ACCA Paper 2.6

Audit and Internal Review (International)

POCKET NOTES

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Preface

These new Pocket Notes contain everything you need to know for the exam, presented in a unique visual way that makes revision easy and effective.

Written by experienced lecturers and authors, these Pocket Notes break down content into manageable chunks to maximise your concentration.

A GUIDE TO THE EXAM

IN THIS CHAPTER

- THE EXAM
- THE KEYS TO SUCCESS IN PAPER 2.6

THE EXAM

Section A (60%)

3 compulsory scenario-based questions, normally 20 marks each. These are based on the key areas of the syllabus:

- professional ethics
- risk assessment and the response to assessed risks
- internal audit
- internal controls
- substantive audit evidence

Section B (40%)

Choice of 2 from 3 questions, worth 20 marks each. These may come from any part of the syllabus.

Aim of the paper

To develop knowledge and understanding of the audit process and its application in the context of the external regulatory framework and for business control and development.

THE KEYS TO SUCCESS IN PAPER 2.6

1 Answer the question

Read the question extremely carefully, paying attention to the verbs telling you what to do, and to the mark allocation. You must make (at least) one point in your answer for every mark available.

Example

Explain why London is the greatest capital city in the world.

(5 marks)

Skeleton answer

(i) Interesting historical sights
(ii) Easy to travel around
(iii) People are friendly
(iv) Prices are reasonable
(v) Good choice of restaurants and bars

The point is that, because this question offers 5 marks, you must write (at least) 5 short paragraphs in your answer, each containing a separate point. Don't write one long paragraph. Make it clear to the marker that you have thought of 5 separate points, by presenting each one in a separate paragraph. If you can't think of enough points, keep thinking! Always present at least as many points as there are marks available, even if you don't think some of them are very good.

EXAM FOCUS

Sometimes the question will state specifically how many points you should make but, if not, you should produce as many points in your answer as there are marks available. For example, if a question is for 6 marks and you can only think of 3 good points:

- just give the 3 points and you'll score 3 out of 6
- give the 3 good points plus 3 not very good points and you'll score $3 + (3 \times ½) = 4½$ out of 6

2 Don't overrun your time allocation

You must be absolutely strict with yourself with your time allocation for each question. 180 minutes for 100 marks means 1.8 minutes per mark. You must not spend more than 36 minutes on a 20 mark question, simply because it is much easier to pick up the first 10 marks available on a question than the remaining 10 marks. In the exam room, write down the times for each 36 minutes during the exam, and force yourself to finish your attempt at each question within the time available. Such discipline may not be fun, but it is the approach that will earn you most marks in the exam.

EXAM FOCUS

Answer five questions as instructed. For example:

- answer 3 questions very well but run out of time

  3×16 marks = 48 marks FAIL

- answer 5 questions, 3 moderately and 2 poorly

  $(3 \times 12) + (2 \times 8) = 52$ marks PASS

3 Think before you start writing

Spend a moment deciding what to bring in to your answer:

- specific auditing standards?
- specific accounting standards?
- ethical guidelines?

The broader your answer, the more marks you will earn.
Write a little about a lot of topics, rather than a lot about a few topics.

THE NATURE, PURPOSE AND SCOPE OF AUDIT AND REVIEW

1

IN THIS CHAPTER

- THE NATURE OF AUDIT
- THE EXTERNAL AUDIT PROCESS
- MATERIALITY

THE NATURE OF AUDIT

! DEFINITION !

An **audit** is the independent examination of the evidence from which the financial statements are derived, in order to give the reader of those statements confidence as to the truth and fairness of the state of affairs which they disclose.

Requirement for audit

In many countries, company law requires all publicly quoted companies and all large companies (defined as those with turnover greater than £5.6 million) to appoint external auditors who will report whether the financial statements have been properly prepared and whether they give a true and fair view.

Other organisations (e.g., small private companies, partnerships, etc) may choose to be audited, but there is usually no legal requirement.

