- **Human threats**: Hackers may be able to get into the organisation's internal network, either to steal data or to damage the system. Political terrorism is a major risk in the era of cyber-terrorism.

- **Fraud**: The theft of funds by dishonest use of a computer system.
- **Deliberate sabotage**: For example, commercial espionage, malicious damage or industrial action.
- **Viruses and other corruptions**: Can spread through the network to all of the organisation'scomputers.
- **Malware**: This term is used for hostile or intrusive software such as worms, Trojan horses, spyware and other malicious programs.
- **Denial of Service (DoS) attack**: A denial of service attack is characterised by an attempt by attackers to prevent legitimate users of a service from using that service.

In recent years, there has been an alarming rise in the number of so called 'cyber attacks' carried out by hackers and saboteurs, intent on causing maximum disruption to organisational IT systems.

The growth of big data and its use in the business environment poses new risks for businesses and for auditors. Some recent high-profile incidents of security breaches have highlighted the reputational risk that organisations face when data is hacked. In addition, the failure to protect personal data can result in fines for breaching data protection legislation.

The ICAEW publication *Audit insights: cyber security* (2014) identified four areas for businesses to consider to mitigate the risk:

- consider 'cyber' implications in all business activities, not simply as an IT issue
- accept the fact that security will be compromised and act accordingly
- focus on critical information assets and key data
- get the basics right

On the final point, it is estimated that up to 80% of security breaches could be prevented by having basic protection measures, such as malware, in place. There is also evidence of complacency, where businesses believe that they have adequate security in place and therefore no more needs to be done.

6.6.1 Challenges and recommendations

In this section consideration is given to those challenges – identified by the ICAEW's 2014 report –that organisations face when trying to understand cyber risks, as well as to how organisations can combat these challenges:

- **Communication is a key barrier to common understanding and discussion.** The language of cyber security is often highly technical and difficult for the layperson to fully understand. As a result it is becoming increasingly important for organisations to install a chief information security officer (CISO) to translate such language into a form which is accessible for employees to understand. Organisations need to work with security professionals to build better communication about the articulation and management of cyber risks, and the value of associated security spending.
- **Organisational structures need to define responsibility and accountability for cyber security.** Particularly in larger organisations, in recent years there has been a growth in the number of entities operating information security functions. The challenge for these departments is finding individuals with the specialist skills and expertise to help the organisation protect itself against cyber-attacks.
- **Board-level accountability for cyber risks needs to be determined**, but at present in many organisations it is unclear who is ultimately responsible for managing cyber risks. Accountability for such activity could be assigned to a number of roles including the CEO, chief risk officer, chief information officer and even the HR director. Equally important is the need to ensure that clear lines of responsibility for cyber security are embedded in day-to-day operations throughout the organisation. Furthermore, the board need to regularly

consider the organisation's risk tolerance and risk appetite in relation to cyber security and reflect this in risk management strategies.

- **Non-executive directors and audit committees also need to play a part** in tackling cyber security,by ensuring that the executive management put in place adequate provisions to safeguard the organisation. For non-executive directors to be effective they need to have sufficient knowledge and confidence to hold the board to account in a meaningful way.

It is, however, important to note that the points outlined above in ICAEW's report do present some challenges for small and medium sized enterprises. Creating new positions such as the chief information security officer role and introducing dedicated information security teams is very often unviable for smaller entities. Due to their size, and simpler business models, the associated costs involved in pursuing best practice in the field of cyber security often mean that smaller organisations lag behind their larger counterparts. Smaller organisations are unlikely to have dedicated IT departments or in-house experts monitoring their exposure to cyber risk. It is common for such organisations to rely on external third parties such as outsource firms providing IT services to put in place measures to address the threats posed by cyber risk. As a result it is likely that to some degreea 'cyber gap' will remain.

6.6.2 IT security controls

Security can be subdivided into a number of aspects.

- **Prevention:** Practical measures such as the use of passwords and securing IT assets by keeping doors leading to servers locked when not in use may help to prevent unauthorised access. In practice it is impossible to prevent all threats cost-effectively.
- **Detection:** Detection techniques are often combined with prevention techniques: a log can be maintained of unauthorised attempts to gain access to a computer system.
- **Deterrence**: As an example, computer misuse by personnel can be made grounds for dismissal.
- **Recovery procedures**: If the threat occurs, its consequences can be contained.
- **Correction procedures**: These ensure the vulnerability is dealt with (for example, by instituting stricter controls).
- **Threat avoidance**: This might mean changing the design of the system.

6.6.3 Combating IT risks and IT security

There are a number of practical measures that organisations can take in combating IT risks.

- **Business continuity planning:** This means that there should be measures to ensure that if major failures or disasters occur, the business will not be completely unable to function.
- **Systems access control**: This includes protection of information, information systems, networked services, detection of unauthorised activities and security when using the systems.
- **Systems development and maintenance**: This includes security measures and steps to protect data in operational and application systems and also ensuring that IT projects and support are conducted securely.
- **Physical and environmental security**: Measures should be taken to prevent unauthorised access, damage and interference to business premises, assets, information and information facilities and prevention of theft.
- **Compliance** with any relevant legal requirements and also with organisational policies in standards. There is no point in having them if they are not enforced.
- **Personnel security**: This covers issues such as recruitment of trustworthy employees, and also reporting of security-related incidents. Training is particularly important, with the aim that users are aware of information security threats and concerns and are equipped to comply with the organisation's security policy.

- **Security organisation:** It should be clear who has responsibility for the various aspects of information security. Additional considerations will apply if facilities and assets are accessed by third parties or responsibility for information processing has been outsourced.
- **Computer and network management:** This includes ensuring continuity of operations and minimising the risk of systems failures, also protecting the integrity of systems and safeguarding information, particularly when exchanged between organisations. Particularly important is protection from viruses.
- **Asset classification and control:** Information is an asset, just like a machine, building or a vehicle, and security will be improved if information assets have an 'owner', and are classified according to how much protection they need.
- **Security policy:** A written document setting out the organisation's approach to information security should be available to all staff.

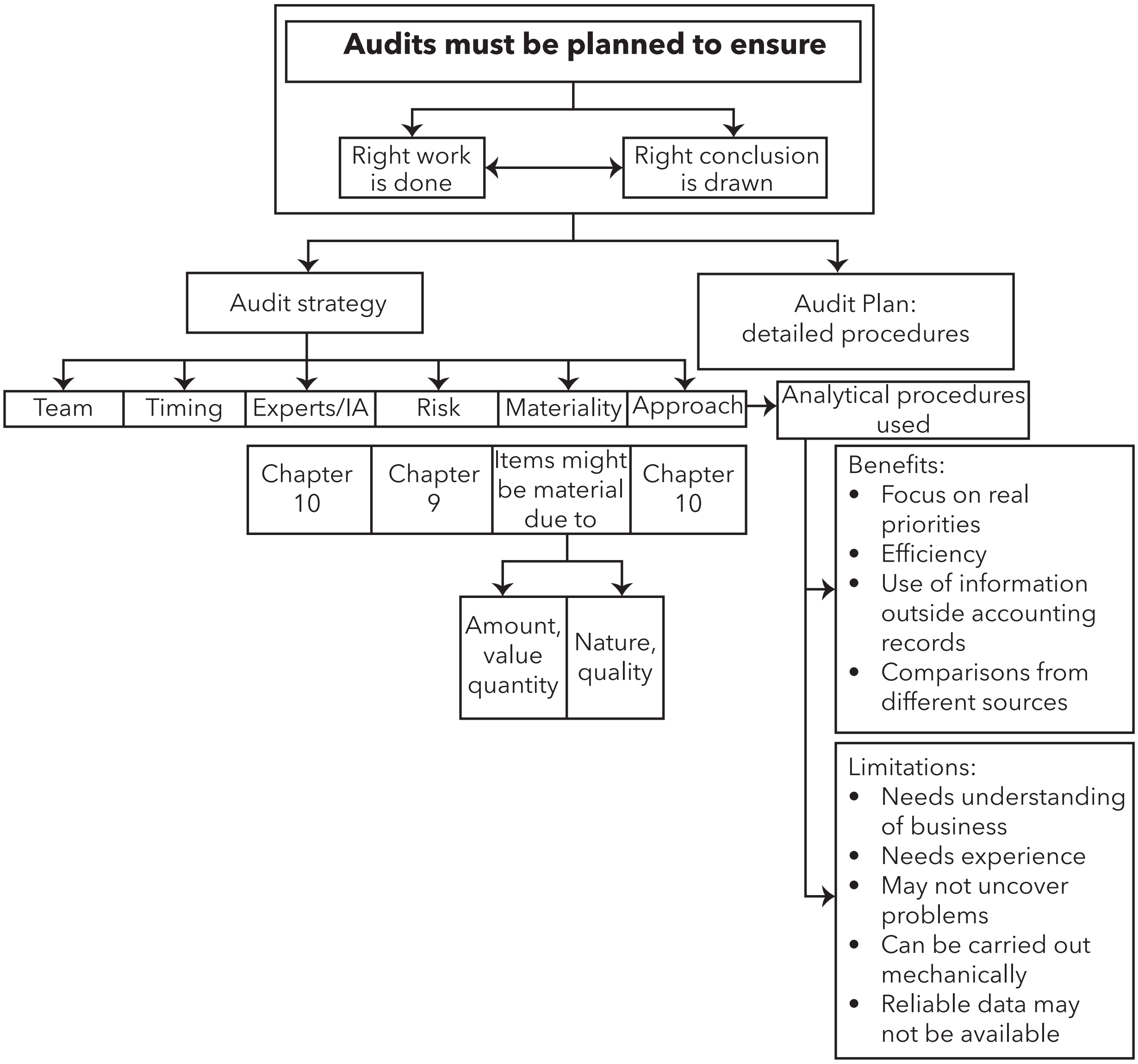
Context example: Cyber security

One of your audit clients, Derby Ltd (Derby) has outsourced its payroll function. The service organisation that processes the payroll provides Derby with monthly payroll information for its employees. Using this information Derby pays wages and salaries directly into its employees' bank accounts, and pays the relevant payroll taxes to the tax authorities.

The business risks arising from the outsourcing of Derby's payroll function, and the implications for the financial statements, are as follows:

- Loss, theft or misuse of personal data
- Reputational damage
- Fines for late submissions to the tax authorities
- Fines for breach of data protection legislation
- Risk of material misstatements in the financial statements due to unrecognised provisions, failure to disclose contingent liabilities or going concern issues, and inappropriate basis of preparation

Summary


Audits must be planned to ensure
Right work is done
Right conclusion is drawn
Audit strategy
Audit Plan: detailed procedures
Team
Timing
Experts/IA
Risk
Materiality
Approach
Analytical procedures used
Chapter 10
Chapter 9
Items might be material due to
Chapter 10
Amount, value quantity
Nature, quality
Benefits:
• Focus on real priorities
• Efficiency
• Use of information outside accounting records
• Comparisons from different sources
Limitations:
• Needs understanding of business
• Needs experience
• May not uncover problems
• Can be carried out mechanically
• Reliable data may not be available

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you identify the four key reasons for planning the audit? (Topic 1)	
(2) Can you explain the difference between the audit strategy and the audit plan? (Topic 2)	
(3) Can you explain the difference between materiality and performance materiality? (Topic 3)	
(4) What are the thresholds for materiality? (Topic 3)	
(5) Can you explain the key limitations of analytical procedures? (Topic 4)	
(6) Can you explain the auditor's responsibilities relating to going concern? (Topic 5)	
(7) Can you explain the most significant risks to cyber security that an organisation might encounter? (Topic 6)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	**Learning benefit from attempting this question**	**Yes/No**
Q7	The question covers an examinable topic.	
Q8	This substantial question is broadly representative of the way in which this topic could be examined, and provides a good test of your work on this chapter.	
Q9	This substantial question is broadly representative of the way in which this topic could be examined, and provides a good test of your work on this chapter.	

Once you have attempted these questions, you can continue your studies by moving onto the next chapter, Understanding the entity and its environment.

Technical reference

1 The need to plan

ISA 300.2

2 Overall audit strategy and audit plan

ISA 300.7–9

3 Materiality

- Concept of materiality – ISA 320.2
- When materiality is relevant – ISA 320.5

4 Analytical procedures

ISA 315.14(b)

5 Going concern

ISA 570

6 Risk factors

ISA 240

ICAEW *Audit insights: cyber security* (2014)

Self-test questions

Answer the following questions.

1 Analytical procedures should be carried out by an audit junior.

A True

B False

2 State why audits are planned.

(You attempted one part of this question (for 8 marks) in Chapter 5.)

3 Why should care be taken if using a standardised audit pack?

4 Give an example of an item being material by its nature.

5 The gross profit percentage in your client's draft financial statements is the same as in the previous year.

Requirement

What further information would you require in order to use this fact at the planning stage of the audit?

Total: 1 marks

6 Jay plc (Jay), Finch plc (Finch), Sparrow Ltd (Sparrow)

Described below are situations which have arisen in three audit clients of your firm. The year end in each case is 31 March 20X6.

Jay plc (Jay)

The directors have included the following note to the financial statements for the year ended 31 March 20X6:

"Although the company has incurred significant trading losses and cash outflows during the last two years, the directors believe that the effects of internal restructuring and corporate disposals undertaken will bring about improved results as indicated in the detailed profit and cash flow forecasts for the period to the end of March 20X7. These forecasts indicate that the company will be able to trade within its agreed working capital facility for at least the next 12 months from the date of this report. Considerable progress has been made on the financial restructuring of the company.

On the basis of the above factors the directors consider it is appropriate that the financial statements are prepared on the going concern basis. Should the company fail to meet its forecasts, the going concern basis may prove to be inappropriate. In such circumstances adjustments are likely to have to be made to the net assets shown in these financial statements to reduce assets to their recoverable amounts, to reclassify non-current assets and payables due after more than one year to current assets and current liabilities and to provide for further liabilities that may arise."

Finch plc (Finch)

Finch has included the results of Wren Ltd ('Wren'), a subsidiary, in the consolidated financial statements. Wren is audited by a different firm of auditors who have modified their opinion on Wren's financial statements for the year ended 31 March 20X6 because a fire at the company's premises destroyed the physical inventory count sheets which were the only record of the year-end inventory. Wren has included inventory at its estimated cost of CU500,000 in the financial statements for the year ended 31 March 20X6.

The consolidated pre-tax profit of Finch is CU33.4 million and the pre-tax profit of Wren is CU1.2 million for the year ended 31 March 20X6.

Sparrow Ltd (Sparrow)

On 30 April 20X6, the board of directors decided to undertake a restructuring programme which would commence in June 20X6. A provision of CU1.8 million in respect of the restructuring costs has been included in the financial statements for the year ended 31 March 20X6.

The pre-tax profit of Sparrow for the year ended 31 March 20X6 is CU7.2 million.

Requirements

6.1 Discuss what is meant by the concepts of materiality and a true and fair view.

(6 marks)

6.2 Explain why there can be difficulties for auditors regarding materiality and true and fair in relation to the three cases above: Jay, Finch and Sparrow.

(6 marks)
Total: 12 marks

7 Jog Ltd

Your firm has recently been appointed as auditor of Jog Ltd ('Jog'), a company operating within the sports and leisure sector. Your audit manager has arranged a meeting with the company's finance director for early next week and she has asked you to assist her, in advance of this meeting, with the audit planning for the year ending 30 June 20X6. Your audit manager has also asked you to carry outsome preliminary analytical procedures on the year-end financial statements of Jog when these become available.

Jog's business can be split into the following three divisions:

- Sports equipment retail outlets: 35 sports equipment retail outlets located in 'out of town' retail parks
- Fitness clubs: 15 fitness clubs, each offering a fully equipped gym together with yoga, aerobics, and circuit training classes
- Machine manufacture: a manufacturing unit in which running machines and rowing machines are assembled using components sourced from overseas.

Further information:

Sports equipment retail outlets

The retail outlets are all located close to major towns and cities throughout the whole of the Bangladesh. Each outlet stocks a standard range of products which are supplied from a central warehouse operated by Jog. Salaries for the core staff at the outlets are paid by Jog's head office by direct bank transfer.
Each outlet is run on a day-to-day basis by a manager who is responsible for hiring casual staff to cover peak periods. These casual staff members are generally paid using cash from the till.

Jog received some bad publicity during the year following its inclusion in a television documentary which revealed that one of its non-BD sports shoe suppliers was making its employees work long hours for very low wages. In an attempt to manage this adverse press attention, Jog has now had to source these products from alternative suppliers based in Bangladesh.

Fitness clubs

Jog's 15 fitness clubs are all located directly above existing Jog retail outlets. Each club has its own on-site manager and is operated independently of the adjacent retail outlet. Customers of the fitness clubs pay by one of three methods: on a 'pay per session' basis over the fitness club counter; by monthly direct debit paid into Jog's head office bank account; or by annual subscription to head office. Customers are then issued with a membership card which enables them to gain access to the club.

The company operates a bonus incentive scheme for the managers at both its retail outlets and fitness clubs. The size of the bonus is linked to the profitability of their individual operation.

Machine manufacture

During the year Jog started to manufacture its own running machines and rowing machines. It sources the machine components from China. These components are assembled in Bangladesh at Jog's factory for sale both in Jog's own stores under their own 'Jog' brand and also to independent sports shops under the 'Iron Champ' brand. The latter accounts for approximately 80% of Jog's total production of both running and rowing machines. Sales to independent sports shops achieve a gross profit margin of 50%, whereas sales to Jog's own shops are made to that division at cost plus 10%.

Jog is invoiced by its non-BD component suppliers in their respective local currency. The components are sent by sea, which means that Jog's typical lead time for components from the placing of an order to delivery in Bangladesh is three months. Jog is required to pay its suppliers 50% with order and 50% upon receipt of the components in Bangladesh.

Quality management

In line with your firm's system of quality management, procedures were conducted prior to accepting Jog as an audit client, to ensure that it was appropriate to accept such an appointment. Your audit manager has asked you to consider the other objectives of a system of quality management and why they may be particularly relevant to Jog.

Requirements

Answer the following questions:

7.1

(1) List, with reasons, the information you would require in order to carry out analytical procedures on the draft financial statements of Jog for the year ending 30 June 20X6.

(2) Set out the limitations of using analytical procedures at the planning stage of an audit.

(8 marks)

7.2 Identify which of the circumstances outlined above, should be taken into account when planning the audit of Jog. Explain clearly why these matters are important and set out their effect on your proposed audit work.

(24 marks)

Total: 32 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Purpose of planning:

- To enable the audit to be performed in an effective and timely manner
- To ensure that:
  - appropriate attention is directed to important areas of the audit
  - potential problems are identified
  - work is completed expeditiously
- Assists in:
  - proper assignment of work to the team
  - coordination of work done by others
- Facilitates review

Answer to Interactive question 2

Benefits:

- Identifies items for attention that detailed tests may miss
- Uses information outside accounting records, for example, budgets
- Allows comparison of data from different sources

Limitations:

- A good knowledge of the business is required to understand results
- Consistency of results may conceal a material error
- There may be a tendency to carry out procedures mechanically, without appropriate professional scepticism
- Requires an experienced member of staff to be done properly
- Reliable data may not be available

Answers to Self-test questions

1 Correct answer(s):

B False

Experience and understanding are required to carry out analytical procedures properly.

2 To ensure that the right work is carried out resulting in the right conclusion being drawn.

3 It is important for the audit plan to be tailored to the client.

4 Examples include:

- Related party transactions
- Directors' transactions
- CU1 that makes a company small/medium/large
- CU1 that turns a profit into a loss

5 Further information required:

- Client's expectation of GP%
- Changes in year that affect GP%

6 Jay plc (Jay), Finch plc (Finch), Sparrow Ltd (Sparrow)

6.1 Materiality

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

Materiality:

(1) is not capable of mathematical definition

(2) can be quantitative (size) or qualitative (nature)

(3) may be considered in the context of any individual primary statement within the financial statements or of the individual items included within them

(4) depends on the size of the item or error judged in the particular circumstances of its omission or misstatement

True and fair

True is generally accepted as meaning in accordance with the facts and fair as meaning objective or unbiased and concerned with the presentational aspects of information including substance over form.
Furthermore, there may be more than one true and fair view for a given set of circumstances.

The concepts of materiality and true and fair require the exercise of professional judgement.

6.2 Jay

Materiality/true and fair

The difference between the figures prepared on each basis may not be significantly different.However, the effect on the business is so significant that the user needs to be made aware ofthe situation. The auditor needs to judge whether the disclosures are sufficient for the user to understand the circumstances.

Finch

Materiality/true and fair

Although material to Wren as 42% of pre-tax profits, it is unlikely to be considered material in the context of the consolidated pre-tax profit as it is only 1.5% of consolidated pre-tax profit.

Materiality should be considered in the context of the entity on which the auditor is reporting.However, it may be material by nature if a key ratio (eg, current ratio) is affected.

Sparrow Materiality/true and fair

There is no obligation at the reporting date in respect of restructuring costs. The financial statements therefore do not comply with IFRS, *Provisions and Contingencies* as they include a provision in respect of restructuring costs. The amount of the provision for restructuring costs is considered material by size as it is 25% of pre tax profit, thereby exceeding the commonly used yardstick of 5%–10% of pre tax profit.

7 Jog Ltd

7.1 Information required:

Individual statements of comprehensive income and split of the statement of financial position for each division are required. Each division has different profit margins and the split of the statement of financial position figures will enable the calculation of inventory and trade receivable days for each division.

Budget information for each division is required, together with the date from which the machine division commenced trading, so that its figures can be adjusted to take account of a trading period of less than one year. Comparative information by division from Jog's previous financial statements will also be needed. This information will allow actual and budget performance to be compared. This could identify material or significant items, potential misstatements or variations from expected results.

If available, financial information from companies in the same industries could be used to identify where the company has performed well or badly and prompt areas for further enquiry by the auditor.

Limitation:

One limitation of analytical procedures at the planning stage of an audit is that the auditor needs a good understanding of the business to interpret the results of analytical procedures. If analytical procedures are performed mechanically, a consistency of results from one year to the next may in fact conceal a material error which may not be identified. Effective analytical procedures need to be carried out by experienced members of staff and they rely upon good quality and reliable information being available from the client which may not always be available.

7.2 This is a new audit client which means that there is a lack of cumulative prior knowledge which in turn increases the risk of an undetected misstatement in the financial statements. The audit work will include an evaluation of the company's accounting systems and internal controls in addition to consideration of opening balances. Adequate planning will be essential to avoid over-auditing in the first year.

The company operates from 35 locations at which it holds material balances of inventory and non-current assets. The risk of a breakdown in head office controls is higher in multi-site locations. The year-end attendance at inventory counts should cover all material locations and it would be efficient to take the inventory count attendance as an opportunity to inspect material non-current assets and carry out selected cash counts. If the audit approach relies upon controls, it must be ensured that the tests of controls sample covers all material locations.

The company makes cash sales in its retail outlets and fitness clubs and it pays its casual staff in cash. Cash transactions increase the risk of misappropriation of cash and the understatement of revenue in the financial statements. The employment of casual staff may also mean that the company is failing to declare the appropriate amounts of TAX, which could lead to penalties from the tax authorities. The effect of this on the audit work is that controls over cash must be evaluated and audit effort should be directed to confirming the completeness of recorded sales. In addition, the company's compliance with TAX regulations should be considered and the wages included in the financial statements should be checked to ensure that this agrees with the company's payroll records.

The company has received adverse publicity over the use of 'sweatshops'. This may damage the reputation of the company which could in turn affect the status of Jog as a going concern.

The audit work should attempt to assess the effect of the publicity on Jog's business. The cost implications of the switch by Jog to alternative suppliers in Bangladesh also need to be considered as part of the audit work.

Jog fitness clubs receive annual subscriptions which may cause revenue to be recognised in the wrong accounting year. The company's accounting policy for revenue recognition will need to be considered and audit work should include testing of new subscriptions close to the year end to ensure that an appropriate proportion of income is deferred at the year end.

The company has a profit-related bonus scheme increasing the risk of manipulation of profit by the company's management. Audit work should include checks on income recognition to ensure it has not been accelerated to boost profits. For similar reasons purchase cut-off should be checked to identify any potential suppressed invoices.

The company purchases its machine components in a foreign currency, under payment terms which specify 50% be paid with order. Foreign currency transactions may lead to the incorrect translation of these transactions in the financial statements. The existence of a three-month delivery lead time on these transactions may also give rise to adverse foreign currency exposure. Component payment terms may also lead to cut-off errors arising from incorrect treatment of the first 50% paid with order. The audit work should include sample checks of the company's foreign exchange translation to an independent source such as the FT. The steps taken to minimise the company's exposure to foreign exchange risk needs to be discussed with management. Careful consideration should be given to cut-off for any goods in transit at the year end.

Some of the machines manufactured using imported components are transferred to the company's retail outlets at cost plus 10%. This inter-divisional trading means the value of the retail outlet inventory may contain some unrealised profit. In addition, the practice of adding only 10% onto the cost price, may cause outlets to under-price these products, damaging the gross profit margin of the company as a whole. The audit approach should ensure all inter- divisional trading is separately analysed so that any unrealised profit can be identified.

Chapter 8

Understanding the entity and its environment

Introduction

Learning outcomes

Syllabus links

Examination context

Chapter study guidance

Learning topics

1 Why?

2 How?

3 What?

Summary

Further question practice

Technical reference

Self-test questions

Answers to Interactive questions

Answers to Self-test questions

Introduction

Learning outcomes

Planning and performing engagements

Students will be able to plan and perform assurance engagements in accordance with the terms of the engagements and appropriate standards.

- Explain, in the context of a given scenario, why it is important to have an understanding of the business when planning an engagement
- Identify ways of gaining an understanding of a client's business
- Recognise the circumstances under which it may be necessary to bring in expertise (including expertise in technology) from other parties to support assurance processes
- Identify the risks arising from error, fraud and non-compliance with law and other regulations, , and assess their implications for the engagement

Syllabus links

We introduced this topic in Assurance, where you learnt the basic content of ISA 315, *Identifying and Assessing the Risks of Material Misstatement*. In this syllabus you need to consolidate and build on this knowledge.

Examination context

Understanding the entity is a key component of risk assessment. Risk assessment is the subject of Chapter 9, which is a big exam topic.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	It is vital that assurance providers have a good understanding of the entity they are providing assurance to and the environment in which it operates, or their work could be meaningless. For example, if they misunderstand the nature of the	Chapter 8 is another revision chapter. Read section 1 carefully though so that you really understand the importance of understanding the entity.	Understanding the entity is a key component of risk assessment. Risk assessment is the subject of Chapter 9, which is a big exam topic.	

Topic	Practical significance	Study approach	Exam approach	Self-test questions
	business, they could miss key risks and items in the financial statements could be seriously misstated. In addition, if they do not understand their client's business, they will be incapable of carrying out an audit in accordance with auditing standards, which could lead to negligence claims. **Stop and think** Why is it so important to understand the entities in relation to which assurance is being given?			
2		Read through this section carefully and attempt the interactive question.	This topic could form part of a question in any part of the examination.	
3	ISA 315 provides a framework for the issues of which an auditor needs to gain an understanding.	Read through this section carefully and attempt the activity.	This topic could form part of a question in any part of the examination.	1, 2

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1 Why?

Section overview

- It is important to understand the client's business:
  - in order to assess risk
  - in order to comply with auditing standards

You know from your previous studies and from what has already been said in this Workbook that assessing risk is very important in assurance engagements.

In general terms, it is clearly impossible to be sure how risky a client may be if you do not understand:

- who they are
- what they do
- how they do it
- whether there are any special circumstances (like specific laws and regulations) which govern their business
- the integrity and competence of their staff

If you understand a client's business properly you will:

- be able to assess the skills and competence which the audit team needs
- be able to plan your audit work so that it is appropriate and efficient
- be able to assess what controls have been put in place by the client which may reduce the level of control risk
- be able to assess any significant risks which need special attention
- be able to perform analytical procedures
- comply with professional requirements

Also, assessing risk is compulsory – ISAs 315 and 330 require it.

Finally, consider fraud – understanding the entity may not guarantee that you will uncover a clever,well-laid fraud, but not understanding the entity certainly will guarantee that you have very little chance of finding it.

Auditors need to be particularly vigilant during a period of economic downturn and uncertainty, when company directors and accountants may be under pressure to present favourable results by artificially increasing revenues or profits. Whilst a variety of treatments may be permitted by legislation and accepted standards, aggressive earnings management, as this practice is known, is a form of fraud.

2 How?

Section overview

- Understanding of the client's business can be obtained from:
  - External sources of information (such as industry surveys/publications)
  - The firm (permanent files (including previous years' audited financial statements), correspondence files, personnel associated with the engagement in previous years)

- The client (personnel, correspondence/procedures manuals, watching procedures, current year management accounts)
- Auditors are required to carry out a combination of procedures to understand the business:
  - Inquiries of client personnel
  - Analytical procedures
  - Observation and inspection

It is important to understand where the information comes from.

2.1 External sources

There are reports auditors can look at:

- credit reference agencies
- industry surveys
- industry publications such as trade journals
- Companies House (RJSC) searches.

Remember, for an existing client, assurance staff have a better source of information much closer to home.

2.2 The firm

Remember, the firm should not have taken the client on in the first place if it does not have the competence to service it in line with ethical and professional standards. So, it follows that someone inthe firm must know something about the client and its environment. Usually the person who has most knowledge will either be the engagement partner or, for firms dealing with industries where specialist knowledge is required, the industry expert.

It is the firm's responsibility to ensure that audit staff are properly briefed, but it is also the responsibility of each member of the team to ensure they are properly briefed. Team members:

- read:
  - last year's file
  - the permanent file
  - the correspondence file
  - the tax file
- talk to:
  - the partner
  - the manager
  - the tax person
  - last year's senior
  - the firm's industry specialist

This may appear both obvious and a bit woolly, but it is specifically dealt with in ISA 315. As you know, there is a requirement for a discussion of the client's business as part of the planning process,and for that discussion to be documented.

You also need to consider your own knowledge and background.

- Have you worked on similar clients before?
- What do you know of the industry?
- How would you expect it to work?

2.3 The client

Then move out to the client:

- Talk to the people responsible for the area you are auditing – the people actually doing the work and their bosses
- Read internal correspondence and minutes of board/committee meetings – you have rights of access, subject to your professional duty of confidentiality
- Read internal audit reports (if there is an internal audit function)
- Observe what goes on around you, how transactions are recorded and how processes are operated
- Look at the website, brochures etc

To be professional, auditors must be wary of ignorance combined with pride. If something is difficult to understand – ask. If it is still difficult, it is possible that you should not be doing the audit, but it is also possible that there is a fraud going on.

You learnt about the specific requirements of ISA 315 in relation to obtaining the information in your Assurance studies. Remember, you are required to use a combination of the following procedures:

- Inquiry of management and others within the entity
- Analytical procedures
- Observation and inspection

2.4 Summary

The following figure provides a general summary of how an understanding of the entity can be achieved.

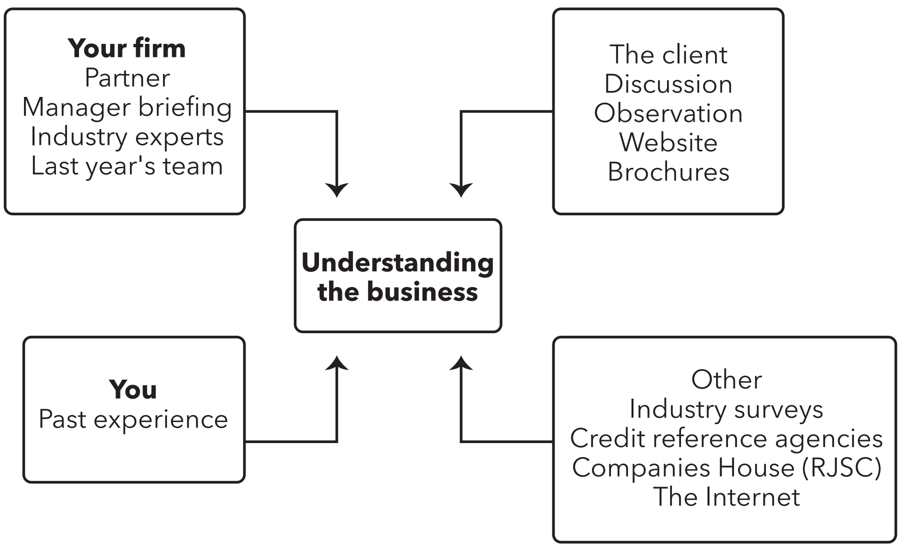


Figure 8.1: Sources of information

Professional skills focus: Assimilating and using information

Where the audit is a recurring audit, the audit team will need to confirm that their understanding of the entity from the previous year is still valid. They will then need to obtain an understanding of what has happened over the year, and of where the entity is at the time of the current year's audit.

Interactive question 1: Sources of information

From what sources of information can auditors obtain a knowledge of the entity they are about to audit and the industry in which that entity operates?

See Answer at the end of this chapter.

3 What?

Section overview

- The auditors need to understand any aspect of the business which might affect the audit.
- ISA 315 contains a list of potential areas to be understood.

3.1 The basics

If the following nine questions have been answered in sufficient depth, the audit file should contain sufficient evidence that the auditors have satisfied the requirements of ISA 315, *Identifying and Assessing the Risks of Material Misstatement.*

- What does the client do?
- What are the characteristics of the industry/environment in which it operates?
- Is it governed by specific laws and regulations, or is it at greater risk than other businesses from the incidence of more general laws and regulations?
- What are the characteristics of its relationships with external parties, shareholders, other stakeholders, trading partners and providers of finance?
- Is it under threat from takeover or lack of finance?
- Are there any dealings with related parties?
- How competent is its management?
- Are suitable systems and controls in place?
- What is the applicable financial reporting framework and what accounting policies has it adopted?

The figure below may help.

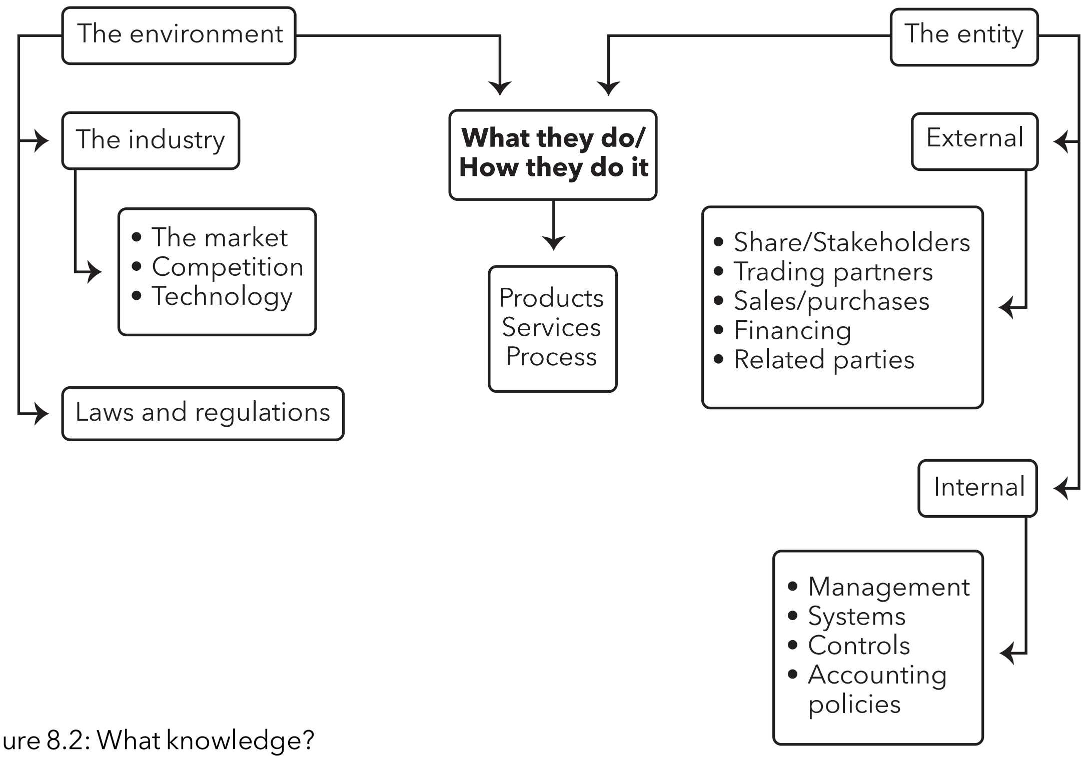


Figure 8.2: What knowledge?

3.2 Laws and regulations

To understand the client, auditors need to have a good understanding of any laws and regulations which have an impact on its operations.

Laws and regulations are considered to be of two types:

- those which affect the preparation of financial statements
- those which affect the way the client conducts its business

Clearly the auditor should know about relevant laws and regulations, such as the Companies Act 1994 and IFRS® Standards, which affect the way the financial statements are prepared. The auditor is not expected to be an expert in all the laws and regulations which affect the client, but it is not quite as simple as this, if a client fails to comply with the laws and regulations which govern its business:

- it will very soon go out of business; and
- this will have a material impact on its financial statements.

It follows, therefore, that if an audit firm has a client in the haulage industry, it cannot simply ignore what the law says about tachographs and vehicle maintenance. If a client runs a restaurant the auditors need to know something of the food hygiene enforcement regime operated by local authorities. Auditors need to consider the effect of data protection regulations on the audited entity.

How much knowledge an assurance provider should have and in what depth is another question of risk.

- If the likely impact of non-compliance is assessed as low, auditors will ask management for background information.
- If the likely impact is assessed as high, but management has good systems for controlling the risk,auditors will confirm that the systems appear to operate effectively.
- If the risk is high and management appears to do nothing about it…let us simply say it will have adirect impact on audit work.

List of indicators of non-compliance:

- Investigation by regulatory organisations or by a government department
- Payment of fines or penalties
- Payments for unspecified services or loans to consultants, related parties, employees or government employees
- Sales commissions or agents' fees that appear excessive in relation to those normally paid by the entity or in its industry or to the services actually received
- Purchasing at prices significantly above or below market price
- Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts
- Unusual transactions with companies registered in tax havens
- **Payments for goods or services made other than to the country from which** the goods or services originated
- Payments without proper exchange control documentation
- Existence of an information system that fails, whether by design or by accident, to provideadequate audit trail or sufficient evidence
- Unauthorised transactions or improperly recorded transactions
- Adverse media comment

C H A P T E R

8

3.3 Understanding the applicable financial reporting framework

ISA 315 requires the auditor to understand the entity's financial reporting framework, including (ISA 315: para. A82):

- accounting principles and industry-specific practices (eg, loans and investments for banks, or research and development for pharmaceuticals)
- revenue recognition
- accounting for financial instruments, including related credit losses foreign currency assets, liabilities and transactions
- accounting for unusual or complex transactions

The auditor should understand the entity's accounting policies, including any changes to them and including:

- The methods the entity uses to recognise, measure, present and disclose significant and unusual transactions
- The effect of significant accounting policies in controversial or emerging areas for which there is alack of authoritative guidance or consensus
- Changes in the environment (eg, accounting or tax changes) that may necessitate a change in accounting policies
- Financial reporting standards and laws and regulations that are new to the entity, and when and how the entity will adopt, or comply with, such requirements

An example here might be an entity which acquires a subsidiary for the first time – this will bring with it new accounting requirements and the need to understand how the entity has applied the financial reporting requirements in relation to this (ISA 315: para. A83).

3.4 Sustainability impact

The auditor may consider the implications of climate-related risks when obtaining an understanding of the entity and whether climate-related risks influence:

- the entity's business model (such as the entity's supply chain)
- industry factors (such as competitive environment, supplier and customer relationships, and technological developments)
- regulatory factors (such as climate-related laws and regulations)
- other external factors (such as the economic conditions, interest rates and availability of financing, commodity prices and inflation or currency revaluation)

The auditor is required to obtain an understanding of an entity's system of internal control which includes risk management and climate change may factor into understanding the entity's process for identifying climate-related business risks. Based on the risk assessment procedures, the auditor is required to identify and assess the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances and disclosures.

Climate-related risks may give rise to risks of material misstatement in respect of one or more relevant assertions, for example, accuracy, valuation and allocation, rights and obligations, and presentation for a class of transaction, account balance or disclosures.

The impact of commitments such as Net Zero or the UN Paris Agreement may impact on amounts or disclosures in the financial statements, for example, limiting useful life of assets, increasing the requirement for impairment, which increases the risk of misstatement.

3.5 Fraud

ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* stresses that auditors have no responsibility for the prevention and detection of fraud as such – that is management's job, but fraud can have a material impact on financial statements, so it becomes a part of audit after all!

Remember, the ISA makes a crucial distinction between two types of misstatements arising from fraud:

- Misstatements arising from fraudulent financial reporting
- Misstatements arising from misappropriation of assets

In understanding the client's business there are some key questions that need to be asked:

- Can the figures be manipulated and if so, how?
- Which areas are most susceptible to manipulation?
- Can assets be misappropriated and if so, how?
- Which areas are most at risk?

Professional skills focus: Applying judgement

The audit team is required to discuss the risks arising from fraud at the planning meeting.

3.6 Service organisations

Increasingly, companies are outsourcing processes and operations to third party organisations. Some examples of activities that may be outsourced are:

- information processing
- maintenance of accounting records
- facilities management

ISA 402, *Audit Considerations Relating to an Entity Using a Service Organisation* highlights the issues that must be considered if the auditor discovers during the planning phase of the audit that the client (the user) has outsourced, for example, its payroll accounting function. In broad terms the main requirements are to:

- obtain an understanding of the services provided by a service organisation, including internal control, specifically:
  - the nature of the services provided by the service organisation
  - the nature and materiality of the transactions processed
  - the degree of interaction between the activities of the service organisation and those of the company
  - the nature of the relationship between the user entity and the service organisation, including the relevant contractual terms
- consider access to sources of evidence
- assess the risks arising

The user auditor, in obtaining an understanding of the service organisation's internal controls, may obtain one of the following reports from the auditor of the service organisation:

- A report with the objective of conveying reasonable assurance that includes the service auditor's opinion on management's description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.
- A report as above that also provides the service auditor's opinion on the operating effectiveness of the controls, and a description of the service auditor's tests of the controls and the results thereof.

Interactive question 2: What matters?

