ACCA

Audit and Assurance
(F8)

Revision Notes

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4. Evidence is persuasive not conclusive – the opinion is based on audit evidence gathered; however, while this evidence can indicate possible issues affecting the audit opinion, evidence involves estimates and judgments and hence does not give a definite conclusion.
5. Even if everything reported on was examined and found to be satisfactory, there may be other items which should have been included– the completeness problem.
6. Auditors plan their work to detect material errors and frauds only – so small frauds (or large frauds split into many small amounts) may go unnoticed.

An external audit has a number of other issues which reduce its usefulness

1. Audit report format – the format of the opinion is determined by International Standards on Auditing. However, the terminology used is not usually understood by non-accountants. This means that users may not actually understand the audit opinion given.
2. Historic information – the audit report is often issued some time after the year end, and so the financial information can be quite different to the current position. In the current marketplace where companies' financial positions can change quite quickly, the audit opinion may no longer be relevant as it is out of date.
3. Auditors need to understand their clients in great depth if they are to understand how fraud could be carried out and hidden. However, auditors cannot become too close to their clients or their independence will be called into question.
4. Where auditors spot error or fraud, their primary legal responsibility is to report this to management. Any external reporting is hampered by rules on confidentiality.

Duties of the auditors

Fundamental duties are to:

- Form an opinion on whether the financial statements give a true and fair view and are prepared in accordance with applicable reporting framework
- Issue an audit report.

Duty to check and ensure: Adequate accounting records, Compliance with legislation, Truth and fairness, Adequacy of financial statements disclosures

Rights of the auditors

1. Right of access at all times to the company's books, accounts and vouchers.
2. Right to require from an officer of the company such information or explanations as they think necessary for the performance of their duties as auditors.
3. Right to receive all communications relating to written resolutions.

Audit planning

Importance of audit planning

1. It helps the auditor to devote appropriate attention to important areas of the audit.
2. It helps the auditor to identify and resolve potential problems on a timely basis.
3. It helps the auditor to properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
4. It assists in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks and the proper assignment of work to them.
5. It facilitates the direction and supervision of engagement team members and the review of their work.
6. It assists, where applicable, in the coordination of work done by experts

Audit Strategy: An audit strategy sets the scope, timing and direction of the audit and guides the development of the more detailed audit plan.

Audit plan: Once the overall strategy has been planned, detailed consideration can be given to each individual audit objective and how it can be best met.

Audit risk

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

Audit risk is a function of two main components being the risks of material misstatement and detection risk. Risk of material misstatement is made up of two components, inherent risk and control risk.

The formula for the audit risk is

Audit Risk = Risk of material misstatement in the financial statements x Detection Risk