Compare an audit with a review:

	AUDIT	REVIEW
Requirement	Required by law in many countries for public companies and large companies	No legal requirement
Assurance provided	High level of assurance	Moderate level of assurance
Form of opinion provided	Positive opinion, i.e. the auditor reports whether (or not) the accounts give a true and fair view	Negative opinion, i.e. the reviewer reports whether anything has come to his attention suggesting that the accounts do not give a true and fair view

Clearly, less work will be carried out on a review engagement than an audit engagement. A lesser fee will be charged, and less assurance provided to the reader of the accounts.

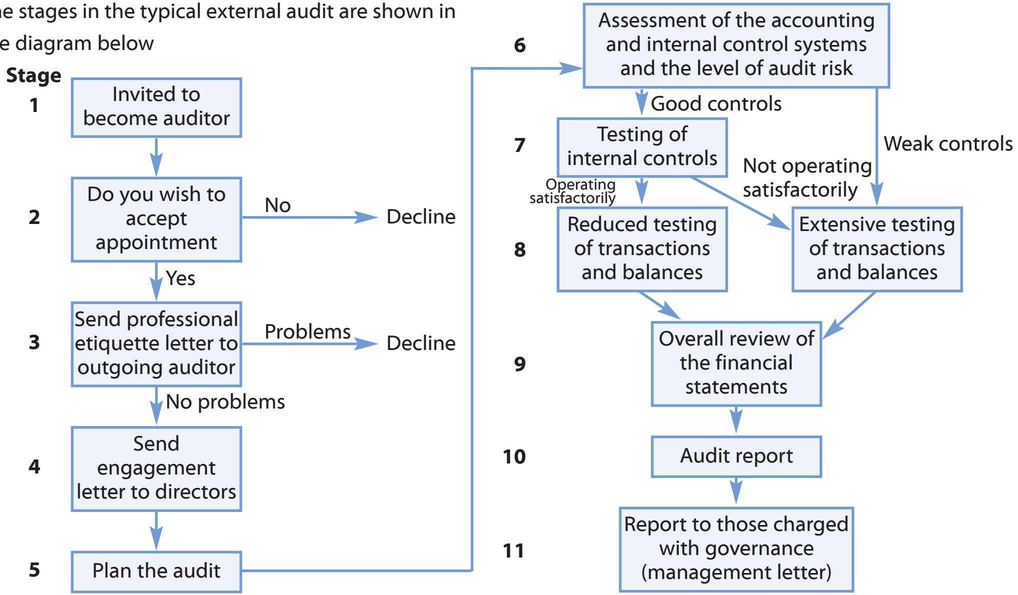
Compare external audit with internal audit:

Traditionally, internal auditors were employees of the entity being audited, however the outsourcing of the internal audit function to an external provider (e.g. a firm of accountants) is now increasingly common.

	EXTERNAL AUDIT	**INTERNAL AUDIT**
Role	External auditors are appointed to report to the shareholders whether the financial statements give a true and fair view	Internal auditors exist to assist management, by advising on the organisation's risk management processes and systems of control
Requirement	Legal requirement in many countries for public companies, large companies and many public bodies	No legal requirement, but corporate governance guidelines recommend that the need for internal audit is regularly assessed
Scope of work	Determined by the auditor in order to carry out his statutory duty to report. Financial focus only	Determined by management, covers both operational and financial matters

THE EXTERNAL AUDIT PROCESS

The stages in the typical external audit are shown in the diagram below



Stages of the audit

1 The auditor is approached by a company with a view to being nominated as the company's auditor.

2 The auditor will consider:
- Ethical matters – e.g., independence
- Legal matters
- Practical matters – e.g., does the auditor have the staff available when required to do the audit?

3 The auditor will write to the previous auditors asking if there are any reasons why the auditor should hesitate before being appointed.

4 The engagement letter records in writing the contractual basis of the relationship between the auditor and the company, in order to avoid possible misunderstandings in the future.

5 The auditor must plan in order that the audit will be performed in an effective manner.

6 The auditor carries out risk assessment procedures to learn about the entity and its internal controls.

7 If this preliminary evaluation of internal controls suggests that they are strong in theory, then their actual performance in practice is tested (tests of control).

8 If the controls are operating satisfactorily in practice, then only a reduced amount of detailed testing (substantive procedures) is required to maintain audit risk at an acceptable

level. If the controls are believed to be weak, or are not operating satisfactorily in practice, then extensive substantive procedures will be necessary to reduce audit risk to an acceptable level.