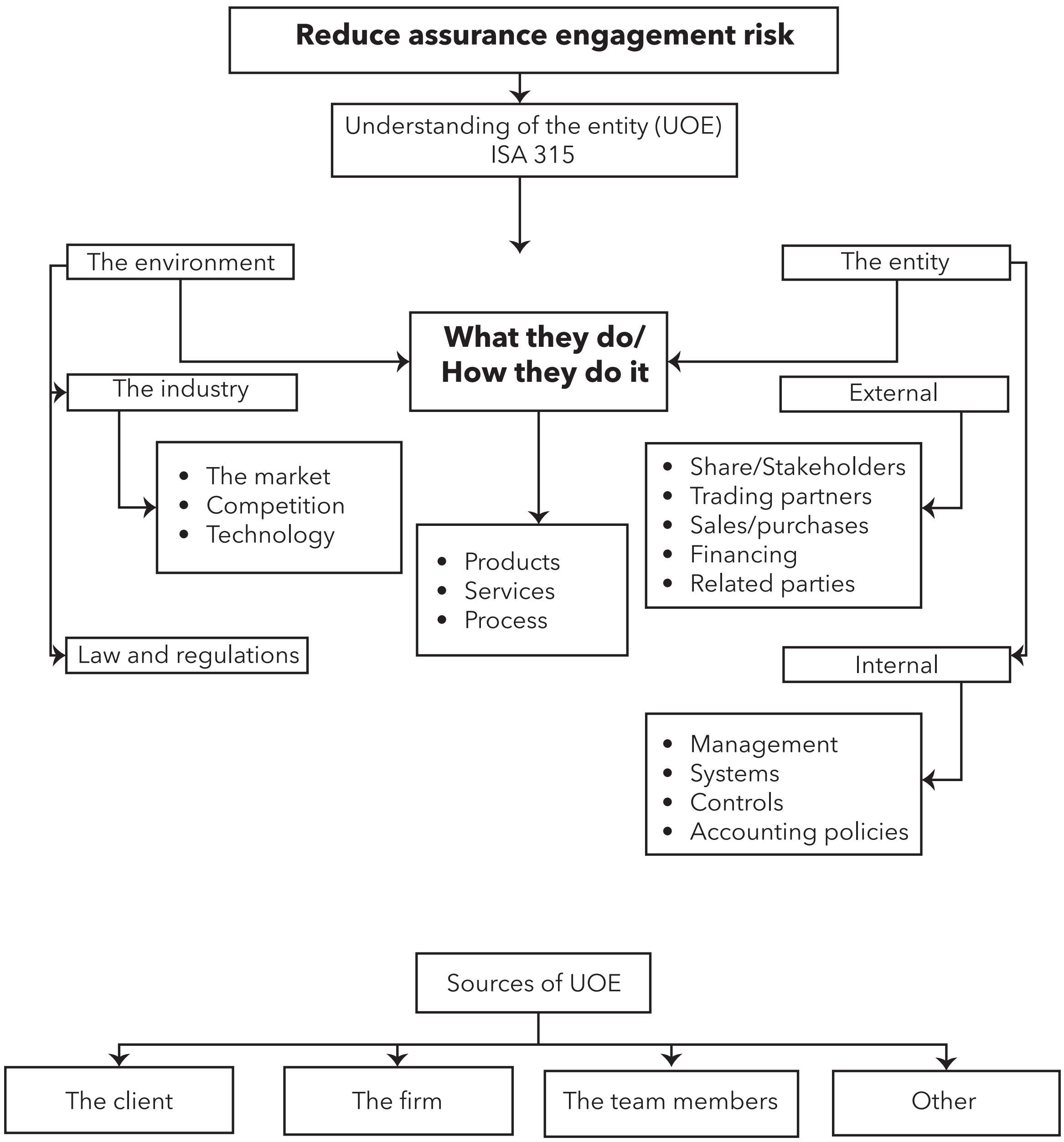
Auditors should use their knowledge of the business to assess the risks arising from fraud, error and non-compliance with laws and regulations.

Requirement

What matters should they consider in making this assessment?

See **Answer** at the end of this chapter.

Summary



Reduce assurance engagement risk
Understanding of the entity (UOE)
ISA 315
The environment
The industry
The market
Competition
Technology
Law and regulations
What they do/
How they do it
Products
Services
Process
The entity
External
Share/Stakeholders
Trading partners
Sales/purchases
Financing
Related parties
Internal
Management
Systems
Controls
Accounting policies
Sources of UOE
The client
The firm
The team members
Other

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you explain the main benefits of understanding the client's business? (Topic 1)	
(2) Can you explain the principal sources of information about a client's business? (Topic 2)	
(3) Can you identify the nine questions that should be answered in order to understand the entity? (Topic 3)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q1	This question should help you to learn the information in this chapter, which forms the basis of the more exam-standard questions in Chapter 9.	
Q2	This question should help you to learn the information in this chapter, which forms the basis of the more exam-standard questions in Chapter 9.	

Once you have attempted these questions, you can continue your studies by moving onto the next chapter, Risk assessment.

Technical reference

1 Why it is important to understand the client's business

ISA 315.A50–51

2 How to gain an understanding of the client's business

ISA 315

3 What aspects of the client's business should be understood

ISA 250.

ISA 315.19–20

ISA 402

Self-test questions

Answer the following questions.

1 Knowledge of client

What key knowledge should an audit firm obtain about its client and why is this understanding of the entity important?

Total: 3 marks

2 G Co

G Co is a manufacturing company which has one factory and two warehouse sites. It imports raw materials from Asia.

Requirement

What are the key factors the auditors need to consider about G Co and how this may affect their audit?

Total: 3 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Sources of information:

- Previous experience with entity and its industry
  - Last year's file/audit team
  - Permanent file
  - Tax file
  - Correspondence file
- Visits to entity's premises and plant facilities
- Discussion with people within entity
- Discussion with other auditors and with legal/other advisers who have provided services to the entity or within the industry (eg, industry specialists)
- Publications related to the industry legislation and regulations that significantly affect the entity,eg, industry surveys
- Industry publications such as trade journals
- Documents produced by the entity/entity website
- Companies House (RJSC) searches

Answer to Interactive question 2

Non-compliance

- Previous experience
- Incidents which call into question integrity or competence of management or other staff, eg:
  - Investigations
  - Payment of fines/penalties
- Unusual transactions/payments
- Payments for/of
  - Unspecified services/loans
  - Excessive commission
- Unauthorised/improperly recorded transactions
- Accounting system which fails to provide adequate audit trail/sufficient evidence
- Adverse media comment

Fraud/error (ISA 240 Appendix 3)

- Discrepancies in the accounting records, eg:
  - Incomplete recording of transactions
  - Significant last-minute adjustments
- Conflicting or missing evidence, eg:
  - Missing documents
  - Unexplained items on reconciliations
- Problematic or unusual relationships between the auditor and management, eg:
  - Denial of access to records or delays in producing information
  - Complaints about the conduct of the audit
- Other, eg:
  - Accounting policies at variance with industry norms
  - Frequent, unnecessary changes in accounting estimates

Answers to Self-test questions

1 Knowledge of client

Key knowledge to obtain:

- Nature of the business
- Key personnel and their integrity/competence
- Whether there are any laws or regulations which apply to the entity
- Whether there are any pressures on the directors which may lead them to show the company in a more favourable light than might otherwise be the case – for example:
  - directors' profit related bonuses
  - cash flow/financing concerns
  - stock market pressures
- Strength of internal control systems
- Existence of related parties and related party transactions
- Complex account transactions

Why important?

The above knowledge is important in order for the auditor to assess the level of risk associated with the client and the potential likelihood that an incorrect opinion may be given.

2 G Co

Key factors:

- As a manufacturing company, G Co will hold inventory of raw materials, work in progress and finished goods at the end of the year.

The auditor will need to consider whether the valuation of work in progress is appropriate given its stage of completion and that only production overheads are included.

- G Co has two warehouse sites.

The auditor should obtain an understanding as to how G Co ensures all inventory items held are counted only once and how goods moving between sites are dealt with to ensure they are properly recorded.

- G Co imports raw materials.

Inventory items may well be in transit at the end of the year. The auditor will need to consider when title to the goods passes to G Co in order to assess when the goods should be included in inventory at the year end.

It is also possible that the raw materials attract import duties and so the auditors should consider whether the cost of raw materials is fairly stated.

Chapter 9

Risk assessment

Introduction

Learning outcomes

Planning and performing engagements

Students will be able to plan and perform assurance engagements in accordance with the terms of the engagements and appropriate standards.

- Identify the risks arising from, or affecting, a given set of business processes (including risks associated with an entity's use of emerging technology, cyber security) and circumstances and assess their implications for the engagement
- Assess significant business risks (including risks associated with going concern, climate change, technological advances, cyber security) identified for their potential impact upon an organisation, in particular their potential impact on performance measurement;
- Identify the components of risk for a specified assurance engagement
- Identify the components of audit risk for a specified audit engagement, including the breakdown of audit risk into inherent risk, control risk and detection risk
- Evaluate the impact of risk and materiality in preparing the audit plan, including the nature, timing and extent of audit procedures

Syllabus links

Risk assessment has already been covered in some detail in the Assurance syllabus. At this Professional level, the key issue is being able to carry out risk assessment, that is, identify and assess, not merely understand the components of risk and be able to identify them.

Examination context

Risk assessment is a very important area for your exam.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	We have already focused on the importance of risk to auditors. This section focuses on business risk, which the auditor needs to understand as part of 'understanding the entity'. If the entity has failed to manage its business risks properly then this	Read through Chapter 9 carefully working through all the examples and activities. This chapter covers an area of important practical significance, and it is therefore of importance for your exam also. You should not focus on rote learning the material in this	Risk assessment is a very important area for your exam. It could come up in any part of the examination, and is likely to appear in a long-form question.	6

Topic	Practical significance	Study approach	Exam approach	Self-test questions
	could affect the audit via the going concern assumption. **Stop and think** Reflect on why risk assessment is important to auditors before commencing your study of this chapter.	section; it is meant to give you something to bear in mind when you are answering practical questions on this area in your exam.		
2	If you work in audit, you will carry out risk assessment procedures at some point in your career. If you work in industry, you should see this in practice, as assurance providers carry out risk assessment procedures in your business.	Work through the section carefully, including the worked examples. It is less important that you learn the general categories of audit risks (inherent vs control vs detection risks) than that you are able to identify and develop risks as they appear in real situations.	This topic could come up in any part of the examination, and is likely to appear in a long-form question.	1, 2, 3, 4, 5
3	Assessing the risks of material misstatement is a key skill for your exam and for your work, whether in practice or in industry.	Attempt the activity.	This topic could come up in any part of the examination, and is likely to appear in a long-form question.	7
4	The concept of 'significant risks' represents an attempt to prioritise risks.	Read the section, including the worked example. When you are assessing risks in your exam, pause to consider whether a risk is significant.	This topic could come up in any part of the examination, and is likely to appear in a long-form question.	

Topic	Practical significance	Study approach	Exam approach	Self-test questions
5	Keeping proper documentation is a key skill for a member of the audit team.	Read through the section carefully.	The material in this section is not as centrally important as some other parts of this chapter, but it could crop up in any part of the examination.	

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1 Business risk

Section overview

There are three general categories of business risk

- financial risk
- operational risk
- compliance risk

Business risk was introduced in your Assurance studies.

Definition

Business risk: Is the risk inherent to the company in its operations. It includes risks at all levels of the business. ISA 315 defines business risk as a "risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies".There are three general categories of business risk:

- Financial risks are the risks arising from the financial activities or financial consequences of an operation, for example, cash flow issues or overtrading.
- Operational risks are the risks arising with regard to operations; for example, the risk that a major supplier will be lost and the company will be unable to operate.
- Compliance risk is the risk that arises from non-compliance with laws and regulations that surround the business, for example a restaurant failing to comply with food hygiene regulations might face fines, enforced closure, legal action from customers and so on.

Business risk management is an area in which assurance can be required. Why? Because the risk that the company accepts has a direct impact on the risk of the investment that anyone purchasing shares in a company (a minority share or a company takeover) or lending money to a company is making.

However, it is not simply shareholders and lenders that will want assurance in this area. Management might want assurance services to provide an indication of how well they are performing in controlling the risks to the company, to ensure it continues in business, but also as evidence that it is operating efficiently and cost-effectively. Management may employ an internal audit department to (among other things) monitor internal controls or may seek external assistance.

Auditors are interested in business risk because issues which pose threats to the business may in some cases also be a risk of the financial statements being misstated (which is a component of audit risk). For example, if a particular division of a business was threatened with closure, the valuation of all the assets associated with that division would be affected. In more general terms, if an economic downturn puts pressure on a company to meet the expectations of providers of finance, management might be tempted to manipulate the financial statements. This may also have a bearing on the assessment of the going concern assumption.

Business risks may also arise from the broad process of climate change. Businesses are likely to have an increasing responsibility to report on their impact on the natural environment; auditors then have a responsibility to challenge businesses on how they have assessed and reported their impact on the environment, together with any business risks arising from climate change.

Specific business risks that may arise in relation to climate change include the following:

- Risk of the business not complying with climate change regulation, which could lead to fines, loss of licences or being forced to close
- Sectoral risks, for example to agriculture, as crops fail could lead to major losses. Supermarkets may lose business if they are unable to secure their supply chains
- Risk that a business loses major investors if it is not climate change friendly
- Risk that traditional business is unable to adapt, eg, a car manufacturer not moving to electric vehicles
- Direct threat as a result of extreme climate events, such as the Australian bush fires of 2020

Professional skills focus: Applying judgement

Both in the exam and in real life, whenever you hear about something that has happened with a client, try to think about the effect it might have on the financial statements. In this way, you can connect business risks to the audit risks that will be discussed in the next section.

2 Audit risk

Section overview

There are three components of audit risk:

- inherent risk (part of the 'Risk of material misstatement')
- control risk (part of the 'Risk of material misstatement')
- detection risk

You have already covered audit risk (the risk of giving an inappropriate opinion in relation to the financial statements) in detail.

Audit risk is a function of the risks of material misstatement and detection risk.

Risks of material misstatement may exist at two levels: the overall **financial statement level**, and the **assertion level** for classes of transactions, account balances and disclosures.

Risks at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions. Events or conditions that may indicate risks of material misstatement at the financial statement level are:

- lack of personnel with appropriate accounting and financial reporting skills
- control deficiencies – particularly in the control environment, risk assessment process and processfor monitoring, and especially those not addressed by management
- past misstatements, history of errors or a significant amount of adjustments at period end

Risks of material misstatement at the assertion level consist of two components, inherent and control risk.

2.1 Risk assessment procedures

The auditor is required to perform risk assessment procedures to understand:

- the entity and its environment (internal, external and performance measures)
- the financial reporting framework and accounting policies

Based on this, the auditor assesses how the inherent risk factors make the assertions susceptible to misstatement (ISA 315: para. 19).

2.2 Unbiased auditing

ISA 315 emphasises the need for the auditor to assess risks "in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory" (ISA 315: para. 13). This could be considered an application of the auditor's professional scepticism in the context of the risk assessment (ISA 315: para. A12).

These phrases could seem woolly or vague, but in reality they are at the centre of the ISAs' portrait of the auditor as an independent and questioning mind. The notion of an unbiased investigation of contradictory evidence can make auditing a compelling area to work in, far removed from the dryness of an auditor who mindlessly performs procedures without interest or understanding.

2.3 Inherent risk

Definition

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

In other words, how likely is it that the account balance or transaction will be wrong? And how likely is it that, as a result, the financial statements will be misstated by a material amount? Inherent risk canbe analysed on a number of levels which are covered in turn below.

For the identified risks of material misstatement at the assertion level, a separate assessment of inherent risk and control risk is required by ISA 315. Inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. The degree to which inherent risk varies is referred to in ISA 315 as the **spectrum of inherent risk** (this means simply the 'spectrum' ranging from high to low risk).

Definition

Inherent risk factors: Characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure, before consideration of controls. Such factors may be qualitative or quantitative, and include **complexity, subjectivity, change, uncertainty** or susceptibility to misstatement due to **management bias** or other **fraud** risk factors insofar as they affect inherent risk (ISA 315: para.12f).

ISA 315 gives the following examples of the inherent risk factors.

Inherent risk factor	Examples
Complexity	**Regulatory:** Operations that are subject to a high degree of **complex regulation** **Business model:** The existence of complex alliances and joint ventures Applicable **financial reporting framework**: Accounting measurements that involve complex processes
Subjectivity	Applicable financial reporting framework: A wide range of possible measurement criteria of an **accounting estimate**, eg, **depreciation** Management's selection of a **valuation technique** or model for a non-current asset, such as investment properties
Change	**Economic conditions:** Operations in regions that are **economically unstable** **Markets:** Operations exposed to **volatile markets**, eg, futures trading **Customer loss**: Going concern and liquidity issues including loss of significant customers **Industry model:** Changes in the industry in which the entity operates **Business model:** Changes in the supply chain Developing or offering new products or services, or moving into new lines of business **Geography:** Expanding into new locations
Uncertainty	**Reporting**: Estimates involving significant **estimation uncertainty**
Susceptibility to misstatement due to management bias or other fraud risk factors as far as they affect inherent risk	**Reporting**: Opportunities for management and employees to engage in **fraudulent financial reporting** **Transactions:** Significant transactions with **related parties** Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities

2.3.1 Assessing inherent risk

The auditor assesses how significant an inherent risk is – meaning how big the potential misstatement could be – and places it on the 'spectrum of inherent risk'. This is done by applying the inherent risk factors, which the auditor uses to determine the **likelihood** and the **magnitude** of a potential misstatement.

Likelihood × Magnitude = position on spectrum of inherent risk

'Magnitude' here is related to the concept of materiality, since ISA 315 states that it includes both quantitative and qualitative factors.

It is possible, for example, that a risk may be of low likelihood but of such potential magnitude that it will fall high up on the spectrum.

The auditor should take into account financial statement level risks when they are considering risks atthe assertion level, and vice versa (ie, they might discover a pervasive risk when they are assessing particular assertion level risks) (ISA 315: paras. A215-216).

When assessing inherent risk, the auditor must also consider whether a risk is a 'significant risk', which we will consider in detail later in this chapter.

Context example: Risks at financial statement and assertion levels

A finance manager at the entity was found to have perpetrated a fraud during the year that involved making inflated payments to suppliers. This gives rise to assertion level risks in relation to payables and expenses, but also a financial statement level risk as a result of management bias and a poor control environment.

2.4 Control risk

Definition

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

So the key questions are:

- What is management doing to stop things going wrong?
- If measures have been taken, are they effective?

Control risk will be lower where effective control measures are taken. However, there will always be control risk due to the limitations of internal controls:

- cost > benefit
- routine/non-routine transactions
- human error
- management override
- circumvention by collusion
- changes in procedures

The auditor will first form an 'initial expectation' of whether they will be able to rely on the entity's controls. If they cannot, then control risk is not relevant and the audit will be conducted as if there were no controls in place, ie, so that the only risk of material misstatement is inherent risk (ISA 315: para. 34).

If the auditor expects to be able to rely on the control system, then they will make an assessment of control risk, ie, how risky the system is. They will then need to confirm whether this assessment is correct before they conduct the main controls testing as such – this is called 'testing the operating effectiveness of controls' (ISA (315: paras. A226–228).

It is possible that a single risk may be mitigated by a number of controls, both direct and indirect, which the auditor will need to take into account when assessing control risk. An example of this would be an **automated control**, which will be affected by both the assertion-level control in question, and the risks arising from the general IT controls

Finally, ISA 315 requires the auditor to understand the **entity's use of IT in its business**. This then gives rise to the need to assess the **risks arising from the use of IT**, together with the controls that address these risks (ISA 315: para. 26).

2.5 Detection risk

Judgements about inherent risk and control risk, depend on the assurance provider's understanding of the client's business and the systems and controls set up by the client's management.

The third component of audit risk – detection risk – depends on matters which are under the assurance provider's control.

Definition

Detection risk: The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements (ISA 200: para. 13e).

It is up to the auditor to organise the way the engagement is handled, so that the risk of material misstatement is reduced to acceptable levels.

This will include:

- ensuring the audit team (including the engagement partner) has the necessary mix and depth of experience and skills
- devising an audit plan which tackles the audit risks

The audit approach (which we shall look at in Chapter 10) is the way in which the auditor assembles sufficient audit evidence to build up a satisfactory level of audit confidence, and which can come from tests of controls, analytical procedures and tests of details.

Because the auditor cannot check every transaction, audit work is carried out on a test basis. The auditor will select a sample.

The possibility that the opinions you form, perfectly validly, from the results of your sample, are different from those you would have formed if you had been able to examine the whole population is called sampling risk.

Non-sampling risk is the possibility of coming to the wrong conclusion about the financial statements for any other reason, for example:

- lack of understanding of the nature of your client's business
- use of invalid sampling techniques
- failure to investigate a particular class of assets, liabilities or transactions

Professional skills focus: Applying judgement

The classification of risks into the categories of inherent, control and detection risks could also be thought of as the analysis of a matter into several different risks that may be present: the inherent risk that the entity should address, the risk arising if the entity's controls are not adequate, and the risk arising if the auditor does not properly test the entity's controls.

3 Assessing the risks of material misstatement

Section overview

- The best way to learn the skill of identifying and assessing risk of misstatement is to practice doing it in exam questions.

Try the interactive question that follows:

Interactive question 1: Assessing the risks of material misstatement

Your firm has recently been appointed auditor of Trendy Products Ltd, a wholesaler of clothing and fashion accessories geared to the younger market. You are responsible for planning the audit, and have obtained the following background information.

The company imports most of its goods from manufacturers in the Far East. The suppliers issue invoices in dollars, payable within 30 days. The finance director uses a mixture of forward exchange contracts and spot purchases of dollars to pay these suppliers.

Most of the company's customers are small retailers. However, the company has increased its sales by 50% in the last quarter due to a new contract to supply a large retailer. In order to secure this new business, credit terms had to be relaxed from the standard 30 days to 60 days for this customer.

As a result of this expansion the company is finding it difficult to stay within its overdraft limit and is currently negotiating with the bank to increase the facility.

The company recently upgraded its PC-based modular purchases, sales and nominal ledger systems to an integrated system. The accounting package was supplied by a software company which had recently commenced trading.

The software supplier assisted the company with the changeover from the old system to the new. As a result, management decided that there was no need to involve the previous auditor or to have a parallel run.

Mrs Evans is solely responsible for the input of data, but due to the changeover she is several weeks behind with her work. She hopes to be up to date by the time of the audit as she intends to work overtime to clear the backlog.

The company has introduced an incentive scheme under which the directors are entitled to a bonus on achieving a certain level of profit. The bonus will be paid 30 days after the audited accounts are available.

Requirement

Identify the factors that impact on audit risk in respect of the above matters, and state what effect these would have on audit procedures.

Note: You should set out your answer in a two-column format using the headings 'Risk factor' and 'Effect on audit procedures'.

See **Answer** at the end of this chapter.

4 Significant risks

Section overview

- Significant risks are referred to in ISA 315.
- Significant risks are those that fall at the upper end of the spectrum of inherent risk, assessed using the inherent risk factors.

ISA 315 refers to what it calls significant risks.

Definition

Significant risk: An identified risk of material misstatement: (i) For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or (ii) That is to be treated as a significant risk in accordance with the requirements of other ISAs (ISA 315: para. 12l).

ISA 315 requires the auditor to determine whether any of the risks identified are significant risks (ISA 315: para. 32). Significant risks are those that are "at the upper end of the spectrum of inherent risk", which is assessed using the inherent risk factors. In practice they tend to be unusual or one-off matters.

The auditor must determine whether the controls in relation to a significant risk are likely to be effective.

Examples of issues with high levels of inherent risk – which might give rise to significant risks – include the following (ISA 315: para. A221).

- Transactions for which there are **multiple acceptable accounting treatments**, such that **subjectivity** is involved.
- **Accounting estimates** that have high estimation uncertainty or complex models.
- **Complexity in data collection** and processing to support account balances.
- Account balances or quantitative disclosures that involve **complex calculations**.
- **Accounting principles** that may be subject to **differing interpretation**.
- **Changes in the entity's business** that involve changes in accounting; for example, mergers and acquisitions.

The ISA notes that **there are some risks for which the auditor must test controls**, ie, for which substantive procedures alone do not provide sufficient appropriate audit evidence (315: paras. 33, A222–3). This would be the case for **routine business transactions** which involve little or no manual intervention (eg, those making extensive use of IT), in which case the risk is whether the controls are appropriately designed and operated. The **example** given by the standard is of revenue for a telecommunications company, for which there is no observable evidence of call/data activity, so the auditor must test controls to determine whether data around calls is captured correctly by the system (315: para. A224).

Context example: Significant risks

- Property purchases and sales
- Acquisition and disposal of businesses
- Decision to factor receivables

- Potential sale of the business
- Diversification into new sectors

Of course, remember that what is unusual for one company is not necessarily unusual for another. Hence, we are reminded of the importance of knowledge of the particular business being audited.

5 Documentation

Section overview

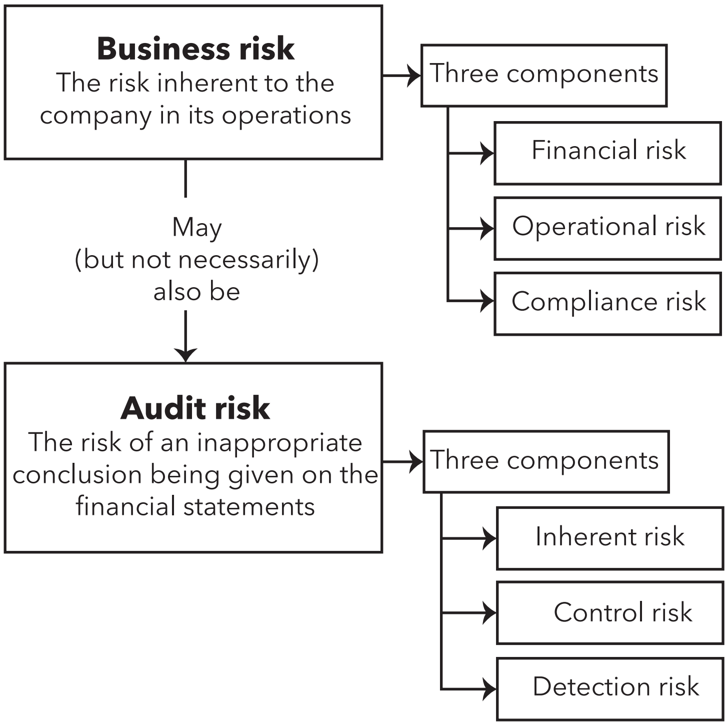
- ISAs 315 and 330 contain a number of requirements regarding documentation.

You know about the need for auditors to document their audit work from your Assurance studies. ISAs 315 and 330 contain a number of requirements about documentation, and we shall briefly run through those here.

The following matters should be documented:

- The discussion among the audit team and the significant decisions reached
- Key elements of the auditor's understanding, together with the sources of the information from which the auditor's understanding was obtained and the risk assessment procedures performed
- The evaluation of the design of identified controls, and determination whether such controls have been implemented
- Risks at the financial statement level and at the assertion level, including significant risks, and the rationale for the significant judgements made
- The overall responses to address the risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed
- The results of audit procedures and conclusions
- If the auditors have relied on evidence about the effectiveness of controls from previous audits,conclusions about how this is appropriate
- A demonstration of how the financial statements agree or reconcile with the underlying accounting records

Summary



Business risk
The risk inherent to the company in its operations
Three components
Financial risk
Operational risk
Compliance risk
May
(but not necessarily)
also be
Audit risk
The risk of an inappropriate conclusion being given on the financial statements
Three components
Inherent risk
Control risk
Detection risk

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. It not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you explain the three main categories of business risk? (Topic 1)	
(2) Can you explain the three main categories of audit risk? (Topic 2)	
(3) Can you generate audit procedures to address the risks you have identified in the scenario? (Topic 3)	
(4) Can you distinguish a significant risk from an ordinary audit risk? (Topic 4)	
(5) Can you identify the matters that should be documented? (Topic 5)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q2	The relationship between the elements of audit risk is a fundamental issue for this paper.	
Q6	This question helps you to practise identifying risks, which is the basis of some of the longer questions.	
Q7	This exam-style question is at the core of this chapter, and it is essential that you attempt it.	

Once you have attempted these questions, you can continue your studies by moving onto the next chapter, Audit approach.

Technical Reference

1 Business risk

ISA 315.12 (b)

2 Audit risk

ISA 200. ISA 315.13–18

3 Assessing the risks of material misstatement

ISA 315.28–37

4 Significant risks

ISA 315.12 (l)

5 Documentation

ISA 315.38 and ISA 330.28–30

Self-test questions

Answer the following questions.

1 Risk of fraud

Auditors should plan and perform their audit procedures recognising that fraud and error may materially affect the financial statements.

Requirement

Give four examples of indicators in a business that the risk of fraud and error may be high.

2 As part of the audit planning for a client the auditor has evaluated the components of audit risk; namely, control risk, detection risk and inherent risk.

Their tests of controls reveal deficiencies in the operation of the system of internal control, and they are now reassessing the risks to the audit.

Requirement

Since control risk has increased, describe the effect of this on the other components of risk.

3 What is the meaning and implication of high inherent risk?

4 What is the meaning and implication of high detection risk?

5 If an auditor decides that an acceptable level of audit risk is 5%, what does this mean?

6 Earthmovers Ltd is a civil engineering company that provides a pipe-laying service to the energy, water and telecommunications industries. It uses much heavy plant and machinery, and is subject to the strict provisions of health and safety at work regulations.

Requirement

Identify the risks to which breaches of these regulations could expose the company, and the implications for the audit in the event of such breaches.

7 Shades Ltd

You are planning the audit of Shades Ltd for the year ending 30 June 20X9. The principal activities of the company are the manufacture and distribution of a range of window blind systems and of the component parts for window blinds. Approximately 50% of revenue is generated from overseas customers.

During your preparation for the planning meeting with the finance director, the following matters have been highlighted as significant.

Operating results

The company has had a successful year to date with revenue, gross and operating margins up on the previous year.

	10 months to 30 April 20X9	10 months to 30 April 20X8	Year to 30 June 20X8
	CU'000	CU'000	CU'000
Revenue	22,656	19,597	22,557
Cost of sales	13,367	12,472	14,313
Gross profit	9,289	7,125	8,244
Operating expenses	4,531	4,115	4,732
Operating profit	4,758	3,010	3,512
Gross profit margin	41%	36%	37%
Operating profit margin	21%	15%	16%

Inventories at 30 April 20X9 were CU4.3 million compared with CU 3.6 million at 30 April 20X8 and CU3.4million at 30 June 20X8.

New computer system

During the year the company replaced its accounting software with a fully integrated standard package modified by the supplier to the company's requirements.

Incentive scheme

During the year the company introduced an incentive scheme under which the executive directors are entitled to a bonus based on pre-tax profits. The bonus will be paid thirty days after the audited accounts are available.

Requirement

In respect of the above, identify and explain the potential audit risks and indicate the matters you would discuss with the finance director at your planning meeting.

Total: 20 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Risk factor	Effect on audit procedures
This is a new audit appointment. New appointment increases detection risk due to lack of cumulative/prior knowledge from previous audits.	Accounting systems and internal controls need to be ascertained. Current period audit work should have regard to the opening balances and comparatives. ISA 510 and ISA 710 will assist the auditor.
Trendy Products Ltd operates in the fashion industry. The nature of the industry contributes to high inherent risk, as clothes and accessories do not stay in fashion and year end allowances to reduce inventory to NRV may be inadequate.	Evaluate inventory count instructions for procedure to identify obsolete items. Review post year-end order book to establish adequacy of allowances to reduce inventory to NRV.
Most purchases are imported and paid for in dollars. Inherent risk is increased by exposure to dollar fluctuations.	Any gains and losses on dollar transactions/year-end balances should be taken to the statement of profit or loss and monetary items should be translated at the year-end rate.
Economic dependence on a principal customer. Pressure from the new customer may increase inherent risk.	Having expanded to accommodate this customer, ensure the going concern assumption remains appropriate if the new contract is terminated.
The company is currently renegotiating its overdraft. Deterioration of cash flows increases going concern risk, which will be made worse if the overdraft is withdrawn.	The auditor should review management assessment of going concern. The effect on liquidity ratios, debtor days etc, should be calculated and actions to remedy the cash flow problems discussed with directors.
The bank may seek to place reliance on the audited accounts before negotiations are finalised. This increases risk as management have amotive to manipulate the accounts.	Particular attention should be given to bank overdraft/creditor cut-off; most likely areas of misstatement and significant areas where judgement is involved, eg, provisions; and impact of potential audit adjustments on key ratios.
The software company being used has only recently commenced trading. Inherent risk may be increased by the inexperience of the software company.	The level of audit testing of the new system is likely to be higher than for an accounting package with a good track record.
There is a potential risk that data transfer was inaccurate or incomplete. If any significant problems with the changeover are encountered then, in the absence of a parallel run, proper accounting records may not have been kept.	The lack of proper accounting records may need referring to in the auditor's report.

Risk factor	Effect on audit procedures
Human error is more likely if overtime working is excessive, therefore inherent risk is increased.	Cut-off should be carefully reviewed as errorsare more likely if data processing is not up todate at the year end.
There is a backlog of data input. Human error is more likely if overtime working is excessive, therefore inherent risk is increased.	
The introduction of the incentive scheme may cause management to overstate the profit.	Extended checks and/or increased sample sizes to look for potential understatement of liabilities and expenses, and overstatement of assets and income.

Answers to Self-test questions

1 Risk of fraud

Four from:

- Previous experience of integrity or competence of management
- Financial reporting pressures (profit-based rewards)
- Weaknesses in design or operation of systems
- High staff turnover
- Industry characteristics, for example, cash handling
- Unusual transactions
- Problems in obtaining audit evidence
- Inadequate control over information systems data

2 Effect of increased control risk (CR)

On inherent risk (IR)

Impact dependent upon IR assessment

- if IR also high, increased testing required to render DR low
- if IR low, control weakness impact may not be as significant on audit risk (AR). May increase work required to reduce DR to ensure AR is acceptable
- provided DR is managed, control weaknesses should not affect AR

Other components must cancel impact of control weaknesses on AR

3 Meaning = risk of material errors arising is high Implication = detection risk must be rendered low

4 Meaning and implication:

a. Assessed levels of inherent and control risk are low.

b. High risk that substantive procedures do not detect material misstatement.

c. Implies small sample sizes.

5 Meaning – audit risk 5%

a. 5% chance of an invalid conclusion (audit opinion) being drawn after all procedures completed; or

b. 95% confident that audit opinion will be valid.

6 Risks and audit implications:

Risks	Audit implications
Civil liabilities to victims	Possibility of:
Statutory fines and penalties	• Unrecorded liabilities • Impairment of property, plant and equipment
Increased insurance premiums	
Loss of reputation	
Forced closure	Going concern doubts

CHAPTER 9

7 **Shades Ltd**

Audit risks	Matters to discuss
Manufacturing company	
Inventories may be materially misstated due to difficulties in estimating the degree of completion of work in progress (WIP) Estimating the net realisable value (NRV) of certain window blind systems	The methods used by the company to determine the stage of completion and valuation of WIP The NRV of window blind systems awaiting sale or installation
Overseas customers	
Sales in foreign currencies may not be translated at an appropriate rate, resulting inrevenue and receivables being misstated in the financial statements	The rate used to translate transactions on foreign currencies The procedures adopted to ensure compliance with accounting standards
Irrecoverable debts	
There may be insufficient allowance made for irrecoverable debts as a result of increased difficulties in assessing credit worthiness and recoverability for overseas customers	The techniques used to assess credit worthiness of customers, particularly those based overseas Method used to monitor and chase slow payers Whether there are any known irrecoverable or doubtful debts The reasons for any seasonal variations within the company's sales The methods of managing cash flow and working capital to address the impact of seasonal variations
Seasonal business Misstatements in monthly revenue and expenditure figures may be more difficult to detect as a result of seasonal variations in the business	
Revenue growth	
Revenue may be overstated. The increased volume of sales may increase the extent of errors arising within the accounting records	The reasons for the increase in revenue this period Whether any noticeable increase in error rates within the accounting records has occurred
Gross profit increase	
Gross profit may be overstated as a result of items in transit to overseas customers being included in both year-end inventories and revenue purchases being understated	The reasons for the increase this period Procedures used to ensure that transactions just before or after the year end are recorded in the correct accounting period How adequate provision is made for purchases, particularly those invoiced post year end
Operating profit increase	
Operating expenses may be understated due to recording being incomplete and the	The procedures for ensuring the completeness of recording expenditure

Audit risks	Matters to discuss
client failing to fully accrue for such expenses	The methods used for identifying and making adequate provision for accruals
Increasing inventory values	
The company may have difficulty in selling certain lines of inventory if items are made to customer specification and then orders cancelled. Such lines may be overvalued in the financial statements	The proportion of lines of inventory made specifically to order The adaptability of such lines in the event of order cancellations The anticipated future revenue from sales of the type of blinds The level of advance orders received
Change in accounting system	
Misstatements may increase as a result of information being lost or incorrectly transferred from the old to new systems	The procedures used to ensure that all accounting information was correctly transferred from old to new systems The type of change over which was used, eg, parallel running, stepped changeover direct changeover
New computer system	
Modifications to the new computer software may reduce its reliability. This, together with the relative unfamiliarity of client staff with the new system, will increase the risk of errors arising	The extent and nature of any problems being experienced with the new system The extent of training and system support given to staff operating the new system The criteria used to choose the new system and the reason for the change
Bonus scheme	
The scheme provides an incentive for directors to overstate income and understate expenditure	The nature of any conditions attached to the bonus The effect on profits since the introduction of the scheme The anticipated level of bonus payable this period
Disclosure	
The audited accounts may fail to properly disclose such bonuses within directors' emoluments Similarly, failure to properly include such bonuses may result in current liabilities being understated	The proposed treatment and disclosure of the directors' bonuses within the financial statements Whether the directors are aware of the auditor's legal duty to make good any disclosure lapses in this area in the auditor's report

Chapter 10

Audit approach

Introduction

Learning outcomes

Planning and performing engagements

Students will be able to plan and perform assurance engagements in accordance with the terms of the engagements and appropriate standards

- Assess the impact of risk and materiality on the engagement plan of assurance procedures to be performed on historical and prospective information, including the nature, timing and extent of assurance procedures, for a given organisation
- Determine an approach appropriate for an engagement for a specified organisation which addresses:
  - possible reliance on controls (including those within IT systems)
  - use of technology during an assurance engagement (including data analytics and results of data analytics routines, data visualisations generated by audit software, AI and automated tools)
  - the organisation's adoption of technological advances, including cloud computing
  - using the work of internal audit
  - using the work of other experts
  - using the work of another auditor
  - probable extent of tests of controls and of substantive procedures, including analytical procedures and data analytics
  - the nature and extent of client-generated information, including reliability of clients' reports and underlying system-generated data
  - the probable number, timing, staffing and location of assurance visits
  - the financial statement implications of climate change
- analyse and interpret data extracted from an organisation's accounting records and reflected in data analytics software to identify trends and risks of misstatement

Syllabus links

This area was introduced, in connection with evidence, in Assurance.

Examination context

In the exam, you could be asked to identify risks and then justify an approach towards those risks.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	The importance of audit approach is two-fold: It is important for an audit firm that its audits are carried out in accordance with professional standards. How the tests used impact on audit cost. **Stop and think** Why would a firm want to rely on the client's systems and internal auditors?	Read through all the sections in this chapter carefully.	In the exam, you could be asked to identify risks and then justify an approach towards those risks. Questions in this area could crop up in any part of the examination.	2
2	The auditor will usually seek to rely on the entity's internal controls. This approach is usually more efficient than adopting a primarily substantive approach to the audit.	Read through the section carefully and attempt the activity.		1
3	Substantive testing now includes the use of audit data analytics routines.	Read through the section carefully and attempt the activities.		3
4	Auditors may use the work of others eg, that of internal audit, or of experts in a particular area.	Read through the section carefully and attempt the activities.		4, 5, 6, 7, 9
5	Financial statements frequently include estimated figures, which are a key source of uncertainty for auditors.	Read through this section carefully.		
6	Practical issues should be addressed by the audit plan.	Read through this section carefully.		

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1 Responding to the risk assessment

Section overview

- The auditor must formulate an approach to assessed risks of material misstatement.
- Overall responses include issues such as emphasising to the team the importance of professional scepticism, allocating more staff, using experts or providing more supervision.
- The auditor must also determine further audit procedures to address the risks of material misstatement.
- There are three sources of audit confidence: tests of controls, tests of details and analytical procedures.
- Remember, some substantive procedures (that is, tests of details and/or analytical procedures) must be carried out.

The main requirement of ISA 330, *The Auditor's Responses to Assessed Risks* is that in order to reduce audit risk to an acceptably low level, the auditor should determine overall responses to assessed risks at the financial statement level, and should design and perform further audit procedures to respond to assessed risks at the assertion level.

In other words, having assessed the risks of material misstatements in the financial statements, the auditor has to **plan the work** that will be carried out **to ensure** that **they can draw a conclusion** about whether the financial statements give a true and fair view; that is, that any material misstatements have been identified and amended if necessary.

1.1 Overall responses

Overall responses to risks of material misstatement will be changes to the general audit strategy or re-affirmations to staff of the general audit strategy. For example:

- emphasising to audit staff the need to maintain professional scepticism
- assigning additional or more experienced staff to the audit team
- using experts, the work of internal auditors or other auditors
- changing the nature, timing and extent of supervision and review on the audit
- incorporating more unpredictability into the audit procedures
- changing the audit strategy

The evaluation of the control environment that will have taken place as part of the assessment of the client's internal control systems will help the auditor determine whether they are going to take a substantive approach (focusing mainly on substantive procedures) or a combined approach (tests of controls and substantive procedures).

1.2 Responses to the risks of material misstatement at the assertion level

The ISA says that "the auditor shall design and perform further audit procedures whose **nature**, **timing** and **extent** are based on and are responsive to the assessed risks of material misstatement at the assertion level". Nature refers to the purpose and the type of test that is carried out. The extent of audit tests is determined by sampling, which we covered in our Assurance studies. The auditors must also have to consider the timing of tests – before the year end or after, or possibly, continuously throughout the year using CAATs.

Auditors will need increasingly to consider risks arising from climate change at the assertion level, for example where a business is affected by environmental laws and regulations , or where the changing climate could give rise to business risks (which form part of the auditor's understanding of the entity).

1.3 Sources of audit confidence

To reduce the level of risk that the financial statements might be wrong, the auditors have to build up audit confidence based on sufficient appropriate audit evidence.

We have looked at the nature and sources of audit evidence in your Assurance studies. In summary, there are three sources of audit confidence.

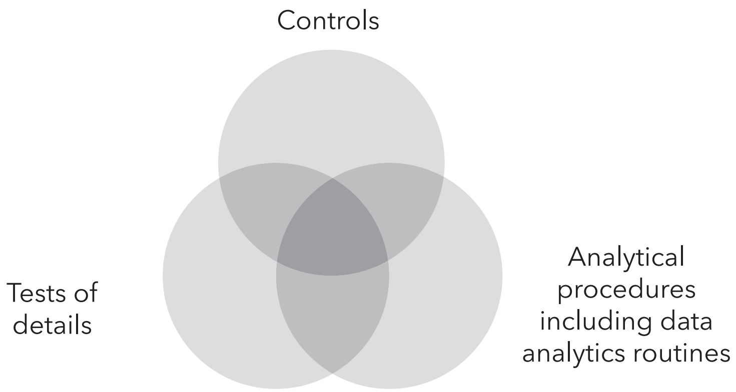


Figure 10.1: Sources of audit confidence

You know what internal controls are from your Assurance studies.

To derive audit confidence from the client's controls, auditors have to ascertain them (by enquiry), document them and then test them to make sure that:

- they operate in the way they think they do (by walkthrough procedures); and
- they are effective (by tests of controls).

You covered the nature of controls and their strengths and weaknesses in your Assurance studies. We will revisit some key issues in section 2 of this chapter.

During the planning process the audit team decides on the use of these sources to give sufficient audit confidence and what the mix should be.

