Internal controls, risk assessment, management and monitoring

The firm should establish systems and controls to effectively manage the risk that the firm is exposed to in terms of money laundering activities. This could include:

- Client screening procedures to minimize the risk of taking on a new client with a high risk money laundering activities
- Systems and controls to ensure that training is taken/attended and understood by the employees
- Systems that allow periodic testing that the firms' policies and procedures comply with legislative and regulatory requirements.

Change in Audit Firm:

This includes the factors due to which audit client consider changing the Audit Firm

1. **Audit Fee**

The audit fee can be a very sensitive issue.

- Perceived to be too high-If directors of a company believe that audit is a necessary evil, they will seek to obtain it for as little money as they can.
- Perceived not to be value for money.It is possible that a company could be paying their audit firm a fee that they consider reasonable for an audit, but they just believe that another firm could give them a better audit for a similar fee.
- Not competitive
- Interest in whether price is negotiable Instead of every intention of keeping the present auditor, putting the audit out to tender would give him more insight 'into how competitive his audit fee is.
    - ➢ He might receive a competitive tender which offers him far more than he receives from his current auditor and he changes his auditor.
    - ➢ It could also mean that, when forced to justify his position, the current auditor reassesses his service and comes up with a far more competitive deal is possible that a company could be paying their audit firm a fee that they consider reasonable for an audit, but they just believe that another, firm could give them a better audit for a similar fee.

Loans, guarantees and overdue fees	The auditor will have fear of not getting paid so will keep the client happy to ensure payment	**Rule:** No loans or guarantees allowed to or from client that is not a bank or Similar institution. Significant overdue fees are deemed a loan, hence not allowed
Contingent fees		Consider the following factors when accepting a contingent fee for a non assurance work from an assurance client: • The range of possible fee outcomes the degree of variability in the fee • The basis on which the fee is to be determined • Whether the transaction is to be reviewed by an independent third party • The effect of the transaction on the assurance engagement In other circumstances it may be appropriate to accept a contingent fee for non-assurance work if suitable **safeguards** are in place. Examples include: • Making disclosures to the audit committee about the fees • Reviewing or determination of the fee by an unrelated third party • Quality control policies and procedures

<table>
<tr><td colspan="3">Dependence on client
The auditor will have a fear of losing a lot of income therefore will appease the client
Possible safeguards include:
• Reducing the dependency on the client;
• External quality control reviews; or
• Consulting a third party, such as a professional regulatory body or a professional accountant, on key audit judgments.
For audit-clients that are public interest entities, the Code states that where total fees from the client represent more than 15% of the firm's total fees for two consecutive years, the firm shall:
• Disclose this to those charged with governance.
• Arrange for a review to be conducted, either by an external professional accountant or by a regulatory body. This review can be either before the audit opinion on the second year's financial statements is issued (a 'pre-issuance review'), or after it is issued (a 'post Issuance review').
If total fees significantly exceed 15%, then a post-issuance review may not be sufficient, and a pre-issuance review will be required.
If fees continue to exceed 15% each year the disclosure to and discussion with those charged with governance shall occur and a pre-issuance or a post issuance review must be carried out each year, depending on the extent of the threat.</td></tr>
<tr><td>Temporary Staff assignments Staff may be loaned to an audit client, but only for a short period of time. Staff must not assume management responsibilities.</td><td>The audit client must be responsible for directing and supervising the activities of the loaned staff.</td><td>• Conducting an additional review of the work performed by the loaned staff
• Not giving the loaned staff audit responsibility for any function or activity on the audit, that they performed during the temporary staff assignment; or
• Not including the loaned staff in the audit team.</td></tr>
<tr><td>Receipt/Payment of referral fees</td><td>Creates self interest threat to objectivity and professional competency and due care</td><td>Evaluated the significance of threat and apply safeguards when necessary, like:</td></tr>
</table>

	the accounting treatment, and the consequences of the tax advice would be material, then the service should not be provided. • Assistance in the resolution of tax disputes may be provided in some cases. However if the firm is acting as an advocate of the client and the effect of the matter is material to the financial statements to be audited the firm is not permitted to act. Also to be taken into consideration is whether the firm itself provided the service which is the subject of the dispute as this will increase the threat if it is appropriate to provide the service the safeguards include using professionals who are not members of the audit team to perform the service, and obtaining advice on the service from an external tax professional.