9 Once all the detailed audit testing is complete, the auditor should review the financial statements as a whole.

10 The auditor should issue the audit report which is published with the financial statements in the Annual Report document.

11 The auditor should report any weaknesses found in internal control to the directors, in a management letter.

MATERIALITY

! DEFINITION !

Information is **material** if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

The auditor's responsibility is to plan and perform the audit to provide reasonable assurance that the financial statements are **free of material misstatement** and give a true and fair view. In practice any amount less than 10 per cent of profit before tax is probably not material, and any amount greater than 10 per cent of profit before tax is probably material.

STATUTORY AUDITS

2

IN THIS CHAPTER

- APPOINTMENT AND REMOVAL OF AUDITORS
- THE AUDITOR'S RIGHTS AND DUTIES
- REGULATION OF THE AUDITING PROFESSION
- IAASB PRONOUNCEMENTS

APPOINTMENT AND REMOVAL OF AUDITORS

The external auditor must be appointed/removed and must carry out his role in accordance with:

- local statutory requirements
- professional regulations, particularly the auditing standards (ISAs) issued by the International Auditing Standards Board (IAASB)

THE AUDITOR'S RIGHTS AND DUTIES

Rights

- of access at all times to all books and records
- to receive information and explanations from the officers of the company
- to receive notice of and attend company meetings
- to receive notice of any intention to propose their removal
- to requisition an Extraordinary General Meeting (EGM) on their resignation

Duties

- to report to the shareholders and directors on whether the financial statements give a true and fair view in accordance with the applicable financial reporting framework

- to form an opinion as to whether:
  - adequate **R**eturns have been received from branches not visited
  - **A**ccounting records are consistent with the financial statements
  - **P**roper accounting records have been kept
  - all **I**nformation and explanations have been received from the officers
  - the **D**irectors' report is consistent with the financial statements

  (The auditor must report if he is not satisfied with anY of the above points. Use the mnemonic RAPID to remember these points.)
- to state certain items (e.g., directors' emoluments) in the audit report, if not given in the financial statements
- to make a statement of circumstances when they cease to hold the office of auditor

REGULATION OF THE AUDITING PROFESSION

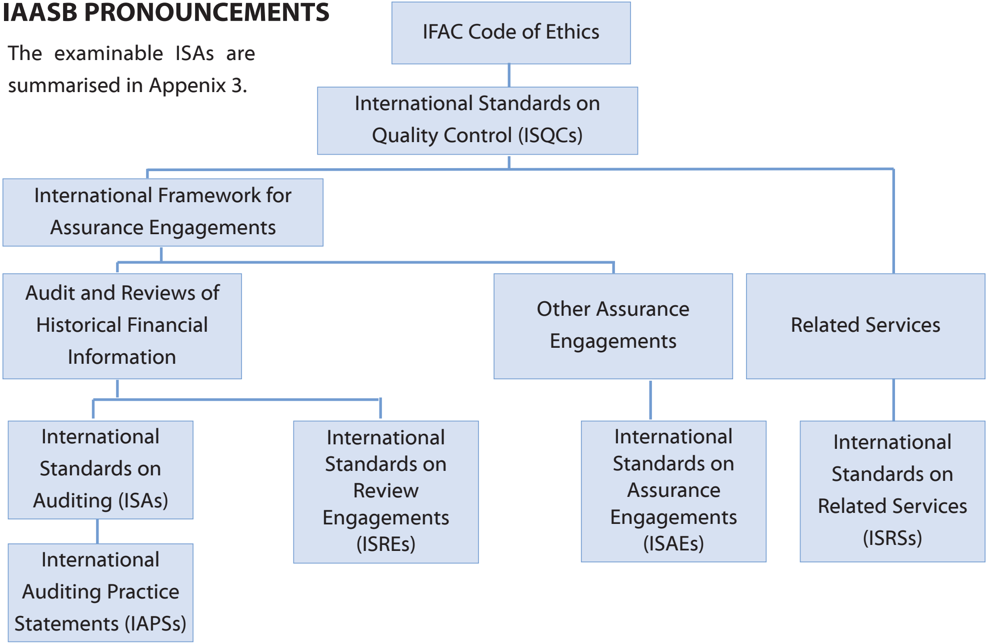
The International Federation of Accountants (IFAC) is the global organisation for the accountancy profession, based in New York.