The audit plan will record the approach to be used as decided on by the audit team.

1.4 Additional guidance

ISA 501, *Audit Evidence – Specific Considerations for Selected Items* illustrates how the principles of ISA 500, *Audit Evidence* should be applied to certain items in the financial statements. Two areas that it covers are particularly relevant in this syllabus:

- attendance at physical inventory counting
- litigation and claims

You will have looked at the procedures normally performed at an inventory count in your studies for the Assurance exam.

Context example: Audit of inventories

You could audit inventory by counting it all and working out what it is worth by exhaustive checking to invoices etc – **reliance on tests of details** (substantive approach).

Alternatively, you could look at the client's systems for recording purchases and revenue, for checking goods into the warehouse, and for ensuring security of the warehouse site. Should you conclude that the systems are sound you may wish to place **reliance on controls.**

You could also look at the breakdown of inventory over the last few years, consider the normal inventory levels the client carries and their relationship to purchases and cost of sales, the basis for overhead and labour recovery, and you might think that all in all the inventory figure looks about right – **reliance on analytical procedures.**

In practice you are likely to do a combination of all three. Auditing standards require you to carry out some substantive procedures (tests of details or analytical procedures) so **placing reliance solely on controls is not an option.** Carrying out some controls testing reduces the amount of substantive testing to be carried out, but it does not eliminate the need for substantive tests. The precise mix changes depending on the nature of the client:

- For a small-scale client at a single location, it may be just as efficient to observe the inventory count and to carry out a number of test counts as it is to spend a great deal of time evaluating the system, or calculating ratios. You will be relying on controls such as the reliability of the inventory checkers to a limited extent, but you will also have a good deal of confidence about the final figure deriving from the substantive work you have done; ie, your own test counts.
- For a large national building supplies company with a large number of depots, you are likely to rely to a greater extent on your assessment of controls and analytical review.

Interactive question 1: Reliance on controls

List the factors that you would consider in deciding at the planning stage of the audit whether to seek to rely on internal controls as part of the audit.

See **Answer** at the end of this chapter.

1.5 Sustainability context

If the effects of climate-related risks form part of the materiality assessment, the auditors may need to perform **further audit procedures** in response to climate-related risks and obtain **more persuasive audit evidence** the higher the assessment of risk.

2 Reliance on controls

Section overview

- The auditors carry out tests of controls when:
  - they are intending to rely on controls; or
  - they are unable to derive sufficient evidence from substantive procedures.
- In summary, ISA 330 says that if auditors want to rely on a control:
  - they have to test it
  - the have to obtain evidence that it is effective
  - they have to obtain evidence that it operated throughout the period under review
  - they have to flex their approach in accordance with the nature of the control and the risk it is seeking to mitigate

ISA 330 says auditors need to carry out tests of controls under two sets of circumstances:

- when they are intending to rely on controls to reduce audit risk; or
- when they are unable to derive sufficient evidence from substantive procedures.

The type of testing will depend on the nature of the control.

The client's procedures for authorising expenditure, for example could take many forms:

- There could be an approval box in a grid rubber stamped on invoices – auditors would check that the stamp had been applied and the box signed or initialled on a sample of invoices.
- Expenditure over a certain level may need to be approved by the board, or by a committee – auditors would check the minutes of the relevant meetings.
- The client may operate a budgetary control system, where managers have responsibility for particular projects, and where the board, or a committee will periodically review actual performance against budget.

Procedures here may be more difficult to devise.

- The auditors could review the minutes of the relevant meetings.
- The auditors could select a sample of projects and make actual/budget comparisons and then follow up to see what the client did in response to any overruns.
- The auditors could attend the relevant meetings and observe how they are conducted – but would need to be careful about whether the auditors' presence at the meeting will affect the way the meeting is conducted.

In respect of general IT controls the following questions are relevant.

- How do these operate?
- Is the auditor justified in assuming that they function properly?
- If a client uses a recognised accounting package such as Quick Books or Sage Line 50, is the auditor justified in assuming that, for example VAT will be calculated correctly?

It may be necessary to use Computer Assisted Audit Techniques (CAATs) to prove these assumptions. We considered testing controls in Assurance.

Auditors will need to determine whether controls are manual or automated, and to adapt their approach accordingly. Manual controls, such as the physical counting of inventory, can be verified by auditor presence during the counting. An automated continuous inventory checking system, on the other hand, will need testing of the computer program that produces the information output.

It should be noted that not all entities will have systems of internal control in place, and in such circumstances only a fully substantive audit approach is possible.

Interactive question 2: Reliance on internal controls

In the course of planning an audit several internal controls in the company's systems have been identified. List the conditions that each control must satisfy if it is to be relied upon in reducing the extent of substantive procedures to be performed.

See **Answer** at the end of this chapter.

Interactive question 3: Bix plc

You are the senior auditor in charge of the audit of Bix plc, a manufacturing company. You have been talking with the payroll supervisor who has commented on the strength of the company's payroll internal control system. She has assumed that this internal control system guarantees the completeness, accuracy and validity of the payroll accounting records.

Requirements

3.1 State whether you agree with the supervisor's assumption that an internal control system can guarantee the completeness, accuracy and validity of the records, supporting your answer by using examples from a payroll system.

3.2 The supervisor has also asked you to explain some internal control terminology which she doesnot understand.

Explain the meaning of the following terms, using payroll examples different from those you have given above.

(1) Segregation of duties

(2) Approval and control of documents

See **Answer** at the end of this chapter.

3 Substantive approach

Section overview

- Substantive procedures constitute tests of details and/or analytical procedures.
- Auditors always carry out a number of substantive procedures.
- The number of substantive procedures carried out will depend on the level of risk, the amount of reliance on controls and the results of controls testing.

As you know, substantive procedures fall into two categories: analytical procedures and tests of details.

The auditor must always carry out substantive procedures on material items.

ISA 330 says "irrespective of the assessed risk of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure".

In addition, the auditor **must** carry out the following substantive procedures:

- Agreeing the financial statements to the underlying accounting records
- Examining material journal entries
- Examining other adjustments made in preparing the financial statements

The auditor must determine when it is appropriate to use which type of substantive procedure.

Analytical procedures tend to be appropriate for large volumes of predictable transactions (for example, wages and salaries). **Other procedures** (**tests of details**) may be appropriate to gain information about account balances (for example, inventories or trade receivables), particularly verifying the assertions of existence and valuation. Substantive procedures were covered in detail in your studies for Assurance where you studied the principles of audit evidence outlined in ISA 500, *Audit Evidence* as well as specific procedures such as those described in ISA 505, *External Confirmations*.

Tests of details rather than analytical procedures are likely to be more appropriate with regard to matters which have been identified as **significant risks**, but the auditor must determine procedures that are specifically responsive to that risk, which may include analytical procedures. Significant risksare likely to be the most difficult to obtain sufficient appropriate evidence about.

How much substantive testing is carried out will depend on:

- whether the auditor wants to rely on controls in the first place (in which case substantive testing might be reduced)
- whether controls testing reveals that controls can be relied on (if they cannot, the auditors will have to increase substantive testing)

In the Assurance exam you studied ISA 530, *Audit Sampling* and saw how sample sizes are determined based on the assessment of audit risk. Improvements in technology and the use of audit data analytics can enable auditors to perform testing on 100% of a population, and can also be used to monitor transactions on a more frequent or even continuous basis.

Professional skills focus: Applying judgement

Most audits make use of controls testing, since this will usually result in a more efficient audit. If you work in audit, think about what kind of testing your firm tends to use.

3.1 Data analytics

The FRC's (UK) Thematic Review *The Use of Data Analytics in the Audit of Financial Statements* provides the following definition:

Definition

Data analytics: "… when used to obtain audit evidence in a financial statement audit, is the science and art of discovering and analysing patterns, deviations and inconsistencies, and extracting other useful information in the data underlying or related to the subject matter of an audit through analysis,modelling and visualisation for the purposes of planning and performing the audit" (FRC (UK), Thematic Review, January 2017).

Data analysis has been used in the business and other sectors for some time. It was originally developed by technology firms for the purposes of data mining and modelling, especially in banking and retail. More recently data analytics is being seen as a practical way for auditors to approach IT issues and the complex uses of data, especially in large organisations.

Auditors have been using computer-assisted audit techniques (CAATs) since the days when their audit clients started computerising their accounting systems. Such CAATs tended to be entity- specific and were therefore not widely used as a general audit tool. Standard tools were first developed in 2005 to enable auditors to test journal entries as part of their responsibilities in relation to fraud under ISA 240.

Data analytics is now also seen as a means of improving audit quality, from its use in the risk assessment process through to the testing of controls and substantive procedures including analytical procedures. The quality of audit information is also enhanced through the use of graphics and other means to visualise large volumes of data and the results of audit procedures. In addition, audit procedures can be carried out on a continuous basis rather than being concentrated at the year end.

ISAs are based on the systems-based approach to audit, which seeks to obtain audit evidence by placing reliance on internal controls rather than on carrying out extensive substantive testing. The emergence of the use of data analytics in audit engagements, especially by the larger firms, enables auditors to examine 100% of the entity's transactions. An example of how data analytics can be usedis in the analysis of journals to show, for example:

- year on year comparisons
- the number of manual input vs system-generated journals
- identifying who is raising journals and when
- activity identifying potential fraud risk, such as round sum amounts, seldom used accounts or suspense accounts
- identifying unusual double entries, or transactions which fall outside expected accounts within a transaction cycle
- identifying transactions that do not occur regularly, and which may therefore be at greater risk of error

The use of data analytics has the potential to transform the way in which audits are carried out for the better, but there are some negative impacts that need to be addressed:

- The cost of setting up the infrastructure can be prohibitive, especially for smaller firms.
- The quality of the underlying data is crucial.
- Staff need training in the new skills needed to manipulate data and to interpret the results.
- Ensuring the security of client and audit data.

You can read more in the ICAEW publication *Data analytics for external auditors*, which can be viewed on the ICAEW website.

3.1.1 Commonly performed data analytics routines

The following routines that auditors can perform when carrying out risk analysis, transactions and controls testing, and analytical procedures, or to support judgements andto provide insights. Many routines can be carried out with little or no management involvement, which enhances the independence of the evidence or information obtained.

- Comparing the last time an item was bought with the last time it was sold, for cost/NRV purposes
- Inventory ageing and how many days inventory is in stock by item
- Receivables and payables ageing and the reduction in overdue debt over time by customer
- Analysis of revenue trends split by product or region
- Analysis of gross margins and revenues, highlighting items with negative margins
- Matches of orders to cash and purchases to payments

- 'Can do did do testing' of user codes to test whether segregation of duties is appropriate, and whether any inappropriate combinations of users have been involved in processing transactions
- Detailed recalculations of depreciation on fixed assets by item, either using approximations (suchas assuming sales and purchases are mid-month) or using the entire data set and exact dates
- Analysis of capital expenditure vs repairs and maintenance
- Three-way matches between purchase/sales orders, goods received/despatched documentation and invoices

The FRC's (UK) Thematic Review identified the use in the audit market of data analytics to:

- analyse all transactions in a population, stratify that population and identify outliers for further examination
- reperform calculations relevant to the financial statements
- match transactions as they pass through a processing cycle
- assist in segregation of duties testing
- compare entity data to externally obtained data
- manipulate data to assess the impact of different assumptions

(FRC (UK), Thematic Review, January 2017)

The use of data analytics means that procedures can be performed much more quickly and also, more significantly, to a higher standard. The extent to which this activity contributes to improvements in audit quality is largely dependent on the skills and judgement applied to analysing and drawing conclusions from the results obtained.

In practice, data analytics tools may be used for:

- risk analysis
- transaction and controls testing
- analytical procedures
- in support of judgements
- to provide business insights

3.1.2 Data analytics and audit quality

The FRC's (UK) Thematic Review noted that potential improvements in audit quality provide a key driver to audit firms when using data analytics. These improvements include:

- deepening the auditor's understanding of the entity
- facilitating the focus of audit testing on the areas of highest risk through stratification of large populations
- aiding the exercise of professional scepticism
- improving consistency and central oversight in group audits
- enabling the auditor to perform tests on large or complex datasets where a manual approach would not be feasible
- improving audit efficiency
- identifying instances of fraud
- enhancing communications with audit committees

(FRC (UK), Thematic Review, January 2017)

Data visualisations

A key element of data analytics as they are applied by auditors are data visualisations. Data visualisations are used by the auditor as part of the process of risk identification and analysis, which isa key part of the Audit and Assurance exam. The audited entity's data is imported into the auditor's data analytics software. Data visualisations then present the auditor with the data in a simple and visual form, so that they can then investigate it in more detail where needed.

It will be necessary for the auditor to investigate the visualised data in tandem with their understanding of the entity, so that they can better understand the trends that emerge. In the Audit and Assurance exam this would mean interpreting any data that is give in the light of information given in the scenario. The data visualisation may help to shed light on information given elsewhere in a question.

A further aspect of auditing in a data analytics environment is the use of AI or other automated tools by the auditor. As with other analytics routines, these can be a helpful starting point for further investigation, eg, if a potential anomaly is identified by the data analytics software, the auditor is then in a position to perform work to discover the reason for the anomaly. This may involve further analysis of data, but may also include more traditional audit work such as performing audit procedures or making enquiries of management.

Professional skills focus: Applying judgement

If you use analytics software in your audit work, consider whether what you are doing is part of a controls-testing approach, or whether it is a substantive procedure.

Context example: Analytics dashboard

Deep Ltd is a retailer of packaging; most of Deep Ltd's customers are small online businesses which require packaging for deliveries to individual customers at home. Deep Ltd's year end is 31 December.

Deep Ltd's finance director has told you that revenue tends to peak during the Christmas holiday period, in December.

The audit firm has imported Deep Ltd's data into its analytics software. The following dashboard is available.

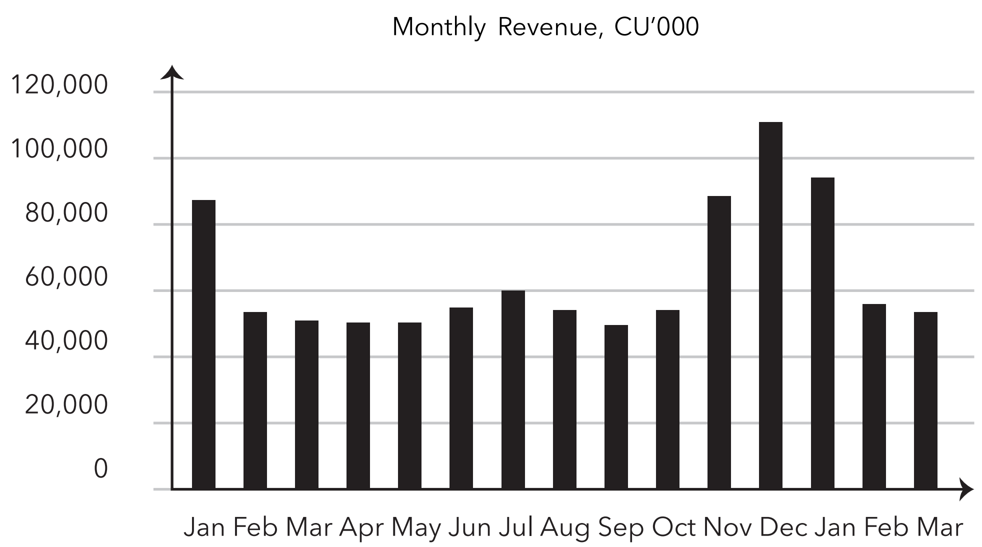


Figure 10.2: Revenue dashboard

The auditor examining this data would notice that revenue does indeed peak around December,which confirms what the finance director has told you.

However, it should be noticed that significant sales are also made in January, before revenue drops away from the peak in February.

It is possible that this could be because the peak period simply continues, for example into the January sales period.

Alternatively, it could be there has been a failure to properly apply the sales cut off around the year end of 31 December.

Audit procedures should be performed to confirm whether this is the case; these could include further analytics procedures, depending on what data is available to the auditor.

Interactive question 4: Substantive testing

King Ltd is a new audit client of your firm.

The finance director has attended a seminar on 'Understanding how your auditors work', and has come away convinced that you will be able to rely on the internal controls within the company to reduce the overall amount of work done.

Requirement

Identify the circumstances in which this approach may not be possible, leading you to undertake full substantive testing.

See **Answer** at the end of this chapter.

Interactive question 5: Hydra Ltd

Your firm acts as auditor to Hydra Ltd, which manufactures and bottles non-alcoholic drinks in Bangladesh under licence from a Swiss company.

Hydra Ltd has two products only: 'Eau Vital', a sparkling cold drink made from fruit juices, herbal extracts and mineral water, and 'Glowvine', which is to be served hot, made from grape juices, herbsand spices.

Royalties are payable to the Swiss company, which is not related to Hydra Ltd, at the rate of 20p per bottle of Eau Vital or Glowvine sold. Royalties are included in cost of sales, and Hydra Ltd expects to make an average mark-up on total cost of 150% for Eau Vital and 120% for Glowvine.

To reflect environmental concerns the customer is charged a deposit of 10p, which is reimbursed on return of the bottle. This scheme was introduced during the year. The theme of concern for the environment is echoed in Hydra Ltd's advertising, which emphasises the natural ingredients.

The final audit is scheduled to commence in two weeks' time. You have recently received a copy of Hydra Ltd's management accounts, which reflect the position for the current year.

	20X6	20X5
	CU'000	CU'000
Revenue	3,280	1,876
Gross profit	1,940	1,042
Profit from operations	1,345	807

Requirements

5.1 Prepare a schedule that indicates the analytical procedures which would form part of your year-end substantive procedures. Where relevant, suggest possible reasons for the changes between 20X6 and 20X5.

5.2 Explain what impact the new scheme involving deposits on bottles will have on the audit of liabilities at the year end.

See **Answer** at the end of this chapter.

4 Use of the work of others

Section overview

- External auditors may make use of work internal audit have done when carrying out their own external audit procedures.
- External auditors may make use of the work of an auditor's expert when carrying out audit procedures.
- Auditors of a group have a duty to report on the truth and fairness of group accounts.
- Auditors of a group have the right to require from auditors of subsidiaries the information and explanations they need.
- Note that for some standards which have not been redrafted since ISQMs 1 and 2 and ISA 220 (Revised) were issued, the term 'quality control' is still used, but you can assume that this means the same thing as 'quality management'.

4.1 Use of the work of internal audit

ISA 610, *Using the Work of Internal Auditors* states that as part of their planning procedures, auditors must determine whether or not they wish to use the work of the audit client's internal audit function. While the external auditor has sole responsibility for the opinion expressed, some internal audit work may be helpful to them in forming a decision.

As you learnt in your Assurance Workbook, the scope and objectives of internal auditing can vary widely. Normally, however, internal audit operates in one or more of the following broad are as.

- Review and monitoring internal control systems
- Examination of financial and operating information
- Review of operating activities, eg, economy, efficiency and effectiveness of operations
- Review of compliance with laws and regulations
- Risk management
- Governance

An effective internal audit function may reduce, modify or alter the timing of external audit procedures, but it can **never** eliminate them entirely. Even where the internal audit function is deemed ineffective, it may still be useful to be aware of the internal audit conclusions. The effectiveness of internal audit will have a great impact on how the external auditors assess the whole control system and the assessment of audit risk.

The ISA says that the external auditor shall determine "whether the work of the internal audit function … can be used, and if so, in which areas and to what extent" and shall determine "whether that work is adequate for purposes of the audit".

4.1.1 Evaluating the internal audit function

The following table is a summary of the factors that the external auditors will take into account when making their assessment of internal audit.

Assessment of internal audit	
Objectivity	Consider the **status** of the function within the entity, whothey **report** to, whether they have any **conflicting responsibilities** or **restrictions** placed on their function. Consider also to what extent management acts on internal audit **recommendations**
Competence	Consider whether internal auditors have adequate **resources, technical training and proficiency,** and whether internal auditors possess the **required knowledge** of financial reporting. They will also consider whether the internal auditors are **members of professional bodies**
Systematic and disciplined approach	Consider whether internal audit is **properly planned, supervised, reviewed** and **documented**, whether the function has appropriate **quality management procedures, audit manuals, work programmes** and **documentation**

If any one of the above factors is lacking, the external auditor shall **not** use the work of the internal audit function.

Interactive question 6: Using the work of internal audit

You are currently involved in planning the audit of Midget Ltd. At the beginning of the year that you are auditing, the company set up an internal audit department, and this is the first visit since you were aware of its existence. From your initial discussions with the managing director, you have established that Mrs Gnome, the internal auditor, has undertaken a number of assignments across the company, and fed back to the board on her findings.

Requirement

What factors should you take into account when considering whether you can rely on the work undertaken by Mrs Gnome and her staff?

See **Answer** at the end of this chapter.

4.1.2 Using the work of internal audit

The objectives of internal audit will differ from those of the external auditors. However, some of the means of achieving their respective objectives are often similar, and so some of the internal auditors' work may be used by the external auditors. External auditors may use internal auditors' work on the following areas:

- testing of the operating effectiveness of controls
- substantive procedures involving limited judgement
- observations of inventory counts
- tracing transactions through the information system relevant to financial reporting
- testing of compliance with regulatory requirements
- in some circumstances, audits or reviews of the financial information of subsidiaries

4.1.3 Timing of liaison and co-ordination

All timing of internal audit work should be agreed as early as possible, and in particular how it coordinates with the external auditors' work. Liaison with the internal auditors should take place at regular intervals throughout the audit. Information on tests and conclusions should be passed both to and from internal auditors.

4.1.4 Determining the nature and extent of work of the internal audit function that can be used

The ISA states that, "As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed … and its relevance to the external auditor's overall audit strategy and audit plan."

The evaluation here will consider whether:

- the work was properly planned, performed, supervised, reviewed and documented
- sufficient, appropriate evidence was obtained to enable the internal auditors to draw reasonable conclusions
- conclusions reached are appropriate and reports are consistent with the work performed

The nature, timing and extent of the testing of the specific work of internal auditing will depend upon the external auditor's judgement of the risk and materiality of the area concerned, the preliminary assessment of internal auditing and the evaluation of specific work by internal auditing. Such tests may include examination of items already examined by internal auditors, examination of other similar items and observation of internal auditing procedures.

If the external auditors decide that the internal audit work is not adequate, they should extend their own procedures in order to obtain appropriate evidence.

Interactive question 7: Extensions plc

Extensions plc is a retailer of fashion accessories. It has revenue of CU54 million and 150 shops throughout the Bangladesh. It also has six regional warehouses from which the shops are supplied with goods.

The company has an internal audit department which is based at the company's head office in Dhaka. Internal auditors make regular visits to the shops and warehouses.

This is the first year that your firm has acted as auditor for Extensions plc. The partner in charge of the audit has expressed his opinion that the internal audit department might be able to assist the external audit team in carrying out its work.

Requirements

7.1 State, with reasons, the information that you would require to make an assessment of the likely effectiveness and the relevance of the internal audit function.

7.2 Describe four typical procedures that might be carried out by the internal auditors during their visits to the shops and warehouses, and on which you might wish to rely.

7.3 Assuming that you intend to rely on the work of the internal audit department of Extensions plc, describe briefly the effect this will have on your audit of the company's financial statements.

See **Answer** at the end of this chapter.

4.1.5 Monitoring of internal audit by the audit committee

Where the work of the internal audit function is monitored by the entity's audit committee, the external auditor may wish to review any performance indicators used by the audit committee as part of their monitoring role. Performance indicators for assessing the work of internal audit might include:

- progress against annual and long-term plans of work to be completed
- recommendations accepted as a percentage of recommendations made
- recommendations implemented within a specified time period as a percentage of recommendations accepted
- total time taken for an audit assignment compared to planned/budgeted time
- number of reports produced within target dates
- feedback from users via satisfaction surveys

4.2 Using the work of an expert

Definitions

Expert: Is a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.

Auditor's expert: Is an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert (ISA 620).

Management's expert: Is an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements (ISA 500).

Professional audit staff are highly trained and educated, but their experience and training is limited to accountancy and audit matters. In certain situations it will therefore be necessary to employ someone else with different expert knowledge.

Auditors have **sole responsibility** for their opinion, but may use the work of an expert. An expert may be engaged by:

- a client (management's expert) to provide **specialist advice** on a particular matter which affects the financial statements
- the auditors (auditor's expert) in order to obtain **sufficient audit evidence** regarding certain financial statement assertions

ISA 620, *Using the Work of an Auditor's Expert* defines an auditor's expert as someone who has expertise in a field other than accounting or auditing including expertise in such matters as:

- valuations of complex financial instruments and certain types of assets, eg, land and buildings,plant and machinery
- actuarial calculations of insurance or employee benefit liabilities
- estimation of oil and gas reserves
- valuation of environmental liabilities
- interpretations of contracts, laws and regulations
- analysis of complex or unusual tax compliance issues

Auditors may also use experts when designing procedures and evaluating the results of procedures performed using data analytics.

The ISA states that the auditor "has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert".

4.2.1 Determining the need to use the work of an auditor's expert

Considerations when deciding whether to use an auditor's expert may include:

- whether management has used a management's expert in preparing the financial statements;
- the nature and significance of the matter, including its complexity;
- the risks of material misstatement in the matter;
- the expected nature of procedures to respond to identified risks, including: the auditor's knowledge of and experience with the work of experts in relation to such matters; and
- the availability of alternative sources of audit evidence.

When management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

- the nature, scope and objectives of the management's expert's work
- whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services
- the extent to which management can exercise control or influence over the work of the management's expert
- the management's expert's competence and capabilities
- whether the management's expert is subject to technical performance standards or other professional or industry requirements
- any controls within the entity over the management's expert's work

4.2.2 Competence, capabilities and objectivity of the auditor's expert

Experts used by the auditor must have the necessary competence (nature and level of expertise) capabilities (the time, resources and physical ability to exercise that competence) and objectivity (lack of bias, conflict of interest or the influence of others) for the auditor's purposes. In the case of external experts, the auditor must consider whether any interests or relationships are a potential threat to that expert's objectivity. Although an auditor's expert is not technically part of the audit team, ISA 620 notes that they are still bound by the ICAB's *Ethical Standard* and must be independent.

Information regarding the above qualities may come from a variety of sources, including:

- personal experience with previous work of that expert
- discussions with that expert

- discussions with other auditors or others who are familiar with that expert's work
- knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition
- published papers or books written by that expert
- the auditor's firm's quality management policies and procedures

The auditor will take into account whether the expert's work is subject to technical performance standards, other professional or industry requirements, ethical standards and other standards of professional bodies, or legislative requirements.

4.2.3 Agreement with the auditor's expert

The nature, scope and objectives of the auditor's expert's work will vary from one assignment to another and these must therefore be agreed between the auditor and the expert, whether the expertis internal or external.

The following circumstances indicate the need for the agreement to be in writing:

- The auditor's expert will have access to sensitive or confidential entity information.
- The respective roles or responsibilities of the auditor and the auditor's expert are different from those normally expected.
- Multi-jurisdictional legal or regulatory requirements apply.
- The matter to which the auditor's expert's work relates is highly complex.
- The auditor has not previously used work performed by that expert.
- The greater the extent of the auditor's expert's work, and its significance in the context of the audit.

The agreement between the auditor and the auditor's external expert may take the form of an engagement letter (as you have seen in your Assurance studies) although this is not the only form that the agreement may take. Where an engagement letter is used ISA 620 recommends that the following are included:

- nature, scope and objectives of the auditor's external expert's work
- the respective roles and responsibilities of the auditor and the auditor's external expert
- communications and reporting
- confidentiality

4.2.4 Evaluating the adequacy of the auditor's expert's work

Auditors should assess whether the work of the expert is adequate for the auditor's purposes. In order to evaluate the adequacy, the auditor may carry specific procedures such as:

- inquiries of the auditor's expert
- reviewing the auditor's expert's working papers and reports
- corroborative procedures such as observing the expert's work and confirmation with third parties
- discussion with another expert with relevant expertise
- discussing the auditor's expert's report with management

4.2.5 Using the work of a management's expert

If information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall:

- evaluate the competence, capabilities and objectivity or that expert
- obtain an understanding of the work of that expert
- evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion

Context example: Valuation of a commercial building

An expert valuation of a commercial building could be compared to the value of other, similar commercial buildings in estate agents' windows or on the web.

The auditors do **not** have the expertise to judge the assumptions and methods used; these are the responsibility of the expert. However, the auditors should seek to obtain an understanding of these assumptions etc, to consider their reasonableness based on other audit evidence, knowledge of the business and so on.

This may involve discussion with both the client and the expert. Additional procedures (including use of another expert) may be necessary.

4.2.6 Sustainability impact

Auditors of entities that are affected by climate-related risks may require climate-related expertise to obtain sufficient appropriate audit evidence, for example, the cost of decommissioning a plant or rehabilitating environmental damage due to regulatory changes.

4.3 Other auditors (in a group situation)

When an audit firm audits a company that is a parent in a group of companies, they will be responsible for carrying out the audit on that parent company's individual financial statements and also the audit on that parent's group financial statements. The group financial statements are knownas consolidated financial statements, defined by IFRS 10 as "financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity." In simple terms this means that the individual statements of each company in a group are combined (subject to adjustments for intra-group transactions) to produce one set of financial statements for the group as a whole.

In respect of the group financial statements, the audit firm may or may not be the auditor for other companies in that group whose financial statements are consolidated into the group financial statements.

ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* provides guidance to the auditor of a group where one or more of the components of that group are audited by other auditors.

Definitions

Component: Is an entity whose financial information is included in the group financial statements.

Component auditors: Are auditors who perform work on financial information related to a component of the group audit. A component auditor may also be a Key Audit Partner.

Group engagement team: Are the auditors with responsibility for performing work on the consolidation process, communicating with component auditors and reporting on the group financial statements.

4.3.1 Responsibility

The group engagement partner is responsible for the audit opinion for the group, and for conducting the audit in accordance with legal and regulatory requirements. The auditor's report on the group financial statements should not therefore contain a reference to component auditors unless such a reference is required by law.

4.3.2 Understanding the component auditor

If a group engagement team is planning to request work on the financial information of a component from a component auditor, the team shall obtain an understanding of the following:

- Whether the component auditor understands and will comply with **ethical requirements** and can demonstrate **independence**
- The component auditor's **professional competence**
- Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain **sufficient appropriate audit evidence**
- Whether the component auditor operates in a regulatory environment that actively oversees auditors

If a component auditor does not meet the independence requirements that are relevant to the group audit the group engagement team will need to obtain sufficient appropriate audit evidence relating to the financial information of the component without using the audit work of the component auditor.

4.3.3 Responding to assessed risks

ISA 600 states that "the auditor is required to design and implement appropriate responses to address the assessed risks of material misstatement in the financial statements". It is up to the group engagement team to determine the nature of the work to be done and whether it should be done by the group engagement team or by component auditors.

Where reliance is to be placed on the effective operation of group-wide controls at component level, these controls shall be tested, by either the group engagement team or by the component auditor.

4.3.4 Communication with the component auditor

The group engagement team will need to communicate its requirements, such as work to be performed, to the component auditor. Communication includes the following:

- detail of the work to be performed and the use to be made of that work
- the form and content of communication from the component auditor to the group engagement team
- request for confirmation that the component auditor will cooperate with the group engagement team
- ethical and independence requirements
- materiality levels for the financial information of the component
- significant risks of fraud and error relating to the group that are relevant to the component auditor
- a list of related parties and a request that the component auditor advises the group engagement team of any other related parties not on the list

The group engagement team will require the component auditor to communicate to them matters relevant to the conclusion on the group audit, including the following:

- confirmation that the component auditor has complied with ethical, independence, and professional competence requirements
- confirmation that the component auditor has complied with the group engagement team's requirements
- financial information of the component audited by the component auditor
- information on instances of non-compliance with laws or regulations
- a list of uncorrected misstatements
- indicators of possible management bias

- significant deficiencies in component internal control
- significant matters communicated to those charged with governance including suspected fraud
- any other matters relevant to the group audit
- overall findings, conclusions or opinions

4.3.5 Evaluating the sufficiency and appropriateness of audit evidence obtained

The group engagement team is responsible for evaluating the work performed by the component auditor.

Where the work of the component auditor is deemed to be insufficient, the group engagement team will determine what additional procedures need to be performed, and by whom.

The group engagement team needs to ensure that sufficient appropriate audit evidence has bee obtained by both its own procedures and those of the component auditor.

Where is has not been possible to obtain sufficient appropriate audit evidence the group engagement partner needs to evaluate the effect on the group audit opinion.

Interactive question 8: Using the work of other auditors

You are the group auditor of Golden Holdings plc, a listed company, which has components in the UK and overseas, many of which are audited by other firms. All components are involved in the manufacture or distribution of metal goods and have the same accounting period as Golden Holdings plc.

Requirement

Outline why you would wish to review the work of the auditors of components not audited by your firm and detail the work you would carry out in that review.

See Answer at the end of this chapter.

5 Audit of accounting estimates

Section overview

- Financial statements contain many estimates.
- These estimates are often made when there are uncertainties about the outcome of events and involve the use of judgement.
- As a result the risk of material misstatements is higher where estimates are involved.

ISA 540, *Auditing Accounting Estimates and Related Disclosures* was revised in 2018, reflecting the IAASB's project to update guidance in this area so that it better applies to the current accounting standards on revenue, leasing and financial instruments.

The auditor's objective is to obtain sufficient appropriate audit evidence about whether accounting estimates (and related disclosures) are reasonable in the context of the applicable financial reporting framework, ie, IFRS. Fundamentally it is the responsibility of management to prepare the financial statements, and this may include making accounting estimates. The responsibility of the auditor is to obtain sufficient appropriate audit evidence regarding the truth and fairness of these accounting estimates. The auditor considers the risks of material misstatement, which includes both the inherent risk of the amount being estimated and the entity's internal controls in relation to those risks, ie, how reliable is the entity's process for arriving at the estimated financial information.

5.1 Key concepts of ISA 540

Definitions

Accounting estimate: Is a monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty.

Estimation uncertainty: Is susceptibility to an inherent lack of precision in measurement (ISA 540: para. 12).

Before getting into the detail of ISA 540, it may be helpful to have an idea of the kinds of accounting estimates the ISA is concerned with.

- Inventory obsolescence
- Depreciation of property and equipment
- Valuation of financial instruments
- Outcome of pending litigation
- Fair value of assets or liabilities acquired in a business combination, including the determination of goodwill and intangible assets
- Impairment of long-lived assets or property or equipment held for disposal
- Non-monetary exchanges of assets or liabilities between independent parties
- Revenue recognised for long-term contracts

(ISA 540: para. A1)

Many amounts in the financial statements are based on estimates that are made by management, but making these estimates is often not an exact science – it can be subject to what the ISA calls significant **estimation uncertainty**. This is a result of the **inherent limitations** of the preparer's knowledge (one cannot know everything), and the need to draw upon their judgement and their subjectivity in making estimates. The key concept here is therefore not misstatement, but the underlying **reasonableness** of the estimate. 'Reasonable' means that the financial reporting requirements have been applied appropriately, in line not just with specific rules or requirements but with their objective as well – having regard for their spirit as well as the letter (ISA 540: paras. 2– 9).

It should be borne in mind that **not** all accounting estimates involve a high degree of estimation uncertainty, for example; it may be possible to estimate the fair value of an investment by simply looking up its price as listed on the stock exchange (ISA 540: para. A16).

ISA 540 thinks about accounting estimates in terms of **inherent risk** and **control risk**. The starting point is the auditor's consideration of the risk that is inherent in the estimate; where the risk is higher than more stringent controls will be needed. By contrast, some estimates will carry low inherent risks,need less stringent controls and can therefore be audited more easily. ISA 540's requirements are therefore **scalable** according to the level of **inherent risk** for the accounting estimate in question.

ISA 540 introduced the idea that there is a **spectrum of inherent risk**, and that the auditor's assessment of inherent risk – which must be conducted separately from the assessment of control risk – should focus on the following **inherent risk factors**:

- estimation uncertainty
- complexity
- subjectivity
- other inherent risk factors eg, a change in IFRS that impacts the calculation of the estimate

In addition to assessing inherent risk, the auditor must assess **control risk**, and can only rely on controls if procedures are then performed to test those controls. Procedures are responsive to the sum total of inherent risk and control risk, and should address specific assertions.

The need to apply **professional scepticism** increases with inherent risk. Given that this is an area that will often entail the use of subjectivity and judgement by management, there is a heightened need for the auditor to apply their professional scepticism.

ISA 540 distinguishes the **data** used in making an estimate from any **assumptions** made. Data is factual and verifiable – defined as "information that can be obtained through direct observation or from a party external to the entity". Assumptions are not like this because they can be changed – they"may be selected by management from a range of appropriate alternatives". This distinction may sound self-evident, in practice the two can be harder to distinguish.

5.2 Understanding the entity's accounting estimates

The auditor first obtains an understanding of matters related to accounting estimates, and then assesses the risks of material misstatement (inherent and control risks).

Obtaining an understanding divides itself into:

- understanding the entity and its environment;
- understanding the applicable financial reporting framework; and
- understanding the entity's system of internal control.

(ISA 540: para. 13)

Understanding the entity and its environment and the applicable financial reporting framework is connected to inherent risk, whereas understanding the entity's system of internal control connected to control risk.

Understanding the entity here should include understanding the need for accounting estimates,based on transactions and events, as well as IFRS requirements as they apply to the entity.

Understanding the entity's system of internal control here should include understanding thefollowing issues:

- The entity's oversight of financial reporting.The auditor should consider whether:
  - management has created a culture of honesty; and
  - those charged with governance are independent of management, and are able to oversee and evaluate management's process for making accounting estimates.

This is particularly important where accounting estimates involve significant judgement and subjectivity, have high estimation uncertainty, or are complex.

- Management's experts and the use of specialised skills.

The auditor should consider whether there is a need for management to engage an expert, depending on:

  - how specialised the matter is
  - the complexity of the models applied

- how unusual or infrequent is the issue requiring estimation

- The entity's own risk assessment process

The auditor should understand the entity's risk assessment process; this may help the auditor to understand the issues involved, eg, the requirements of IFRS Standards in the area, or the availability of data to make the required estimate.

Understanding the entity's risk assessment can also help the auditor to assess whether management is **biased**, ie, based on whether the risk assessment is objective.

- The entity's information system, ie, how management and the entity have arrived at estimates, including:
  - how information relating to accounting estimates flows through the entity's information system
  - how management makes estimates, ie, how **methods**, **data** and **assumptions** are identified and applied
  - how management understands and addresses **estimation uncertainty**
- How management reviews the outcome of past estimates

There is a particular need for the auditor to **review the outcome of past estimates**, as this mayreveal new risks that need to be taken into account in the current period.

There may also be a need to engage an **auditor's expert** in this area, or to plan for an engagement team that includes the required specialised skills. Matters affecting the assessment of whether this is necessary include (ISA 540: para. A61):

- The **nature** of the estimates (eg, mineral deposits, agricultural assets, insurance liabilities)
- The degree of **estimation uncertainty**
- The **complexity** of the method or model used
- The complexity of the **IFRS requirements**

5.3 Identifying and assessing the risks of material misstatement

The auditor's risk assessment focuses on the inherent risk factors, ie:

- the degree of **estimation uncertainty**
- **subjectivity** and **complexity**

  In relation to **estimation uncertainty**, the degree of estimation uncertainty depends on:

- whether the **IFRS** requires a method, or the use of assumptions, that carry a high degree of estimation uncertainty
- the **business environment** – a tumultuous environment might give rise to uncertainty
- whether it is possible to obtain sufficiently precise or reliable information regarding a **future event**

(eg, in relation to a contingent liability), or regarding present conditions

Regarding **complexity and subjectivity**, the ISA requires consideration of the degree to which complexity affects the selection and application of the method, assumptions and data.

The auditor must consider whether any of the risks counts as a **significant risk** in line with ISA 315, and whether they must therefore obtain an understanding of the entity's controls in relation to that risk.

5.4 Responses to the assessed risks of material misstatement

Definitions

Auditor's point estimate: Or auditor's range is the amount, or range of amounts respectively,developed by the auditor in evaluating management's point estimate.

Management's point estimate: Is the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate (ISA 540: para. 12).

This is arguably the core of ISA 540. The auditor must either:
obtain evidence from subsequent events (up to the date of the auditor's report);

- test how management made its estimate; or
- develop an auditor's estimate ('auditor's point estimate').

These are covered in turn below.

5.4.1 Evidence from events occurring up to the date of the auditor's report

One approach is for the auditor to consider whether subsequent events can shed any light on whether an estimate made for the end of the reporting period was reasonable. An example of this might be inventory selling prices, which may provide evidence for the valuation of inventory at the year end.

In this case, the auditor considers whether this evidence is directly relevant to the accounting estimate in question.

5.4.2 Testing how management made the accounting estimate

This may be appropriate where, for example:

- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that **management's current period process is appropriate**.
- The accounting estimate is based on a **large population** of items of a similar nature that individually are not significant.
- The **IFRS specifies** how management is expected to make the accounting estimate. For example, this may be the case for an expected credit loss provision.
- The accounting estimate is derived from the **routine** processing of data.

When testing management's estimate, the auditor considers:

(a) the **method** chosen by management
(b) any significant **assumptions** made by management
(c) the **data** used in the estimate
(d) how management has **selected a point estimate** and has approached the existence of

estimation uncertainty

Management's selection of a point estimate is connected to how it has approached the existence of estimation uncertainty. The auditor performs procedures to address whether management has understood **estimation uncertainty**, and has chosen a point estimate that addresses it. If management's point estimate does not properly address estimation uncertainty, then the auditor should ask management to do so. If management still does not take estimation uncertainty into account then the auditor should **develop an auditor's point estimate**, ie, the auditor should do it themselves. In this case it is possible that there is an internal control deficiency that should be reported in line with ISA 265.

5.4.3 Developing an auditor's point estimate or range

This is the last of the three basic approaches to auditing accounting estimates (along with evidence from subsequent events, and testing how management made the estimate). The ISA makes it clear that, broadly speaking, this approach should only be adopted where the auditor cannot rely on management's estimate.

The ISA suggests the following examples of when this approach may be appropriate:

- The auditor's review of similar accounting estimates made in the **prior period** financial statements suggests that management's current period process is not expected to be effective.
- The entity's **controls** within and over management's process for making accounting estimates are **not well designed** or properly implemented.
- **Events or transactions** between the period end and the date of the auditor's report **have not beenproperly taken into account**, when it is appropriate for management to do so, and such events or transactions appear to contradict management's point estimate.
- **There are appropriate alternative assumptions** or sources of relevant data that can be used in developing an auditor's point estimate or a range.
- **Management has not** taken appropriate steps to **understand** or address the **estimation uncertainty**.

The auditor **may** choose this as the main approach to auditing accounting estimates, but in this case they would still need to comply with the requirements of the ISA to obtain an understanding of the entity and its internal controls relating to accounting estimates, and in particular to understand how management made its estimates (method, data, and assumptions).