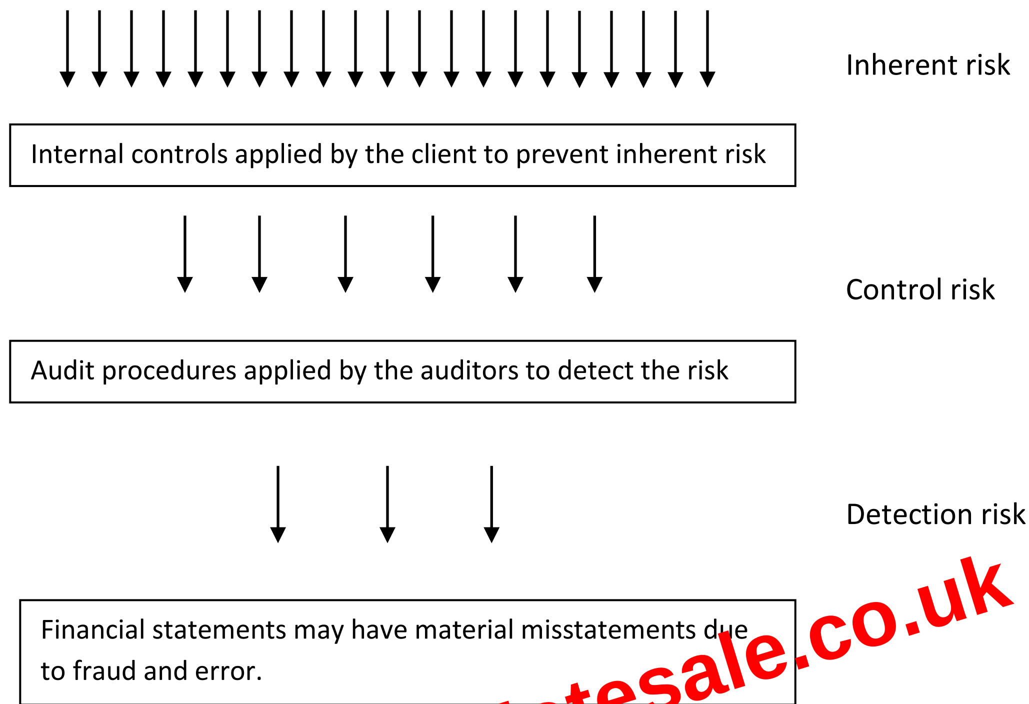
Or

Audit risk = Inherent risk x Control risk x Detection risk

Importance of risk assessment

1. Assessing engagement risks at the planning stage, this will ensure that attention is focused early on the area's most likely to cause material misstatements.
2. It will help the auditor to fully understand the entity, which is vital for an effective audit.
3. Any unusual transactions or balances would also be identified early, so that these could be addressed in a timely manner.
4. Assessing risks early should also result in an efficient audit. The team will only focus their time and effort on key areas as opposed to balances or transactions that might be immaterial or unlikely to contain errors.
5. In addition assessing risk early should ensure that the most appropriate team is selected with more experienced staff allocated to higher risk audits and high risk balances.
6. A thorough risk analysis should ultimately reduce the risk of an inappropriate audit opinion being given.
7. It should enable the auditor to have a good understanding of the risks of fraud, money laundering, etc.
8. Assessing risk should enable the auditor to assess whether the client is a going concern.

Risk management



Inherent risk

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

Inherent risk describes something about the nature of a business or its transactions that make it particularly susceptible to material misstatements.

Inherent risk is affected by the nature of an entity and factors like:

- Changes in the industry it operates in.
- Operations that are subject to a high degree of regulation.
- Going concern and liquidity issues including loss of significant customers.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Application of new accounting standards.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant accounting estimates.
- Pending litigation and contingent liabilities.

Control risk

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

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

The following factors can result in an increase in control risk:

- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key management.
- Deficiencies in internal control, especially those not addressed by management.
- Changes in the information technology (IT) environment.
- Installation of significant new IT systems related to financial reporting

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

Detection risk is all down to the auditors and is the risk that the auditor's procedures fail to detect a material misstatement.

Detection risk is affected by sampling and non-sampling risk and factors like:

- Inadequate planning.
- Inappropriate assignment of personnel to the engagement team.
- Failing to apply professional scepticism.
- Inadequate supervision and review of the audit work performed.
- Incorrect sampling techniques performed.
- Incorrect sample sizes

Detection risk includes sampling risk and non-sampling risk.

Sampling risk= sample is not representative of the population.
Non sampling risk = auditor's procedures or the conclusion reached are incorrect.

		Examples of control activities are: **Segregation of duties** Assignment of roles/responsibilities to different people, thereby reducing the risk of fraud and error occurring. The concept is that no individual person should be responsible for more than one of the following duties: 1. the authorization of a transaction 2. the recording of the transaction in the accounting records 3. the custody of the asset relating to the transaction **Information processing** Computer controls including general IT controls, which cover a range of applications and support the overall IT environment and application controls which operate on a cycle/business process level (details given separately). **Authorization** Approval of transactions by a suitably responsible official to ensure transactions are genuine **Physical controls** Restricting access to physical assets such as cash, inventory and plant and equipment, thereby reducing the risk of theft. **Performance reviews** Comparison or review of the performance of the business by looking at areas such as budget v actual results. **Arithmetical controls** Controls which check the arithmetical accuracy of accounting records. **Account reconciliations** Comparison of an account balance with another source; often this source is from a third party, such as the bank, with differences being investigated.
5	Monitoring of controls	It is the process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes the monitoring of controls through ongoing activities, separate evaluations, or a combination of the two.