A committee of IFAC is the International Auditing and Assurance Standards Board (IAASB), which works to improve the uniformity of auditing practices worldwide by issuing pronouncements (particularly International Standards on Auditing (ISAs)) and promoting their acceptance.

It is up to the authorities in each country to decide on the applicability of ISAs in that country. For example, in the UK and Ireland, the Auditing Practices Board (APB) is responsible for developing and publishing UK and Irish auditing standards. It does this by looking at each ISA issued by the IAASB, adding any supplementary material deemed necessary in the UK and Irish context, and then issuing each supplemented standard as an ISA (UK and Ireland).

IAASB PRONOUNCEMENTS

The examinable ISAs are summarised in Appenix 3.



PROFESSIONAL ETHICS AND CODES OF CONDUCT

3

IN THIS CHAPTER

- ETHICAL PRINCIPLES
- INTEGRITY, OBJECTIVITY AND INDEPENDENCE
- CONFIDENTIALITY
- THE ENGAGEMENT LETTER

ETHICAL PRINCIPLES

EXAM FOCUS

Professional ethics has been highlighted by the examiner as a key area of the syllabus, so will be examined often. Learn the principles in the various Codes of Ethics, but do not be afraid to use your common sense in deciding whether a proposed action is ethically acceptable for an auditor.

The sources of ethical principles are:

- the ACCA Rules of Professional Conduct, comprising a Code of Ethics and Professional Conduct Regulations
- the IFAC Code of Ethics for Professional Accountants

These two sources contain very similar rules. It is only the ACCA rules that are specifically examinable for this paper.

The ACCA Code of Ethics contains five Fundamental Principles that all ACCA members should follow:

- integrity
- objectivity
- competence
- due skill, care, diligence and expedition
- courtesy and consideration

Threats to compliance with the Fundamental Principles must be identified, evaluated and responded to. Possible responses are elimination of the threat, or reduction of the threat to an acceptable level by the implementation of safeguards. Ultimately, compliance with the Fundamental Principles cannot be compromised. If neither elimination nor reduction is possible, then the engagement cannot be accepted.

INTEGRITY, OBJECTIVITY AND INDEPENDENCE

- **Integrity** implies not merely honesty but fair dealing and truthfulness
- **Objectivity** is the state of mind which has regard to all considerations relevant to the task in hand but no other
- **Independence** is freedom from any external control or influence in making decisions

EXAM FOCUS

Knowledge of the Fundamental Principles is a good starting point for structuring an answer to a question on ethical matters. Apply each principle to the scenario. If there is a threat, can it be eliminated, or reduced through safeguards?

THREAT TO INDEPENDENCE	POSSIBLE SAFEGUARD
Auditor has financial involvement in company (e.g., owns shares, has lent money, there are overdue fees)	This threat must be eliminated, e.g. by selling shares owned in the client company as soon as possible
Auditor has been in the post for many years	No-one should act as the engagement partner for more than 5 years. A new partner should take over the audit
Auditor is unduly dependent on client	Fees from one client should not exceed 15% of the gross practice income (10% for public interest companies)
Auditor is offered gifts or hospitality from the client	Only very modest gifts and hospitality can be accepted
Auditor provides other services to the client (e.g., accountancy work, tax advice)	The auditor should not take management decisions. Accountancy work should only be performed for a public company in an emergency situation

CONFIDENTIALITY

Information confidential to a client or employer acquired in the course of professional work should not be disclosed to a third party, except where:

- consent has been obtained from the client or employer, or
- there is a public duty to disclose, or
- there is a legal or professional right or duty to disclose

THE ENGAGEMENT LETTER

The engagement letter is sent by the auditor to the client at the beginning of any new audit. It sets out the terms of the engagement and should avoid any misunderstandings between the client and the auditor as to their respective roles.

An example letter is reproduced in Appendix 4.