The auditor shall ensure that their own estimate is based only on information that is supported by audit evidence. The auditor must also not neglect the **disclosures** that the entity should have made regarding **estimation uncertainty.**

The auditor may develop a point estimate or a range in a number of ways, for example by:

- **using a different model** than the one used by management, eg, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model;
- using management's model but developing **alternative assumptions or data** sources to those used by management;
- **using the auditor's own method** but developing alternative assumptions to those used by management;
- employing or engaging a **person with specialised expertise** to develop or execute a model, or to provide relevant assumptions; or
- **consideration of other comparable conditions**, transactions or events, or, where relevant, markets for comparable assets or liabilities.

5.5 Disclosures

IFRS Standards may require significant disclosures to be made in respect of accounting estimates; the auditor must obtain sufficient appropriate audit evidence in relation to these disclosures.

5.6 Indicators of possible management bias

Definition

Management bias: Is a lack of neutrality by management in the preparation of information.

Accounting estimates may require management to apply judgement to mitigate the effects of subjectivity and complexity. The kinds of judgements made by management may help to reveal any bias that management might have.

Examples of indicators of possible management bias

- Changes in an accounting estimate when management has made a subjective assessment that there has been a change in circumstances (ie, an arbitrary change of an estimate).

- Selection or development of significant assumptions or the data that yield a point estimate favourable for management objectives.
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

If management bias is discovered, the auditor shall consider the effect on the audit. It should be noted that an intention to mislead is fraudulent in nature.

5.7 Overall evaluation based on audit procedures performed

ISA 540 requires auditors to 'stand back' and perform an overall evaluation of the audit procedures.

This evaluation shall consider whether:

(a) the assessments of the risks at the assertion level remain appropriate, including when indicators of possible management bias have been identified;

(b) management's decisions are in accordance with IFRS Standards; and

(c) sufficient appropriate audit evidence has been obtained.

The auditor shall be sure to include **contradictory evidence** in their assessment. If insufficient evidence is obtained then this may have an implication for the auditor's opinion, determined in line with ISA 705.

The auditor must make a **final assessment of the reasonableness** of the accounting estimates based on the audit evidence in order to conclude whether the accounting estimates are reasonable or are misstated.

If there are any differences in between management's point estimates and the auditors' point estimates supported by audit evidence, the auditors should consider whether the **difference is a misstatement** which indicates that management's point estimate lies outside the auditor's range. The concept of the **auditor's range** is thus crucial in telling the difference between an acceptable difference of opinion regarding the accounting estimate, and a misstatement. Any misstatement would then be assessed separately for material in line with ISA 450 – ie, the assessment of materiality is conceptually distinct from the question of whether the misstatement lies outside the auditor's range.

Interactive question 9: Estimated allowances

Explain how the auditor would approach the audit of an allowance for receivables.

See **Answer** at the end of this chapter.

5.8 Sustainability impact

Given the facts and circumstances of an entity, climate-related risks may have an impact on the entity's client-related accounting estimates such as fair value and impairment of non-current assets and the sufficiency of climate-related provisions and contingent liabilities. Matters that the auditor may take into account in auditing accounting estimates may include:

- environmental regulatory factors;
- whether the methods, assumptions and data used remain appropriate; and
- the degree to which the accounting estimate is subject to estimation uncertainty may be impacted because of climate change.

The IAASB practice alert *The Consideration of Climate-Related Risks in an Audit of Financial Statements* (IAASB, 2021) discusses the problems associated with estimates when methodologies change due to advances in technology and updates to regulatory frameworks imposed by government. Understandably, such developments might affect the uncertainty attached to estimates, not least the timescales used for estimating asset lifetimes.

6 Practical issues

Section overview

The audit strategy will also address practical issues such as audit timing, staffing and location.

6.1 The audit team

As part of the audit planning process, the right team will need to be selected:This will depend on matching the need for:

- experience
- specialist knowledge
- ensuring that work is done at the right level

with the risks associated with the audit.

As discussed in Chapter 5, for every engagement there will be an engagement partner who takes overall responsibility for the engagement and who has specific responsibility for:

- ensuring the firm and the team's competence
- ensuring the firm and the team's objectivity
- approving the audit strategy
- communicating their knowledge of the client to the audit team
- ensuring that staff are briefed and supervised appropriately
- ensuring appropriate reviews are carried out of staff's work
- reviewing the financial statements, the key areas and any working papers not otherwise reviewed

There should normally be at least one other person involved on the audit to review the work done.

Beyond this the precise make-up of the team will depend on the scale of the engagement and the different roles can be filled by people with different levels of experience within the firm.

However, most engagements will have a 'senior' or 'in charge' responsible for the day-to-day running of the audit and supervising assistants.

There may well be a 'manager' or 'supervisor' who has more responsibilities for the administration, planning and review of the engagement and would be expected to do less of the detailed testing work than the senior.

Finally there are the assistants who, depending on their experience will take on the execution of the more detailed audit tasks.

The audit strategy should make clear who is responsible for which aspects of the audit, and should strike the difficult balance between:

- ensuring each member of the team has sufficient experience for the job in hand;
- setting new challenges so that experience can be gained; and
- Cost.

6.2 Budgets and deadlines

Audit firms, like any business, are in business to make a profit. The pursuit of profit must not take precedence over professional and quality considerations, nevertheless the audit plan should make perfectly clear:

- when the deadline is
- how much the budget is

6.3 Interim and final audits

Typically much of the systems assessment work and tests of details on the statement of profit or loss will be carried out at the interim stage, with greater focus on the statement of financial position at a final audit.

However, think about a number of factors here:

- What about the statement of profit or loss for the last couple of months of the year?
- If the auditors are relying on controls, were they effective in the period between the interim auditand the year end?
- If the auditors have tested inventory, or receivables at the interim stage, are they happy with the'roll forward' to the year end?

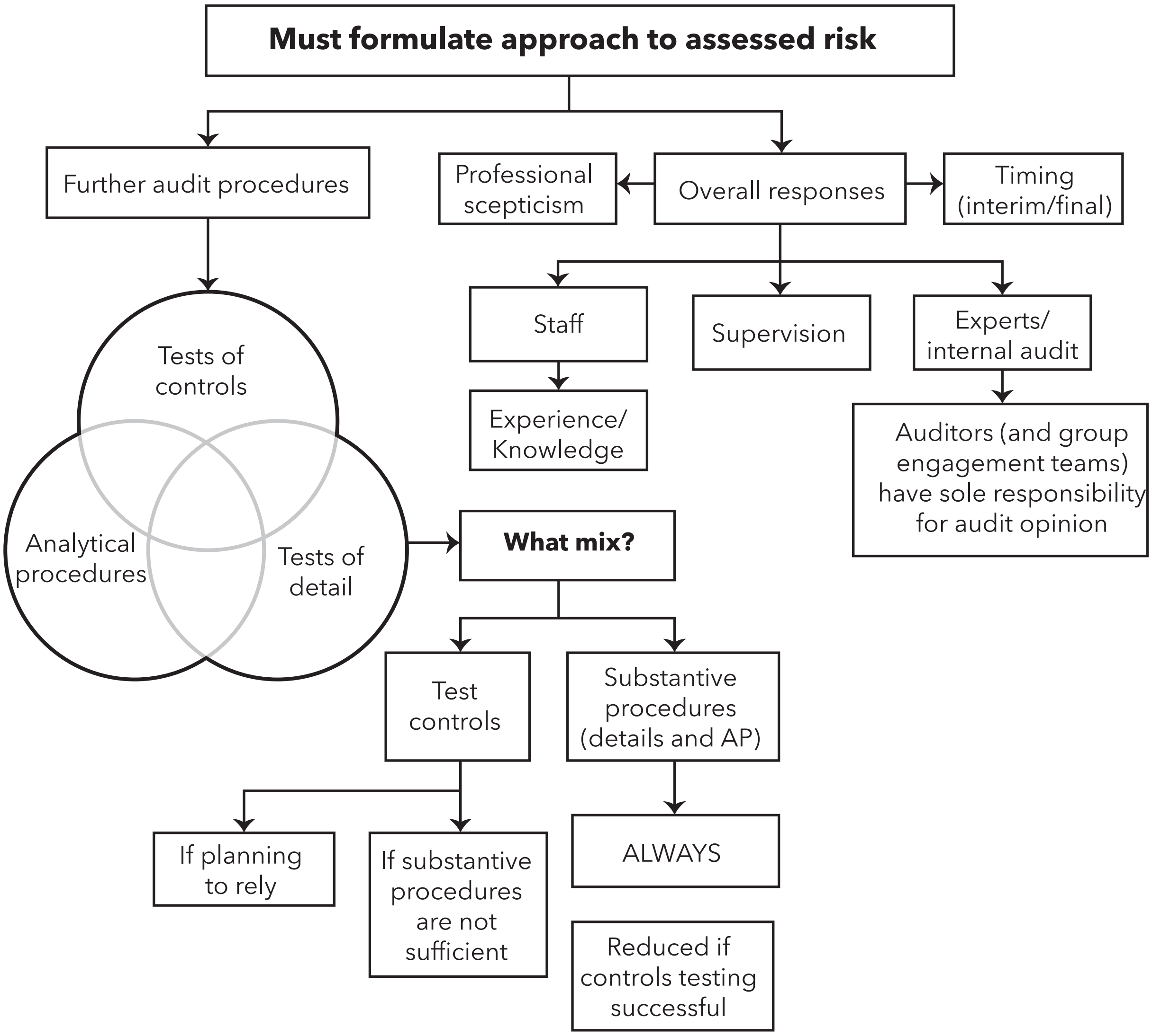
6.4 Location

As hinted at above, the location that the audit work takes place at will depend on the nature of the client and the risk assessment. Some clients will only have one location, in which case the audit will take place at that location. Other clients may have several locations, and the auditors will have to make judgements about which locations are riskier than others and need the auditor to visit them. It may be necessary to attend all locations that a client has at some stage during the audit.

6.5 Nature of evidence

It will be important to address the practical issue of what sources of evidence the audit firm expects to obtain during the audit. You learnt about the quality of audit evidence in your Assurance Workbook. Information generated by the client is never as good quality as information generated by the auditor or from third parties. The audit strategy should set out where information should be sought from third parties (such as in respect of receivables or confirmation of a loan).

Summary



CHAPTER 10

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. It not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you identify the three sources of audit evidence? (Topic 1)	
(2) Can you identify the four main things that an auditor should do if they intend to rely on controls? (Topic 2)	
(3) Can you identify the three substantive procedures that an auditor could carry out? (Topic 3)	
(4) Can you explain how an external auditor assesses the internal audit function? (Topic 4)	
(5) Can you give four examples of accounting estimates including in the financial statements? (Topic 5)	
(6) Which three factors should be considered when selecting the audit team? (Topic 6)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q1	This question tests a point of fundamental knowledge.	
Q4	This is an examinable topic that you should be able to answer a question on.	
Q9	This exam-style question is at the core of this chapter, and it is essential that you attempt it.	

Once you have attempted these questions, you can continue your studies by moving onto the next chapter, Audit of different types of entity.

Technical reference

1 Responding to the risk assessment

Overall responses – ISA 330

Responses to risks of material misstatement at the assertion level – ISA 330

2 Reliance on controls

ISA 330

3 Substantive approach

ISA 330

4 Use of the work of others

Internal audit – ISA 610 Auditor's expert – ISA 620 Management's expert – ISA 500 Other auditors – ISA 600

5 Audit of accounting estimates

ISA 540

IAASB (2020) *The Consideration of Climate-Related Risks in an Audit of Financial Statements* [Online].Available at: https://www.ifac.org/system/files/publications/files/IAASB-Climate-Audit-Practice- Alert.pdf [Accessed: 27 June 2022]

6 Practical issues

N/A

CHAPTER 10

Self-test questions

Answer the following questions.

1 It is appropriate to rely solely on controls testing in relation to the existence of inventory.

A True

B False

2 What are the three sources of audit confidence?

3 The auditor must always carry out substantive procedures.

A True

B False

4 Which of the following will external auditors consider in their assessment of whether to use the work of internal audit?

A To whom the internal audit department reports

B The technical training of the staff in the department

C The fact that the fee will fall if much use can be made of internal audit work

D Whether internal audit work is properly documented

5 External auditors will not rely on the work of an expert who works for the entity.

A True

B False

6 Group engagement teams may refer to the work of component auditors in their report on the group financial statements.

A True

B False

7 Group engagement teams will not be able to form an opinion on group financial statements if:

A The component auditors are not from the same firm

B They have knowledge of the whole group

C The component auditors do not carry out all the procedures as specified by the group engagement team

D The portion of the financial statements they do not audit is material

8 The minimum ideal number of staff used in an audit is:

A One

B Two

C Three

D Four

9 **Gasoleum Ltd**

Your firm is the auditor of Gasoleum Ltd which operates 15 petrol stations in and around Dhaka. You are the senior in charge of the audit for the year ending 31 July 20X7 and are engaged on the audit planning.

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

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

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

The company has an internal auditor, whose principal function is to monitor continuously and test the operation of internal controls throughout the organisation. The internal auditor is also responsible for coordinating the year-end inventory count.

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

Requirements

9.1 Identify, from the situation outlined above, circumstances particular to Gasoleum Ltd that should be taken into account when planning the audit, explaining clearly why these matters should be taken into account.

(6 marks)

9.2 Describe the extent to which the work performed by the internal auditor may affect your planning, and the factors that could limit the use you may wish to make of their work.

(6 marks)

Total: 12 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

The factors are:

- the approach that has been taken in previous years
- whether a substantive approach would be more effective
- the results of walk-through tests on the systems (that is, do the systems operate as the auditor has been led to believe, if so, it may be possible to rely on internal controls)
- the results of preliminary evaluations of the effectiveness of the controls
- improvements made to the system of control (perhaps as a result of a management letter in prior years)

Answer to Interactive question 2

The conditions are as follows:

- whether the controls have operated throughout the year
- whether the control has been evidenced and tested
- whether reliance on the control assists audit objectives, that is, whether it is relevant to the validity of a financial statement assertion, such as that revenue is complete
- whether it is cost-effective to test controls
- whether the results of tests of controls are satisfactory

Answer to Interactive question 3

3.1 Supervisor's assumption Objectives and limitations Completeness

To ensure that all workers who should be paid are included on the payroll:

- Payroll expense could be reconciled to production output records.
- Management could review exception reports of employees having personnel records butnot included on the payroll.

However,

Cost/Benefit

The expense of setting up computerised personnel records may outweigh the benefit to the company. (Risk is of over payment as employees entitled to pay are likely to bring non-payment to management's attention promptly.)

Changes in conditions

A reduction in the ratio of production to support staff may limit the usefulness of production output records as a basis of comparison.

Accuracy

To prevent errors in payroll deductions:

- Calculations of TAX, can be checked prior to processing.
- Non-statutory deductions (eg, pension contributions, union subscriptions) should require prior authorisation in writing.

However,

Human error/misunderstanding

Errors in deductions may not be detected, due to fatigue, distraction, misjudgement or misinterpretation.

Non-routine transactions

Systematic checking procedures may be directed at routine deductions (eg, TAX) rather than non-routine transactions (eg, give as you earn, maintenance payments).

Validity

To ensure that employees are only paid for work done:

- Hours worked per time sheets (or clock cards) can be approved by a departmental manager (or supervisor).
- The duties of payroll preparation and payment should be segregated.

However,

Abuse of override

Authorisation could be given for a new employee to be added to the payroll without the proper checks being carried out by the authoriser.

Collusion

The person responsible for paying wages could collude with the person responsible for accounting for wages to perpetrate and conceal a theft of wages.

3.2 Internal control terminology

Segregation of duties

Meaning

Segregation of duties is a factor reflected in the control environment (the overall attitude, awareness and actions of management regarding internal controls in the entity).

If one person has responsibility for the recording and processing of a complete transaction, they may also have the power to falsify the records or to misappropriate money or assets without being discovered.

Separation of these responsibilities will reduce the risk of intentional or unintentional errors occurring.

The functions that should normally be separated include authorisation, execution, custody and recording.

Examples

- Calculations of TAX and deductions should be reviewed and authorised by the payroll supervisor who is not actually involved in performing the calculations.
- Unclaimed wages should be kept by someone (eg, the cashier) other than the person responsible for recording payroll entries, otherwise there could be a temptation to falsify the figures and pocket some of the wages.

Approval and control of documents

Meaning

Approval and control of documents is a specific control procedure (aimed at preventing or detecting and correcting errors).

Approval is concerned with ensuring that transactions are properly authorised prior to execution.

Control of documents is aimed at ensuring that all, and only valid transactions, are promptly recorded.

Examples

- Overtime pay should be approved by a manager or director prior to payroll preparation, to ensure that employees are paid at authorised rates.
- Clock cards should be batched and control totals established (eg, number of cards, total hours worked, hash total of employee number) prior to submission to payroll department, toprevent (or detect for early investigation) any omissions (or unauthorised insertions).
- The numerical sequence of forms for new joiners should be checked periodically to detect omissions (or unauthorised insertions).

Answer to Interactive question 4

Circumstances include:

- the auditor's initial assessment is that controls are not strong
- there is a lack of evidence that controls are in operation
- the controls are tested and results show that the controls are not strong
- it is not cost-effective to test controls

Answer to Interactive question 5

5.1 Analytical procedures and reasons for change:

Analytical procedures	**Possible reasons for change**
Analyse revenue per product type by month	A difference in the rate of increase would indicate a switch from one product to the other. Seasonal variations are expected as Glowvine is largely a winter product and Eau Vital a summer product.
Analyse gross profit per product type by month	GP margin has increased from 55.5% to 59.1%. The higher margin indicates a move from Glowvine to Eau Vital (possibly due to a mild winter in 20X5/X6).
Analyse cost of goods sold per product type by month	Cost of goods sold only increased by 60.6%, while revenue increased by almost 75%. Again, a possible reason could be the switch from one product to the other. It does seem a disproportionately small increase, especially as royalties are included in cost of goods sold and remain constant per bottle sold, regardless of product. However, recycling of glass bottle returns could account for the slower rate of increase.

Analytical procedures	Possible reasons for change
Analyse distribution and administrative costs into:	These have increased by 153%, contributing to the fall in net profit margin from 43% to 41%. The increase in these costs could have been caused by:
Administrative cost (especially deposit scheme)	Implementation of the deposit scheme (unlikely to account for the whole increase as not operational for the whole year)
Advertising costs	Increased advertising costs to promote the deposit scheme and 'environment friendly' nature of the products (this could also have contributed to the increase in revenue)
Transport costs	Increased transport costs in proportion to the 75% increase in revenue
Labour costs	Increased labour costs, again in proportion to the rise in revenue
Analysis of nature, valuation and consistency of treatment of closing inventories. Compare with inventories held at end of previous years. The disproportionately smaller increase in cost of goods sold could be caused by an error in the counting or valuation of closing inventories, causing them to be overstated and thus cost of goods sold reduced.	The disproportionately smaller increase in cost of goods sold could be caused by an error in the counting or valuation of closing inventories, causing them to be overstated and thus cost of goods sold reduced.

5.2 Impact of deposit scheme on audit of liabilities

Liabilities at the 20X6 year end will have increased, as this is the first year in which the scheme has been implemented. This should be evident in analytical procedures on sundry payables.

The amount may be material as the number of bottles sold and not returned per annum could be high.

It is necessary to ascertain and evaluate the client's procedure for recording:

(1) the number of bottles (or cases) sold

(2) the number of bottles returned

(3) the number outstanding

As this is the first year of the scheme there will be no opening liability to provide added assurance.

Consideration should be given to the length of time the client intends to keep the provision in place. It may be that, each year, the previous year's provision can be written back.

Because of the uncertainty in calculating the liability required and the fact that the final figure may rest on an estimate of the number of bottles likely to be returned, the auditor's main concern will be that liabilities are not understated.

The auditor therefore needs to be satisfied that returns are recorded with reasonable accuracy.

Records of returns will be received from retailers (mainly supermarkets and off-licences) and the auditor will need to be satisfied that the client can reasonably rely on these records. Since the retailers will be requesting a refund of money paid by them with the returns, there is a risk that the number of returns may be overstated.

In summary, the principal impact on the audit of liabilities will be:

(1) an additional year end liability in 20X6

(2) uncertainty in the calculation of the liability, and therefore

(3) the risk that this liability may be understated

Answer to Interactive question 6

You should take into account the following factors:

- The objectivity of the department, including its freedom from conflicting responsibilities and the level of management it reports to. In this case, you know that Mrs Gnome reports directly to the board of directors, so the department has an important status in the company. You would also consider whether there is any limitation on the assignments carried out, and to what extent recommendations are acted upon by management.
- The competence of the people carrying out the work. In this case it would be necessary to inquire about the competence of Mrs Gnome; for example, is she a qualified accountant? It would also be necessary to identify the other members of the internal audit team (if there are any) and assess their competence as well.
- The application of a systematic and disciplined approach. The external auditors should review the work carried out by the internal auditors to check that it was documented in the first place, and to assess whether it was planned and whether there is evidence of its being supervised and reviewed.
- Communication with external audit. You would need to enquire what arrangements have been put in place to enable internal audit to communicate freely and effectively with external audit.

Answer to Interactive question 7

7.1 Information for assessment and reasons:

Information	**Reasons**
The organisational status and reporting responsibilities of the internal auditor and any constraints and restrictions thereon.	The degree of objectivity is increased when internal audit: is free to plan and carry out its work and communicate fully with the external auditor has access to the highest level of management
Areas of responsibility assigned by management to internal audit, such as review of: Accounting systems and internal controls Implementation of corporate plans	Not all areas in which internal audit may operate will be relevant to the external auditor. (Relevant) (Not relevant)
Routine tasks carried out by internal audit staff such as authorisation of petty cash reimbursements	In these respects, staff are not functioning as internal audit (simply as an internal control).
Internal auditor's formal terms of reference	Internal auditor's role will be most relevant where it has a bearing on the financial statements and involves a specialisation.
Internal audit documentation such as an audit manual and audit plans	It is more likely that due professional care is being exercised where the work of internal audit is properly planned, controlled, recorded and reviewed.

Information	Reasons
Professional membership and practical experience (including computer auditing skills) of internal audit staff	Unless internal audit is technically competent it is inappropriate to place reliance on it.
Internal audit reports generated and feedback thereon	How the company responds to internal audit findings may be regarded as a measure of the department's effectiveness.
Number of staff, computer facilities and any other resources available to internal audit	The effectiveness of internal audit (and hence the reliance placed thereon) will be limited if the department is under-resourced.

7.2 Typical procedures (four only)

Inspection of tangible non-current assets

Assets seen at the warehouses (eg, delivery vehicle fleet) should be noted and subsequently agreed to the fixed asset register maintained at head office (HO). Assets recorded in the register (eg, shop fixtures and fittings) should be selected for inspection prior to visits to ensure their existence.

Attendance at inventory counts

Periodic counts (eg, monthly) should be attended:

- on a rotational basis
- at warehouses and larger shops

to ensure adherence to the company's procedures. Test counts should be made to confirm the accuracy and completeness of the inventory counts.

Cash

Cash counts should be carried out on cash register takings (and petty cash floats) whenever shops (and warehouses) are visited on a 'surprise' basis.

Goods despatch

Internal control procedures should be observed to be in operation, for example, to ensure that all despatches are documented and destined for the company's retail outlets.

Employee verification

Payroll procedures are likely to be carried out at HO, warehouses and shops informing HO on a weekly basis of hours worked by employees, illness and holiday etc. However, new employees, especially in the shops (and probably also in the warehouses) will be recruited locally and their details notified to HO.

Internal audit will be able to select a sample of employees from HO records and ensure on their visits to shops and warehouses that these represent bonafide employees.

7.3 Effect on audit

Systems documentation

The accuracy of systems documentation which has been prepared by internal audit need only be confirmed using 'walk-through tests'. This saves time (if the systems documentation is correct) since only copies will be required for the audit file.

Tests of controls

The level of independent testing (ie, by the external auditor) can be reduced where controls have been satisfactorily tested by internal audit, especially if error rates are found to be similar.In particular, attendance at stocktaking at the year end may be limited to those locations with the highest stockholdings.

Substantive procedures

Internal audit's evidence (eg, concerning the existence of tangible non-current assets) will reduce sample sizes for year-end verification work. Substantive procedures may also be reduced where the internal audit checks reconciliations (eg, bank reconciliations).

Answer to Interactive question 8

Reasons for reviewing the work of other auditors

The main consideration which concerns the audit of all group accounts is that the parent company's auditors are responsible to the members of that company for the audit opinion on the whole of the group financial statements.

It may be stated (in the notes to the financial statements) that the financial statements of certain components have been audited by other firms, but this does not absolve the parent company auditors from any of their responsibilities.

The auditors of a parent company have to report to its members on the truth and fairness of the view given by the financial statements of the company and its components dealt with in the group financial statements. The auditors should have powers to obtain such information and explanations as they reasonably require from the components and their auditors, or from the parent company in the case of overseas components, in order that they can discharge their responsibilities as parent company auditors.

The auditing standard ISA 600 clarifies how the group engagement team can carry out a review of the audits of components in order to satisfy themselves that, with the inclusion of figures not audited by themselves, the group financial statements give a true and fair view.

The scope, standard and independence of the work carried out by the auditors of components (the component auditors) are the most important matters which need to be examined by the group engagement team before relying on financial statements not audited by them. The group engagement team need to be satisfied that all material areas of the financial statements of components have been audited satisfactorily and in a manner compatible with that of the group engagement team's requirements.

Work to be carried out by group engagement team in reviewing the component auditors' work

(a) Before commencing the audit the group engagement team needs to provide instructions to the component auditor in the form of an engagement letter which should include the following matters relating to planning the audit work:

- confirmation that the component auditor will cooperate with the group engagement team
- timetable for completing the audit
- dates of planned visits
- key contacts
- work to be performed by the component auditor
- ethical requirements
- component materiality levels
- details of related parties
- work to be performed on intra-group transactions
- guidance on statutory reporting responsibilities
- specific instructions for a subsequent events review where required

(b) Carry out a detailed review of the component auditors' working papers on each component whose results materially affect the view given by the group financial statements. This review will enable the group engagement team to ascertain whether (inter alia):

- An up-to-date permanent file exists with details of the nature of the component's business, its staff organisation, its accounting records, previous year's financial statements and copies of important legal documents.
- The systems examination has been properly completed, documented and reported on to management after discussion.
- Tests of controls and substantive procedures have been properly and appropriately carried out, and audit programmes properly completed and signed.
- All other working papers are comprehensive and explicit.
- The overall review of the financial statements has been adequately carried out, and adequate use of analytical procedures has been undertaken throughout the audit.
- The financial statements agree in all respects with the accounting records and comply with all relevant legal requirements and accounting standards.
- Minutes of board and general meetings have been scrutinised and important matters noted.
- The audit work has been carried out in accordance with approved auditing standards.
- The financial statements agree in all respects with the accounting records and comply with all relevant legal and professional requirements.
- The audit work has been properly reviewed within the firm of auditors and any laid down quality management policies and procedures adhered to.
- Any points requiring discussion with the parent company's management have been noted and brought to the group engagement team's' attention (including any matters which might warrant a qualification in the auditor's report on the component company's financial statements).
- Adequate audit evidence has been obtained to form a basis for the audit opinion on both the components' financial statements and those of the group.

If the group engagement team are not satisfied as a result of the above review, they should arrange for further audit work to be carried out either by the component auditors on their behalf, or jointly with them. The component auditors are fully responsible for their own work; any additional tests are those required for the purpose of the audit of the group financial statements.

Answer to Interactive question 9

Audit approach

- Review the requirements of the appropriate financial reporting framework for allowances for receivables.
- Discuss with management how the allowance has been calculated.
- Obtain a breakdown of the allowance, agree balances to the receivables ledger and reperform calculations.
- Compare actual receivables written off in prior periods with previous estimates.
- Ascertain who is responsible for reviewing and approving the allowance.
- Obtain an aged listing of receivables as at the reporting date and identify overdue amounts and review correspondence relating to these accounts and arrive at an independent estimate of the allowance required.
- Compare this with management's estimate.
- Review cash received from customers after the reporting date up to the date of the auditor's report to identify whether any receivables balances that appeared to be doubtful have subsequently been settled.

Answers to Self-test questions

1 Correct answer(s):

B False

2 The three sources are:

- Tests of controls
- Analytical procedures
- Tests of details

3 Correct answer(s):

A True

4 Correct answer(s):

A To whom the internal audit department reports

B The technical training of the staff in the department

D Whether internal audit work is properly documented

5 Correct answer(s):

B False

6 Correct answer(s):

B False

7 Correct answer(s):

C The component auditors do not carry out all the procedures as specified by the group engagement team

8 Correct answer(s):

B Two

One to carry out the work and another to review it.

9 Gasoleum Ltd

9.1 Notes for a planning meeting

Circumstance	Why taken into account
Multiple business locations	Increases inherent risk (eg, if the organisational structure is loose and difficult to manage).
Intense price competition	May lead to uneconomic price discounting, possibly threatening viability of business.
Recent expansion of outlets into minimarkets	Increases complexity of business and may lead to loss of management control.
Perishable nature and limited shelf-life of food and drinks inventories	Increase risk of overstatement of inventory values.
Large volume of cash transactions	Increases risk of incomplete income recording.

Circumstance	Why taken into account
Nature of the business (garage environment)	Increases risk of loss of inventories and cash due to theft or staff pilferage. May limit effectiveness of physical security controls (eg, over access to terminals).
Recent introduction of sales of National Lottery tickets	Increases inherent risk (eg, the risk of loss to Gasoleum Ltd if incorrect amounts are paid out on winning tickets).
Direct input via PCs at branches	Increases risk of misstatement, as batch controls will not be feasible and scope for other input controls may be limited.
Small number of staff at each location (eg, one or two)	Limits scope for segregation of duties within branches and therefore increases control risk.
Branch-based nature of business	Limits effectiveness of management control over activities of individual branches thereby increasing control risk.
Use of part-time staff and high staff turnover	May inhibit effectiveness of controls within branches.

9.2 Effect of work of internal auditor on audit planning

(1) The internal auditor's identification and documentation of areas of weakness will give direction to areas requiring increased substantive procedures.

(2) Work of the internal auditor may assist in selection of branches for audit visits, (eg, where control failures have occurred).

(3) The internal auditor may attend year-end inventory counts at one or more branches, potentially reducing the number of branches to be visited by us.

(4) Work performed by the internal auditor may provide evidence to confirm operation of control procedures, on which we may seek to rely to reduce the extent of our own procedures.

(5) Documentation of systems and controls by the internal auditor, including changes due to the National Lottery, may reduce extent of our planning visits, as walkthrough checks may be sufficient to confirm systems documentation.

Chapter 11

Audits of different types of entity

Introduction

Learning outcomes

Planning and performing engagements

Students will be able to plan and perform assurance engagements in accordance with the terms of the engagements and appropriate standards.

- Discuss the differences between the audit of a non-specialised profit-oriented entity and the audit of a given specialised profit-oriented entity
- Discuss the differences between the audit of a non-specialised profit-oriented entity and the audit of a given not-for-profit entity
- Specify and explain the steps necessary to plan, perform, conclude and report on the audit of the financial statements of a non-specialised profit-oriented entity in accordance with the terms of the engagement including appropriate auditing standards

Syllabus links

You have covered the key issues relating to planning non-specialised audits in this Workbook. You covered obtaining evidence on non-specialised audits in greater detail in your Assurance studies.

Examination context

Complex auditing requirements relating to specialised entities are not examinable.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	Although all companies are unique, many are fairly standard for audit purposes, and would be described as non-specialised. However, some entities and companies have specialised requirements which add complexity to the audit being carried out. **Stop and think** Why might certain entities have special audit requirements?	This short section should be read through quickly.	Complex auditing requirements relating to specialised entities are not examinable. The material in this section may be examined in a short-form question.	1

Topic	Practical significance	Study approach	Exam approach	Self-test questions
2	Many firms have specialisms within their audit departments, so if you work in practice, you may find you specialise in the audit of certain specialised entities or not-for-profit entities. an audit firm such as the National Audit Office that undertakes public sector audit work. Alternatively, you do not audit one of these entities at all.	Read this section carefully, including the worked example and the activities.	The material in this section could be tested anywhere in the examination.	2, 3, 4, 5, 6

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1 Non-specialised and specialised entities

Section overview

- The majority of audits relate to non-specialised profit orientated entities.
- The standard audit features outlined in this workbook and in the Assurance Workbook apply to this type of entity.
- Some entities are 'special' in some way, for example:
- The entity is subject to extra regulations, such as banks or insurers, or charities/NGO (note that weshall look in particular at not-for-profit entities below).
- The entity is subject to professional rules, such as solicitors.
- Such entities may be subject to special auditing guidance, all of which is outside the scope of your syllabus.
- It is important to note that many of these entities require a 'normal' statutory audit as well as any additional requirements upon them.
- In which case, the auditors need to assess the particular risks associated with the specialised entities which will cause any differences in audit approach.

Many audits undertaken in Bangladesh relate to non-specialised profit-making entities (that is a 'normal' company operating for profit. For example, a manufacturing company, a service company, a retail company). The audit procedures outlined in this Workbook so far and in your Assurance Workbook all relate to this type of entity, and the majority of questions in your exam are likely to be set in this context. However, some entities are 'special' in some way, for example, they are subject to extra laws and regulations (for example, banks or insurers) or they are subject to particular professional rules, such as solicitors. Such entities may or may not require a statutory audit. As always the auditor must be aware of the particular risks associated with the entity in order to plan and conduct the audit.

Specialised entities are often subject to particular requirements that pose additional factors for auditors. For example, under their professional rules, solicitors require a 'solicitors' accounts rules audit'. Some specialised entities are subject to special accounting and auditing guidance, which adds detail to the audit, in addition to the normal statutory audit that is being carried out. Such specialised guidance is beyond the scope of your syllabus. You should simply be aware that audits of such specialised entities will have special requirements in addition to normal audit requirements that makes auditing them more complex.

2 Not-for-profit entities

Section overview

- There are various types of organisations which do not exist for the purpose of maximising shareholder wealth, which may require an audit.
- The audit risks associated with not-for-profit organisations may well be different from other entities.
- Cash may be significant in small not-for-profit NGOs and controls are likely to be limited. Income may well be a risk area, particularly where money is donated or raised informally.
- Obtaining audit evidence may be a problem, particularly where small NGOs have informal arrangements and there might be limitations on the scope of the audit.
- In all not-for-profit audits it will be necessary to ensure accounting policies used are appropriate.

- The nature of the report will depend on statutory and entity requirements, but it should conform to ISA 700 criteria.
- The public sector comprises a large number of varied not-for-profit organisations, and also private companies which are profit oriented, running (outsourced) public services.

The key objective of most companies is to manage their shareholders' investments well. In a large majority of cases, 'manage the shareholders' investment' means 'create a profit', as this will create returns to the shareholders in the form of dividends or growth in the capital value of their shares. However, some companies and other entities do not operate for the purpose of making profit but have other objectives instead. Examples include charities/NGO and organisations in the public sector.

Many of these organisations are legislated for and the Acts which relate to them may specify how they are to report their results. Some of the organisations mentioned above may be companies (often companies limited by guarantee) and so are required to prepare financial statements and have them audited under companies legislation.

Where a statutory audit is required, the auditors will be required to produce the statutory audit opinion concerning the truth and fairness of financial statements.

Where a statutory audit is not required, it is possible that the organisation might have one anyway for the benefit of interested stakeholders, such as the public or people who give to a charity/NGO.

It is also possible that such entities will have special, additional requirements of an audit. These may be required by a Regulator, or by the constitution of the organisation. For example, a NGO's constitution may require an audit of whether the NGO is operating in accordance with its charitable purpose.

An audit of a not-for-profit organisation may vary from a 'for-profit audit' due to:

- its objectives and the impact on operations and reporting
- the purpose an audit is required

When carrying out an audit of a not-for-profit organisation, it is vital that the auditor establishes:

- whether a statutory audit is required;
- if not, what the objectives of the engagement are;
- what the engagement is to report on;
- to whom the report should be addressed; and
- what form the report should take.

Professional skills focus: Applying judgement

Many of the skills required to perform a specialised audit overlap with those of a statutory auditor, but you would need to undergo training in order to understand the specific requirements of the entity in question.

2.1 NGOs

NGOs are regulated under the Foreign Donations (Voluntary Activities) Regulation Act, 2016. This sets out what a NGO is and outlines how they are regulated. The NGOs regulator is the NGO Affairs Bureau.

Definition

NGO: An institution which:

- is established for charitable purposes only; and
- any organization registered by the bureau to conduct voluntary activities inside Bangladesh, and any organization or NGO registered under any prevalent law of any foreign country and also registered under this act shall be included.

The Foreign Donations (Voluntary Activities) Regulation Act, 2016 recognises the following charitable purposes:

- Prevention or relief of poverty
- Advancement of one or more of the following:
  - education
  - religion
  - health/saving lives
  - citizenship/community development
  - arts/culture/heritage/science
  - amateur sport
  - human rights/conflict resolution/promotion of religious or racial harmony/equality/diversity
  - environmental protection/improvement
  - animal welfare
- The relief of those in need by reason of youth, age, ill-health, disability, financial hardship or other disadvantage.
- The promotion of the efficiency of the armed forces of the Crown, the police, fire and rescue or ambulance services.

NGO accounts should comprise the following.

- A **statement of financial activities** that shows all resources made available to the NGO and all expenditure incurred and reconciles all changes in its funds.
- Where the NGO is required to prepare accounts in accordance with the Companies Act, or similar legislation, or where the governing instrument so requires, a **summary income and expenditure account** in certain circumstances.
- A **balance sheet** that shows the assets, liabilities and funds of the NGO. The balance sheet (or its notes) should also explain, in general terms, how the funds may, because of restrictions imposed by donors, be utilised.
- A **statement of cash flows** is mandatory.
- **Notes**

A NGO's governing document may contain specific provisions about audit requirements. In such cases the NGO must follow the higher standard of scrutiny required by either the statutory framework or governing document.

The verification process is a less onerous form of scrutiny than an audit and correspondingly gives a lower level of assurance. The examiner is not required to give an opinion as to whether the accounts give a true and fair view. Instead they must report whether or not any matter has come to their attention indicating that:

- proper accounting records have not been kept
- the accounts do not comply with such records
- the accounts fail to comply with relevant regulations

In addition, if such matters have become apparent, the report should include details of:

- material expenditure or actions contrary to the trusts of the NGO
- failure to provide information or explanations to which the examiner is entitled
- evidence that the accounts prepared on an accruals basis are materially inconsistent with the trustees' annual report

In order to produce this report, the verifier should:

- check whether the NGO is eligible to have an independent examination
- check for any conflict of interest that prevents the examiner from carrying out their independent examination
- record the independent examination
- plan the independent examination
- check that accounting records are kept to the required standard
- check that the accounts are consistent with the accounting records
- if the accounts are prepared on an accruals basis and one or more related party transactions took place the examiner must check if these were properly disclosed in the notes to the accounts
- check the reasonableness of the significant estimates and judgements and accounting policies used in accounting for the types of fund held and in the preparation of the accounts
- the examiner must check whether the trustees have considered the financial circumstances of the NGO at the end of the reporting period and, if the accounts are prepared on an accruals basis, check whether the trustees have made an assessment of the NGO's position as a going concern when approving the accounts
- check the form and content of the accounts
- identify items from the analytical review of the accounts that need to be followed up for further explanation or evidence
- compare the trustees' annual report with the accounts
- write and sign the independent examination report

2.1.1 Planning

When planning the audit of a NGO, the auditors should particularly consider the following:

- the scope of the audit
- recent recommendations of the **NGO Affairs Bureau** or the other regulatory bodies
- the acceptability of accounting policies adopted
- changes in circumstances in the sector in which the NGO operates
- past experience of the effectiveness of the NGO's accounting system
- key audit areas
- the amount of detail included in the financial statements on which the auditors are required to report

In order to identify the key audit areas, the auditors will have to consider audit risk.

There are certain risks applicable to NGOs that might not necessarily be applicable to other companies. The auditors should consider the following:

Problem	Key factors
Inherent risk	The complexity and extent of regulation The significance of donations and cash receipts Difficulties of the NGO in establishing ownership and timing of voluntary income where funds are raised by non-controlled bodies Lack of predictable income or precisely identifiable relationship between expenditure and income Uncertainty of future income Restrictions imposed by the objectives and powers given by NGO's governing documents The importance of restricted funds (funds which the company is only allowed to put to a specific purpose) The extent and nature of trading activities must be compatible with the entity's charitable status The complexity of tax rules (whether Income, Capital, Value Added or local rates) relating to NGOs The sensitivity of certain key statistics, such as the proportion of resources used in administration The need to maintain adequate resources for future expenditure while avoiding the build-up of reserves which could appear excessive
Control risk	The amount of time committed by trustees to the NGO's affairs The skills and qualifications of individual trustees The frequency and regularity of trustee meetings The form and content of trustee meetings The independence of trustees from each other The division of duties between trustees The degree of involvement in, or supervision of, the NGO's transactions on the part of individual trustees
Control environment	A recognised plan of the NGO's structure showing clearly the areas of responsibility and lines of authority and reporting Segregation of duties Supervision by trustees of activities of staff where segregation of duties is not practical Competence, training and qualification of paid staff and any volunteers appropriate to the tasks they have to perform Involvement of the trustees in the recruitment, appointment and supervision of senior executives Access of trustees to independent professional advice where necessary Budgetary controls in the form of estimates of income and expenditure for each financial year and comparison of actual results with the estimates on a regular basis Communication of results of such reviews to the trustees on a regular basis

Professional skills focus: Applying judgement

Auditors of NGOs will need to apply ISAs ; the considerations contained in the table above can be thought of as helping to apply ISA 315 to NGOs.

2.1.2 Internal controls

Small NGOs in particular will generally suffer from internal control weaknesses common to small enterprises, such as **lack of segregation of duties** and use of **unqualified staff**. Short comings may arise from the staff's lack of training and also, if they are volunteers, from their attitude, in that they may resent formal procedures.

The auditors will have to consider particularly carefully whether they will be able to obtain adequate assurance that the accounting records do reflect all the transactions of the enterprise and bear in mind whether there are any related statutory reporting requirements.

The following sorts of internal control might be typical of a number of charity/NGOs.

Cash donations	
Source	**Examples of controls**
Collecting boxes and tins	Numerical control over boxes and tins Satisfactory sealing of boxes and tins so that any opening prior to recording cash is apparent Regular collection and recording of proceeds from collecting boxes Dual control over counting and recording of proceeds
Postal receipts	Unopened mail kept securely Dual control over the opening of mail Immediate recording of donations on opening of mail or receipt Agreement of bank paying-in slips to record of receipts by an independent person

Other donations	
Source	**Examples of controls**
Gift aid	Regular checks and follow-up procedures to ensure due amounts are received Regular checks to ensure all tax repayments have been obtained
Legacies	Comprehensive correspondence files maintained in respect of each legacy Regular reports and follow-up procedures undertaken in respect of outstanding legacies
Donations in kind	In the case of NGO shops, separation of recording, storage and sale of inventory

Other income	
Source	**Examples of controls**
Fund-raising activities	Records maintained for each fund-raising event Other appropriate controls maintained over receipts Controls maintained over expenses as for administrative expenses
Central and local government grants and loans	Regular checks that all sources of income or funds are fully utilised and appropriate claims made Ensuring income or funds are correctly applied

Use of resources	
Resource	**Examples of controls**
Restricted funds	Separate records maintained of relevant revenue, expenditure and assets Terms controlling application of fund Oversight of application of fund monies by independent personnel or trustees
Grants to beneficiaries	• Records maintained, as appropriate, of requests for material grantsreceived and their treatment • Appropriate checks made on applications and applicants for grants,and that amounts paid are *intra vires* • Records maintained of all grant decisions, checking that proper authority exists, that adequate documentation is presented to decision-making meetings, and that any conflicts of interest are recorded • Control to ensure grants made are properly spent by the recipient for the specified purpose, for example requirements for returns with supporting documentation or auditors' reports concerning expenditure, or monitoring visits

Conversely, large NGOs might have very strong controls and the auditors may find that they are able to rely on them to a great extent. Remember, however, that while relying on controls might be acceptable in order to determine whether the financial statements give a true and fair view, it might not be acceptable to meet any special additional auditing requirements that the NGO has.