Familiarity threat: Occurs when, because of a close relationship, members become too sympathetic to the interests of others.
Familiarity threat arises in conjunction with a **self-interest threat** for example family and personal relationship, employment with a client and recent service with a client.
Possible **safeguards** include:

- Rotating the senior personnel off the audit team
- Having a professional accountant who was not a member of the audit team review the work of the senior personnel Regular independent Internal or external quality reviews of the engagement.

The rules for public interest entities are stricter. If an individual is a key audit partner for seven years, they must be rotated off the audit for two years.
The Code does allow some flexibility here. If key partner continuity is particularly beneficial to audit quality, and there is some unforeseen circumstance (such as the intended engagement partner becoming seriously ill), then the key audit partner can remain on the audit for an additional year, making eight years in total.
If a client that was not a public interest entity becomes one, then the seven year limit still applies. However if the individual has served the audit client as a key audit partner for six or more years when the client becomes a public interest entity, the partner may continue to serve in that capacity for a maximum of two additional years before rotating off the engagement.
Finally, if the firm has only a few people capable of being a key audit partner for a public

Points of ethics considerations

- On acceptance of a new client.
- At the planning stage of any audit.
- At the completion stage of any audit.
- Whenever additional, non audit services are provided to an audit client.
- If any event, or change in circumstances occurs this may mean that the firm's independence may be threatened.

Professional Liability

The auditor's liability

Liability may be:

- Criminal:
- accepts appointment without being qualified to act;
- involved in fraud;
- guilty of "insider dealing"; or
- other offences
- Civil
- Contract or
- Tort of negligence

Negligence

Is a common law concept, It seeks to provide compensation to a person who has suffered loss due to another person's wrongful neglect.

To succeed in an action for negligence, an injured party must prove three things:

- A duty of care which is enforceable at law existed.
- This duty of care was breached.
- The breach caused the injured party loss. In the case of negligence in relation to financial advisers/auditors, this loss must be pecuniary (i.e. financial) loss.

The client

The company has a contract with the audit firm.

Duty of care exists?	Automatic
Breached?	Must be proved
Loss arising?	Must be proved

Liability limitation agreement:

Is a contractual limitation of the auditor's liability to a company? There are several possible implications for the profession which are discussed below

1) Audit quality

Audit quality could suffer as a result. The argument is that auditors could become less concerned with the quality of their work, in the knowledge that if there was a claim against them, the financial consequences are limited.

2) Value of the audit opinion

As a consequence of the point above, many argue that users of the financial statements will place less reliance on the audit opinion, resulting in less credible financial statements.

3) Pressure on audit fees

It is considered that firms may be under pressure from clients to reduce their audit fees. This is a response to the fact that if the audit firm has reduced its risk exposure, then the fee for providing the audit service should be reduced.

4) Competition in the audit market

The ability to set a cap on auditor's liability could distort the audit market. Bigger audit firms may have the ability to set a high cap, which creates a disadvantage to smaller audit firms. However, it can be argued that the ability to set a cap actually helps the audit market, by protecting firms and making collapse less likely, and can promote competition between the larger firms.

How to restrict the liability

1) Professional Indemnity Insurance

Professional indemnity insurance is insurance against civil claims made by clients and third parties arising from work undertaken by the firm.

Fidelity guarantee insurance is insurance against liability arising through any acts of fraud or dishonesty by any partner, director or employee in respect of money or goods "held in trust by the firm.

ACCA requires that firms holding practicing certificates and auditing certificates have professional indemnity insurance with a reputable insurance company.

If the firm has employees, it must also have fidelity guarantee insurance. The insurance must cover 'all civil liability incurred in connection with the conduct of the firm's business by the partners, directors or employees.

The cover must continue to exist for six years after a member ceases to engage in public practice.

- A consideration of any allegations of fraud that have come to the auditors' attention
- A consideration of the risk of management override of controls

Enquiries from management regarding;

- Management assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments;
- Management's process for identifying and responding to the risks of fraud in the entity; including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;
- Management s communication, if any, to those charged with governance regarding its processes for identifying arid responding to the risks of fraud in the entity; and
- Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

For those entities that have an internal audit function, the auditor shall- make inquiries of internal audit to determine whether it has knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.