INTERNAL AUDIT AND REVIEW I

4

IN THIS CHAPTER

- CORPORATE GOVERNANCE
- AUDIT COMMITTEES
- OUTSOURCING OF INTERNAL AUDIT

CORPORATE GOVERNANCE

! DEFINITION !

Corporate governance concerns the way that a company is directed and controlled. It covers the role of the board of directors and the overall control environment.

Corporate governance is a topical subject, following recent high-profile corporate collapses (such as Enron), where poor standards of governance contributed to the problems.

Corporate governance is of interest to both external auditors and internal auditors.

The examiner has identified the role of internal audit in risk management and corporate governance as a key area of the syllabus.

The Organisation for Economic Co-operation and Development (OECD) has developed a set of Principles of Corporate Governance, that all OECD member countries should follow when establishing their own required standards of corporate governance practice.

In the UK, best standards of corporate governance are set out in the Combined Code on Corporate Governance. Listed companies must follow the Combined Code, or else explain their non-compliance.

The principles in the Combined Code cover five areas:

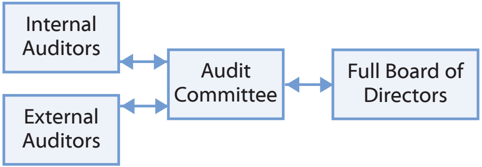
- **the board of directors**
- **accountability and audit**
- **institutional shareholders**
- **directors' remuneration**
- **relations with shareholders**

AUDIT COMMITTEES

! DEFINITION !

An **audit committee** consists of independent non-executive directors who are responsible for monitoring and reviewing the company's internal financial controls and the integrity of the financial statements.

The audit committee acts as an interface between the full board of directors on the one hand, and the internal and external auditors on the other hand.



The Combined Code requires companies to have an audit committee, so all UK listed companies must now establish and operate an audit committee, or else explain why not. At least one member of the audit committee must have recent and relevant financial experience.

OUTSOURCING OF INTERNAL AUDIT

Traditionally, internal auditors were full-time employees of the organisation being audited. There is now a growing trend towards buying-in internal audit services from external suppliers.

Advantages of outsourcing	Disadvantages of outsourcing
• specialist skills can be bought in when needed, rather than having to be paid for throughout the year • greater focus on cost and efficiency • may improve operational independence	• conflict of interest if the outsourced internal audit service is being provided by the external auditors • difficult to ensure high standards once the contract has been awarded and the previous employees have left • lack of flexibility, since no permanent presence

INTERNAL AUDIT AND REVIEW II

5

IN THIS CHAPTER

- NATURE OF INTERNAL AUDIT ASSIGNMENTS
- OPERATIONAL INTERNAL REVIEW ASSIGNMENTS

NATURE OF INTERNAL AUDIT ASSIGNMENTS

! DEFINITION !

A **value for money audit** is an investigation into whether an organisation has made proper arrangements for securing economy, efficiency and effectiveness in the use of resources.

Economy

The activity is achieving the necessary quality at the lowest possible cost.

Efficiency

The activity is using the minimum inputs for the output achieved, or gaining the maximum output from the given inputs.

Effectiveness

The activity is helping to achieve overall management objectives.

! DEFINITION !

A **best value audit**, typically used in local government, is an investigation into whether there is a public demonstration that value is being achieved.

Challenge

The current position is challenged to establish whether better options may exist.

Compare

Performance is compared with similar service providers to establish how good the current position is.

Consult

All users and providers of the service are invited to put forward their views.

Compete

The organisation must demonstrate that it is following the most efficient and effective service.

! DEFINITION !

An **information technology audit** is carried out by internal auditors to cover all aspects of hardware, software, the internet and the overall IT environment in order to report on risks and controls over input, output and processing.

IT audits are likely to be carried out by computer specialists rather than by general internal audit staff

! DEFINITION !

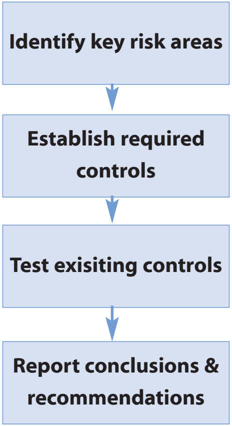
Financial internal audit involves the monitoring of financial accounting systems and management accounts to ensure that they are running efficiently and accurately. This was the traditional role of internal audit staff.