2.1.3 Substantive procedures

When designing substantive procedures for NGOs the auditors should give special attention to the possibility of:

- **understatement or incompleteness** of the **recording of all income** including gifts in kind, cash donations, and legacies
- **overstatement of cash grants or expenses**
- **misanalysis** or misuse in the application of funds (such as restricted funds which the NGO might only be able to use for specific purposes)

- misstatement or omission of assets including donated properties and investments
- the existence of restricted or uncontrollable funds in foreign or independent branches

Completeness of income can be a particularly problematic area. Areas auditors may check:

- loss of income through fraud
- recognition of income from professional fund raisers
- recognition of income from branches, associates or subsidiaries
- income from informal fund-raising groups
- income from grants

2.1.4 Overall review

The auditors must consider carefully whether the accounting policies adopted are appropriate to the activities, constitution and objectives of the NGO, and are consistently applied, and whether the financial statements adequately disclose these policies and fairly present the state of affairs and the results for the accounting period.

In particular, the auditors should consider the basis of disclosing income from fund raising activities (for example net or gross), accounting for income and expenses (accruals or cash), the capitalising of expenditure on non-current assets, apportioning administrative expenditure, and recognising income from donations and legacies.

NGOs without significant endowments or accumulated funds will often be dependent upon future income from voluntary sources. In these circumstances auditors may question whether a going concern basis of accounting is appropriate.

2.1.5 Reporting

On not-for-profit audits where a statutory auditor's report is required, the auditors should issue the standard auditor's report which we will consider in Chapter 13. They should also consider whether any additional statutory requirements fall on the auditor's report.

Where an association or NGO is having an audit for the benefit of its members or trustees, the standard auditor's report may not be required or appropriate. The auditor should bear in mind the objectives of the audit and make suitable references in the auditor's report. However, the ISA 700 format will still be relevant. The auditor should ensure that they make the following matters clear:

- the addressees of the report
- what the report relates to
- the scope of the engagement
- the respective responsibilities of auditors and management/trustees/directors
- the work done
- the opinion formed

The points made above are general points. Remember that not all clubs and NGOs will be the same. If you have a question in the exam relating to a NGO, apply this general knowledge to the specifics given in the question and be logical when formulating your answer.

2.1.6 Glossary of terms

The following definitions refer to some of the terms used with respect to charity/NGOs:

- Trustees: the people responsible for the overall control of the NGO and for ensuring that it is properly managed.
- Endowments: these may be in the form of investments or property, the income from which can bespent by the charity/NGO.

- Restricted funds: funds which can be spent at the discretion of the trustees.
- Designated funds: funds which may be used for specific purposes only, which may be requestedby the donor of the funds.

Context example: NGO

Headington Hospice Co is a small, local NGO which operates a small children's hospice and two NGO shops which raise money for the ongoing work of the hospice. The hospice receives grants from the health authority, sponsorship from some local businesses, receives income from the NGO shops which are entirely voluntarily operated and receives donations from individuals. It employs three nurses, a part-time hospice manager and an accountant donates their time to keep the books and produce the annual accounts. As the company's turnover falls below the exemption limit, it is not required to have an audit by law, but the terms of its constitution require that an audit of the accountsis required for the benefit of the trustees that gives an opinion as to whether the financial statements give a true and fair view and to whether the NGO is meeting its objectives, as set out in the constitutional document.

The scope of this audit is therefore two-fold. The auditors are to report on the truth and fairness of the financial statement for the benefit of the trustees and also on whether the NGO is meeting its objectives. The auditors should therefore establish what the objectives of the NGO are, and consider whether the objectives are being met.

The auditors should consider whether any recommendations of the NGO Affairs Bureau apply to Headington Hospice. It is unlikely that there have been any substantial changes in the sector in which it works.

In terms of audit approach, the auditor will need to devote attention to cash receipts and income, as the Hospice receives donations from the public and also receives cash income from the NGO shops. The auditors will need to determine if there is a good control system in place and whether they feel that they can place reliance on it.

In terms of substantive procedures, in particular, it will be necessary to consider non-current assets, to determine whether the premises the hospice and NGO shops should be included on the balance sheet of the NGO. The auditor will also need to assess the nature of the grants received from the health authority to determine how they should be accounted for. These things should all be considered as part of the accounting policy review. The auditor should also be aware of issues such as depreciation during this review, as the hospice may own specialised medical equipment which makes such issues complex.

Another matter which the auditor must consider is the issue of going concern. This will include an assessment of the sponsorship deals which the NGO has in place and any consideration of future sponsorship. The grant position must also be considered, as must the likelihood of future donations.

The auditors should also consider matters such as personnel, for example, whether any existing arrangements with doctors' practices will continue in existence.

The issues relating to cash donations and grants will be particularly relevant. Particular matters which might be an issue at Headington Hospice are:

- completeness of cash income from various sources
- accounting for the grants from the local authority

Interactive question 1: Links Famine Relief

You have recently been appointed to audit Links Famine Relief, a small registered charity which receives donations from individuals to provide food in worldwide famine areas.

The charity is run by a voluntary management committee, which has monthly meetings, and it employs the following full-time staff:

(1) A director, Ms Roberts, who suggests fund raising activities and payments for relief of famine,and implements the policies adopted by the management committee; and

(2) A secretary (and bookkeeper), Ms Beech, who deals with correspondence and keeps the accounting records.

Links Famine Relief is required by its constitution to have an annual external audit of its financial statements.

You are planning the audit of income of the charity for the year ended 5 April 20X7 and are considering the controls which should be exercised over income.

The previous year's accounts, to 5 April 20X6 (which have been audited by another firm) show the following income.

	CU	CU
Gifts under non-taxing arrangements		15,335
Tax reclaimed on gifts under non-taxing arrangements		4,325
		19,660
Postal donations		63,452
Autumn Fair		2,671
Other income		
Legacies	7,538	
Bank deposit account interest	2,774	
		10,312
		96,095

Notes

1 Income from gifts under non-taxing arrangements is stated net. Each person who pays by gift aid has filled in a special tax form, which is kept by the secretary, Ms Beech.

2 All gifts under non-taxing arrangements are paid by banker's order – they are credited directly to the charity's bank account from the donor's bank. Donors make their payments by gift aid either monthly or annually.

3 The tax reclaimed on these gifts is 28.2% (22/78) of the net value of the gifts, and relates to income received during the year – as the tax is received after the year end, an appropriate amount recoverable is included in the balance sheet. The treasurer, who is a voluntary (unpaid) member of the management committee, completes the form for reclaiming the income tax, using the special tax forms (in Note 1 above) and checks to the full-time secretary's records that each donor has made the full payment in the year required by the arrangement.

4 Donations received through the post are dealt with by Ms Beech. These donations are either cheques or cash (bank notes and coins). Ms Beech prepares a daily list of donations received, which lists the cheques received and total cash (divided between the different denominations of bank note and coin). The total on this form is recorded in the cash book. She then prepares a paying-in slip and banks these donations daily. When there is a special fund-raising campaign, Ms Beech receives help in dealing with these donations from voluntary members of the management committee.

5 The Autumn Fair takes place every year on a Saturday in October. Members of the management committee and other supporters of the charity give items to sell (for example food, garden plants, clothing). A charge is made for entrance to the fair and coffee and biscuits are available at a small charge. At the end of the fair, Ms Beech collects the takings from each of the stalls, and she banks them the following Monday.

6 Legacies are received irregularly, and are usually sent directly to the director of the charity who gives them to Ms Beech for banking. They are stated separately on the daily bankings list (in note (4) above).

7 Bank deposit account interest is paid gross of income tax by the bank, as the Links Famine Reliefis a charity.

Requirement

List and briefly describe the work you would carry out on the audit of income of the charity, the controls you would expect to see in operation and the problems you may experience for the following sources of income, as detailed in the statement of profit or loss above:

(1) Gifts under non-taxing arrangements

(2) Tax reclaimed on gifts made under non-taxing arrangements

(3) Donations received through the post

(4) Autumn Fair

See Answer at the end of this chapter.

2.2 Public sector

The following provides a brief introduction to public sector auditing and some of the concepts used in the audit of public sector entities. You are only required to have knowledge of how audit of public sector entities differs from the audit of non-specialised entities. In depth knowledge of the working of the public sector, the operation of the Comptroller and Auditor General (CAG) of Bangladesh and the content of PSIAS (Public Sector Internal Audit Standards) is not required.

The public sector comprises a great variety of organisations including central and local government. It also includes private companies which are profit orientated, running outsourced public services. Auditing by an independent external auditor is important, in order to provide external accountability to the community at large. For example, local authorities which provide many local services such as schools will be subject to an audit of their financial statements, as will the NHS Trust that runs local hospitals. Audit helps to ensure that:

- Public funds have been spent for proper, authorised purposes and legally within statutory powers.
- Organisations install and operate controls to limit the possibility of corrupt practice, fraud and poor administration.

The manner in which the auditors conduct their work is affected by auditing standards and other regulatory influences including:

- specific statutory requirements
- requirements of the sponsoring (or funding) department
- contractual requirements contained in terms of engagement

Organisations in the public sector are often subject to a high degree of regulation. The nature of regulation affecting public sector bodies ranges from statutory to detailed administrative requirements.

The Comptroller and Auditor General (CAG) of Bangladesh is a public sector organisation specialising in public sector audit work.

2.2.1 Principles of audit in the public sector

The purpose of audit in the public sector is accountability. It helps ensure that public money is spent wisely and handled with integrity. Audit in the public sector is not just an exercise in checking what has happened in the past, but making recommendations for future good practice.

The Public Audit Forum (a representative of the major public audit bodies in the UK) sets out three key principles of audit in the public sector:

- **independence** of public sector auditors from organisations being audited
- the wide **scope** of audit in the public sector (see below)
- the ability of public sector auditors to **make their results available** to the public and democratically appointed officials

The wide scope of audit in the public sector is an important issue and one in which it differs from the statutory 'private' companies audit we have focused on thus far in your studies. A public sector audit covers not only the audit of financial statements, and internal control systems if required, but also covers the issues of regularity, propriety and value for money.

Regularity

In a public sector audit, auditors must ensure that the transactions carried out by the organisation are **in accordance with the legislation that governs those transactions**, or the regulations issued by Parliament or NBR in relation to that organisation.

Propriety

This concept is linked to the expectations of the public or the authority which sets up the organisation being audited, that is, auditors must ensure that transactions and business are **being carried out in the way that they should be**, that is ethically, with integrity and according to any existing standards of conduct.

Value for money

Finally, in a public sector audit it is critical to ensure that that **best use is being made of resources** (money raised from the public through taxation) in providing the service. Public sector audits therefore include evaluations of the economy (spend less), efficiency (spend well) and effectiveness (spend wisely) of use of public resources.

2.2.2 The Public Accounts Committee

The Public Accounts Committee is a committee to examine public expenditure to ensure that it achieves value for money.

2.2.3 The Comptroller and Auditor General (CAG) of Bangladesh

The Office of the Comptroller and Auditor General (OCAG) is the country's independent oversight institution and an important pillar of the country's National Integrity System (NIS). This is also known as the Supreme Audit Institution (SAI) of Bangladesh. Mandated by Article 128(1) of the Constitution of Bangladesh, the Comptroller and Auditor General (CAG) is responsible for auditing government receipts and expenditure and providing opinion as to whether these are duly accounted for and comply with the financial rules and regulations established by the Government. Section 5(1) of the CAG (Additional Functions) Act, 1974 further gives him the authority to audit statutory public authorities, public enterprises and local authorities. The Constitution guarantees the CAG complete independence in determining the scope and extent of audit. He submits his report to the President of the Republic who causes them to be laid before Parliament.

2.2.4 Audit of government grants

Government grants, such as enterprise development schemes, are issued in response to certain criteria, such as a need to improve employment in disadvantaged areas. It is important that such grant schemes are audited to ensure that the criteria for the grants are being met, that the schemes operate well and whether the government department responsible for the grant is managing it and ensuring its effectiveness.

2.2.5 International Standards on Auditing

The International Standards on Auditing apply to audit work undertaken in the public sector. Where applicable the standards contain 'Considerations Specific to Public Sector Entities' which highlight some of the different considerations that apply in the audit of entities in the public sector. Some examples are given below:

- ISA 315, *Identifying and Assessing the Risks of Material Misstatement*

For the audits of public sector entities, law, regulation or other authority may affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

- ISA 520, *Analytical Procedures*

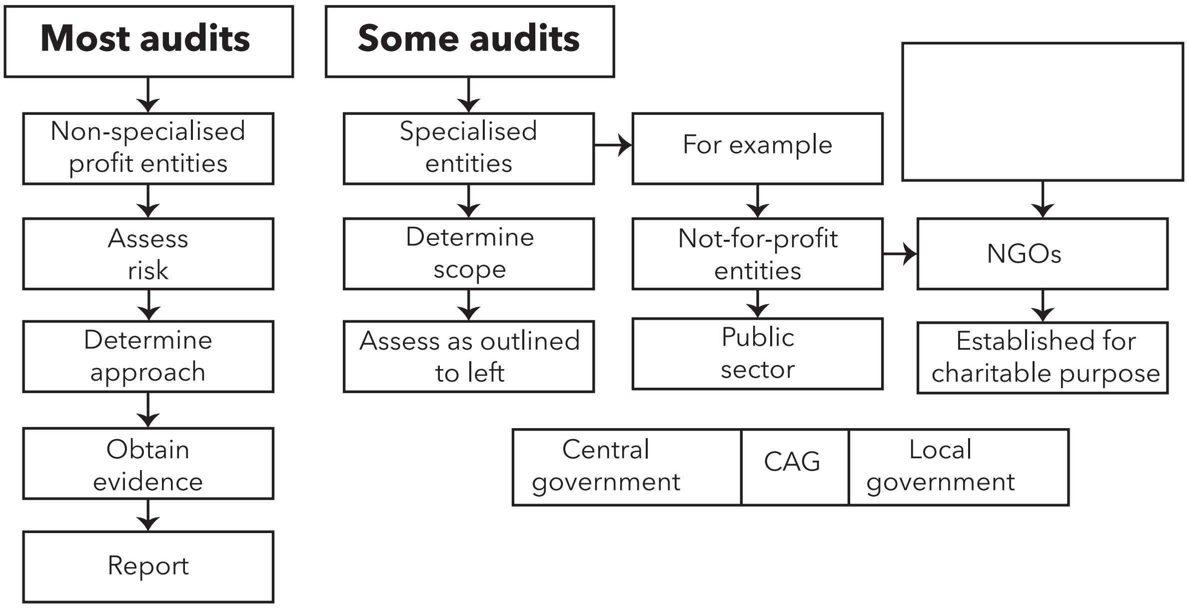
The relationships between individual financial statement items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities: for example, in many public sector entities there may be little direct relationship between revenue and expenditure.

In the public sector industry data or statistics for comparative purposes may not be available.

- ISA 570, *Going Concern*

Going concern risks may arise, but are not limited to, situations where public sector entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatisation. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern in the public sector may include situations where the public sector entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by the public sector entity.

Summary


Most audits
Non-specialised profit entities
Assess risk
Determine approach
Obtain evidence
Report
Some audits
Specialised entities
Determine scope
Assess as outlined to left
For example
Not-for-profit entities
Public sector
NGOs
Established for charitable purpose
Central government
CAG
Local government

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you give two examples of entities that need specialised audits? (Topic 1)	
(2) Can you explain the points of similarity and difference between not-for-profit audits and private sector audits? (Topic 2)	
(3) Can you identify the standards that should be applied to public sector audits? (Topic 2)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q1	This question provides a good little test of your knowledge of this area.	
Q5	This question provides a good little test of your knowledge of this area.	
Q6	This substantial question is a thorough test and gives an insight into how this area could be examined.	

Once you have attempted these questions, you can continue your studies by moving onto the next chapter, Audit completion.

Technical reference

1 Non-specialised and specialised entities

n/a

2 Not-for-profit entities

Foreign Donations (Voluntary Activities) Regulation Act, 2016

Self-test questions

Answer the following questions.

1 Which of the following might require a specialist audit and why?

A Care Share Ltd, a charity limited by guarantee

B Pytox plc, a listed parent of a group of manufacturing companies

C Loyds plc, a bank

D Allied Insurance Company plc, an insurer

E Linens Ltd, a retail company

2 Will an auditor's report for a NGO have to conform to ISA 700 criteria?

3 What is CAG?

4 Help the Kids Ltd, a registered charity, has income of CU150,000 and assets of CU750,000. It is required to have an audit of its financial statements.

A True

B False

5 What four issues are likely to fall within the scope of a public audit?

6 Safe Haven

You have been appointed the auditor of Safe Haven which has a year end of 31 May. Safe Haven is a small, registered charity based in a small town in Warshire. The organisation provides shelter for abandoned dogs and puppies with the aim of finding new homes for as many as possible.

The charity is managed by a voluntary committee, including a Chair (Alun Jenkins), a Treasurer (Amanda Jones) and a Secretary (Gordon Brand). Appointment is by annual election by the committee each year however Alun, Gordon and Amanda have held their posts for a number of years as other committee members feel unable to give the required time commitment.

Safe Haven also employs a number of paid employees. The shelter is managed by John and Jane Sheldon, who are husband and wife. There is a kennel cleaner and a part-time bookkeeper. In addition, a number of unpaid volunteers help out at the shelter as and when they are needed depending on the number of animals at the centre at a particular point in time.

The main sources of income are as follows:

- Charity shop

This is run by a full-time manager, assisted by a team of volunteers. Members of the public make donations (primarily clothes and toys) which are then sold in the shop. All transactions are in cash. The shop does not accept cheques or credit cards. The transactions are recorded by the till, with completed till rolls being passed on to the bookkeeper.

- Collections

Volunteers make house calls on a regular basis. In addition, on Saturday mornings, volunteers make collections in three local town centres. All cash is counted by the volunteers, and returned to the bookkeeper with a receipt confirming the amount.

- Dog Show

Each year on 1 June, a Peace Festival is held in the town. As part of this event Safe Haven organise a dog show. Any member of the public can enter their dog by completing an entry form which can be obtained from the shop.

Tickets to see the show can be purchased up to two weeks in advance from the shop or can be purchased on the day at the Festival. In recent years the show has been a great success, although two years ago it had to be cancelled due to bad weather.

T-shirts can also be purchased from a stall manned by volunteers.

- Sponsorship

Safe Haven is sponsored by a local pet supplies company. The company makes an annual donation and provides prizes for the winners of the dog show. In return for this their services are advertised in the event programme and their logo is printed on the T shirts.

The main expenses are as follows:

- Rent, rates, heat and light

Both the shelter and the shop are rented properties. These expenses are all paid by monthly direct debit.

- Employee costs

John and Jane Sheldon and the shop manager are salaried. They are paid directly into their bank accounts on a monthly basis. The kennel cleaner and the bookkeeper are paid by the hour. They are paid by cheque on a weekly basis.

- Vet bills

The local vet provides their time free but any medicines etc, do need to be paid for. Payments are made by cheque on receipt of the invoice.

- Printing costs

Leaflets are produced to support fund raising campaigns. The most significant element of this cost is the dog show programme which outlines the timetable of events. The programmes are printed and delivered to Safe Haven in May. The printer invoices at the time of delivery.

The accounts are maintained by the bookkeeper on a computerised spreadsheet. Occasionally, the treasurer may also assist with the preparation of accounting information at particularly busy times in the year, for example, immediately after the dog show.

Requirements

6.1 List the factors specific to the audit of a charity which would affect inherent and control risk.

6.2 As the auditor of Safe Haven discuss the key planning issues based on the above scenario.

6.3 Outline the audit work you would plan to perform in respect of the following expenses:

(1) Rent, rates, light and heat

(2) Employee costs

(3) Vet bills

(4) Printing costs

(20 marks)

Total: 20 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

The audit consideration in relation to the various sources of income of the Links Famine Relief charity would be as follows:

(1) Gifts made under non-taxing arrangements

This type of income should not present any particular audit problem as the donations are made by banker's order direct to the charity's bank account and so it would be difficult for such income to be 'intercepted' and misappropriated.

Specific tests required would be as follows:

(a) Check a sample of receipts from the bank statements to the cash book to ensure that the income has been properly recorded.

(b) Check a sample of the receipts to the special tax forms to ensure that the full amount due has been received.

Any discrepancies revealed by either of the above tests should be followed up with Ms Beech.

(2) Tax reclaimed on gifts made under non-taxing arrangements

Once again this income should not pose any particular audit problems. The auditors should check the claim form submitted to the tax authorities.

(3) Donations received through the post

There is a serious problem here as the nature of this income is not predictable and also because of the lack of internal check with Ms Beech being almost entirely responsible for the receipt of these monies, the recording of the income and the banking of the cash and cheques received. The auditors may ultimately have to express a qualified opinion relating to the uncertainty surrounding the completeness of income of this type.

Notwithstanding the above reservations, specific audit tests required would be as follows:

(a) Check the details on the daily listings of donations received to the cash book, bank statements and paying-in slips, ensuring that the details agree in all respects and that there is no evidence of any delay in the banking of this income.

(b) Check the donations received by reference to any correspondence which may have been received with the cheques or cash.

(c) Consider whether the level of income appears reasonable in comparison with previous years and in the light of any special appeals that the charity is known to have made during the course of the year.

(d) Carry out, with permission of the management committee, surprise checks to vouch the completeness and accuracy of the procedures relating to this source of income.

(4) Autumn Fair

Once again there is a potential problem here because of the level of responsibility vested in one person, namely Ms Beech.

Specific work required would be as follows:

(a) Attend the event to observe the proper application of laid down procedures and count the cash at the end of the day.

(b) Check any records maintained by individual stall holders to the summary prepared by Ms Beech.

(c) Check the vouchers supporting any expenditure deducted from the proceeds in order to arrive at the net bankings.

(d) Agree the summary prepared by Ms Beech to the entry in the cash book and on the bank statement.

Answers to Self-test questions

1 Correct answer(s):

A Care Share Ltd, a charity limited by guarantee
C Loyds plc, a bank

D Allied Insurance Company plc, an insurer

Care Share Ltd might have additional NGO Affairs Bureau requirements.

Loyds plc is likely to have additional banking requirements.

Allied Insurance Company plc is likely to have additional insurance requirements.

2 Only if the NGO requires a statutory audit.

3 The Office of the Comptroller and Auditor General (OCAG) is the country's independent oversight institution and an important pillar of the country's National Integrity System (NIS). This is also known as the Supreme Audit Institution (SAI) of Bangladesh.

4 Correct answer(s):

A True

5 The four likely issues are:

- Audit of financial statements
- Regularity
- Propriety
- Value for money

6 Safe Haven

6.1 The following factors would be relevant:

Inherent risk

(1) The extent of regulation depending on the specific nature of the charity
(2) The significance of donations and cash receipts
(3) The extent of credit card and internet donations
(4) The valuation of gifts of assets
(5) Lack of predictable income
(6) Lack of direct relationship between income and expenditure
(7) The sensitivity of issues including the proportion of resources used in admin and fund raising

Control risk

(1) The time committed by trustees to the charity's affairs
(2) The skills and qualifications of the individual trustees
(3) The frequency, form and content of trustee meetings
(4) The division of duties between trustees
(5) The supervision by the trustees of volunteers

6.2 Planning issues for Safe Haven would be as follows:

Completeness of income

Overall this risk is high due to the following factors: the majority of the income is generated in cash, there are numerous different sources of income, and a wide range of people have access to the asset itself due to the use of volunteers.

Looking at each source of income in turn the following points are relevant:

- Charity shop

Whilst till receipts can be agreed to cash received this does not guarantee that all revenue has been put through the till. The main problem here is that it may be difficult to establish an expected relationship between 'revenue' and 'cost of sales'. Items sold are donated by the public, so much will depend on how these items are valued by the charity.

- Street collections

Reconciliations can be performed between cash collected and the receipts submitted by the volunteers to determine accurate recording. Completeness of income, however, will depend largely on the integrity of the volunteers and the overall controls put in place by the charity. In this instance risk is increased by the unpredictable nature of this source of income and the fact that the collection boxes are not sealed. Those responsible for collecting the cash are also responsible for opening the boxes and counting the cash before handing it over to the bookkeeper. This increases the risk of misappropriation.

- Dog show tickets and T-shirts sales

Completeness of income in respect of these sources of revenue is still a concern due to the cash nature of these transactions but more reliable evidence should be available. Revenue generated from ticket sales can be reconciled to the number of tickets sold. This assumes that the charity exercises some control over the issue of tickets for example, tickets are numbered so that it is possible to determine the number sold.

For the T-shirt sales it should be possible to validate the income by comparing the number of items sold with the revenue generated. This depends on the charity adopting very simple inventory control.

- Sponsorship

Completeness should not be an issue here as the amount involved is predetermined and is likely to be paid by cheque or by bank transfer.

Controls

In addition to the specific control issue mentioned above the assessment of the overall control environment will be essential at the planning stage of the audit. As there are concerns about the completeness of income the control environment will provide key evidence about the integrity of the revenue balance.

The auditor will need to consider the ability of the committee to run the organisation effectively. The information suggests that the three main committee members are responsible for the majority of the management so it will be important to determine their respective skills and whether they are able to devote sufficient time.

The ability of the bookkeeper will also need to be established in particular the possible lack of segregation of duties and the fact that the job is currently only done on a part time basis. It may be that records are not being maintained as they should be due to the limited number of hours being worked by that individual. This is emphasised by the fact that the Treasurer is sometimes required to help out.

Accounting treatment

At the planning stage the accounting policies of the charity will need to be reviewed to ensure that they are appropriate and consistent. In particular the point at which income is recognized will need to be established together with any related costs. This is relevant to the income generated from the sale of tickets for the annual dog show. Tickets are available in the last two weeks in May, that is, the last two weeks before the year end and the main cost involved in the show, being the printing of the show programme is also incurred and invoiced in May. The show itself takes place in June.

In respect of the ticket sales made in May it could be argued that this income should not be recognised until the show takes place as it is only earned at this point. However, if the proceeds are non-returnable irrespective of whether the show takes place or not it could be argued that it represents a donation which can be recognised on receipt.

In respect of the programme costs the treatment is a little clearer. These should be provided for at the end of the year even though they relate to an activity which will take place after the year end. There is an obligation to pay for the programmes as a result of a past event that is, the printing company have produced and delivered the programmes.

Evidence

At the planning stage the overall strategy to adopt will need to be determined. In this case it is likely that a controls-based approach will be adopted (as completeness of income is one of the key risks) supported by substantive testing, the extent of which will depend on the results of the tests of controls. The use of analytical review will be more limited due to the lack of predictive patterns in relation to many aspects of the organisation and the lack of relationships between account balances.

6.3 The audit plan would include the following:

Rent, rates, light and heat

(1) Agree total rent/rates for the year to the lease/annual bill.

(2) Check direct debit amounts in the cash book/bank statement.

(3) Compare the cost of heat and light for this year and the previous year and follow up if there are any major differences.

(4) Look at the date on the last utility bill to determine the need for any prepayment or accrual adjustment.

Employee costs

(1) For salaried staff check annual salary to personnel details/contract of employment.

(2) For the bookkeeper and the kennel cleaner, review the controls over the recording of hours worked and check the hourly rates applied to personnel details/contracts of employment.

(3) Check a sample of standing data used to process the payroll.

(4) Recalculate a sample of monthly calculations to ensure that deductions are being made correctly.

(5) Review controls over the weekly authorisation of pay checks and monthly bank transfers.

Vet bills

(1) Confirm with the vet that they have given their time for free.

(2) Compare the total vet bill for this year and last year and calculate a 'cost per animal rescued' if possible.

(3) Trace a sample of entries made in the cash book in respect of vet fees back to the original invoice to confirm that the cost is in respect of this.

(4) Review invoices received after the year end to ensure that any necessary accruals have been recognised.

Printing costs

(1) Obtain the printers' invoice and check that a provision has been included in the accounts at the year end for an amount matching that on the invoice.

(2) Confirm that the programmes have been received

Chapter 12

Audit completion

Introduction

Learning outcomes

Concluding and reporting on engagements

Students will be able to conclude and report on assurance engagements in accordance with the terms of the engagements and appropriate standards.

- Describe the nature and timing of specific procedures designed to identify subsequent events that may require adjustment or disclosure in relation to the matters being reported on
- Describe the nature and timing of specific procedures designed to identify the appropriateness of the going concern assumption, including compliance with relevant legal and regulatory requirements
- Evaluate quantitatively and qualitatively, the results and conclusions obtained from assurance procedures including analytical procedures and data analytics where appropriate
- Draw conclusions on the ability to report on an assurance engagement which are consistent with the results of the assurance work
- Judge when to refer reporting matters for specialist help
- Draw conclusions on the ability to report on an audit engagement, including the opinion for a statutory audit, which are consistent with the results of the audit work

Syllabus links

You will have considered the issue of going concern in Accounting.

Examination context

The reviews carried out at the end of the audit, such as going concern and subsequent events reviews are extremely important so could easily be examined in a short-form or a long-form question in the exam.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	Completion is a very critical stage of the audit because the partner is required to make the important judgements of whether sufficient evidence has been obtained to support the audit opinion and what that opinion should be. **Stop and think** How does an audit partner determine whether there is sufficient audit evidence?	Read through the section carefully.	This topic could be examined anywhere in the examination.	
2	If you work in practice, you may be involved in any part of audit completion. The more senior you become in the firm, the more likely you are to be involved in the completion process.	Read through the section carefully.	This topic could be examined anywhere in the examination.	2
3	The final review of the financial statements is a crucial part of the completion stage.	Read through the section carefully.	This topic couldbe examined anywhere in the examination.	1

CHAPTER 12

Topic	Practical significance	Study approach	Exam approach	Self-testquestions
4	There are several other matters that should be considered at the completion stage. Going concern is among the most important of these.	Read through the section carefully, including the worked example and activities.	The reviews carried out at the end of the audit, such as going concern and subsequent events reviews are extremely important so could easily be examined in a short form or a long form question in the exam.	3, 4, 5, 6, 7

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter

1 The completion phase

Section overview

- Although completion should in theory be simple if the audit has been well planned and executed,there are a number of aspects to it which can make it complex.

There are three phases to the audit:

- planning
- evidence gathering
- completion

In the theory, the completion phase should be relatively smooth:

- if the work has been well planned
- if the staff have been well briefed and well trained
- if the staff execute the plan efficiently and to time

All the partner has to do is review the file, come to a decision about the final issues demanding professional judgement and sign off the accounts. However, there are lots of components to the completion phase.

The fact is that if the various procedures and other activities which make up the completion phase are not accomplished efficiently and to time, almost everything else is wasted. Budget overruns and under-recovery also tend to happen if closedown is not managed well.

This chapter talks in terms of audit, due to the auditing standards covered in it, but similar procedures might be carried out as part of a review.

Professional skills focus: Applying judgement

As you progress in your training you may find yourself spending more time working to resolve review points arising from the work you performed at the evidence gathering phase.

2 Audit opinion

Section overview

- The partner needs to consider:
  - The financial statements
  - The work done to support the audit opinion

Remember the possible cost of getting the audit opinion wrong:

- If someone can demonstrate that the auditor owed them a duty of care and they suffered loss by relying on the financial statements, they could sue the auditor.
- As a member of ICAB, the auditor could also face disciplinary proceedings, fines and penalties.

Making sure the appropriate opinion is given is therefore important. There are two components of the completion phase:

- the financial statements themselves; and
- the work which has been done to support the opinion.

2.1 The financial statements

When considering the financial statements at the completion stage, the partner responsible for signing the auditor's report is interested in the answers to three questions:

- Do the financial statements comply with the provisions of the Companies Act 1994?
- Do the financial statements make sense?
- Has the auditor's report been drafted properly? (We will look at this in Chapter 13.)

We will consider the first two questions in the next section of this chapter.

2.2 The work done to support the opinion

Your review of the work done has four aspects to it:

- whether the work done was in line with the audit plan
- whether the right work has been done (perhaps the plan needed to be flexed in the light of conditions actually encountered by the client)
- whether enough work has been done
- the issues arising

3 Financial statement review

Section overview

- The important questions are:
  - Do the financial statements comply with the law and regulations (which will be tested using a disclosure checklist)?
  - Do the financial statements make sense (which will be tested by analytical procedures)?

3.1 Do the financial statements comply with the Companies Act 1994?

Determining this ought to be relatively simple – every firm should use a checklist to ensure that the financial statements comply with the disclosure requirements of the Companies Act and relevant accounting standards. Such checklists usually form a part of the 'audit packs' which firms use.

To some extent the job has been made easier by the widespread use of accounts production software, but software is only as good as the people writing it, installing it and using it.

For example:

- If directors' emoluments are not coded to the right account in the chart of accounts, they will not be disclosed properly in the financial statements.
- If the client has a material accounting policy which is not in the 'standard list' in the template on which the financial statements are based, it will not appear in the accounting policies note unless you add it.

Checklisting the accounts, therefore, is still a good idea.

As you know from your other studies, the nature of financial statements these days is incredibly complex. Companies be aware that:

- there are a large number of financial reporting standards – either Bangladesh or International applicable to financial statements
- the Companies Act itself is a substantial document which determines the format to be used in financial statements and the disclosures to be made on the face of the primary statements and in the supporting notes
- the directors' report, and other information released with the financial statements, need to be consistent with the financial statements so the auditor must read that information and resolve any inconsistencies

3.2 Do the financial statements make sense?

We have considered the techniques required to carry out analytical procedures as part of the risk assessment process at the planning stage and as a substantive procedure.

Analytical procedures **must** also be used in the overall review at the end of the audit to assist the auditor when forming an overall conclusion as to whether the financial statements are consistent withthe auditor's understanding of the entity.

The steps for carrying out analytical procedures at this stage of the audit are very similar to those used as part of the risk assessment process at the planning stage, but they happen in a rather different way.

- Interpretation
- Investigation
- Corroboration

3.2.1 Interpretation

The person carrying out the analytical procedures, reads through the financial statements and interprets them, considering the absolute figures themselves and relevant ratios.

3.2.2 Investigation

When analytical procedures are used as risk assessment procedures or as a substantive procedure,the aim is to identify potential problems. The problems are then investigated during fieldwork by making enquiries and gathering audit evidence.

At the completion stage the reviewer will expect to find the answers to the issues raised by the review on the audit file.

3.2.3 Corroboration

Should those answers not be on the file, further work will need to be done.From a practical point of view, it is worth remembering the following:

- For the smaller client, the working papers supporting the final analytical procedures may well be simply an update of the work done at the planning stage.
- For the larger client, the review becomes a much more specific exercise.
- The financial statements used for the analytical procedures need to incorporate any adjustments made as a result of the audit.
- Any problems identified by the procedures, which indicate that the financial statements should be amended, need to be actioned.

4 Other matters

Section overview

- The auditor needs to:
  - evaluate discovered errors
  - ensure opening balance and comparatives are correct
  - consider whether the going concern basis of the financial statements is appropriate
  - review subsequent events
  - obtain necessary written representations

At the completion stage the reviewer has to consider the issues which have been raised by the auditand what the firm's response in the auditor's report should be.

At this stage the reviewer needs to consider:

- Is the impact of errors and misstatements uncovered during the audit likely to be material?
- Are there matters of principle where the auditor disagrees with the client?

The second of these questions can cause severe difficulties for the audit firm in exercising its professional judgement.

It is possible for there to be points of principle which although not material in themselves, in the current period, could lead to problems in the future, or lead to the reassessment of audit risk.

4.1 Errors discovered

ISA 450, *Evaluation of Misstatements Identified During the Audit* requires the auditor to accumulate misstatements identified during the audit unless those misstatements are trivial. The auditor must evaluate the effect of identified misstatements on the audit and evaluate the effect of uncorrected misstatements, if any, on the financial statements.

- Identified misstatements: the auditor will need to consider revising the overall plan if:
  - the misstatements identified indicate that other misstatements may exist, which when accumulated could be material; or
  - accumulated misstatements approach the materiality level set for the audit.

Where management has corrected misstatements detected, the auditor shall perform additional procedures to determine whether misstatements remain.

- Communication and correction of misstatements:
  - The auditor shall inform management of all misstatements and request that they be corrected.
  - If management refuses, the auditor shall ascertain the reason and take this into account in the overall evaluation.
- Examining the effect of uncorrected misstatements:
  - reassess materiality
  - determine whether uncorrected misstatements are material, whether individually or in aggregate

Materiality will depend on the nature of the misstatement and its impact on the financial statements. The auditor is required to inform those charged with governance and to request that corrections be made.

- Written representations:

The auditor shall request confirmation from management that the effect of uncorrected misstatements is immaterial.

- Documentation – audit documentation shall include:
  - the amount below which misstatements are considered trivial
  - all misstatements accumulated
  - the auditor's conclusion regarding materiality of uncorrected misstatements

Certain circumstances may cause the auditor to deem misstatements material even if they are below the materiality level. These circumstances include:

- compliance with regulatory requirements
- masking a change in trends or affecting ratios
- increasing management compensation
- affecting other information in documents included with the audited financial statements

Context example: Enron

US company Enron devised a way of hiding debt by manipulating the detailed accounting rules for dealing with subsidiaries. This led to the non-disclosure of debt in excess of CU20 billion. According to the Washington Post website, the initial transaction on which this technique was first used, was to artificially preserve the value of an investment of CU300,000 which was immaterial in terms of the Enron audit, but the use of the technique led to misstatements which were very material indeed.

4.1.1 Sustainability impact

An omission of information not specifically required to be included in the financial statements but considered to be important to users' understanding of the financial position, financial performance or cash flows of the entity should be considered if this can contribute to a material misstatement.

This may be the case for climate-related information, given investor statements on the importance of climate-related risks to their decision making or where it affects other information to be included in the entity's annual report. As the majority of climate-related information is currently disclosed outsidethe audited financial statements, the auditors may need to consider if its exclusion should be added to accumulated misstatements for consideration if such misstatements are material, individually or in aggregate.

4.2 Opening balances

It may seem odd to consider opening balances at the completion stages of the audit, but the auditor needs to consider whether there is sufficient evidence to support their reliability. If the opening balances are misstated this will mean that the profits for the current year may also be misstated.

Normally where the audit engagement is continuing from previous years, this will not cause a problem, but for a new client there are questions of professional judgement about the reliability of the previous year's accounts, which in turn leads to questions about the quality of work of the previous auditors.

Where the engagement is an initial engagement (financial statements for prior period were not audited or audited by a predecessor auditor) the auditor will again have to consider the risks of unaudited figures from past periods being materially misstated.

ISA 510, *Initial Audit Engagements – Opening Balances* states that, in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

(a) opening balances contain misstatements that materially affect the current period's financial statements; and

(b) appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(a) determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated;

(b) determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) performing one or more of the following:

  (1) whether the prior year financial statements were audited, reviewing the predecessor auditor's working papers to obtain evidence regarding the opening balances;

  (2) evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

  (3) performing specific audit procedures to obtain evidence regarding the opening balances.

Such procedures may include:

- checking receipts from opening receivables
- verifying opening payables in the light of payments made during the current period
- reconciling from an inventory figure which has been audited back to the opening position
- obtaining confirmations from relevant third parties – lenders, valuers etc

The auditor will also need to consider the comparative figures in the financial statements. ISA 710, *Comparative Information – Corresponding Figures and Comparative Financial Statements* states that the objectives of the auditor with respect to comparative information are:

- to obtain sufficient appropriate audit evidence about whether the comparative information has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and
- to report in accordance with the auditor's reporting responsibilities.

Interactive question 1: Opening balances

Your firm has just been appointed auditors of Cross Ltd after the previous auditors were removed following a dispute with the directors. This dispute related to certain costs capitalised by the directors, which the auditors believed should have been written off. (Last year's auditor's report was qualified because of the disagreement.)

Requirement

State the procedures you would carry out regarding the opening balances.

See **Answer** at the end of this chapter.

4.3 Going concern

The problem

The going concern concept is fundamental to the way in which financial statements are prepared and has been so for a very long time indeed.

If you think about it carefully, you will see that it is probably a major contributor to the expectations gap which is considered in a number of places in this Workbook.

Professional skills focus: Applying judgement

It is crucial to realise that management should have performed its own assessment of whether the going concern basis is applicable. In the case of smaller audits, there can sometimes be an issue with this (management may not have done so in sufficient detail).

Context example: The way financial statements are prepared

Consider the deceptively simple example of a non-current asset such as a car. We all know that, as soon as you drive your brand new car away from the showroom it loses a disproportionate amount of its resale value and that this depreciation happens very rapidly in the early stages of the car's life, before flattening out after a couple of years or so. However, in financial statements, the depreciation charge and resultant reduction in the car's net book value is usually dealt with on a straight line basis,because, over time, it is probably truer and fairer to amortise the car's value evenly over its life – it is, after all, an asset which is 'used up' evenly over its life, whatever its resale value at any particular pointin time. It is also administratively easier to calculate depreciation this way.

The reason why this treatment is acceptable is because the company has no intention of disposing ofthe asset at the reporting date, but will use it in the normal course of business until the appropriate time arrives for its disposal. There is, nevertheless, a very real and potentially material difference between the market value of a company's fleet of vehicles and their carrying value in the statement of financial position.

The argument used in the example also applies to a number of other assets. If the company's complete inventory had to be disposed of, or the receivables all collected in on the first day of the new year, it is highly probable that the amounts realised would be less than those shown in the statement of financial position. In addition, liabilities not reflected in the financial statements will crystallise, such as redundancy payments or lease penalty clauses.

It follows from this that, if the going concern concept is not an appropriate basis on which to prepare the financial statements, the implications will be very serious, as almost all of the normal assumptions made will be called into question.

4.3.1 Work to be done

The auditor's responsibility is to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern assumption. The risks of the client not being a going concern will need to be considered and planned for at the planning stage, and, at the completion stage, certain specific tasks will have to be carried out.

These will include the following:

- Consideration of all areas of the statement of financial position to see whether there are indications that the going concern concept may be inappropriate such as:
  - significant receivables unable to pay

- lines of inventory and WIP where net realisable value may be less than cost
- material non-current assets which are no longer usable
- deferred development expenditure which is irrecoverable against relevant revenues
- investments (in subsidiaries or other companies) which have lost value

- Review of future plans for the business including financial forecasts and projections, to ensure that it is probable that the company will be able to continue to trade for at least the forthcoming year (that is, not less than 12 months from the date of approval from the financial statements). If the period to which those charged with governance have paid particular attention in assessing going concern is less than one year from the date of approval of the financial statements, the auditors must ask management to extend their assessment. ISA 570 requires the period of management's assessment to be at least one year from the date of approval of the financial statements, which differs from the IAASB requirement for the period to be from the end of the reporting period.
- Review of the company's borrowing facilities and other sources of finance to ensure that they will be adequate for the forthcoming year and that conditions and covenants imposed by lenders will not be breached.
- Review of minutes and other information such as correspondence with legal advisers, for indications of potential going concern problems.