Unless all of those charged with governance are involved in managing the Entity:

- The auditor shall obtain an understanding of how those charged with governance exercise oversight of management's/processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks
- The auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.
- Any unusual relationship during analytical procedures
- Evaluating whether any fraud risk factors are present

Expectation Gap

This term is used to describe the difference between the expectations of those who rely upon audit reports concerning audit work performed and actual work performed. The expectation gap arises due to a general misunderstanding of the respective responsibilities of management and the auditor and a misunderstanding of the scope of an audit.

Specific issues may include:

- Perception that it is the auditor's duty to prevent and detect fraud
- Perception that the auditor is liable for any errors in the financial statements.
- High profile have brought up the question of whether auditors should actually be responsible for the evaluation of whether a company is a going concern, and how this differs from the way that the responsibilities of the auditor are perceived.

Narrowing the Expectation Gap

The expectation gap could, theoretically, be narrowed in two ways:

1. Educating users- the auditor's report as outlined in ISA 700 includes an explanation of the auditor's responsibilities. It is not clear that any further information would help, and it might even have the effect of bringing the value of the audit into question. One suggestion is that auditors could highlight circumstanced where they have had to rely on directors' representations. Additionally, the audit firm will reiterate the respective responsibilities of management and the auditor, and the nature, scope and purpose of an audit, in the engagement letter.
2. Extending the auditor's responsibilities.
   Suggestions for expanding the auditor's role have included:

- Requiring auditors to report to boards and audit committees on the adequacy of controls to prevent and detect fraud
- Encouraging the use of targeted forensic fraud reviews
- Increasing the requirement to report suspected frauds

Audit Engagement

The client request for a tender or audit proposal

The client asked for nomination in the AGM

Certain factors are considered before submission of audit proposal

Procedures before accepting nomination

Obtain the following information (through 'meeting or otherwise).

- What the client requires from the audit firm, (for example audit, number of visits, tax work)
- What the future plans of the entity are, for example:
  - Is it planning to float its shares on an exchange in the near future?
  - Is growth or diversification anticipated?
- Whether the entity is seeking to change its auditors
- Whether the entity is seeking its first auditors and needs an explanation of audit
- If the entity is changing its auditors, the reason behind this
- Get information to make assessment of how long the work will take and what level of expertise is needed in each area.

Ensure professionally qualified to act:
Consider whether disqualified on legal or ethical grounds
Ensure Existing resources adequate:

- Consider available time, staff and technical expertise
- Does the proposed timetable for the work fit with the current work plan?
- Does the firm have suitable personnel available?
- Where will the work be performed and is it accessible/cost-effective?
- Are (non accounting) specialist skills necessary?
- Will staff need further training to do the work?
- If so, what is the cost of that further training?

Loan stock

There is a risk of inadequate disclosure regarding the loan in the notes to the financial statements, IFRS 7 Financial Instruments: Disclosures requires narrative and numerical disclosures relating to financial instruments that give rise to risk exposure. Given the materiality of the loan, it is likely that disclosure would be required.

New IT system

A new system relevant to financial reporting was introduced. ISA 315 indicates that the installation of significant new IT systems related to financial reporting is an event that may indicate a risk of material misstatement. Errors may have occurred in transferring data from the old to the new system, and the controls over the new system may not be operating effectively.

Audit Risk

Risk that auditors may give an inappropriate opinion

These are of two types:

1. FSs Risk or Entity Risk
2. Detection Risk

1. FSs Risk or Entity Risk:

The Risk of material misstatements in FSs

These are further categorized in two types:

Inherent Risk:	Control risk
The Risk of errors or misstatements due to the nature of its transactions OR The risk that items will be misstated due to characteristics of those items	The risk of errors or misstatements because the company's internal controls are not strong enough to prevent, detect and correct them

INHERENT RISK-Client as a whole	
Integrity and attitude to risk of directors and management	Domination by a single individual can cause problems
Management experience and knowledge	Changes in management and quality of financial management
Unusual pressures on management	Tight reporting deadlines, or market or financing expectations
Nature of business	Technological obsolescence or over- dependence on single product
Industry factors	Competitive conditions, regulatory requirements, technology developments, changes in customer demand
Information technology	Lack of supporting documentation concentration of expertise in a few people, potential for unauthorized access

Fashion items

Wide geographical spread of business operations

This type of business model could be hard to control, increasing the likelihood of inefficiencies, systems deficiencies, and theft of inventories or cash.