The external auditors may wish to rely on the work of financial internal audit in order to reduce the volume of substantive work that they will have to carry out.

OPERATIONAL INTERNAL REVIEW ASSIGNMENTS

Operational assignments should focus on the identification of the principal business risks involved which may prevent the organisation achieving its objectives, and the assessment of the extent to which controls are in place and are operating effectively to manage these risks.

Therefore the internal auditor should proceed as follows:



Typical assignments are described below.

Procurement department

Procurement (or purchasing) is the act of obtaining goods and services from outside suppliers. Primary risks are:

- fictitious or excessive payments made to suppliers
- inaccurate or delayed payments
- best value not achieved from current suppliers

Marketing department

Marketing involves pricing, placing and promoting the company's products. Primary risks are:

- advertising that breaches regulations
- advertising that loses customers
- advertising that is expensive but achieves no new sales

Treasury department

Treasury involves the handling of all financial matters, including raising and investing finance, cashflow management, banking procedures and currency management. Potential risks can be huge, and if not properly managed can bring down companies. Primary risks are:

- failure to manage cashflow leading to cash shortfalls at critical times
- failure to manage currency leading to massive exchange losses
- high finance costs due to selection of wrong source of funds

Human resources (HR) department

HR encompasses a wider role than a traditional personnel department. HR includes responsibility for recruitment, training, remuneration policy, disciplinary procedures and leavers. Primary risks are:

- failure to identify and recruit the right skills
- staff are not properly trained
- staff paid wrong rates, or for time not worked

PLANNING AND RECORDING THE AUDIT

6

IN THIS CHAPTER

- PLANNING THE AUDIT
- STAFFING AND TRAINING ISSUES
- RECORDING THE AUDIT PROCESS

PLANNING THE AUDIT

! DEFINITIONS !

Planning an audit involves establishing the overall audit strategy for the engagement, and developing an audit plan, in order to reduce audit risk to an acceptably low level.

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

Adequate planning helps to ensure that:

- attention is paid to the important areas of the audit
- potential problems are identified and resolved on a timely basis
- the audit engagement is organised and managed in order to be performed in an efficient and effective manner
- work is properly assigned to the individual team members

Planning activities

Establish the overall audit strategy

↓

Develop an audit plan

↓

Only then, start to carry out audit procedures

The overall **audit strategy** sets the scope, timing and direction of the audit. Once the audit strategy has been established, the auditor can start to develop a more detailed **audit plan** to address the matters identified in the audit strategy.

The audit strategy and audit plan should be updated and revised as necessary during the course of the audit. For example, the audit procedures to be carried out for material classes of transactions and account balances cannot be finalised until the results of the risk assessment procedures have been analysed.

STAFFING AND TRAINING ISSUES

Planning procedures include the appropriate staffing of the audit, covering such matters as:

- number of staff required
- level of expertise required
- length of time each member of staff will be needed

RECORDING THE AUDIT PROCESS

! DEFINITION !

Documentation means the material (working papers) prepared by or for, or obtained and retained by, the auditor in connection with the performance of the audit. Such material may be in the form of paper or electronic media.

The working papers must be sufficiently complete and detailed to provide an overall understanding of the audit. In particular, the working papers should record the auditor's reasoning on all significant matters which require the exercise of judgement, and the auditor's conclusions thereon.

It is common for the working papers to be split into two separate files:

- **permanent file** – matters of continuing interest
- **current file** – matters of this year's interest

The auditor must adopt procedures for maintaining the confidentiality and safe custody of the working papers, and retain them for a period sufficient to meet the needs of the practice and to comply with relevant legal and professional requirements for record retention. In the UK, for example, auditors are required to keep all audit working papers for a period of at least six years following the period to which they relate.

RELIANCE ON THE WORK OF OTHERS IN THE AUDIT

7

IN THIS CHAPTER

- RELIANCE ON EXPERTS
- RELIANCE ON INTERNAL AUDIT
- SERVICE ORGANISATIONS

RELIANCE ON EXPERTS

! DEFINITION !

An **expert** is a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.