ISA 570 contains requirements for those entities that are required (and those that choose voluntarily) to report on how they have applied the BSEC Corporate Governance Code. These requirements can be summarised as follows.

The auditor shall read and consider the following in evaluating management's assessment of the entity's ability to continue as a going concern:

- The board's confirmation in the annual report that it has carried out a robust assessment of the entity's emerging and principle risks.
- The disclosures in the annual report that describe those principal risks, what procedures are inplace to identify emerging risks and an explanation of how these are being managed or mitigated.
- The board's statement in the financial statements about whether it considered it appropriate to adopt the going concern basis of accounting in preparing them, and its identification of any material uncertainties to the entity's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements.
- The board's explanation in the annual report as to how it has assessed the prospects of the entity, over what period it has done so and why it considers that period to be appropriate.
- The board's statement as to whether it has a reasonable expectation that the entity will be able to continue in operation and meet its liabilities as they fall due over the period of its assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions.

Should the auditor have anything material to add to the above then this shall be included in the auditor's report. Matters that the auditor may wish to add include the following:

- Information that indicates that that the annual report and accounts are not fair and balanced with respect to the principal risks facing the entity.
- Matters relating to the robustness of the directors' assessment of risks that the auditor has communicated to the audit committee but that are not appropriately addressed in the annual report.

A list of possible symptoms of going concern problems from ISA 570, *Going Concern* is reproduced in Chapter 7, section 5.

ISA 570 also says that the auditors have to discuss the going concern issue with the client's management, to test the assumptions they have made to ensure they are justified, to obtain written representations from management about the things they are intending to do in the future to ensure that the going concern basis is appropriate and to review that disclosures made in the financial statements relating to going concern are sufficient to give a true and fair view.

4.3.2 The liquidation basis

If it becomes clear that the client cannot be considered to be a going concern, the financial statements will need to disclose this and the basis for preparing them will change to the liquidationor 'break-up' basis.

This means that values will have to be adjusted to the amounts expected to be realised. In practice this tends not to be a problem for the auditor, because by the time this stage is reached, the client may well have passed into the hands of the receiver or 'corporate recovery' expert.

Alternatively, when it is intended to wind-up a solvent client within the next 12 months on a voluntary basis, the values may not in the event be very different.

4.3.3 Implications for the auditor's report

Unfortunately, this is not the end of the story because, where there are doubts about a company's going concern status, the auditors and management are likely to reach different conclusions, and this has implications for the auditor's report.

If the going concern assumption is appropriate but a material uncertainty exists about the ability of an entity to continue as a going concern and the uncertainty is adequately disclosed in the financial statements, the auditor should express an unqualified opinion but modify the auditor's report by adding a 'material uncertainty related to going concern' section (see Chapter 13).

If the financial statements fail to give a true and fair view because it is inappropriate to use the going concern basis, the auditor should express an adverse opinion (see Chapter 13).

Finally, auditors are bound to include a separate section in their report headed 'Conclusions relating to Going Concern', in which they report on whether the going concern assumption is appropriate and whether management has not disclosed any material uncertainties in relation to it. Auditors must do this even where the going concern assumption is appropriate, in line with ISA 570

Interactive question 2: Gamston Burgers plc

You are the auditor of Gamston Burgers plc, whose principal activities are haulage and warehousing services and the repair of lorries.

During the current year the company has suffered a significant fall in revenue and gross profit, which has led to a trading loss. The company is also experiencing cash flow problems.

You have been informed by the managing director that the fall in revenue is due to:

- the loss, half way through the year, of a long-standing customer to a competitor
- a decline in trade in the lorry repair business

Due to the reduction in the repairs business the company has decided to close the workshop and sell the inventory of equipment and spares.

During the year the company replaced a number of vehicles, funding them by a combination of leasing and an increased overdraft facility. The facility is to be reviewed early next year after the audited accounts are available.

The draft accounts show a loss for the current year but the forecasts indicate a return to profitability in 20X6, as the managing director is optimistic about generating additional revenue from new contracts.

Requirements

2.1 Explain why an auditor attaches so much importance to considering an entity's ability to continue as a going concern.

2.2 Describe the audit work you would undertake in order to ascertain whether Gamston Burgers plc is a going concern.

2.3 Explain the effect on your auditor's report on the financial statements of Gamston Burgers plc if you:

(1) agree with the director's assertion; and

(2) conclude that trading conditions will not improve.

See Answer at the end of this chapter.

4.3.4 Sustainability impact

There may be certain instances when a climate-related risk could give rise to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern, for example, a ban on certain energies or technologies, the extent of a specific adverse weather event or the magnitude of any climate-related litigation.

4.4 Subsequent events

If the auditor's report says that the financial statements give a true and fair view, but the company goes under shortly after the financial statements are published, someone is likely to question whether the auditors knew what they were talking about.

If it then emerges that there were significant receivables who failed to pay up, or material amounts of inventory which turned out not to be realisable, you might think that such questions were justified.

Clearly, therefore, a review of events after the reporting period is both a sensible thing to do and, according to ISA 560, *Subsequent Events,* compulsory.

ISA 560 recognises the two different types of subsequent event according to IAS 10:

- those that provide evidence of conditions that existed at the date of the financial statements (adjusting events); and
- those that provide evidence of conditions that arose after the date of the financial statements (non-adjusting events).

Examples of adjusting events (that should be reflected in the financial statements):

- resolution of a court case
- bankruptcy of a major customer
- evidence of the NRV of inventories
- discovery of fraud or errors

Examples of non-adjusting events (that are not reflected in the financial statements but should be disclosed in the notes if they are material):

- destruction of a major asset by flood or fire
- major share transactions
- announcement of a plan to close part of a business
- dividends proposed/declared after the end of the reporting period

Note: If a 'non-adjusting event' occurs after the reporting date that means that it is no longer appropriate to assume that the entity is a going concern then the financial statements should be restated.

ISA 560 also recognises three time periods and recommends the following responses:

Period	Audit response
Up to the date of the auditor's report	Carry out audit procedures outlined in ISA 560 Consider whether the appropriate amendments/disclosures have been made in the financial statements Consider whether there is a need to amend the auditor's report
Between the date of the auditor's report and the date the financial statements are issued	No responsibility for further work in this period, but if the auditor becomes aware of material facts: Discuss with management Take appropriate action
After the financial statements are issued	No responsibility for further work in this period, but if the auditor becomes aware of material facts: Discuss with management Take appropriate action Where the relevant fact did not exist at the date of the auditor's report there are no statutory provisions for revising the financial statements: Discuss with management whether to withdraw the financial statements Take advice on possibility of withdrawing the auditor's report

4.4.1 Audit procedures up to the date of the auditors' report

Procedures testing subsequent events	
Enquiries of management	Status of items involving **subjective judgement**/accounted for using preliminary data Whether there are any new **commitments**, borrowings or guarantees Whether there have been any: **sales** or destruction of **assets** **issues** of **shares/debentures** or changes in business structure **developments** involving **risk areas, provisions and contingencies** **unusual accounting adjustments** **major events** (eg, going concern problems) affecting appropriateness of accounting policies for estimates

Procedures testing subsequent events	
Other procedures	**Review** management procedures for identifying subsequent events to ensure that such events are identified **Read minutes** of general board/committee meetings and enquire about unusual items **Review latest accounting records** and financial information and budgets and forecasts **Obtain evidence** concerning any litigation or claims from the company's solicitors (only with client permission)

Interactive question 3: Subsequent events review

You are the auditor of Weekly Ltd, which derives half its revenue from sales to one large national company. During your audit you notice that the sales ledger balance of this customer has nearly doubled during the year, although sales to it have increased only marginally.

Requirement

Note down the main elements of your subsequent events review programme relating to this receivable balance.

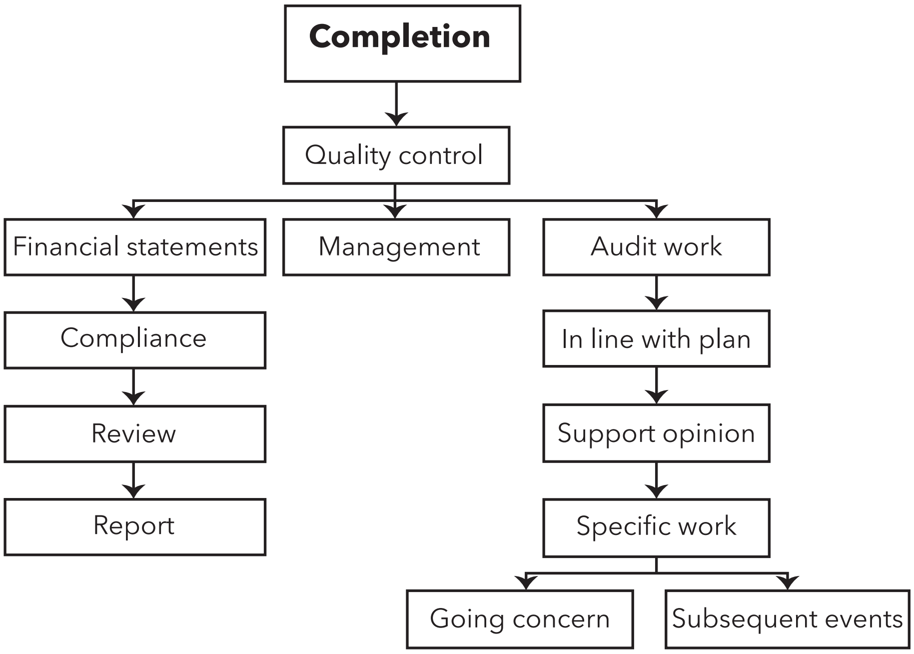
See **Answer** at the end of this chapter.

4.5 Written representations

You learnt about the nature and purpose of written management representations in your studies for Assurance.

According to ISA 580, *Written Representations,* the auditor is required to obtain certain written representations from management as part of its audit evidence. These representations will usually be collated and finalised at the completion stage of the audit. The representation letter should be signed by the directors (or a directors' board minute of the representation obtained) before the auditors sign the auditor's report – if not, the auditors have not obtained all the evidence they required to sign the auditor's report in the first place.

Summary



CHAPTER 12

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you explain the two main components of the completion phase? (Topic2)	
(2) Can you explain the three steps for carrying out analytical procedures at the review stage? (Topic 3)	
(3) Can you explain the five things the auditor needs to do in relation to uncorrected misstatements? (Topic 3)	
(4) Can you identify the effect on the auditor's report where the entity has properly disclosed a material uncertainty in respect of the going concern assumption? (Topic 3)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions areparticularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q4	Going concern is a topical area, and it is important you are able to identify companies with going concern problems.	
Q6	This substantial question is a thorough test and gives an insight into how this area could be examined.	
Q7	This question provides a good test of this area.	

Once you have attempted these questions, you can continue your studies by moving onto the nextchapter, Reporting.

Technical reference

1 The completion phase

n/a

2 Audit opinion – n/a

n/a

3 Financial statement review

- Do the financial statements comply with the Companies Act 1994? – CA 1994
- Do the financial statements make sense? – ISA 520

4 Other matters – ISA 320

- Opening balances and comparatives – ISAs 510 and 710
- Going concern – ISA 570
- Subsequent events – ISA 560
- Written representations – ISA 580

Self-test questions

Answer the following questions.

1 It is appropriate to use a checklist to determine whether the financial statements comply with the Companies Act.

A True

B False

2 Which three questions will the partner responsible for signing the auditor's report seek to answer at completion?

3 Opening balances need only be checked in a new auditor situation.

A True

B False

4 List five financial indicators that a company has going concern problems.

5 Is the auditor responsible for discovering relevant subsequent events after the auditor's report has been signed?

6 **Supachill Ltd**

You have recently been appointed auditor of Supachill Ltd and are planning the audit for the year ending 31 December 20X5. You have obtained the following background information about the company.

The company prepares chilled foods and sells them to supermarkets under its own brand name and that of a national supermarket chain, with which it has a one-year renewable contract. At present this contract represents 45% of revenue. The company is currently negotiating a substantial contract with another supermarket chain, but is reluctant to agree to the prices and 60 days' credit facility demanded.

On 1 January 20X5 the managing director, who was previously involved in property development, acquired all the shares in Supachill Ltd from Omega plc, a conglomerate, which was rationalising its operations.

Immediately following the acquisition Supachill Ltd had net assets of CU2 million, after taking account of low interest loans of CU5 million from Omega plc. These loans are secured on the freehold property of the company and are repayable in equal quarterly instalments over a five-year period until 31 December 20X9. Day-to-day working capital is funded by an overdraft facility of CU1.5 million, secured by a fixed and floating charge on the other assets of the company. This facility is to be reviewed by the bank early in 20X6 after the audited accounts are available.

The original business plan envisaged the acquisition of an adjacent factory to enable the company to double its output, but this expansion has been postponed.

The managing director has explained that there will be a delay in preparing the draft accounts as the finance director has left and has yet to be replaced. The accountant is assisted in the day-to-day accounting function by temporary staff. There is a projected loss for the year but forecasts indicate a return to profitability in the next financial year.

Requirements

6.1 From the situation outlined above, identify circumstances particular to Supachill Ltd that give you cause for concern. Explain why such factors give cause for concern.

(12 marks)

6.2 Describe the procedures that you would undertake during the course of your audit in order to satisfy yourself on the status of Supachill Ltd as a going concern.

(6 marks)

Total: 18 marks

7 Your client has lost a contract with its major customer. As a result the company is in financial difficulties. The bank is threatening to foreclose on its loan.

You are concerned that the company may not be a going concern, although, looking ahead nine months from the date of approval of the financial statements, the directors inform you that there is a good future for the business.

Requirement

What steps would you take to enable you to assess whether the directors' assertions are reasonable? What impact would the nine-month period referred to above have on your auditor's report?

Total: 3 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Regarding all opening balances:

- check prior year closing balances have been correctly brought forward;
- where appropriate, restated;
- consider impact of current year work on opening balances (eg, irrecoverable debts write off incurrent year compared to opening allowance); or
- review management's working papers, accounting and internal control systems for prior year.

For capitalised costs:

- Agree amounts capitalised to supporting documentation (to confirm amount)
- Discuss with previous auditors the reason for the qualification
- Decide whether opening balances need amendment

Answer to Interactive question 2

2.1 Importance of going concern

(1) The 'Going concern basis of accounting' is an accounting concept. It is presumed to apply to any financial statements, unless contrary disclosure is given.

(2) The amount at which assets and liabilities are included in the statement of financial position may be significantly different where the company is not a going concern. For example:

- Assets will be valued on a break-up basis.
- Additional provisions (eg, for closure costs) may be required.

(3) The classification of items will differ where financial statements reflect a break-up basis. For example, non-current assets/liabilities reclassified as current.

(4) The risk of failure is a real threat to many businesses and the failure of the auditor to give any warning may result in litigation/adverse publicity.

2.2 Audit work regarding going concern

To ascertain whether Gamston Burgers plc can meet its debts as they fall due:

(1) Obtain a written statement (management representation) from the managing director confirming their considered view that the company is a going concern.

(2) Review management's profit and cash flow forecasts for the next financial year to ascertain, *inter alia*, the company's working capital requirements.

(3) Confirm the appropriateness of relevant assumptions (eg, average trade receivables collection period) by comparison with ratios obtained from analytical procedures.

(4) Request a statement of borrowing facilities to be included in the bank confirmation letter.

(5) Review the day-to-day utilisation of the bank overdraft facility and its proximity to the current limit.

(6) Obtain a loan confirmation from the leasing company and confirm that all instalments to date have been met.

(7) Discuss with the credit controller (or financial accountant) the current pressures under which the company is being placed by larger customers who may be seeking extended credit terms.

(8) Undertake sensitivity analysis on client's forecasts to variable factors both within the managing director's control and outside it.

(9) Review the level of trade and other payables (including VAT and TAX and whether any penalties are being incurred) after the reporting date and the extent to which they are financing short-term needs.

To ascertain whether Gamston Burgers plc can otherwise continue in business (ie, return to profitable trading):

(1) Obtain a copy of tenders submitted/correspondence to date concerning any new contracts currently being negotiated and monitor all subsequent developments.

(2) Review drivers' logs, reports on warehouse utilisation etc, and discuss with management how current spare capacity will be utilised by new contracts obtained.

(3) Review the terms of the contract with the long-standing customer which was lost and the grounds on which it was lost to a competitor.

(4) Verify reasonableness of estimates arising from closure of workshop (eg, concerning costs of external servicing of the transport vehicle fleet).

(5) Obtain written confirmation from the company's legal adviser as to whether or not there are any pending legal claims (eg, in respect of inventory losses from warehouses, late deliveries, damage to goods in transit etc).

2.3 Agree with director's assertion

If doubt surrounding the going concern status of the company is minimal, disclosure in the financial statements would not be required in order to give a true and fair view. The auditor's opinion would therefore be unqualified. The report would still, however, need to contain a section headed 'Conclusions relating to Going Concern' in which the auditor would state that they are required to report by exception in relation to going concern, and have nothing to report in relation to this.

If the branch is so material that its inability to trade could affect the going concern status of the company (unlikely), the matter should be disclosed in the financial statements. If adequate disclosure is made in the financial statements, the auditor should express an unqualified opinion but modify their report by adding a paragraph headed 'Material Uncertainty Related to Going Concern' that:

- highlights the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the company's ability to continue as a going concern
- draws attention to the note in the financial statements that discloses these matters

Disagree with director's assertion

The form of auditor's report will depend upon the materiality of the branch and extent to which the uncertainty has been disclosed in the financial statements.

As the director appears confident about the future of this branch, it is unlikely that adequate (if any) disclosure has been made. The auditor's opinion would therefore be qualified on the grounds of material misstatement due to the inadequate disclosure of the uncertainty.

Answer to Interactive question 3

Main elements:

- Monitor post year end customer receipts (to confirm recoverability)
- Review of customer correspondence (to ascertain problem, eg, dispute)
- Calculation of trade receivables collection period, by month, after year end (to determine whether situation is deteriorating further)
- Consider likely effectiveness of any reservation of title clause/other security (to assess possible extent of recovery if customer liquidated)
- Review latest available audited accounts of customer (for indications of GC problems)
- Review level of post year end sales and orders (to determine whether situation is continuing unchecked)

Answers to Self-test questions

1 Correct answer(s):

A True

2 Three questions:

- Do the financial statements comply with the provisions of the Companies Act 1994?
- Do the financial statements make sense?
- Has the auditor's report been drafted properly?

3 Correct answer(s):

B False

4 Five from:

(1) Net liabilities or net current liability position

(2) Necessary borrowing facilities have not been agreed

(3) Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings

(4) Major debt repayment falling due where refinancing is necessary to the entity's continued existence

(5) Major restructuring of debt

(6) Indications of withdrawal of financial support by creditors

(7) Negative operating cash flows indicated by historical or prospective financial statements

(8) Adverse key financial ratios

(9) Substantial operating losses or significant deterioration in the value of assets used to generate cash flows

(10) Major losses or cash flow problems which have arisen since the reporting date

(11) Arrears or discontinuance of dividends

(12) Inability to pay creditors on due dates

(13) Inability to comply with terms of loan agreements

(14) Reduction in normal terms of credit by suppliers

(15) Change from credit to cash-on-delivery transactions with suppliers

(16) Inability to obtain financing for essential new product development or other essential investments

(17) Substantial sale of non-current assets not intended to be replaced

5 No, but they will have to take appropriate steps if made aware of them.

6 Supachill Ltd

6.1 Circumstances and explanation:

Circumstance	Explanation
The client's economic dependence on its principal customer (45% of revenue on a one year renewable contract).	The going concern assumption may not be appropriate if, for any reason, this major contractis not renewed.
Deterioration of cash flows, due to customers demanding/taking extended periods of credit (up to 60 days).	The risk of irrecoverable and doubtful debts is increased, and year end receivables may be materially overstated if allowances are not adequate.
Pressure from the potential customer's demands.	Profit margins may be adversely affected, increasing doubts about the company's continuation as a going concern.
Sale by conglomerate on favourable terms (low interest loans).	Omega plc may not have been optimistic about Supachill Ltd's future prospects, which therefore raises going concern doubts.
High gearing with repayments due in near future (CU250,000 per quarter).	Any breach in loan terms (eg, if instalments are not being met) may result in foreclosure. Additional funding may be difficult to raise as security base is diminished.
The postponement of plans for expansion (but it could be considered amitigating factor).	The adequacy of the working capital available, both the short and medium term must be assessed.
The managing director's (MD) lack of knowledge of the nature of the business and the industry.	The MD may lack the acumen to trade out of the loss-making situation, thereby increasing which it operates. Inherent risk.
The loss of key staff (finance director).	The reduction in supervision over the accounting functions may increase both inherent and control risk and result in more errors arising with the increase in the accountant's workload and failure to detect and correct errors.
The delay in preparing draft accounts may increase inherent risk if the audit deadline cannot be postponed.	Increased pressure on the audit timetable to meet a possible bank deadline late in the year could result in a material misstatement being undetected by audit procedures.
Only temporary accounts staff are available to assist accountant.	The risk of errors arising is increased (eg, due to insufficient training/ supervision).
The bank's reliance on audited accounts, increasing management's motive to 'inflate' profit.	Particular attention should be given to the accuracy of bank overdraft/payables cut-off and the impact of potential adjustments on key ratios (eg, acid test ratio).

Circumstance	Explanation
The projected loss may cause the MD to bias the results. If, for example, the bank is already aware of (and accepts) the projection, the MD may ensure that the loss is met (eg, by over-providing against asset values). Alternatively, the reported loss may be understated by understating allowances.	Attention should be given to all matters of judgement which materially affect the statement of profit or loss. In particular, the need for inventory and receivable allowances should be assessed (ie, tested for overstatement) as well as their adequacy (ie, tested for understatement).
Lack of cumulative/prior knowledge from which assurance can be derived.	Adequate planning is essential to audit efficiency to avoid over-auditing (due to increase in inherent risk) in the first year.
The nature of the client's business.	Chilled foods increase inherent risk as they are perishable and there may be understatement of year end allowances to reduce inventory to NRV.

6.2 Procedures

To ensure that the company can meet its debts as they fall due

(1) Obtain a written statement from the managing director confirming their considered view that the company is a going concern.

(2) Review management's profit and cash flow forecasts for the next financial year (and beyond, if available) to ascertain the company's working capital requirements.

(3) Confirm the appropriateness of relevant assumptions, eg, average debt collection period,by comparison with ratios obtained through analytical procedures.

(4) Request a statement of borrowing facilities to be included in the bank confirmation letter.

(5) Review the day-to-day utilisation of the bank overdraft facility and its proximity to the current limit.

(6) Obtain confirmation of loan from Omega plc and that all quarterly instalments of loan repayment to date have been met.

(7) Discuss with the credit controller (or financial accountant) the current pressures under which the company is being placed by larger customers seeking extended credit terms.

(8) Review the MD's agreement with Omega plc for the purchase of Supachill Ltd to ascertain the circumstances under which interest rates or repayment terms could be varied.

(9) Review the level of trade and other payables, including VAT and TAX and whether any penalties are being incurred, and the extent to which they are financing short-termneeds.

To ensure that the company can otherwise continue in business

(1) Obtain a copy of correspondence to date concerning the contract currently being negotiated, and monitor all subsequent developments.

(2) Review production records and order books, and discuss with management how current spare capacity can accommodate substantial new contracts (as the expansion plans have been postponed).

(3) Review the terms of the existing one-year renewable contract and correspondence with this customer, to ascertain whether there are any grounds for this contract not to be renewed.

(4) Discuss with the MD any possible new sources of finance for the expansion.

(5) Obtain written confirmation from the company's legal advisor as to whether or not there are any pending legal claims (eg, in respect of food poisoning).

(6) Discuss with the MD and/or the company's recruitment adviser the response to any advertisement for the position of finance director.

7 **Regarding ability to continue in business**

- Discuss with directors, eg:
  - Likelihood of alternative sales markets
  - Advertising/marketing strategy
  - Prospects of product diversification
- Scrutinise current year's order book
- Review tenders for new contracts
- Review published trading results for industry (expanding or in decline)

Regarding ability to meet debts as fall due

- Discuss with directors, eg:
  - Any intention to sell surplus assets
  - Impending negotiations for new sources of finance
  - Professional advice sought from bank
  - Confirm with bank/other lenders negotiations to date

Nine-month period – effect

- If period used for going concern assessment < 1 year from date of approval of financial statements
- And that fact not disclosed in financial statements
- Disclose in auditor's report
- But do not qualify auditor's report regarding this

Chapter 13

Reporting

Introduction

Learning outcomes

Concluding and reporting on engagements

Students will be able to conclude and report on assurance engagements in accordance with the terms of the engagements and appropriate standards.

- Draft suitable extracts for an assurance report (including any report to the management issued as part of the engagement) in relation to a specified organisation on the basis of given information, including in the extracts (where appropriate) statements of facts, their potential effects, and recommendations for action relevant to the needs and nature of the organisation being reported upon
- Advise on reports to be issued to those responsible for governance in accordance with standards, legislation, regulation and codes of corporate governance
- Explain the elements (both explicit and implicit) of the auditor's report issued in accordance with the International Standards on Auditing and statutory requirements and recommend the nature of an audit opinion to be given in such a report
- Draft suitable extracts for an auditor's report (and any report to the management issued as part of the engagement) in relation to a specified organisation on the basis of given information, including in the extracts (where appropriate) statements of facts, their potential effects, and recommendations for action relevant to the needs and nature of the organisation being reported upon

Syllabus links

The basic unmodified auditor's report was introduced in Assurance.

Examination context

This is an important area for the exam. Auditor's reports feature regularly in exams.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	The auditor is required to communicate with those charged with governance regarding the entity's internal controls. Points for inclusion within this letter should be raised by the audit team during the fieldwork stage of the audit.	Read through the material in this section and attempt the activity.	This area could be tested in either a short or a long form question.	1, 2
2	The report is the last aspect of the audit process. Historically, problems with the wording of reports have contributed largely to the expectations gap. In recent years attempts have been made to close this gap, partly by revising those ISAs that deal with the form and content of the auditor's report. **Stop and think** How do auditors fulfil their obligations when producing the auditor's report?	Read this section very carefully, as it is extremely important. Do not overlook the worked examples.	The material in this topic is crucial for your exam and is very likely to be tested at some point.	3, 4

Topic	Practical significance	Study approach	Exam approach	Self-test questions
3	If you work in practice, you are more likely to be involved in carrying out disclosure checklists on the financial statements (as discussed in the previous chapter) than drafting the auditor's report. However, you should be aware when a modified auditor's report might be required, so that you can highlight that fact to senior audit staff members.	This is another vital topic, so you need to work through this section very carefully.	The material in this topic is crucial for your exam and is very likely to be tested at some point.	5, 6, 7, 8
4	Auditors may also audit financial statements prepared in line with frameworks other than IFRS, or may audit an incomplete set of financial statements.	Read through this section carefully.	This topic is not highly examinable, but could crop up in a short form question.	

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1. Communication with those charged with governance

Section overview

- Auditors are required to report privately to those charged with governance on various matters arising from the audit.
- Relevant matters include:
  - auditor's responsibilities in relation to the audit of financial statements
  - planned scope and timing of the audit
  - significant findings from the audit
  - auditor independence
- Matters may be communicated orally or in writing.
- They should be recorded in audit working papers.

Various auditing standards require auditors to report certain audit matters arising to those charged with governance. This report will be 'private' and just for the attention of those charged with governance, as opposed to the auditor's report, which is a published document.

The requirements in relation to this private reporting are found in the main in ISA 260, *Communication with those Charged with Governance* which deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements.

ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* specifically requires the auditor to communicate any significant deficiencies in internal control encountered during the course of their audit work. Whether a deficiency is significant is a matter of professional judgement for the auditor. Matters to consider will include the likelihood of material misstatements and potential losses or fraud.

1.1 Appropriate persons

Definition

Those charged with governance: Is the term used to describe the role of persons entrusted with the supervision, control and direction of the entity. Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting and reporting to interested parties. Those charged with governance include management only when it performs such functions.

Those charged with governance include the directors (executive and non-executive) of a company and the members of an audit committee where one exists. For other types of entity, those charged with governance usually include equivalent persons such as the partners, proprietors, committee of management or trustees.

The auditors may communicate with the whole board, the supervisory board or the audit committee depending on the governance structure of the organisation. The auditor should ensure that those charged with governance are provided with a copy of the audit engagement letter on a timely basis.

To avoid misunderstandings, the engagement letter should explain that auditors will only communicate matters that come to their attention as a result of the performance of the audit. It should state that the auditors are not required to design procedures for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

The letter may also:

- describe the form which any communications on governance matters will take
- identify the appropriate persons with whom such communications will be made
- identify any specific matters of governance interest which it has agreed are to be communicated

1.2 Matters to be communicated

The scope of ISA 260 is limited to matters that come to the auditors' attention as a result of the audit; the auditors are not required to design procedures to identify matters of governance interest.

Such matters would include:

- the auditor's responsibilities in relation to the financial statement audit
- planned scope and timing of the audit
- significant findings from the audit
- auditor independence (in the case of listed entities)

Under significant findings the standard lists the following:

- Written representations the auditor is requesting
- The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures
- Significant difficulties, if any, encountered during the audit
- Significant matters, if any, arising from the audit that were discussed with management
- Other matters, if any, arising from the audit that, in the auditor's professional judgement, are significant to the oversight of the financial reporting process

Where the audited entity is listed, auditors shall do the following:

- Confirm that the engagement team have complied with ethical requirements relating to independence.
- Declare all relationships between the firm and the entity that may have a bearing on independence, including details of fees for non-audit services.
- Detail the related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

For entities that report on how they have applied the BSEC Corporate Governance Code, the auditor should also report to the audit committee any information that the auditor deems relevant with respect to fulfilling its responsibilities under the Code.

1.2.1 Communicating deficiencies in internal control

ISA 265 does not require auditors to perform specific tests on internal control, over and above their normal audit work, but it does require them to report on deficiencies encountered during the course of that work. The specific requirements are the following:

- The auditor shall determine whether deficiencies in internal control have been identified.
- Where deficiencies have been identified, the auditor shall determine whether those deficiencies are significant.
- Significant deficiencies shall be communicated in writing to those charged with governance.
- Significant deficiencies shall be communicated in writing to management.

- Other deficiencies shall be communicated to management if the auditor considers them important enough to warrant management attention.
- Written communication shall include a description of the deficiencies and their potential effects, and sufficient information to understand the context of the communication.
- The written communication shall include sufficient information to enable those charged with governance and management to understand the context, in particular:
  - The purpose of the audit was for the auditor to express an opinion on the financial statements.
  - The audit included consideration of internal controls relevant to the preparation of financial statements, in order to design audit procedures, not in order to express an opinion on those controls.
  - The matters being reported are limited to those deficiencies that the auditor has identified during the audit that merit being reported to those charged with governance.

The standard gives examples of matters that the auditor may consider in determining whether deficiencies are significant. These examples include:

- the likelihood of the deficiencies leading to material misstatements
- the susceptibility to loss or fraud
- the financial statement amounts
- the volume of activity
- the importance of the controls to the financial reporting process

1.3 How?

Matters may be communicated orally or in writing, but they should be recorded in the audit working papers, however discussed. Certain matters must, however, be communicated in writing, for example significant deficiencies in internal controls. Auditors should make clear that the audit is not designed to identify all relevant matters connected with governance and they should have regard to local laws and regulations, and local guidance on confidentiality when communicating with management.

1.4 Attributes for effective communication to those charged with governance

The communication should have the following attributes:

- **Timing**: It should be sufficiently prompt to enable those charged with governance to take appropriate action, for example, items relating to the financial statements should be reported before the financial statements are approved.
- **Extent, form and frequency**: Should be appropriate. What is appropriate will depend on the size of the entity and the way in which those charged with governance operate.
- **Expectations**: It should fulfil the expectations of the auditors and those charged with governance, and therefore, the nature of the communication should be agreed early in the audit process, for example, in the letter of engagement, so that misunderstandings are minimised.
- **Management comments**: Should be included where they are relevant and will aid the understanding of those charged with governance.
- **Previous year's points**: Should be repeated if no action has been taken and the auditors believe that they are still relevant. If there are no new points to be made, the auditors should make that point.
- **Disclaimer**: Should be included so that third parties do not seek to rely on the information given within the report.

Effective communication is a two-way process between auditors and those charged with governance. Communication received from the client should be documented and responded to appropriately.

Interactive question 1: Mouse and Ratty Ltd

You are currently undertaking an assurance engagement for Mouse and Ratty Ltd, a large firm of PR consultants in Leeds.

During the course of the work you have found a number of issues on which you need to report. These can be summarised as follows:

(1) You have found a total of CU18,000 of unauthorised expenditure on IT equipment. Any IT expenditure in excess of CU150 has to be authorised by a director.

(2) The IT expenditure for the year is 65% in excess of budget. There does not appear to have been an investment project which was not budgeted for. There seems to be little reason for the rise.

(3) Large sums for travelling expenses are not being authorised when in excess of nightly limits set. Four executives spent a total of CU25,000 in excess of nightly limits throughout the year.

(4) When examining work in progress, it became clear that there were sums which have been therefor more than six months without being billed. These total CU56,000. There appears to be no explanation for this.

(5) When overtime forms are submitted, any amounts of more than three hours per month need to be authorised. This is rarely done. The company paid out CU180,000 in unauthorised overtime.

(6) There are no controls over non-chargeable time. The proportion of non-chargeable time for individual executives varies from 5% to 34%.

Requirement

Identify the following:

(1) The internal control deficiencies arising from the above

(2) The risks to which each identified deficiency exposes the company

(3) Actions that the company should take to mitigate those risks

See **Answer** at the end of this chapter.

1.5 Sustainability impact

The degree to which climate-related risks require changes to the company's accounting policies, estimates and disclosures may be significant enough to warrant formal communication with those charged with governance, especially if the disclosure requirements necessitate changes to reporting and disclosure mechanisms.

2. Unmodified auditor's reports

Section overview

- The report per ISA 700 contains a number of standard elements.
- Auditors also report by exception on a number of legal matters.
- With regard to listed companies, the auditor's report will also refer to the review of the corporate governance statement required by the BSEC Corporate Governance Code.

The following sections will look at the types of auditor's reports that auditors may issue. ISA 700, *Forming an Opinion and Reporting on Financial Statements* set out standardised auditor's reports for auditors to use. This has the benefit of providing a degree of consistency between auditor's reports on financial statements and enhances their understandability.

In all cases an opinion on the financial statements will need to be included. The opinion may be:

- An unmodified **opinion**: The auditor is satisfied that the evidence obtained is sufficient and appropriate and supports the view presented in the financial statements prepared by the company's management.
- A modified **opinion**: The auditor is either not satisfied with the sufficiency or appropriateness of the evidence that has been obtained, compared with what could reasonably be expected, or has issues with the content of the financial statements.

In some cases the auditor may need to add additional paragraphs in the auditor's report that would only be included under certain circumstances; these do not, however, indicate that there is anything wrong with the financial statements or the audit evidence obtained.

When the auditor makes amendments to a standard auditor's report (be it due to modifying the audit opinion or adding additional paragraphs) this is referred to as a modified **auditor's report**.

The opinions open to the auditor are therefore to issue:

(a) an unmodified auditor's report

(b) a modified auditor's report with an unmodified audit opinion

(c) a modified auditor's report with a modified audit opinion, which can be a qualified opinion (except for), an adverse opinion or disclaimer of opinion

CHAPTER 13

2.1 Auditing standards and the auditor's report

A number of auditing standards deal with the auditor's report. The ISAs that deal with auditor's reports are largely in line with the equivalent IAASB standards .

- ISA 700, *Forming an Opinion and Reporting on Financial Statements* deals with the content and format of the auditor's report where no additional communication is required beyond the key audit matters, and where the opinion is unmodified.
- ISA 700 provides illustrations of auditor's reports in the Appendix .
- ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*. This is a relatively new standard that requires the auditor to communicate those matters that are viewed by the auditor as most significant, together with an explanation of how those matters were addressed during the course of the audit. The standard also requires a greater audit focus on going concern and how this is disclosed, and more transparency about the work of the auditor. The aim of the standard is to improve the quality of the auditor's report and of financial reporting in general. It applies primarily to listed entities.
- The key requirements of ISA 701 are summarised below:
  - Key audit matters (KAMs) are selected from those matters communicated with those charged with governance, taking into account significant risks, auditor judgements, and events or transactions.
  - A description of each KAM is provided.
  - KAMs are not a substitute for a modified opinion as required by ISA 705.
  - An explanation of how the concept of materiality was applied in planning and performing the audit is provided in the overview of the scope of the audit with specific reference to KAMs.

2.1.1 Sustainability impact

Climate-related risks that could give rise to **material misstatements** which (if uncorrected) may relate to:

- Appropriateness or adequacy of disclosures. For example, the entity may not have appropriately disclosed the effect of climate-related risks.
- Application of the entity's accounting policies. For example, inappropriate recognition and measurement of assets due to the effect of climate-related risks.

The auditor would also need to consider the implications of **non-compliance** with any relevant laws or regulations (such as the Companies Act requirements for climate-related risks and any other information).

The degree to which climate-related risks require auditor attention may result in determining such a matter to be a **key audit matter** which may be affected by significant climate-related auditor judgments or specific climate-related events or transactions.

2.2 The main components of an auditor's report as required by ISA 700

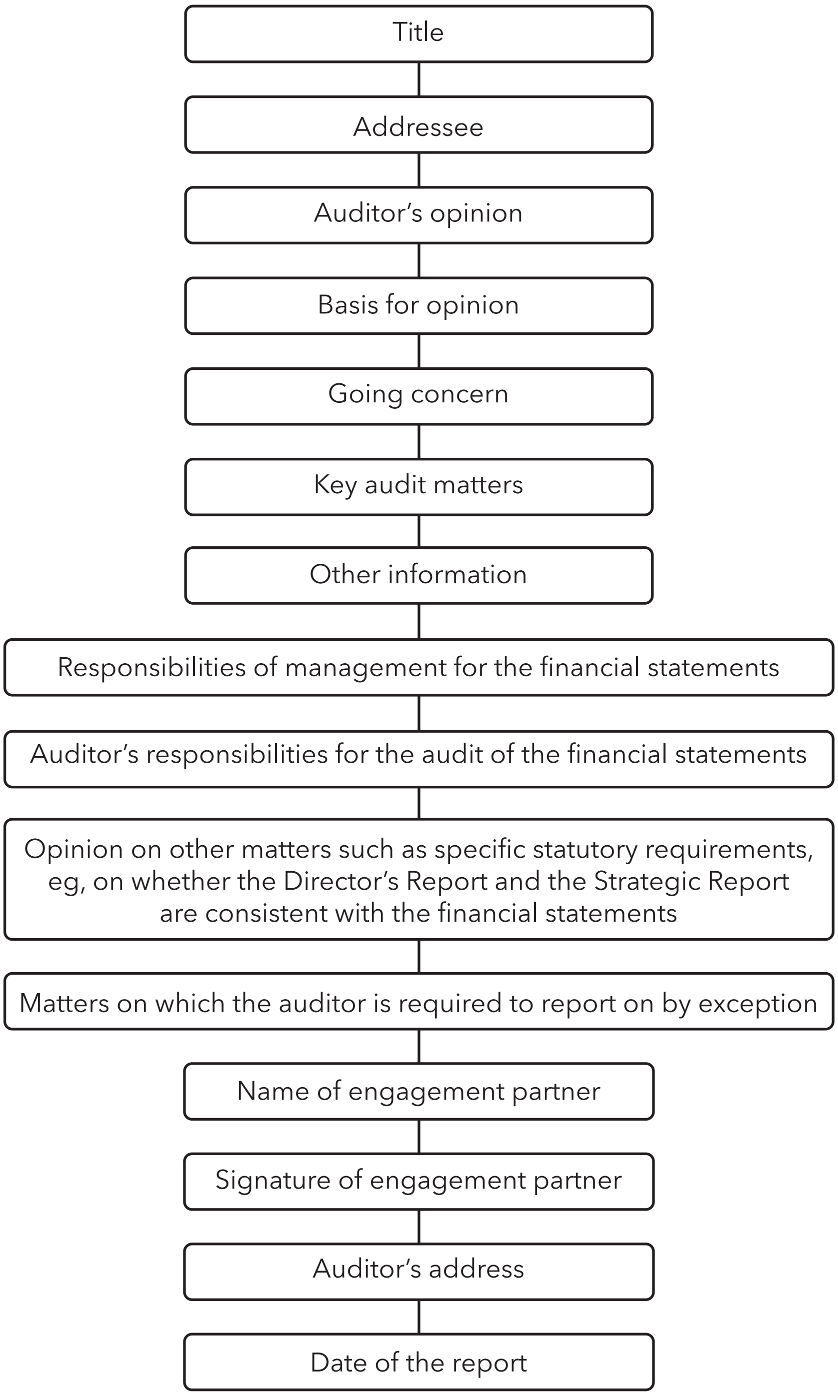


Figure 13.1: Overview: unmodified report

2.2.1 Title

The report needs an appropriate title to distinguish it from the other material included with the financial statements and to try to reduce the 'expectations gap'.

In order to do this the title will include the words **'independent auditor'** to stress that, whilst the financial statements are management's responsibility, the auditor's report is the responsibility of the auditor alone. Using the term 'independent auditor' also serves to distinguish the auditor's report from any other report issued to shareholders.

The title usually also refers to the people to whom the report is addressed.

2.2.2 Addressee

Because in carrying out their audit work the auditors have to deal with management and work closely with the client's management team, it may be forgotten that their report is not directed towards management. The Companies Act requires the auditor's report to be addressed to the members or shareholders of a company because the audit is carried out on their behalf.

Remember the fundamental structure of an assurance engagement:

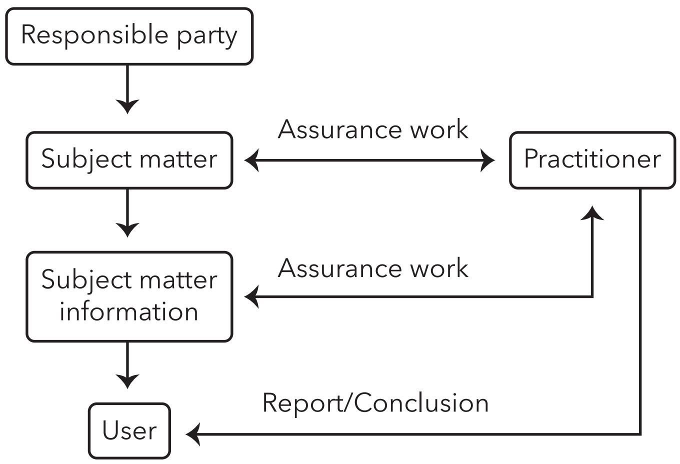


Figure 13.2: Assurance engagement

It is important to remember that the report will be addressed to the user in the tripartite relationship which exists in any assurance engagement, which for an audit means the company's shareholders.