E-commerce- volume of sales

One of the tasks associated with the on-line sales is the scale of the increase in the volume of transactions. There is a risk that the system will be unable to cope with the volume of transactions, leading possibly to unfilled orders and dissatisfied customers. This would harm the reputation of the company and Brand.

E-commerce - security of systems

It is crucial that the on-line sales system is secure as customers are providing their credit card details to the site. Any breach of security could result in credit card details being stolen, and the Co may be liable for losses suffered by customers if their credit card details were used fraudulently.

There would clearly be severe reputational issues in this case. Additionally, the system must be secure from virus infiltration, which could cause system failure, interrupted sales and loss of customer goodwill.

E-commerce - tax and regulatory issues

There are several compliance risks, which arise due to on-line sales. Overseas sales expose Co to potential sales tax complications such as extra tax to be paid on the export of goods to abroad, and additional documentation on overseas sales that may be needed to comply with regulations. Another important regulatory issue is that of data protection. The Co. faces the risk of non-compliance with any data protection regulation relevant to customers providing personal details to the on-line sales system.

Internal systems and controls

The company has a weak control environment and poor systems. Frauds are more likely to occur in the absence of controls and the quality of financial information used by the directors for planning and reviewing business performance could be inadequate

Tax investigations

Recent tax investigations could indicate that the company is not complying with relevant tax regulations, which in turn leads to the risk of fines and -penalties, which could be severe if this is a recurring breach of regulations which has not been resolved.

Outsourcing

Staff may fail to provide a quality service to the Co's customers, leading to loss of customer goodwill.

REPRESENTATIONS:

A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial merits, the assertions therein, or supporting books and records.

Management from whom written representations are requested:

Auditor shall request written representation from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.
ISA 580 requires the auditor to determine appropriate individuals from whom to seek written representation. In most cases this is likely to be management, as they would be expected to have sufficient knowledge of the way in which the entities financial statements have been prepared. However the ISA goes on to point out that in circumstances w*here* others are responsible for the financial statements e.g. those charged with governance then they should be requested to provide the representation,
The ISA emphasizes the need for management to make informed representation. In some cases the auditor request that management confirms that it has made appropriate enquiries to enable it to do so.

ONCE REPRESENTATION RECEIVED THE PROCEDURES ARE:

On Receipt of a written representation the auditors will need to ensure that there is no other evidence that rave discovered during the course of their audit which conflicts with it. They will then have to review presentations made and decide, given the results of the audit testing and their assessment of risk, where they are able to rely on them to give an unqualified opinion on the accounts.

- Seek corroborative audit evidence from sources inside or outside the entity.
- Evaluate whether the representation made by management appears reasonable and are consistent with other audit evidence obtained, including other representations.
- Consider whether the individuals making the representations can be expected to be well informed lie particular matters.

Chapter 6

Reporting

What's in this chapter?

1) **Unmodified opinion**
2) **Contents of Audit Report**
3) **Reasons for recent changes to report**
4) **Change of order**
5) **Modified Report and Opinion**

5. Emphasis of matter / other matter

Sometimes the auditor is happy that the Financial Statements are true and fair, and that all evidence has been received. However, there remains something that the auditor wishes to (or is forced by law to) draw to the attention of those reading the Financial Statements:

- There is a very important Disclosure Note which the shareholders must ensure they have read (typically involving going concern threats). In this case, an Emphasis of Matter paragraph is required in the audit report, directly under the Opinion section.
- There is a mistake/inconsistency in the unaudited documents attached to the Financial Statements ("Other Information"), and this mistake / inconsistency conflicts with the correct information in the FS. In this case, the required paragraph is called an "Other Matter", but also appears under the Opinion section.