	Advantages Questionnaires are quick to prepare, which means they are a cost effective method for recording the system. They ensure that all controls present within the system are considered and recorded; hence missing controls or deficiencies are clearly highlighted. Questionnaires are simple to complete and therefore any members of the team can complete them and they are easy to use and understand. **Disadvantages** It can be easy for the company to overstate the level of the controls present as they are asked a series of questions relating to potential controls. Without careful tailoring of the questionnaire to make it company specific, there is a risk that controls may be misunderstood and unusual controls missed.
Test	Test of controls are performed to obtain audit evidence about 2 things: 1. Whether the ICS is **designed** suitably (to prevent, detect or correct material misstatements 2. Whether the ICS are **operating** properly (test of controls) **Test of controls- examples** – inspection of documents (e.g. authorizations) – enquiries about internal controls which leave no audit trail (e.g. is the person who is SUPPOSED to perform the function actually performing it or is someone else is doing so) – Re-performance of control procedures (e.g. reconciliations) – examination of evidence of management views(e.g. minutes of meetings) – Observation of controls – Using TEST DATA (CAATs) If controls appear strong, they are tested to ensure they operated as described throughout the year. If the results show they operated effectively, substantive testing may be reduced.
Report control weaknesses to management	A letter on internal control (also referred to as a management letter or letter of weakness) is a letter usually forwarded by an auditor to the senior management of a company. The letter should normally be forwarded immediately following the completion of the tests of control and before the commencement of substantive procedures. The letter contains weaknesses identified in the entity's system of internal control as identified by the auditor when performing tests of control and the purpose of the letter is to bring these weaknesses to the attention of management. The weaknesses identified in the main body of the letter should be those which could lead to fraud or material error in or omission from the company's financial

	statements, and will be classified as those relating to: - The design of the systems of accounting and internal control. - The operation of the systems of accounting and internal control. For both categories the implications of the weaknesses should be identified, however minor control issues which the auditor would wish to bring to the attention of the company's senior management should be included in an appendix to the letter of weakness or in a supplementary report. Examples of matters the external auditor should consider in determining whether a deficiency in internal controls is significant include: - The likelihood of the deficiencies leading to material misstatements in the financial statements in the future. - The susceptibility to loss or fraud of the related asset or liability, the subjectivity and complexity of determining estimated amounts. - The financial statement amounts exposed to the deficiencies. - The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies. - The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.

Deciding the extent of substantive testing

Internal controls over financial reporting are strong ► reduce substantive testing

Internal controls over financial reporting are weak ► increase substantive testing

Management assertions, audit procedures and audit evidence

Management is responsible for the preparation of financial statements that give a true and fair view, but what does this really mean?

For each item in the financial statements, management is making assertions.

The auditors need evidence that these financial statements are valid!

'In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement and presentation of classes of transactions and events, account balances and disclosures'.

Consequently auditors use these assertions when considering the potential types of misstatements that may occur and when designing and performing appropriate audit procedures.

Transactions include sales, purchases, and wages paid during the accounting period.

Account balances include all the asset, liabilities and equity interests included in the statement of financial position at the period end.

ISA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment identifies the following assertions:

1. Assertions about classes of transactions and events and related disclosures for the period under audit
2. Assertions about account balances and related disclosures at the period end

Note of caution:

ISA 315 has been recently revised. The solutions of the past exams may not reflect these revisions at the moment. Students are requested to be careful when practicing past exams.

Assertions related to class of transactions and events and related disclosures for the period under audit are

- Occurrence
- Completeness
- Accuracy
- Cut-off
- Classification
- Presentation

- The auditor should identify any disputed amounts, and identify whether these relate to timing differences or whether there are possible errors in the records of the client.
- Any differences due to timing, such as cash in transit, should be matched with cash received after the year end.
- The receivables ledger should be reviewed to identify any possible misposting as this could be a reason for a response with a difference
- If any balances have been flagged as disputed by the receivable, then these should be discussed with management to identify whether a write down is necessary

Substantive testing- Sales Revenue

1. Arithmetical accuracy of invoices checked
2. Recalculate discounts to ensure accuracy
3. Compare the overall level of revenue against prior years and budget and investigate any significant fluctuations.
4. For a sample of invoices match rates to standard price list to confirm accuracy
5. Select a sample of credit notes raised, trace through to the original invoice and ensure invoice correctly removed from sales.
6. Completeness as above: Select a sample of trade customer orders placed and agree these to the dispatch notes and sales invoices through to inclusion in the sales ledger to ensure completeness of revenue.
7. **Cut-off:** Note down the **last GDN** for the year. Take a sample of GDNs immediately before **AND** after the year end and ensure they are recorded in the correct accounting period

Management representations

Written representations/Management representation letter

Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

The auditor needs to obtain written representations from management and, where appropriate, those charged with governance that they believe they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor.