Whilst the auditor's report does not represent a direct commentary on the performance of management over the period, it does state whether or not the account which management gives of its own performance is true and fair.

Understanding this relationship is important to all the parties involved, and clearly setting out the addressee of the report should also contribute to a reduction in the expectations gap.

2.2.3 Opinion paragraph Identifying the statements

Identifying the statements covered by the auditor's report has traditionally been done by referring to the relevant page numbers. However, as well as leaving scope for silly errors if the number of pages changes whilst the financial statements are being finalised, to refer to page numbers has become irrelevant if the financial statements are published as web pages . Best practice, therefore is to refer to the statements by name.

The opinion itself

The auditors will normally express their opinion by reference to the 'true and fair view'. Whilst this term is at the heart of the audit, 'true' and 'fair' are not defined in law or audit guidance. However, for practical purposes the following definitions are generally accepted.

- **True**: information is factual and conforms with reality, not false. In addition, the information conforms with required standards and law. The accounts have been correctly extracted from the books and records.
- **Fair**: information is free from discrimination and bias in compliance with expected standards and rules. The accounts should reflect the commercial substance of the company's underlying transactions.

ISA 700 requires the opinion paragraph to state clearly that the financial statements 'give a true and fair view'.

The financial reporting framework

All financial statements are prepared in accordance with a **financial reporting framework**. This may be in accordance with International Reporting Standards, or the standards used in other jurisdictions.

The Companies Act 1994 embraces 'applicable accounting standards' and the framework reference is usually **have been prepared in accordance with the requirements of the Companies Act 1994.**

2.2.4 Basis for opinion

This provides important context for the auditor's opinion. It should therefore identify:

- that ISAs have been followed
- that the auditor is independent
- the ethical framework under which the auditor operates

2.2.5 Going concern

Auditor's reports must always include a section on going concern. The precise details are tailored to the engagement in question. For reports with unmodified opinions, the section is headed 'Conclusions relating to Going Concern' (ISA 570), and effectively summarises the auditor's conclusions in relation to going concern.

2.2.6 Key audit matters (KAMs)

These are matters that the auditor considers to be of most significance during the audit. A brief description of each KAM should follow.

Professional skills focus: Concluding, recommending and communicating

The KAMs are part of the unmodified auditor's report for listed company audits, but they are specific to the audit in question. Although the standard ISA 700 auditor's report must therefore be 'modified' (or tailored) for the specific audit, this does not mean that it is a report with a modified opinion.

2.2.7 Respective responsibilities of directors and auditors

There is usually a statement of directors' responsibilities towards the financial statements, included either in the directors' report or as a separate statement. A cross reference is therefore made in auditor's reports.

There is also a statement of the auditors' responsibilities, emphasising that the auditor reports on the truth and fairness of the financial statements.

The statement of auditor's responsibilities should include a statement about extent to which the auditor considers the audit capable of detecting irregularities (eg, non-compliance with laws and regulations), including fraud.

2.2.8 Other responsibilities

In some jurisdictions the auditor reports on other matters as required by relevant legislation. The auditor is required to express an opinion as to whether the information in the directors' report is consistent with the financial statements. The auditor is also required to report on whether the strategic report is consistent with the financial statements. All companies are required to produce a strategic report. Auditors are also required to identify the matters that are required by the Companies Act 1994 to be reported on by exception.

2.2.9 Name and signature of engagement partner

This may seem obvious, but it is all to do with emphasising who has responsibility for what.

ISAs requires that where the auditor is a firm, the report must be signed by the ' statutory auditor' in their own name, for and on behalf of the auditor. Prior to this, reports were signed in the name of the firm. In most cases the statutory auditor will be the engagement partner.

2.2.10 **Address**

Again this is to ensure that there is no doubt who is responsible for the report.

ISA 700 requires the report to name the location in the jurisdiction where the auditor practises.

2.2.11 Date

The date of the report should be the date when the auditor has obtained sufficient appropriate evidence to support the opinion.

It should not be earlier than the date when management approves the financial statements.

Context example: auditor's report

An example of a complete auditor's report is given below.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies..

In our opinion, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants' International Code of Ethics for Professional Accountants (including International Independence Standards) (IESBA Code), together with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701.]

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[Reporting in accordance with the reporting requirements in ISA 720 (Revised) – see Illustration 1 in Appendix 2 of ISA 720 (Revised).]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 41(b) of this ISA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, actions taken to eliminate threats or safeguards applied.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation or national auditing standards. The matters addressed by other law, regulation or national auditing standards (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the ISAs may be combined (i.e., included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the ISAs where such a difference exists.

The engagement partner on the audit resulting in this independent auditor's report is [name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

CHAPTER 13

2.2.12 Corporate Governance Code

Publicly traded companies are required to include a Corporate Governance Statement in their annual report. If this is not included, the auditor must report by exception.

2.2.13 Real auditor's reports

Familiarity with real auditor's reports will help you with reporting questions in the exam so you should try to read as many real-life examples as possible.

2.3 ISA 720, *The Auditor's Responsibilities Relating to Other Information*

The audited financial statements are likely to be published in the annual report, which may also include other information. This is defined in the standard as financial and non-financial information, other than the audited financial statements, that is included in the entity's annual reports. Examples of other information would include:

- management report, management commentary, or operating and financial review or similar reports by those charged with governance (for example, a directors' report)
- Chair's statement
- corporate governance statement
- internal control and risk assessment reports

ISA 720 requires the auditor to read the other information. If it is materially inconsistent with the financial statements then this could indicate that there is a material misstatement in the financial statements themselves.

2.3.1 Sustainability impact

Currently, the majority of climate-related information is disclosed in other information, which is included in the annual report, but is outside the audited financial statements. In reading the annual report, the auditor is required to consider whether there is a material inconsistency between disclosure of climate-related information and the financial statements. Material inconsistencies may indicate that there is a material misstatement.

When climate-related information is presented in another document outside the annual report, such as a sustainability report, then auditor must determine whether the document containing the climate-related information is still consistent with the rest of the audited financial statements. There is also the need to consider the relationship between other information and other legally required disclosures (such as those in relation to the strategic report) so it is likely that the auditor would consider this at the same time.

2.3.2 Strategic report and directors' report

- Auditors are also required to report on other information that the entity is required by law to produce and publish with the financial statements. This statutory other information includes:
  - the directors' report
  - the strategic report
  - The separate corporate governance statement

According to ISA 720:

- The auditor shall read the information and assess whether it is consistent with the financial statements.
- If the auditor identifies any inconsistencies between the information in the directors' report or strategic report, and the financial statements, the auditor shall seek to resolve them.
- If the auditor is of the opinion that the information in the directors' report or strategic report is materially inconsistent with the financial statements (and has been unable to resolve the inconsistency), then the auditor shall state that opinion and describe the inconsistency in the auditor's report.
- If an amendment is necessary to the financial statements (and management and those charged with governance refuse to make the amendment), then the auditor expresses a qualified or adverse opinion on the financial statements.

The purpose of the strategic report is to enable shareholders to assess how well the directors have performed in their duty to promote the success of the company.

3. Modified auditor's reports

Section overview

- The wording of an auditor's report may need to be '**modified**' in certain circumstances:
  - where the auditor wishes to highlight an issue but where the audit opinion is **not** affected – an emphasis of matter paragraph (ie, modification to the **report**)
  - where there is an impact on the audit opinion (ie, modification to the **opinion**)

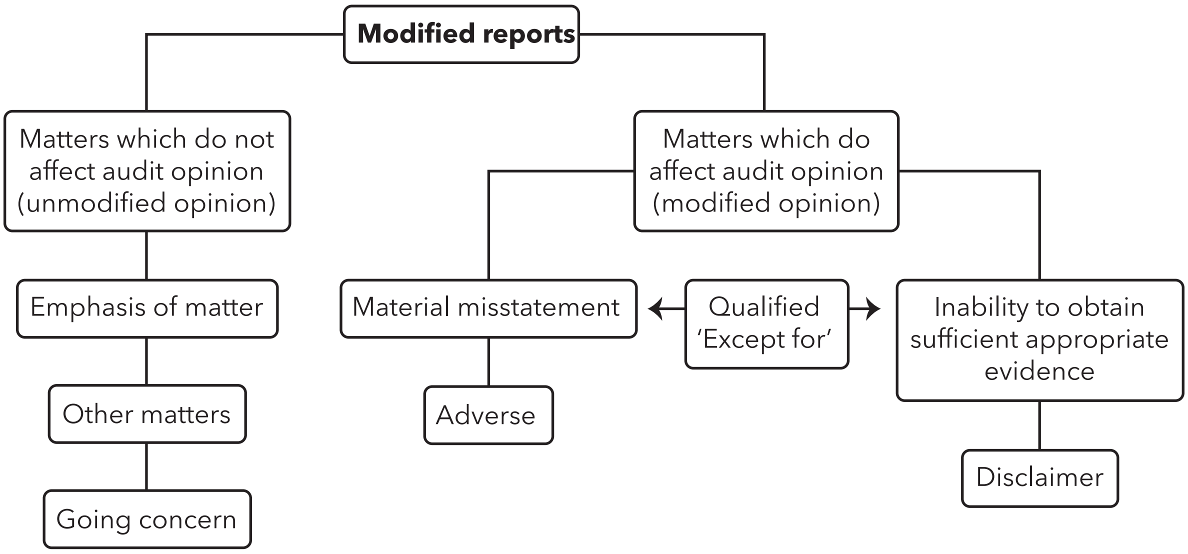


Figure 13.3: Overview: modified reports

Modifications to the auditor's report are covered in two ISAs :

- ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*. Key points relate to the positioning of the 'Basis for Qualified/Adverse/Disclaimer of Opinion' section after the opinion section, and the omission of the 'Key Audit Matters' section when disclaiming an opinion, unless this is required by law or regulation.
- ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. Revisions relate to Key Audit Matters (as required by ISA 701) in particular the Emphasis of Matter paragraph should not be used as a substitute for a description of a Key Audit Matter, and also the positioning of the Emphasis of Matter and Other Matter paragraphs.

In this section we shall be using the term 'modified report'. The ISAs that deal with auditor's reports do not use this term, but it is useful for distinguishing those reports that contain an emphasis of matter paragraph or another matter paragraph.

There are separate ISAs for matters in auditor's reports that do not modify the opinion (ISA 706) and those that do (ISA 705). For your examination you need to be able to follow the logic of Figure 13.3 above and consider the impact of scenarios given in a question on the form of the auditor's report and the type of audit opinion.

The type of modified opinion expressed will depend on the circumstances and the effect of any actual or potential misstatements on the financial statements. Misstatements that are material but not pervasive will lead to an 'except for' qualified opinion, whereas if the misstatements are deemed to be pervasive the opinion will be adverse or will be disclaimed. The term 'pervasive' is defined in ISA 705 as something that affects the financial statements as a whole or a substantial part of them, and which is fundamental to the users' understanding of the financial statements. This is discussed further in section 4.2.

3.1 Emphasis of matter paragraphs and other matter paragraphs

The auditor should add an **'emphasis of matter' paragraph** to the auditor's report where the auditor considers it necessary to draw users' attention to a matter or matters **presented or disclosed in the financial statements** that are of such importance that they are fundamental to users' understanding of the financial statements.

The auditor should add an **'other matter' paragraph** to the auditor's report where the auditor considers it necessary to draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

According to ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* the emphasis of matter paragraph should be included immediately after the opinion on the financial statements paragraph and shall:

- use the heading 'Emphasis of Matter'
- include a clear reference to the matter being emphasised and to where relevant disclosures can be found in the financial statements
- indicate that the auditor's opinion is not modified in respect of the issue dealt with

Similarly, an 'other matter paragraph' should be included immediately after the opinion of the financial statements paragraph and any Emphasis of Matter paragraph or elsewhere in the auditor's report if the content of the Other Matter paragraph is relevant to the Other Reporting Responsibilities section.

If the auditor expects to include and Emphasis of Matter or Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the proposed wording of the paragraph.

ISAs gives the following examples of circumstances where an Emphasis of Matter paragraph could be included:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action
- A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report
- Early application of a new accounting standard that has a material effect on the financial statements
- A major catastrophe that has had a significant effect on the entity's financial position

The standard makes it clear that an Emphasis of Matter paragraph is not a substitute for a modified opinion or for reporting a material uncertainty relating to going concern.

Examples of where an auditor's report could include an 'other matter' paragraph are:

- where the prior period financial statements were audited by another auditor
- where the prior period financial statements were not audited

Worked example: Modified report – unmodified opinion – emphasis of matter

A firm being audited is awaiting the outcome of a lawsuit and as a result it is not possible to quantify the effect this will have on the financial statements.

The details are as follows:

- A lawsuit alleges that the company has infringed certain patent rights and claims royalties and punitive damages. The company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress.
- The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.
- The company makes relevant disclosures in the financial statements.

Requirement

Set out the modification to the auditor's report that the auditor should make in this instance.

Solution

The auditor issues a modified auditor's report, ie, with an emphasis of matter paragraph describing the situation giving rise to the emphasis of matter and its possible effects on the financial statements, including that the effect on the financial statements of the resolution of the uncertainty cannot be quantified. The audit opinion itself is an unmodified opinion.

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at and of its profit (loss) for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards.

Emphasis of matter – possible outcome of a lawsuit

In the forming of our opinion on the financial statements, which is not qualified, we have considered the adequacy of the disclosures made in note x to the financial statements concerning the possible outcome of a lawsuit, alleging infringement of certain patent rights and claiming royalties and punitive damages, where the company is the defendant. The company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements. Our opinion is not modified in respect of this matter.

Registered auditors Address

Date

3.2 Modification of the audit opinion

Circumstances that have an impact on the audit opinion are discussed in ISA 705, *Modificationsto the Opinion in the Independent Auditor's Report*.

The auditor shall modify the opinion when:

(a) The auditor concludes that the financial statements as a whole are not free from material misstatement, eg, where there is disagreement with management about:

- accounting policies;
- accounting treatment; or
- disclosure in the financial statements.

In these circumstances there are two possible outcomes:

- The resulting misstatements are material, but not pervasive, to the financial statements – this will result in a 'qualified opinion' ('except for').
- The resulting misstatements are both material and pervasive to the financial statements such that the auditor concludes that the accounts do not give a true and fair view – an 'adverse opinion'.

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatements, eg, a limitation on the scope of the audit.

In these circumstances there are two possible outcomes:

- The possible effects of undetected misstatements, if any, could be material but not pervasive – this will result in a 'qualified opinion' ('except for').
- The possible effects of undetected misstatements on the financial statements could be both material and pervasive, so serious that the auditor is unable to form an opinion on the financial statements – a 'disclaimer of opinion'.

Worked example: Qualified 'except for' opinion – material misstatement

An auditor is in disagreement with management regarding an accounting treatment. The details areas follows.

- Included in the receivables shown on the statement of financial position is an amount of CUY which is the subject of litigation and against which no allowance has been made. The auditor considers that a full allowance of CUY should have been made.

Requirement

Set out the opinion on the financial statements that the auditor should make in this instance.

Solution

Modified opinion on financial statements arising from material misstatement in relation to accounting treatment

Included in the receivables shown on the statement of financial position is an amount of CUY due from a company which has ceased trading. XYZ Limited has no security for this debt. In our opinion the company is unlikely to receive any payment and a full allowance of CUY should have been made.
Accordingly, receivables should be reduced by CUY, deferred tax liability should be reduced by CUX and profit for the year and retained earnings should be reduced by CUZ.

Except for the financial effect of not making the allowance referred to in the preceding paragraph, in our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at… and of its profit (loss) for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards.

Registered auditor[Address]

[Date]

Worked example: Qualified 'except for' opinion – inability to obtain sufficient appropriate audit evidence

An auditor was unable to observe an inventory count because they were not engaged by the company at the time the count took place. The details are as follows:

- The evidence available to the auditor was limited because they did not observe the counting of the physical inventory as at 31 December 20X1, since that date was prior to the time the auditor was initially engaged as auditor for the company. Owing to the nature of the company's records, the auditor was unable to satisfy themselves as to inventory quantities by other audit procedures.

Requirement

Set out the audit opinion on financial statements that the auditor should make in this instance.

Solution

Audit opinion:

- The inability to obtain sufficient appropriate evidence causes the auditor to issue a modified opinion
  - except for any adjustments that might have been found necessary had they been able to obtain sufficient evidence concerning inventory.
- The limitation of scope was determined by the auditor not to be so material and pervasive as to require a disclaimer of opinion.

Modified opinion on financial statements arising from inability to obtain sufficient appropriate audit evidence

With respect to inventory having a carrying amount of CUX the audit evidence available to us was limited because we did not observe the counting of the physical inventory as at 31 December 20X1,since that date was prior to our appointment as auditor of the company. Owing to the nature of the company's records, we were unable to obtain sufficient appropriate audit evidence regarding the inventory quantities by using other audit procedures.

Except for the financial effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to inventory quantities, in our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 December 20X1 and of its profit (loss) for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards.

Matters on which we are required to report by exception

In respect solely of the limitation on our work relating to inventory, described above:

- We have not obtained all the information and explanations that we considered necessary for the purpose of the audit.
- We were unable to determine whether adequate accounting records had been kept.

We have nothing to report in respect of the following matters where the Companies Act 1994 required us to report to you if, in our opinion:

- returns adequate for our audit have not been received from branches not visited by us;
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made.

Registered auditors[Address]

[Date]

Worked example: Disclaimer of opinion

An auditor was unable to observe all physical inventory and confirm trade receivables during an audit. The details are as follows.

- The evidence available to the auditor was limited because the auditor was not able to observe all physical inventory and confirm trade receivables due to limitations placed on the scope of the auditor's work by the directors of the company.

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Requirement

Set out the opinion that the auditor should make in this instance.

Solution

The auditor has been unable to form a view on the financial statements and issues a modified opinion disclaiming the view given by the financial statements.

Disclaimer of opinion

We were engaged to audit the financial statements of ABC Company which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the Company. Because of the significance of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for disclaimer of opinion

The audit evidence available to us was limited because we were unable to observe the counting of physical inventory having a carrying amount of CUX and send confirmation letters to trade receivables having a carrying amount of CUY due to limitations placed on the scope of our work by the directors of the company. As a result of this we have been unable to obtain sufficient appropriate audit evidence concerning both inventory and trade receivables.

Because of the possible effect of the limitation in evidence available to us, we do not express an opinion as to whether the financial statements:

- give a true and fair view of the state of the company's affairs at and of its profit (loss) for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards.

Matters on which we are required to report by exception

In respect solely of the limitation of our work referred to above:

- We have not obtained all the information and explanations that we considered necessary for the purpose of our audit.
- We were unable to determine whether adequate accounting records have been kept.

We have nothing to report in respect of the following matters where the Companies Act 1994 requires us to report to you if, in our opinion:

- returns adequate for our audit have not been received from branches not visited by us;
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made.

Registered auditors[Address]

[Date]

Worked example: Adverse opinion

A company being audited has made no provision for losses expected to arise on certain long-term contracts. The details are as follows.

- No provision has been made for losses expected to arise on certain long-term contracts currently in progress, as the directors consider that such losses should be off-set against amounts recoverable on other long-term contracts.

Requirement

Set out the opinion that the auditor should make in this instance.

Solution

Auditor opinion:

- In the auditor's opinion, provision should be made for foreseeable losses on individual contracts as required by (specify accounting standards).
- The auditor issues an adverse opinion due to the failure to provide losses and quantifies the impact on the profit for the year, the contract work in progress and deferred tax liability at the year end.

Adverse opinion on financial statements

As more fully explained in note x to the financial statements no provision has been made for losses expected to arise on certain long-term contracts currently in progress, as the directors consider that such losses should be off-set against amounts recoverable on other long-term contracts. In our opinion, provision should be made for foreseeable losses on individual contracts as required by (specify accounting standards). If losses had been so recognised the effect would have been to reduce the carrying amount of contract work in progress by CUX, the deferred tax liability by CUY and the profit for the year and retained earnings at 31 December 20X1 by CUZ.

In view of the effect of the failure to provide for the losses referred to above, in our opinion the financial statements:

- do not give a true and fair view of the state of the company's affairs as at 31 December 20X1 andof its profit (loss) for the year then ended; and
- have not been properly prepared in accordance with International Financial Reporting Standards.

In all other respects, in our opinion the financial statements have been prepared in accordance with the requirements of International Financial Reporting Standards.

Registered auditors [Address]

[Date]

3.3 Emphasis of matter or inability to obtain sufficient appropriate audit evidence

An emphasis of matter paragraph is used when there is a degree of uncertainty surrounding the financial statements, for example where there is uncertainty regarding the outcome of a legal action, or where there are other significant uncertainties which have been disclosed in the financial statements. An inability to obtain sufficient appropriate audit evidence arises when evidence that can reasonably be expected to be available is not available, for example:

- Appointment after the year end may mean that the inventory check may not have been attended.
- The values in the accounts of an overseas subsidiary subject to an oppressive or economically unstable regime may be difficult to ascertain with sufficient reliability.

3.4 Going concern

The effect of going concern on the auditor's report was touched on in Chapter 12.

Going concern is a crucial issue in the audit, and as such it is always addressed in the auditor's report, whether modified or unmodified. The question for auditors is therefore not whether to include a disclosure in respect of going concern, but rather what sort of disclosure they should make in the situation in question.

Where the going concern assumption is appropriate, then auditor's report would not be modified in relation to going concern, but would include a prominent section dealing with the auditor's conclusions relating to going concern.

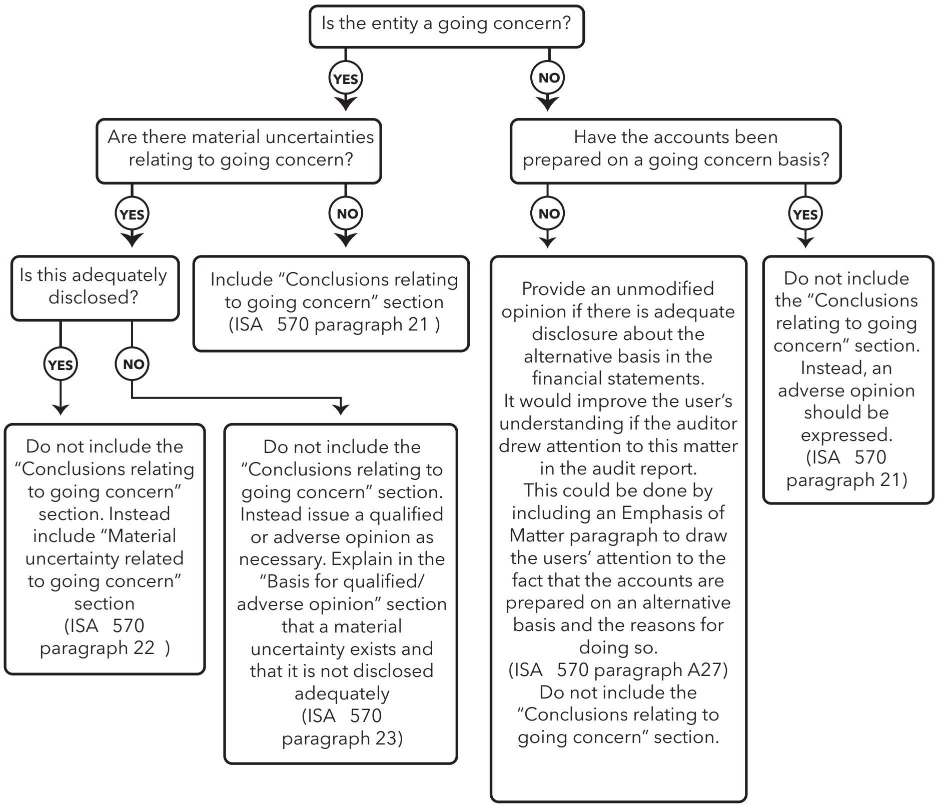
Where the going concern assumption is appropriate but there is a material uncertainty in relation to it, then the financial statements shall disclose this uncertainty. The auditor then highlights the importance of these disclosures by including a 'Material uncertainty relating to going concern' section in the auditor's report. If the disclosures in the financial statement are not appropriate, then this is a material misstatement; the auditor must then express a qualified or adverse opinion. In this case, the auditor's report will include a qualified or adverse opinion, and the situation in relation to the disclosures will be explained in the 'Basis for' qualified or adverse opinion section.

Where the going concern assumption is inappropriate but the financial statements have been prepared on the going concern basis, then this is a material and pervasive misstatement that would give rise to an adverse auditor's opinion. If the financial statements have been prepared on an alternative basis (eg, the liquidation basis) then the auditor would include an emphasis of matter section to emphasise the importance of this.

The situation is summarised by the following table.

	GC assumption appropriate	GC assumption appropriate but with Material Uncertainty	GC assumption inappropriate
Disclosure/treatment adequate	Unmodified opinion – FS are fairly presented Include a 'Conclusions relating to Going Concern' section	Unmodified opinion – FS are fairly presented Include a 'Material Uncertainty relating to Going Concern' section	Unmodified opinion – FS are fairly presented Consider including an Emphasis of Matter section to draw attention to alternative basis of preparation
Disclosure/treatment inadequate	–	Qualified or adverse opinion	Adverse opinion

The matter can also be considered in terms of the following decision tree.



3.5 ISA 720, *The Auditor's Responsibilities Relating to Other Information*

3.5.1 Inconsistencies

ISA 720 also gives the auditor some limited responsibilities with regards to the other information, where there may be material inconsistencies when other information contradicts, or appears to be materially inconsistent with, information in the audited financial statements. This could cast doubt on the credibility of the auditor's report.

The auditor shall read the other information and take the following action if there are inconsistencies:

Amendment necessary to	Auditor response if uncorrected
Audited financial statements	Qualified or adverse opinion
The other information	Describing the material inconsistency in the 'Other information' section of the auditor's report; or Take other actions, eg, seek legal advice.

CHAPTER 13

3.5.2 Material misstatements of the other information

A material misstatement of the other information exists when information, not related to matters appearing in the audited financial statements, is incorrectly stated or presented.

For example, the auditor may believe that there are misstatements contained in some of the employment data within the annual report.

When the auditor considers that there is an apparent misstatement in the other information, they shall request management to correct the other information.

If management refuses to correct the misstatement, the auditor shall communicate the matter with those charged with governance. If the misstatement is still not corrected the auditor shall take appropriate action, including withdrawing from the engagement and considering the implication forthe auditor's report. The misstatement shall be described in the 'Other information' section of the auditor's report.

3.6 Modified opinions – a summary

The available forms of **modification** to the audit opinion may be summarised by the following table:

Auditor's judgement about the pervasiveness of the effects or possible effects on the financialstatements

Nature of matter giving rise tothe modification	Material but not pervasive	Material and pervasive
Financial statements are materially misstated	Qualified opinion ('Except for')	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion ('Except for')	Disclaimer of opinion

Remember, that if a misstatement or a lack of evidence is immaterial the audit opinion will not be modified at all.

Interactive question 2: Auditor's report

You are the auditor of Purity Ltd, a manufacturer of water filters for domestic use. The company headquarters are in Wapping but it also has 10 regional branches to organise the sales effort in each geographical area.

Head office issued instructions for all inventories to be counted at the year end. However, due to an administrative error, the new branch in Newcastle did not receive any instructions and no physical inventory count took place. The inventories were material, estimated at CU50,000 and included in thefinancial statements. No alternative procedures could be applied.

Requirements

2.1 How will your auditor's opinion be modified?

report?

See Answer at the end of this chapter.

Interactive question 3: Modified auditor's report

An auditor is considering possible modification of their auditor's report on the financial statements of three separate companies.

(1) Watkins Ltd is being sued by a customer for material damages. Legal opinion is divided as to the outcome of the case, and all relevant information has been included in the notes.

(2) Pope Ltd suffered a flood at its head office and a significant number of accounting records have been destroyed.

(3) Tilden Ltd has included an allowance for receivables of CU100,000 in the financial statements. Obviously the allowance cannot be estimated with complete accuracy but the reporting partner believes it should be materially higher.

Requirement

Recommend, giving reasons, whether the opinion should be modified in each case.

See Answer at the end of this chapter.

4. Special considerations

Section overview

- Financial statements may be prepared using a different basis of accounting.
- The auditor may be required to report on single financial statements.

4.1 ISA 800, *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*

This ISA aims to address special considerations that are relevant to complete sets of financial statements prepared in accordance with another basis of accounting (for example, other than IFRS or GAAP).

The aim of the ISA is to identify additional audit requirements relating to these areas.

Before undertaking a special purpose audit engagement, the auditor shall ensure there is agreement with the client as to the exact nature of the engagement and the form and content of the report to be issued.

To avoid the possibility of the auditor's report being used for purposes for which it was not intended, the auditor may wish to indicate in the report the purpose for which it is prepared and any restrictions on its distribution and use.

Professional skills focus: Applying judgement

You may well not come across the issues discussed in this section in your work, but you need to be aware that engagements of these sorts do come up in practice, and that this is common enough for there to be ISAs that deal with them.

4.2 ISA 805, *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*

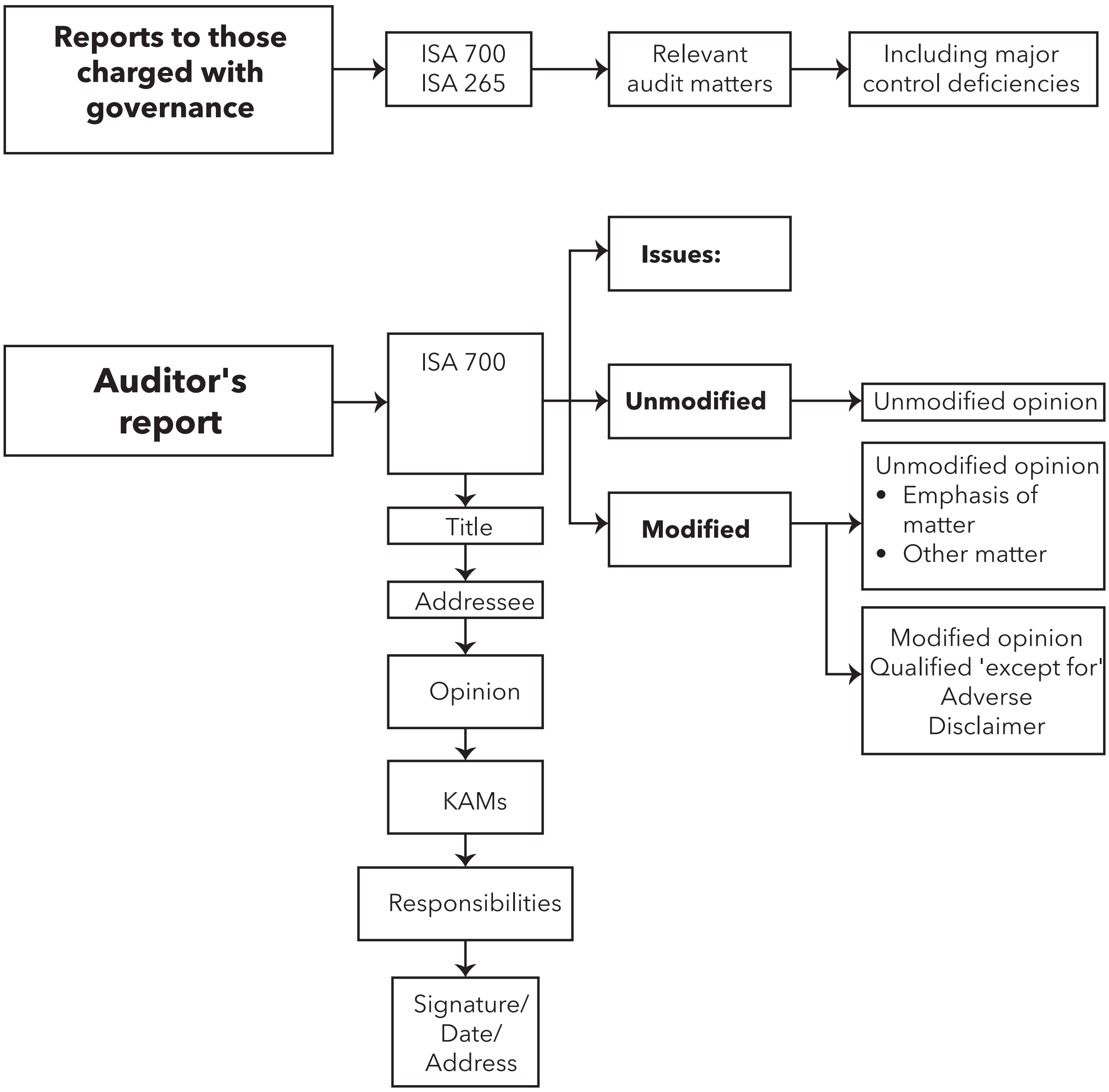
In certain circumstances, an auditor may be required to audit and report on a single financial statement, or a specific element, account or item of the financial statements. Guidance is provided in ISA 805.

Appendix 1 of ISA 805 includes the following examples:

- Accounts receivable, allowances for doubtful accounts receivable, inventory, the liability for accrued benefits of a private pension plan, the recorded value of identified intangible assets, or the liability for 'incurred but not reported' claims in an insurance portfolio, including related notes
- A schedule of externally managed assets and income of a private pension plan, including related notes
- A schedule of net tangible assets, including related notes

This ISA explains how other ISAs are applied in these circumstances. In particular, special considerations are required in relation to acceptance of the engagement, planning and performance and forming an opinion.

Summary


Reports to those charged with governance
ISA 700
ISA 265
Relevant audit matters
Including major control deficiencies
Auditor's report
ISA 700
Issues:
Unmodified
Unmodified opinion
Modified
Unmodified opinion
• Emphasis of matter
• Other matter
Modified opinion
Qualified 'except for'
Adverse
Disclaimer
Title
Addressee
Opinion
KAMs
Responsibilities
Signature/
Date/
Address

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you identify the attributes for effective communication to those with governance? (Topic 1)	
(2) Can you explain the required components of an unmodified auditor's report? (Topic 2)	
(3) Can you identify the auditor's responsibilities in relation to the directors' report and the strategic report? (Topic 3)	
(4) Can you explain the circumstances in which the auditor's opinion should be modified? (Topic 3)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q3	This is typical of what you will need to know on the material in this chapter.	
Q7	This substantial question is a thorough test and gives an insight into how this area could be examined.	
Q8	This substantial question is a thorough test and gives an insight into how this area could be examined.	

Once you have attempted these questions, you can continue your studies by moving onto the next chapter, Other assurance engagements.

Technical reference

1 Communication with those charged with governance

ISA 260 and 265

Relevant persons – ISA 260 Relevant matters – ISA 260 How? ISA 260

2 Unmodified auditor's reports

ISA 700

3 Modified auditor's reports

ISAs 570, 705, 706 and 720

4 Special considerations

ISA 800

ISA 805

Self-test questions

Answer the following questions.

1 A report to those charged with governance should be in writing.

A True

B False

2 Which of the following might be included in a report to those charged with governance?

A The audit approach

B Audit adjustments

C The audit opinion

D Material control deficiencies

3 What two opinions are stated in a unmodified auditor's report?

4 What three things does the scope paragraph include?

5 In what two situations should an audit opinion be modified?

6 **Jay plc (Jay), Finch plc (Finch), Sparrow Ltd (Sparrow)**

(You attempted some parts of this sample exam question in Chapter 7. Now try the rest of this question about the reporting implications.)

Described below are situations which have arisen in three audit clients of your firm. The year end in each case is 31 March 20X6.

Jay plc (Jay)

The directors have included the following note to the financial statements for the year ended 31 March 20X6:

> Although the company has incurred significant trading losses and cash outflows during the last two years, the directors believe that the effects of internal restructuring and corporate disposals undertaken will bring about improved results as indicated in the detailed profit and cash flow forecasts for the period to the end of March 20X7. These forecasts indicate that the company will be able to trade within its agreed working capital facility for at least the next 12 months from the date of this report. Considerable progress has been made on the financial restructuring of the company.
>
> On the basis of the above factors the directors consider it is appropriate that the financial statements are prepared on the going concern basis. Should the company fail to meet its forecasts, the going concern basis may prove to be inappropriate. In such circumstances adjustments are likely to have to be made to the net assets shown in these financial statements to reduce assets to their recoverable amounts, to reclassify non-current assets and payables due after more than one year to current assets and current liabilities and to provide for further liabilities that may arise.

Finch plc ('Finch')

Finch has included the results of Wren Ltd ('Wren'), a subsidiary, in the consolidated financial statements. Wren is audited by a different firm of auditors who have modified their opinion on Wren's financial statements for the year ended 31 March 20X6 because a fire at the company's premises destroyed the physical inventory count sheets which were the only record of the year-end inventory. Wren has included inventory at its estimated cost of CU500,000 in the financial statements for the year ended 31 March 20X6.

The consolidated pre-tax profit of Finch is CU33.4 million and the pre-tax profit of Wren is CU1.2 million for the year ended 31 March 20X6.

Sparrow Ltd ('Sparrow')

On 30 April 2006, the board of directors decided to undertake a restructuring programme which would commence in June 20X6. A provision of CU1.8 million in respect of the restructuring costs has been included in the financial statements for the year ended 31 March 20X6.

The pre-tax profit of Sparrow for the year ended 31 March 20X6 is CU7.2 million.

Requirements

6.1 Discuss what is meant by the concepts of materiality and a true and fair view.

(6 marks)

6.2 Explain why there can be difficulties for auditors regarding materiality and true and fair in relation to the three cases above: Jay, Finch and Sparrow, and state how you might modify your auditor's report in each case.

(14 marks)
Total: 20 marks

7 Ash Ltd, Oak Ltd, Elm Ltd

Described below are three situations which have arisen in three audits. The year end in each case is 31 March 20X8.

1) Ash Ltd uses leased motor vehicles which have been accounted for as rental expenses. However,you believe that these contracts are leases and should have been capitalised at CU51,000. The current treatment does not comply with accounting standards which require leases, where the lessee has control of the asset, to be included within non-current assets and capitalised. Profit for the year would then have been reduced by CU4,000.

The pre-tax profits of Ash Ltd for the year ended 31 March 20X8 were CU600,000, and total assets at 31 March 20X8 were CU5.4 million.

2) A fire in the warehouse of Oak Ltd in April 20X8 destroyed the inventory sheets, which were the only record of the company's inventories at the year end. The company has included an estimated inventory figure of CU780,000.

The pre-tax profits of Oak Ltd for the year ended 31 March 20X8 were CU1.1 million and total assets at 31 March 20X8 were CU6.5 million.

3) Elm Ltd has included a note in the financial statements explaining that 90% of its revenue is derived from a national retailer with whom it has a three-year renewable contract. This contract is due for renewal in September 20X8. However, the directors require the auditor's report on the financial statements to be signed on 31 May 20X8.

Requirements

7.1 Critically evaluate the use of standardised auditor's reports.

(5 marks)

7.2 Discuss briefly each of the situations outlined above, referring to materiality considerations. For each situation describe the effect on the auditor's report.

(10 marks)

Total: 15 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

(1) Deficiency	(2) Risks arising	(3) Action to mitigate
There has been a breakdown of controls over expenditure.	That IT expenditure is uncontrolled and investment is not always clearly for the benefit of the company.	Purchasing department to be warned that no IT expenditure should be incurred without authorisation; otherwise disciplinary action could result.
Excessive amounts are being spent on IT, adversely affecting profit.	IT expenditure is not planned properly, which means that investment may not be as beneficialas it should be.	IT expenditure must only be undertaken under the budget, unless authorised by two directors. Also, if additional investment is required the budget should be flexed.
Travelling expenses in some cases are excessive, with CU25,000 being spent in excess of set limits.	Loss of profits due to excessive expenditure.	Travelling expenses should not be reimbursed when limits are exceeded, unless the prior consent of two directors has been received. The executives involved need to be informed of the problem.
Work-in-progress is not always being billed on a timely basis. This is to the extent that CU56,000 has been held for more than six months.	Items involved are not being billed. This has an adverse effect on cash flow, and eventual recovery may be difficult.	Monthly billing meetings should be held at director level and within teams, where they should be told that any amounts more than two months' old must be billed.
The authorisation controls on overtime are not being exercised.This has resulted in the company paying CU180,000 of excess overtime. Some may be genuine, but controls will reduce this amount.	Excessive costs, adversely affecting profits.	Overtime over one hour per week should be authorised prior to the work being undertaken, and should then be authorised once the time sheet is submitted.
There is no control over non-chargeable time. This leads to a variable amount of non-chargeable time by executives. This varies from 5% to 34%.	With some staff, an excessive amount of the time that they are spending at work is not being charged to clients, thus having an adverse effect on revenue, and hence profits.	Individual staff to be set targets for non-chargeable time, depending on their other responsibilities. Adherence to their targets must be monitored.

Answer to Interactive question 2

2.1 The opinion will be qualified on the grounds of an inability to obtain sufficient appropriate audit evidence, because:

(1) Matter is material but not so pervasive.

(2) Scope of the audit has been limited.

Answer to Interactive question 3

Recommended opinion	Reasons
Unmodified opinion but modified auditor's report by an emphasis of matter paragraph regarding the legal case if considered significant	Significant uncertainty, properly disclosed, does not require a modification
Modified opinion – probably disclaimer	Loss of records results in limitation of scope 'Significant number' implies that auditors will probably be unable to form an opinion
Modified opinion – 'except for'	Audit partner disagrees with size of allowance necessary Problem limited to one area – unlikely to require adverse opinion

Answers to Self-test questions

1 Correct answer(s):

A True

2 Correct answer(s):

A The audit approach

B Audit adjustments

C Material control deficiencies

Although any expected modification to the audit opinion might be noted, the full audit opinion would not be given.

3 Two opinions:

- Give a true and fair view
- Have been properly prepared in accordance with IFRSs

4 The scope paragraph includes:

- A reference to appropriate accounting policies
- A reasonable assurance statement
- A summary of the nature of audit work

5 The auditor has been unable to obtain sufficient appropriate audit evidence.The financial statements are materially misstated.

6 Jay plc (Jay), Finch plc (Finch), Sparrow Ltd (Sparrow)

Part of this question only – the remainder of the answer was given in Chapter 7. Report modi**fications**

Jay

If the financial statements are prepared on the going concern basis of accounting, and the auditor agrees with this, then an unmodified audit opinion will be issued but the auditor would include a paragraph headed 'Material Uncertainty Related to Going Concern' to bring this fact to the attention of the members.

If the financial statements are prepared on the liquidation basis, and the auditor agrees with this, then an unmodified audit opinion will be issued but the auditor would include an emphasis of matter paragraph to draw the fact that the company is not a going concern to the attention of the shareholders.

If the auditor does not agree with the basis used to prepare the accounts, eg, going concern used when liquidation is required, then the audit opinion will be modified, normally due to a material misstatement.

Finch

If not material by nature, the auditor's report on the consolidated financial statements will be unmodified. If material by nature then the audit opinion will be modified (except for) on the grounds of limitation on scope. This would require modifications to the basis of opinion section and the opinion section of the auditor's report. It would also require the auditor to report by exception on accounting records and the availability of information.