Examples of experts include surveyors (to value land and buildings) or lawyers (to advise on the interpretation of regulations).

Auditors have a general knowledge of business, but they cannot be expected to have a detailed knowledge in all disciplines. Therefore the auditor may need to consider audit evidence from specialist experts in arriving at the audit opinion.

In order to be able to rely on the evidence from an expert, the auditor must be satisfied that the expert is competent and objective.

COMPETENCE	OBJECTIVITY
• Professionally qualified • Suitable experience • Good reputation	• Not employed by the client • Not related to the client • Financially independent of the client

When issuing an unmodified audit report, the auditor should not refer to the work of an expert. The opinion is the auditor's; he must ensure that the expert's work is sufficient appropriate evidence for his purposes.

RELIANCE ON INTERNAL AUDIT

The external auditor may wish to rely on the work of internal audit in order to reduce the amount of detailed testing that he (the external auditor) must perform.

Before any reliance is made, the external auditor should assess the internal audit function in terms of:

- organisational status
- scope of function
- technical competence
- due professional care

When the external auditor intends to use specific work of internal audit, he should perform audit procedures on that work to confirm its adequacy for his purposes.

SERVICE ORGANISATIONS

! DEFINITIONS !

A **service organisation** is any entity that provides services to another entity. Examples are banks maintaining safe custody of investments, or a computer bureau operating the payroll function for a small company.

Relevant activities are activities undertaken by a service organisation that are relevant to the audit. The two examples above are relevant activities, while a window-cleaner washing the office windows once a month is not a relevant activity.

At the planning stage, the auditor must determine the significance of service organisation activities to the entity and the relevance to the audit.

INTERNAL CONTROL SYSTEMS

8

IN THIS CHAPTER

- INTERNAL CONTROL
- ASSERTAINING THE SYSTEM
- DOCUMENTING THE SYSTEM
- EVALUATING THE SYSTEM
- COMPUTER-BASED SYSTEMS

INTERNAL CONTROL

! DEFINITION !

Internal control is the process designed and effected by the directors and others to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

Internal control consists of the following components:

- the control environment
- the entity's risk assessment process
- the information system relevant to financial reporting
- control activities
- monitoring of controls

The **control environment** is the overall attitude of management regarding internal controls and their importance. It encompasses management's philosophy (e.g., a commitment to integrity and ethical values), a formal organisation structure and proper training of staff

Different books use different categories of control procedures. One possibility is:

- **A**uthorisation
- **C**omparison
- **C**omputer controls
- **A**rithmetical controls
- **M**aintaining a trial balance and control accounts
- **A**ccounting reconciliations
- **P**hysical controls

(Use the mnemonic ACCA MAP to remember these categories.)

EXAM FOCUS

The examiner has identified internal controls as one of the key areas of the syllabus, so be sure that you fully understand this topic.

ASCERTAINING THE SYSTEM

- examine previous audit work
- client's own documentation of the system
- interview client staff
- trace a transaction through the system (walkthrough test)
- observe procedures

DOCUMENTING THE SYSTEM

Possible methods:

Narrative notes	**Organisation chart**
Complete an Internal Control Questionnaire (ICQ)	**Flowcharts**

EVALUATING THE SYSTEM

Use an **Internal Control Questionnaire (ICQ)** or **Internal Control Evaluation Questionnaire (ICEQ or ICE)**. An ICQ lists all possible controls for each area of the accounts; the client's system is examined to see which controls exist. An ICE does not attempt to record all controls; instead, for each control objective, it asks for the controls which achieve that objective.

An ICE is more useful to the auditor than an ICQ, since it focuses on whether internal control objectives are being met.

COMPUTER-BASED SYSTEMS

The principles of auditing in a computer environment are the same as in other circumstances, but specific problems may be encountered, e.g. lack of primary records, or data needed for audit purposes may be overwritten.

Controls in a computer-based system may be:

- general controls – relating to the environment of computer systems, or
- application controls – relating to the transactions and standing data in each separate application

INTERNAL CONTROL - REVENUE AND PURCHASES

9

IN THIS CHAPTER

THE SALES SYSTEM

Control objectives for all systems are to ensure that only authorised transactions are promptly recorded at the correct amount in the appropriate accounts in the proper accounting period, that access to assets is only in accordance with proper authorisation, and that recorded assets are compared with existing assets.