Written representations are needed to support other audit evidence relevant to the financial statements or specific assertions in the financial statements, if determined necessary by the auditor or required by other International Standards on Auditing.

This may be necessary for judgmental areas where the auditor has to rely on management explanations.

Written representations can be used to confirm that management has communicated to the auditor all deficiencies in internal controls of which management are aware.

Written representations are normally in the form of a letter, written by the company's management and addressed to the auditor. The letter is usually requested from management but can also be requested from the chief operating officer or chief financial officer.

Throughout the fieldwork, the audit team will note any areas where representations may be required

During the final review stage, the auditors will produce a draft representation letter. The directors will review this and then produce it on their letterhead.

It will be signed by the directors and dated as at the date the audit report is signed, but not after.

The ISAs require auditors to obtain written representations from management on matters material to the Financial Statements where other sufficient, appropriate, audit evidence cannot reasonably be expected to exist.

SPECIFIC MATTERS

Included here is anything else that the auditor would like a representation on for example:

- That a certain debt is recoverable
- All bank accounts have been disclosed
- Any plans to reorganize the business or discontinue product lines have already been disclosed.

Refusal to Provide Requested Written Representations

If management refuses to provide a written representation, then the auditor should again review the possibility of obtaining sufficient audit evidence from alternative sources in connection with the matter or issue under review.

If the directors refuse to sign the representation letter, then the auditor has a number of options available to him:

- The auditor could discuss the matter with the directors and try to resolve their problems with the letter.
- The auditor could write a representation letter for the directors, then send this to the directors and ask them to sign it.
- If the auditor considers that he has not received all the information and explanations required for his audit, then the auditor's report should be qualified.
- Before taking these actions, the auditor should explain to the directors the consequences of not signing the representation letter, to try to avoid a confrontation.
- An auditor should reconsider the reliability of other representations.

If the representation is **not consistent** with other audit evidence, the auditor should perform audit procedures to attempt to resolve the matter**.** For this, the auditor should reassess the appropriateness of the risk of material misstatement on account of this inconsistency. If required, the auditor should revise the nature, timing and extent of further audit procedures.

Modified opinion

a) Qualified 'except for'
b) Adverse opinion
c) Disclaimer of opinion

Qualified opinion: Except for
Nature of matter: Material

Reason: Material misstatement or inability to obtain appropriate and sufficient evidence (regarding an accounting policy, transaction, balance or disclosure etc).

Wording:
In our opinion, except for the effects of the matter described in the Basis of Qualified Opinion paragraph the financial statements present fairly, In all material respects, (or give a true and fair view of) the financial position of ABC Company as at December 31, 20X1 and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Adverse opinion
Nature of matter: Material and pervasive

Reason: Misstatements in financial statements
Wording:
In our opinion, because of the significance of the matter discussed in the Basis of Adverse Opinion paragraph, the consolidated financial statements do not present fairly (or do not give a nature and fair view of) the financial position of ABC Company and its subsidiaries as at December 31, 20X1 and (of) their financial performance and their cash flows for the year then ended in accordance with International Financial Reporting Standards.

Disclaimer of opinion
Nature of matter: Material and pervasive

Reason: Inability to obtain sufficient and appropriate evidence
Wording
Because of the significance, of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Limitations of Internal audit

- Independence issues as employees so may be concerned about job security
- If it is not reporting to the AC, management can influence them (they will be checking the work of the people they are reporting to).

Outsourcing Internal Audit

Advantages

- Greater expertise, specialist skills and access to better audit technology without extra cost available
- The risk of staff turnover is passed on to the firm
- Lesser cost of training staff and retaining permanent staff
- May be more independent
- Lesser management time consumed in administering the department
- IA will be immediately available (also good for short term)
- The contract can be set for an appropriate time scale
- Flexibility in terms of that the staff can be called in according to workload

Disadvantages

- May not be independent if the same firm is offering external audit and internal audit
- May be more expensive
- The firm will not have in depth knowledge of the company
- Lesser control by the management over the standard of service
- May have confidentiality issues
- If the company has an existing IA department which is to be made redundant, they may face opposition from the other staff