Sparrow

As the disagreement over the accounting treatment has a material impact on the financial statements, the audit opinion will be an 'except for' modification.

7 Ash Ltd, Oak Ltd, Elm Ltd

7.1 Use of standardised auditor's reports Advantages

(1) The standard acts as a quality assurance mechanism, ie, all auditor's reports contain ths same level of information for the shareholders.

(2) It enhances clarity and understanding as it is produced on a consistent basis. Shareholders know what the various forms of the auditor's report indicate and particularly with modified audit opinions can identify the problems immediately.

(3) For the auditor it makes preparation easier. The auditor knows that they are satisfying their legal and professional responsibilities on the signing of this report.

Disadvantages

(1) There is a danger that readers and users of accounts become over-familiar with the reportand feel that as it is not tailored to their company it is not relevant to them.

(2) It could be seen as inflexible. There are certain situations where the auditor's report would provide a useful vehicle by which to pass on information to the shareholders but normally would not be used in this way, eg, problem of illegal loans to directors.

(3) It does include a certain amount of technical jargon but does not allow for the auditor to explain or expand on these terms if they feel it would be of benefit to the user. This could be particularly relevant when dealing with smaller organisations.

Conclusion

While there are arguments for and against the use of standard auditor's reports on balance the advantages would seem to have more weight than the disadvantages.

7.2 Three situations

Ash Ltd

The accounting treatment adopted by the company does not agree with the relevant accounting standard. This should be discussed with management who should be requested to comply with the accounting standard. If they refuse to do so this should be referred to in the report to management.

Materiality

The adjustment represents 0.67% of profit and 0.94% of total assets. Based on this information it does not appear to be material to the accounts in isolation. However, the impact on liabilities and net assets should also be considered.

Impact on auditor's report

As the adjustment is not material, even if the directors refuse to adopt accounting standard treatment the audit opinion would be unmodified, stating that the accounts give a true and fair view.

Oak Ltd

The issue here is one of a limitation of scope. Due to the loss of the physical inventory count records the auditor will not be able to perform normal audit procedures in this area.

The auditor will need to establish the basis for the estimated figure, eg, book inventory records to determine whether it will provide a reasonable assessment of the year-end balance.

Materiality

The inventory balance itself is clearly material to the accounts as it represents 70% of profit and 12% of total assets. However, in this instance the real issue is the extent to which the inventory balance quoted is incorrect. As the limitation in scope leads to uncertainty, it is not possible to quantify exactly the size of any adjustment. By its nature, however, inventory is a significant balance in the accounts and is therefore likely to be material.

Impact on auditor's report

Assuming that the limitation of scope is material but not so material or pervasive (as the problem is isolated to one balance in the accounts) the auditor's report would be affected as follows:

- It would refer to the fact that the audit work could not be performed fully in accordance with auditing standards.
- It would state that we planned our audit so as to obtain all information necessary but the reference to performance would be dropped.
- A description of the limitation would be given, ie, physical inventory records destroyed including an estimate of the effect.
- The opinion would be qualified using the 'except for... ' opinion.

Elm Ltd

There is a significant uncertainty at the year end in respect of whether or not the company is a going concern. This is dependent upon the renewal of a contract which is significant to the viability of the company. The auditor needs to establish the likelihood of renewal. If the company is not a going concern the accounts should be prepared on the liquidation basis.

Materiality

No information has been provided to quantify the adjustments necessary to prepare the accounts on the liquidation basis but these are likely to be material.

Impact on auditor's report

Assuming the accounts are prepared on a going concern basis:

- Provided that the auditor is satisfied that this treatment is appropriate and that disclosure of the situation is sufficient, an unmodified audit opinion will be issued. Reference to the significant uncertainty would be made by modifying the auditor's report using a section headed 'material uncertainty relating to going concern', together with a statement that the opinion itself is not modified.
- If the auditor disagrees with the treatment adopted (ie, if they feel that it is unlikely that the contract will be renewed) or the level of disclosure is inadequate, the opinion will be modified on the grounds of material misstatement.
- Normally the matter is of such significance that an adverse opinion is issued (ie, the accounts do not give a true and fair view).

If the accounts are prepared on a liquidation basis

Provided the auditor agrees with this treatment and that the basis of preparation is fully disclosed, an unmodified audit opinion will be issued. The liquidation basis of preparation may be referred to in an emphasis of matter paragraph.

Note: One other disadvantage which could have been mentioned in the other part of this question is that the technical distinction between different types of modifications may not be appreciated by users.

Chapter 14

Other assurance engagements

Introduction

Learning outcomes

Planning and performing engagements

Students will be able to plan and perform assurance engagements in accordance with the terms of the engagements and appropriate standards

- Determine an approach appropriate for an engagement for a specified organisation which addresses:
  - the assurance of entities' published sustainability and corporate responsibility report
  - the financial statement implications of climate change
  - probable extent of tests of controls and substantive procedures including analytical procedures and data analytics

Concluding and reporting on engagements

Students will be able to conclude and report on assurance engagements in accordance with the terms of the engagements and appropriate standards.

- Draw conclusions on the ability to report on an assurance engagement which are consistent with the results of the assurance work
- Draft suitable extracts for an assurance report (including any report to the management issued as part of the engagement) in relation to a specified organisation on the basis of given information, including in the extracts (where appropriate) statements of facts, their potential effects, and recommendations for action relevant to the needs and nature of the organisation being reported upon
- Advise on reports to be issued to those responsible for governance in accordance with standards, legislation, regulation and codes of corporate governance
- Judge when to refer reporting matters for specialist help

Syllabus links

Assurance reports were introduced in Assurance.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	This section covers assurance engagements that are not concerned with historical financial information. These engagements can therefore deal with a wide variety of possible subject areas, far beyond accounting and finance.	Read through the section carefully.	This area is most likely to be examined as a short-form question.	1
2	Review engagements are not as common as the statutory audit, but can arise in many different contexts. If you are involved in one then you need to know how they overlap with the audit, and how they differ from it.	Read the section carefully and attempt the activity.	This area is most likely to be examined as a short-form question.	

Topic	Practical significance	Study approach	Exam approach	Self-test questions
3	The report is the last aspect of the assurance process. It is the purpose of the assurance process – it communicates the assurance provider's conclusion on the subject matter to the users. It is therefore of critical practical significance. **Stop and think** How should assurance providers ensure that their reports are not misunderstood?	Read the section carefully, including the worked example, and attempt the activity.	This is the most examinable part of this chapter, and could crop up in either part of the examination.	2, 3, 4

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1 Other assurance engagements

Section overview

- Assurance services improve the quality of decision making for users of information.
- Assurance engagements are classified in terms of their basic type, and the level of assurance provided.
- Assurance engagements may give reasonable assurance or limited assurance.

1.1 ISAE 3000, *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*

ISAE 3000, *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* provides guidance on other assurance engagements. As the title of the ISAE indicates, we are **not** discussing assurance engagements on 'historical financial information', such as reviews of financial statements. Examples of engagements that may fall within the scope of ISAE 3000 are:

- environmental, social and sustainability reports
- information systems, internal control, and corporate governance processes
- compliance with grant conditions, contracts and regulations

ISAE 3000 defines an assurance engagement as follows.

Definition

Assurance engagement: An engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the subject matter information (that is, the outcome of the measurement or evaluation of an underlying subject matter against criteria) (ISAE 3000: para. 12).

1.2 Assurance provided

The level of assurance may be **reasonable** or **limited**. These levels of assurance were discussed in your earlier studies. Remember that absolute assurance can **never** be given on an assurance engagement due to the **inherent limitations** of such engagements.

For revision, the ISAE 3000 definitions are as follows.

Definition

Reasonable assurance engagement: An assurance engagement in which the practitioner reduces engagement risk to an acceptably low level in the circumstances of the engagement as the basis forthe practitioner's conclusion. The practitioner's conclusion is expressed in a form that conveys the practitioner's opinion on the outcome of the measurement or evaluation of the underlying subject matter against criteria.

(ISAE 3000: para. 12)

Definition

Limited assurance engagement: An assurance engagement in which the practitioner reduces engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement as the basis for expressing a conclusion in a form that conveys whether, based on the procedures performed and evidence obtained, a matter(s) has come to the practitioner's attention to cause the practitioner to believe the subject matter information is materially misstated (ISAE 3000: para. 12).

2 Terms of other assurance engagements

Section overview

- It is important to agree terms in the context of a statutory audit.
- Think how much more important this is if a firm is appointed to carry out some other type of assignment.
- Where there is no detailed regulatory framework there will be a much greater risk of misunderstanding, so the negotiation and formal documentation of terms becomes much more important.

2.1 Engagement letter for review of financial statements

The objective of a review of financial statements is, according to ISRE 2400 (Revised), *Engagements to Review Historical Financial Statements*: para. 14, to "(a) obtain limited assurance, primarily by performing inquiry and analytical procedures, about whether the financial statements as a whole are free from material misstatement, thereby enabling the practitioner to express a conclusion on whether anything has come to the practitioner's attention that causes the practitioner to believe the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework; and (b) report on the financial statements as a whole and communicate, as required by this ISRE".

In other words a review of financial statements results in a limited/moderate level of assurance which is expressed negatively.

The terms of engagement are agreed between the client and the practitioner, unlike an audit engagement where these are determined by law and professional standards.

Professional skills focus: Applying judgement

The engagement letter may appear to be a trivial detail, but it is absolutely essential to the engagement. It would be impossible for an assurance engagement to begin without it having been signed.

Interactive question 1: Engagement letter for review of financial statements

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

You have requested that we review the general purpose financial statements of ABC Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this review engagement by means of this letter.

We will perform the following services:

(1) We will review the statement of financial position of ABC Company as of December 31 20X1, and the related statements of income and cash flows for the year then ended, in accordance with the International Standards in Review Engagements (ISRE) 2400 (or refer to relevant national standards or practices applicable to reviews). We will not perform an audit of such financial statements and, accordingly, we will not express an audit opinion on them. Accordingly, we expect to report on the financial statements as follows:

(2) Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view (or are not presented fairly, in all material respects) in accordance with International Financial Reporting Standards.

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

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

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

XYZ LLP

Acknowledged on behalf of ABC Company by (Signed)

(Name and Title) (Date)

Requirement

Explain the purpose of each of the numbered paragraphs.

See Answer at the end of this chapter.

2.2 Agreement of terms on engagements to examine prospective financial information

Guidance here is provided by ISRE 3400, *The Examination of Prospective Financial Information*.

If a firm is appointed, for example, to review a cash flow forecast that a client has prepared to support an attempt to raise finance from a bank, there are further issues to consider and to include in the engagement letter:

- the intended use of the information
- whether the information will be for general or limited distribution
- the nature of the assumptions, that is whether they are best-estimate or hypothetical assumptions
- the elements to be included in the information
- the period covered by the information
- a caveat warning that there could be differences between the forecast and actual performance due to unforeseen circumstances

3 Assurance reports

Section overview

- There is less formal requirement in relation to assurance reports generally than there is for auditor's reports.
- Proformas for review reports and other assurance reports are given in international standards.

As we saw in Chapter 13, Auditor's reports are prescribed by International Standards on Auditing.

There is less formality surrounding more general assurance reports and these reports will often take the most appropriate form.

3.1 Reviews

International Standard on Review Engagements ISRE 2400 (Revised), *Engagements to Review Historical Financial Statements* gives guidance about review reports. Limited assurance is given on review assignments. The ISRE defines limited assurance as "the level of assurance obtained where engagement risk is reduced to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for expressing a conclusion".

The practitioner's conclusion "states that nothing has come to the practitioner's attention that causes the practitioner to believe that the financial statements do not present fairly, in all material respects (or do not give a true and fair view) in accordance with the applicable fair presentation framework".

The requirements of ISRE 2400 are expressed under the following headings:

- Conduct of a review engagement
- Ethical requirements
- Professional scepticism and professional judgement
- Engagement level quality control
- Acceptance and continuance of client relationships and review engagements
- Communication with management and those charged with governance
- Performing the engagement
- Subsequent events
- Written representations
- Evaluating evidence obtained from the procedures performed
- Forming the practitioner's conclusion on the financial statements
- The practitioner's report
- Documentation

Note: The term 'quality management' had not been adopted when ISRE 2400 was issued, so in the context of this standard, you can use assume that 'quality control' and 'quality management' mean the same thing.

An example of a review report with unmodified conclusions is given in the appendix to the ISRE, and it is reproduced here.

Context example: Form of Review Report with Unmodified Conclusions

[Appropriate Addressee]

Report on the financial statements

We have reviewed the accompanying financial statements of ABC Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Practitioner's responsibility

Our responsibility is to express a conclusion on the accompanying financial statements. We conducted our review in accordance with International Standard on Review Engagements (ISRE) 2400 (Revised), *Engagements to Review Historical Financial Statements*. ISRE 2400 (Revised) requiresus to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with ISRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with International Standards on Auditing. Accordingly, we do not expressan audit opinion on these financial statements.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that these financial statements do not present fairly, in all material respects (or *do not give a true and fair view of*) the financial position of ABC Company as at December 31, 20X1, and (*of*) its financial performance and cash flows for the year then ended, in accordance with the International Financial Reporting Standards .

Report on other legal and regulatory requirements

[Form and content of this section of the practitioner's report will vary depending on the nature of the practitioner's other reporting responsibilities.]

[Practitioner's signature]

[Date of the practitioner's report][Practitioner's address]

Notice the main components of the report:

(a) Addressee(s)

This will depend on the specific terms of the assignment. It may be addressed to the directors, or to aspecified third-party user such as a bank.

(b) Scope and responsibilities

The scope of the work is defined and the respective responsibilities of management and the practitioner are clarified.

(c) Nature of work and level of assurance

A description of a review and its limitations, and how it differs from an audit.

(d) Conclusion

As was explained in Chapter 1, the conclusion is expressed in terms of limited assurance.

If the practitioner determines that the financial statements are materially misstated, the **reasons should be stated** and the conclusion modified depending on the impact of the misstatement.

Impact	Effect on report
Material	Express a qualified conclusion on the limited assurance provided
Pervasive	Give an adverse conclusion that the financial statements do not give a true and fair view

The practitioner may feel there has been a limitation in the scope of the work they intended to carry out for the review. If so, they should **describe the limitation.** The limitation may have the following effects.

Impact	Effect on report
Material to one area	Express a qualified conclusion on the limited assurance provided
Pervasive	Disclaim a conclusion

3.2 Reviews of interim financial information

ISRE 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity* applies the basic principles of conducting reviews and preparing review reports as set out in ISRE 2400 to one specific type of review.

3.3 Reports following examination of prospective information

Chapter 1 explained that the nature of prospective information, such as forecasts and projections, affects the level of assurance that can be given. Reports on these assignments may well contain additional 'warnings' for readers.

ISAE 3400, *The Examination of Prospective Financial Information* gives the following list of components for this type of report:

a) Title

b) Addressee

c) Identification of the prospective financial information

d) A reference to the ISAE or relevant national standards

e) A statement that management is responsible for the prospective financial information including the assumptions on which it is based

f) When applicable, a reference to the purpose and/or restricted distribution of the prospective financial information

g) A statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information

h) An opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework

i) Appropriate caveats concerning the achievability of the results indicated by the prospective financial information

j) Date of the report which should be the date procedures have been completed

k) Reporting accountant's address

l) Signature

The standard also gives an extract from a report on a review of prospective financial information:

We have examined the forecast in accordance with the International Standard on Assurance Engagements applicable to the examination of prospective financial information. Management is responsible for the forecast including the assumptions set out in Note X on which it is based.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions and is presented in accordance with…

Actual results are likely to be different from the forecast since anticipated events frequently do not occur as expected and the variation may be material.

Notice the extra final paragraph drawing attention to the nature of prospective financial information, illustrating the type of 'caveat' referred to in (i) above.

Professional skills focus: Applying judgement

Assurance engagements for prospective financial information are different in nature from reviews of historical financial information; with historical information, there is a choice between limited and reasonable assurance, but with prospective information it is not possible to give a reasonable level of assurance.

Interactive question 2: Herbalink Ltd

Herbalink Ltd (Herbalink) is a client of your firm that operates a chain of shops in Cardiff selling ethically produced herbal cosmetics and toiletries. Since opening its first store five years ago, the company has expanded and now has 10 outlets in the south Wales area. The directors wish to continue the company's expansion by opening additional stores in major UK cities and by introducing a mail order service.

In order to finance these expansion plans the directors of Herbalink have been discussing an increase in their borrowing with the company's bank. In support of the funding request the directors have prepared profit and cash flow forecasts for the three years ending 31 December 2016, based on assumptions they have made about the future success of the business. Herbalink's bankers require this information to be examined and reported on by independent accountants, and the directors have asked your firm to undertake this assignment.

Two potential properties have been found for the new outlets, both of which are leasehold premises that will require considerable refurbishment to bring them up to the standard of existing stores.

The mail order service, for which postage will be charged, will be run from the main Cardiff branch which incorporates the central delivery warehouse of the company. The packaging for delivered items will be specially designed to protect the products in transit and to reflect the company's logo and ethical trading credentials.

The ingredients for preparing the herbal products are purchased centrally on credit terms. All ingredients are sourced from UK producers and all packaging is made from recycled materials. Employees at Herbalink are paid at rates above the industry average and are also paid bonuses linked to profits made by the company as a whole.

Requirements

2.1 From the information provided above, identify the key **receipts** and **payments** that you would expect to be included in the cash flow forecasts prepared by the directors of Herbalink. For each receipt and payment, identify the specific matters you would consider when reviewing the reasonableness of the assumptions in forecasting that receipt or payment.

2.2 Explain the role of written representations in the examination of and reporting on forecast information.

2.3 Describe the differences between the **conclusion** expressed in an assurance report on forecast information and the **opinion** expressed in an auditor's report on financial statements. Give reasons for these differences.

See **Answer** at the end of this chapter.

Companies may draw up prospective financial information in a format that suits their own management requirements. Since this is internal information it does not have to be presented in accordance with external financial reporting standards. The following proforma examples show a typical layout for a simple profit forecast and for a cash flow forecast. You may come across more complex examples but the principles remain the same.

XYZ Ltd

Profit forecast for the six months to 30 June 20X3

	January	February	March	April	May	June
	CU	CU	CU	CU	CU	CU
Revenue	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX
Cost of sales	(X,XXX)	(X,XXX)	(X,XXX)	(X,XXX)	(X,XXX)	(X,XXX)
Gross profit	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX
Expenses/overheads						
Rent and rates	XXX	XXX	XXX	XXX	XXX	XXX
Gas and electricity	XXX	XXX	XXX	XXX	XXX	XXX
Telephone	XXX	XXX	XXX	XXX	XXX	XXX
Insurance	XXX	XXX	XXX	XXX	XXX	XXX
Postage and carriage	XXX	XXX	XXX	XXX	XXX	XXX
Advertising	XXX	XXX	XXX	XXX	XXX	XXX
Bank charges	XXX	XXX	XXX	XXX	XXX	XXX
Stationery	XXX	XXX	XXX	XXX	XXX	XXX
	January	February	March	April	May	June
	CU	CU	CU	CU	CU	CU
Wages and salaries	XXX	XXX	XXX	XXX	XXX	XXX
Motor expenses	XXX	XXX	XXX	XXX	XXX	XXX
Professional fees	XXX	XXX	XXX	XXX	XXX	XXX
Depreciation	XXX	XXX	XXX	XXX	XXX	XXX
Other expenses	XXX	XXX	XXX	XXX	XXX	XXX
Total expenses	(X,XXX)	(X,XXX)	(X,XXX)	(X,XXX)	(X,XXX)	(X,XXX)
Net profit/(loss)	XXX	XXX	XXX	XXX	XXX	XXX

CHAPTER 14

XYZ Ltd

Cash flow forecast for the six months to 30 June 20X3

	January	February	March	April	May	June
	CU	CU	CU	CU	CU	CU
Cash balance at start of month	X,XXX	X,XXX	(X,XXX)	(X,XXX)	X,XXX	X,XXX
Cash in						
Cash sales	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX
Share capital investment	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX
Bank loan	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX
Other external finance	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX
Other cash inflows	XXX	XXX	XXX	XXX	XXX	XXX
Total cash receipts	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX
Cash paid out						
Rent and rates	XXX	XXX	XXX	XXX	XXX	XXX
Gas and electricity	XXX	XXX	XXX	XXX	XXX	XXX
Telephone	XXX	XXX	XXX	XXX	XXX	XXX
Insurance	XXX	XXX	XXX	XXX	XXX	XXX
Postage and carriage	XXX	XXX	XXX	XXX	XXX	XXX
Advertising	XXX	XXX	XXX	XXX	XXX	XXX
Bank charges	XXX	XXX	XXX	XXX	XXX	XXX
Stationery	XXX	XXX	XXX	XXX	XXX	XXX
Wages and salaries	XXX	XXX	XXX	XXX	XXX	XXX
Motor expenses	XXX	XXX	XXX	XXX	XXX	XXX
Professional fees	XXX	XXX	XXX	XXX	XXX	XXX
Other operating expenses	XXX	XXX	XXX	XXX	XXX	XXX
Capital expenditure	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX	XXX
Loan repayments	XXX	XXX	XXX	XXX	XXX	XXX
VAT payment to HMRC	XXX	XXX	XXX	XXX	XXX	XXX

	January	February	March	April	May	June
	CU	CU	CU	CU	CU	CU
Bank interest paid	XXX	XXX	XXX	XXX	XXX	XXX
Other financing payments	XXX	XXX	XXX	XXX	XXX	XXX
Total cash paid out	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX	X,XXX
Net cash flow for the month	X,XXX	(X,XXX)	(X,XXX)	X,XXX	X,XXX	X,XXX
Cash balance at end of month	X,XXX	(X,XXX)	(X,XXX)	X,XXX	X,XXX	X,XXX

3.4 ISAE 3402, *Assurance Reports on Controls at a Service Organisation*

Entities that use service organisations may require assurance on the internal controls in operation at the service organisation. ISAE 3402 is designed to complement ISA 402, *Audit Considerations Relating to an Entity Using a Service Organisation*. It applies only when the service organisation is itself responsible for the design and implementation of internal controls.

3.5 ISAE 3410, *Assurance Engagements on Greenhouse Gas Statements*

Entities may prepare greenhouse gas statements (GHG) for a variety of reasons; the statement may be a requirement of a disclosure regime or an emissions trading scheme, or the entity may make voluntary emissions disclosures. From April 2013 all entities listed on the main market of the London Stock Exchange have been required to make mandatory disclosure of greenhouse gas emissions.

ISAE 3410 adopts a risk-based approach to undertaking assurance engagements on greenhouse gas statements, and states that the engagement must also comply with the requirements of ISAE 3000, (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*.

The practitioner's report can provide one of two levels of assurance:

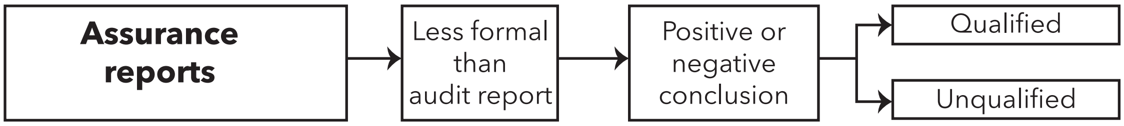
(a) Reasonable assurance – an opinion on whether the greenhouse gas statement has been prepared, in all material respects, in accordance with the applicable criteria.

(b) Limited assurance – a conclusion on whether anything has come to the practitioner's attention to make the practitioner believe that the greenhouse gas statements has not been prepared, in all material respects, in accordance with the applicable criteria.

Some of the specific characteristics of a GHG assurance engagement include the following:

- Multi-disciplinary teams, including assurance skills and GHG competencies relating to laws, regulation, quantification and reporting. More complex engagements may also require information systems expertise and scientific and engineering expertise.
- Inventory uncertainty relating to incomplete scientific knowledge and the difficulty of estimation and measurement.
- Site visits may be required in order to understand the entity and to perform procedures.

Summary


Assurance reports
Less formal than audit report
Positive or negative conclusion
Qualified
Unqualified

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(1) Can you define limited assurance and reasonable assurance engagements? (Topic 1)	
(2) Can you explain the purpose of agreeing terms for an assurance engagement? (Topic 2)	
(3) Can you explain the main contents of an ISRE 2400 report? (Topic 3)	

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question	Yes/No
Q1	This is a fundamental area that you need to know about.	
Q3	This question gives a good test of this area.	
Q4	This substantial question is a thorough test and gives an insight into how this area could be examined.	

.

Technical reference

1 Assurance reports

ISRE 2400

ISRE 2410, ISAE 3000, ISAE 3400, ISAE 3402, ISAE 3410

2 Other assurance engagements

ISAE 3000

3 Terms of other assurance engagements

ISRE 2400

ISRE 340

Self-test questions

Answer the following questions.

1 Limited assurance

What is limited assurance?

2 When would a practitioner not give any assurance in a review engagement?

3 Delta Ltd's sales invoices are produced by its computer system using the relevant price held as standing data on the sales master file. Selling prices are updated by the sales ledger clerk on the verbal authority of the sales director.

Requirement

Draft extracts, suitable for inclusion in the auditor's management letter, which set out the possible consequences, and the recommendations that you would make, in respect of the matters outlined above.

Total: 4 marks

4 Mota Ltd

You are the auditor of Mota Ltd, a distributor of automotive components, and have been provided with the following description of the sales order processing system.

Order entry

Sales orders are taken over the telephone and entered into the computer by a sales order clerk, via a terminal in the sales office, while the customer is on the line. On entry, the order details are read back to the customer for confirmation. The computer checks that there are sufficient inventories to meet the order and that the customer's credit limit is not exceeded.

If the goods are unavailable, the customer is asked if they want the order to be recorded as a 'backorder' which will be fulfilled when there is sufficient inventory. Once accepted, the order is automatically given an order number which is relayed to the customer.

Orders which take a customer over their credit limit are referred to the credit controller who decides, in consultation with the chief accountant, whether or not the customer should be allowed to exceed the credit limit or have the credit limit raised. Any adjustments in respect of overrides of, or increases in, credit limits are input, via a terminal in the accounts department, by the credit controller. Printouts of these amendments are not generated and no other review of credit limits is undertaken.

New customers are referred to the credit controller who obtains credit ratings and references and, on the oral authority of the chief accountant, enters the customer account details onto the sales ledger master file via a terminal in the accounts department.

Despatch of goods

Sequentially numbered packing notes in respect of accepted orders are printed out in the warehouse, and the goods are selected, packed and checked by warehouse staff. Confirmations of packing and any notifications of shortfalls are entered into the computer, via a terminal in the warehouse, by the warehouse supervisor. Two copies of the sequentially numbered delivery advice are printed in the warehouse and sent with the goods to the customer who is required to sign a copy which is returned by the driver to the accounts department. All despatches are checked at the gatehouse to ensure that they are accompanied by the appropriate documentation. The packing notes are filed in numerical order in the warehouse and the sequence is checked for completeness, on a daily basis, by the warehouse supervisor.

The system does not automatically generate purchase orders with manufacturers when a customer's order cannot be fulfilled.

Computer system

All users of the system are required to log on using identification codes and individual passwords which control their level of access to the system. All passwords are changed every 90 days and when employees leave. Systems support is provided by a supplier where the service agreement provides for availability of a back-up system within 72 hours of a systems failure.

Requirements

4.1 Identify the objectives of exercising internal controls over sales order processing. For each objective discuss the extent to which the procedures exercised by Mota Ltd achieve the objective.

Note: You are **not** required to consider sales invoicing or ledger processing.

(8 marks)

4.2 Set out, in a manner suitable for inclusion in a report to management, any deficiencies in the system described above. For each deficiency you should include the possible consequence of the deficiency and a recommendation to remedy the deficiency.

Note: You are **not** required to write a covering letter.

(10 marks)

Total: 18 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

The purpose of each numbered paragraph:

(1) Establishes the purpose of the letter.

(2) Describes the nature of the services to be performed and professional standards that will be followed. The paragraph also emphasises that this is not an audit assignment, and that the nature of the opinion will differ from an audit opinion. This is included to minimise the risk of misunderstandings.

(3) A review gives limited assurance and the opinion will be expressed using a negative form of words. It is important that the directors understand this before the assignment starts, again to eliminate misunderstandings regarding the level of assurance that will be provided.

(4) This paragraph sets out the responsibilities of management in respect of the subject matter of the review.

(5) One of the roles of the engagement letter is to limit the liability being taken on by the practitioner. Here the practitioner is trying to protect himself from being held liable if fraud and errors exist.

(6) It is important that the terms are formally agreed by the two parties so the practitioner requires signed confirmation from the directors that they are in agreement.

Answer to Interactive question 2

2.1 Specific matters to consider:

Receipts

Sales receipts: these should include sales from the new outlets and mail order service, which should be staged to reflect the timing of the opening of the new shops and the commencement of the mail order service. In other respects the inflow should reflect the pattern of prior years. Consideration should be given as to whether amounts are prudent given prevailing economic conditions and whether the introduction of the mail order service has an impact on shop takings.

Bank loan: the amount should correspond to what was agreed with the bank, as evidenced by correspondence, and should be sufficient to cover the expansion costs. The timing of the inflow should precede the start of new business activities.

Payments

Refurbishment costs: these should be based on suppliers' quotations and the outflow should precede the start of new business.

Payments for ingredients and packaging: these should reflect the level of forecast revenue and payments should reflect the suppliers' terms of trading.

Mail order operational costs: these should be based on staffing and packaging based on forecast revenue.

Premises costs: to include extra costs, eg, rent and utility costs relating to the new outlets. The rent should reflect the terms of the lease agreements such as up-front costs, rental periods and rent reviews.

Wages and salaries: these should include the costs of additional staff at the new outlets as wellas the mail order operation. Rates of pay can be compared with the industry average and bonuses should reflect profits.

Sundry payments: to include advertising, training and recruitment costs relating to the new business. Outflows should precede the commencement of new business. Professional fees will include payments to legal advisors and the reporting accountant.

Loan repayments and finance costs: loan instalments should reflect the repayment terms negotiated with the bank and finance costs should reflect market rates and the level of borrowings. All outflows should be recorded on the anticipated due dates.

Tax payments: TAX, VAT and corporation tax should be consistent with the relevant figures inthe profit forecast and should be paid on the due dates.

Dividend payments: these should be in line with prior years' policies or take into account any anticipated changes in policy which should be confirmed by the directors.

General

Sensitivity analysis should be undertaken on key variables, eg, customer receipts, finance costs and raw ingredients.

2.2 Role of written representations:

When conducting an engagement to examine forecast information, written representations are obtained from management regarding:

- the intended use of the forecast information
- the completeness of significant management assumptions
- management's responsibility for the forecast information

The representations provide evidence that management accepts its responsibilities regarding the assumptions and will reduce the risk of any misunderstandings regarding respective responsibilities (ie, narrow the expectations gap). The representation regarding the intended use of the forecasts may protect the reporting accountant from claims for damages from unforeseen third parties.

2.3 Differences between assurance and auditor's reports:

Assurance report

The conclusion of the assurance report on the forecast information will include a statement of negative assurance (ie, limited or moderate assurance) in the form of 'nothing has come to our attention which causes us to believe that the assumptions do not provide a reasonable basis for the forecast'. It will also include an opinion on whether the forecast information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework.

Auditor's report

The opinion in the auditor's report on financial statements will provide reasonable assurance that the financial statements:

- give a true and fair view
- have been properly prepared in accordance with IFRSs

Reasons

Financial statements are mainly based on historical information whereas forecast information is based on assumptions about future events. The historical information can be verified to a greater degree than forecasts, which will always be subject to uncertainty.

Answers to Self-test questions

1 Limited assurance

Assurance of a matter in the absence of any evidence to the contrary.

2 When there was a pervasive limitation in the scope of the review or where the practitioner is of the opinion that the report being reviewed is incorrect.

3 Consequences

Incorrect prices resulting in undercharging of customers and loss to company or overcharging of customers and loss of customer goodwill.

Recommendations

- All price changes to be recorded on standard documentation which should be signed as authorised by sales director
- Printout of amendments obtained and checked to document authorising amendment
- Printout signed as evidence of checking
- Periodic printout of all selling prices checked on one for one basis to authorised price list held by sales director
- Standing data protected by high level password not known to sales ledger clerk
- Spot checks on invoices prior to despatch

4 Mota Ltd

4.1 Internal controls over sales order processing

Objectives	Extent to which achieved by Mota Ltd's procedures
To ensure that goods are available for all orders accepted.	The availability of inventories is checked on the computer system while the customer is on the line. This will be effective only where the system is continuously updated for new orders and deliveries of inventories.
To ensure that existing customers are within their credit limits (including the current order being taken).	The computer system automatically checks that the customer is within their current credit limit. Adjustments to credit limits are carried out by the credit controller but no review of any amendments is carried out.
To ensure that new customers are creditworthy before orders are despatched.	The credit controller carries out credit checks but details are amended on the terminal in the accounts department only after oral authority from the chief accountant, and no subsequent review of new customers is performed.
To ensure that changes to credit limits are valid.	As above.

CHAPTER 14

Objectives	Extent to which achieved by Mota Ltd's procedures
To ensure that the correct goods are despatched to each customer.	Order details are read back to the customer to confirm their accuracy. Packing notes are produced in the warehouse giving the details of the order. However, there is no responsibility assigned in respect of dealing with shortfalls of inventories and ensuring that the customer ultimately receives all of the goods ordered.
To ensure that goods are despatched for all orders accepted.	Packing notes are sequentially numbered and a completeness check is carried out on a daily basis.
To ensure that all goods leaving the premises are in respect of valid orders.	All goods leaving the warehouse are checked at the gatehouse to ensure that they are accompanied by a valid delivery advice.
To ensure that back orders are fulfilled when inventories become available.	There are no procedures in place to ensure that, once goods are received by Mota Ltd, back orders are fulfilled.

4.2 Points for inclusion in a report to management

Deficiency	Consequence	Recommendation
There is no review of amendments to credit limits once these have been processed on the system.	Invalid amendments could be made, leading to supply of goods to non-creditworthy customers.	An exception report should be produced on a weekly basis detailing all changes made to credit limits. This should be reviewed by the chief accountant, and evidenced by their signature, to ensure that all amendments are for valid business reasons.
Authority to enter new customers onto the system is only given orally with no review of the credit ratings and references obtained.	Invalid entries of new customers could be made without detection until non-payment of invoices arises.	The chief accountant should review the credit ratings and references obtained before giving authority to accept the new customer.
There is no responsibility assigned for dealing with shortfalls in orders when they are being selected in the warehouse.	Delivery of part-complete orders and non-delivery of parts of orders will lead to loss of customer goodwill and subsequent loss of revenue.	A daily printout of unprocessed orders should be produced and followed up by the warehouse supervisor.

Deficiency	Consequence	Recommendation
There are no procedures to ensure that back orders are fulfilled when the goods become available.	Delay in fulfilling customer orders will again lead to loss of customer goodwill.	The system should produce a daily list of items that have come into inventory for which there are current back orders. The sales ledger clerk should contact the customer to ensure that the goods are still required and then process the order in the normal manner.
When back orders are accepted the goods which are unavailable are not immediately reordered.	There may be significant delays in fulfilling these orders.	The computer should automatically generate purchase requisitions on a daily basis for items which have been requested but are unavailable. A supervisor should review these purchase requisitions and raise a purchase order where the goods have not already been ordered.

Note: In 4.2 marks were also awarded for identification of the following:

- Credit control procedures do not take the age of the debt into consideration; this could result in goods being despatched to slow payers.
- In respect of the failure to review credit limits on a regular basis, limits may be unrealistically low for customers with a good payment history, resulting in loss of business.
- Response time in respect of systems support is too slow; this could result in delayed and lost orders.

Glossary of terms

Accounting estimate: Is a monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty.

Assurance engagement: An engagement in which a practitioner aims to obtain sufficient appropriateaudit evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the subject matter information (that is, the outcome of the measurement or evaluation of an underlying subject matter against criteria).

Assurance engagement: An engagement in which a practitioner aims to obtain sufficient appropriateevidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the subject matter information (that is, the outcome of the measurement or evaluation of an underlying subject matter against criteria) (ISAE 3000: para. 12).

Audit of financial statements: According to ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* the overall objectives of the auditor in conducting an **audit of financial statements** are as follows:

- To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- To report on the financial statements and communicate as required by the ISA® Standards , in accordance with the auditor's findings.

Auditor's expert: Is an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert (ISA 620).

Auditor's point estimate: Or auditor's range is the amount, or range of amounts respectively, developed by the auditor in evaluating management's point estimate.

Business risk: Is the risk inherent to the company in its operations. It includes risks at all levels of the business. ISA 315 defines business risk as a "risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies". There are three general categories of business risk:

- Financial risks are the risks arising from the financial activities or financial consequences of an operation, for example, cash flow issues or overtrading.
- Operational risks are the risks arising with regard to operations; for example, the risk that a major supplier will be lost and the company will be unable to operate.
- Compliance risk is the risk that arises from non-compliance with laws and regulations that surround the business, for example a restaurant failing to comply with food hygiene regulations might face fines, enforced closure, legal action from customers and so on.

NGO: An institution which:

- is established for charitable purposes only; and
- any organisation registered by the bureau to conduct voluntary activities inside Bangladesh, and any organisation or NGO registered under any prevalent law of any foreign country and also registered under this act shall be included.

Cloud computing: A model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (eg, networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction.

(US Department of Commerce, National Institute of Standards and Technology)

Component: Is an entity whose financial information is included in the group financial statements.

Component auditors: Are auditors who perform work on financial information related to a component of the group audit. A component auditor may also be a Key Audit Partner.

Contingent fees: Fees where the amount of the fee is dependent on some event taking place or some other condition being met. An example might be that the audit fee would be increased if the client's bankers agree to extend available borrowing facilities.

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

Cyber security: The protection of systems, networks and data in cyberspace.

This definition can be extended to include the protection of data from unauthorised modification, disclosure or destruction, and the protection of the information system from the degradation or non-availability of services – in other words, system failure.

Data analytics: "… when used to obtain audit evidence in a financial statement audit, is the science and art of discovering and analysing patterns, deviations and inconsistencies, and extracting other useful information in the data underlying or related to the subject matter of an audit through analysis,modelling and visualisation for the purposes of planning and performing the audit" (FRC (UK), Thematic Review, January 2017).

Detection risk: The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements (ISA 200: para. 13e).

Error: An unintentional misstatement in financial statements, including the omission of an amount or a disclosure.

Estimation uncertainty: Is susceptibility to an inherent lack of precision in measurement (ISA 540: para. 12).

Expert: Is a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.

Greenwashing: A PR tactic used to make a company or product appear environmentally friendly, without meaningfully reducing its environmental impact

Group engagement team: Are the auditors with responsibility for performing work on the consolidation process, communicating with component auditors and reporting on the group financial statements.

Independence: "Freedom from conditions and relationships which, in the context of an *engagement*, would compromise the integrity or objectivity of the *firm* or *covered persons.*"

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

Inherent risk factors: Characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance or disclosure, before consideration of controls. Such factors may be qualitative or quantitative, and include **complexity, subjectivity, change, uncertainty** or susceptibility to misstatement due to **management bias** or other **fraud** risk factors insofar as they affect inherent risk (ISA 315: para. 12f).

ISA 315 gives the following examples of the inherent risk factors.

Inherent risk factor	Examples
Complexity	Regulatory: Operations that are subject to a high degree of complex regulation Business model: The existence of complex alliances and joint ventures Applicable financial reporting framework: Accounting measurements that involve complex processes
Subjectivity	Applicable financial reporting framework: A wide range of possible measurement criteria of an accounting estimate, eg, depreciation Management's selection of a valuation technique or model for a non-current asset, such as investment properties
Change	Economic conditions: Operations in regions that are economically unstable Markets: Operations exposed to volatile markets, eg, futures trading Customer loss: Going concern and liquidity issues including loss of significant customers Industry model: Changes in the industry in which the entity operates Business model: Changes in the supply chain Developing or offering new products or services, or moving into new lines of business Geography: Expanding into new locations
Uncertainty	Reporting: Estimates involving significant estimation uncertainty
Susceptibility to misstatement due to management bias or other fraud risk factors as far as they affect inherent risk	Reporting: Opportunities for management and employees to engage in fraudulent financial reporting Transactions: Significant transactions with related parties Significant amount of non-routine or non-systematic transactions including inter company transactions and large revenue transactions at period end Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities

Integrity: "Being trustworthy, straightforward, honest, fair and candid; complying with the spirit as well as the letter of applicable ethical principles, laws and regulations; behaving so as to maintain the public's trust in the auditing profession; and respecting confidentiality except where disclosure is in the public interest or is required to adhere to legal and professional responsibilities."

Limited assurance engagement: An assurance engagement in which the practitioner reduces engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement as the basis for expressing a conclusion in a form that conveys whether, based on the procedures performed and evidence obtained, a matter(s) has come to the practitioner's attention to cause the practitioner to believe the subject matter information is materially misstated (ISAE 3000: para. 12).

Management bias: Is a lack of neutrality by management in the preparation of information.

Management's expert: Is an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements (ISA 500).

Management's point estimate: Is the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate (ISA 540: para. 12).

Material: Information is **material** if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Non-compliance: Acts of omission or commission intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individuals working for or under the direction of the entity, which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity.

Objectivity: "Acting and making decisions and judgments impartially, fairly and on merit (having regard to all considerations relevant to the task in hand but no other), without discrimination, bias, or compromise because of commercial or personal self-interest, conflicts of interest or the undue influence of others, and having given due consideration to the best available evidence."

Performance materiality: An amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole or, if applicable, for a particular class of transaction, account balance or disclosure.

Professional scepticism: An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence"

Reasonable assurance engagement: An assurance engagement in which the practitioner reduces engagement risk to an acceptably low level in the circumstances of the engagement as the basis for the practitioner's conclusion. The practitioner's conclusion is expressed in a form that conveys the practitioner's opinion on the outcome of the measurement or evaluation of the underlying subject matter against criteria.

Significant risk: An identified risk of material misstatement: (i) For which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood of a misstatement occurring and the magnitude of the potential misstatement should that misstatement occur; or (ii) That is to be treated as a significant risk in accordance with the requirements of other ISAs (ISA 315: para. 12l).

Sustainability: Meeting the needs of the present without compromising the ability of future generations to meet their own needs.

System of internal control: The system designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. For the purposes of the ISAs, the system of internal control consists of five inter-related components: (i) Control environment; (ii) The entity's risk assessment process; (iii) The entity's process to monitor the system of internal control; (iv) The information system and communication; and (v) Control activities. (ISA 315: para. 12m)

System of quality management: A system designed, implemented and operated by a firm to providethe firm with reasonable assurance that:

(a) The firm and its personnel fulfil their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements.

(b) Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.

(c) **Those charged with governance:** Is the term used to describe the role of persons entrusted with the supervision, control and direction of the entity. Those charged with governance ordinarily are accountable for ensuring that the entity achieves its objectives, financial reporting and reporting to interested parties. Those charged with governance include management only when it performs such functions.

Those charged with governance include the directors (executive and non-executive) of a company and the members of an audit committee where one exists. For other types of entity, those charged with governance usually include equivalent persons such as the partners, proprietors, committee of management or trustees.

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