Control procedures are set in place to achieve these control objectives.

Tests of control (or compliance tests) are those tests carried out to determine whether a control procedure has operated satisfactorily during the period.

For the **sales system**, the control objectives include:

- to ensure that all sales revenues are included in the accounts
- to ensure that sales revenues included in the accounts are accurately stated
- to minimise losses through bad debts and/or returns

Control procedures in the sales system can be classified using the ACCA MAP categories described in the previous chapter. For example, authorisation controls include:

- check orders received against customers' credit limits
- accepted orders should be authorised in writing
- bad debts written off and the issue of credit notes should be authorised in writing

One approach to designing tests of control is to list the documents involved in the system, and think of tests for each document. This is illustrated below for a sales system

Customer order

Test for evidence of approval

Despatch note

Test for evidence of a sequence check

Goods received note

Test for:
- evidence that a GRN is raised for all sales returns accepted
- evidence of a sequence check

Sales invoice

Test for:
- serial numbering
- evidence of a sequence check
- evidence of matching sales invoice to despatch notes and customer orders
- correct accounting

Credit note

Test for:
- evidence of approval and matching to GRN correct accounting

Receivables ledger

Test for evidence of authorisation of adjustments to receivables ledger accounts

Receivables ledger control account

Test for:
- evidence of review of reconciliation to receivables leger
- evidence of authorisation of adjustments to receivables ledger control account

THE PURCHASES SYSTEM

For the purchases system, the control objectives include:

- to ensure that all purchased goods/services are ordered under proper authorities and procedures
- to ensure that only necessary goods/services are procured
- to ensure that purchase invoices and related documentation are properly checked and approved before being included in the accounts
- to ensure that expenditures included in the accounts are accurately stated

Again, the control procedures in the purchases system can be classified using the ACCA MAP categories described earlier.

The approach that can be adopted of listing the documents in a system and thinking of tests for each document is illustrated below for a purchases system.

Purchase requisition

Test for:
- evidence of approval
- adherence to authority limits

Purchase order

Test for:
- evidence of a sequence check
- evidence of approval
- adherence to authority limits

Goods received note

Test for evidence of a sequence check

Goods returned note

Test for evidence of a sequence check

Purchase invoice

Test for:
- serial numbering
- evidence of sequence check
- evidence of matching purchase invoices with goods received notes and purchase orders
- evidence of checking casts, extensions and correct treatment of purchase tax
- evidence of account coding
- initiating of invoice grid for work done
- approval of purchase invoice for further processing

Credit note

Test for evidence of matching credit notes to goods returned notes

Payables ledger

Test for evidence of authorisation of adjustments to payables ledger

Payables ledger control account

Test for:
- evidence of reconciliation to payables ledger listing
- evidence of authorisation of adjustments to payables ledger control account

PAYROLL AND OTHER AREAS; REPORTS TO MANAGEMENT

10

IN THIS CHAPTER

- THE PAYROLL SYSTEM
- THE CASH SYSTEM
- REPORTS TO MANAGEMENT

THE PAYROLL SYSTEM

Control objectives:

- wages and salaries should be paid only to the client's employees, for work done, and at authorised rates of pay
- liabilities to the tax authorities for income tax and social security costs should be accurately recorded
- payroll costs should be completely and accurately recorded in the financial statements

Appropriate control procedures can be identified using the usual ACCA MAP classification, for example:

Authorisation control	written authorisation required to employ or dismiss any employee, or to pay overtime
Comparison control	monthly payroll total should be compared with the previous month and with the budget
Computer control	deductions for income tax and social security should be calculated by the computer for each employee each month
Arithmetical control	a sample of calculations should be checked
Maintaining control accounts	an overall wages control account should be maintained
Accounting reconciliations	payroll reconciliations should be regularly carried out by a senior manager
Physical controls	clock cards and timing devices should be carefully maintained. Unclaimed wages should be kept securely until claimed or rebanked

EXAM FOCUS

A popular audit procedure is a 'starters and leavers' test. Select two payrolls some months apart and identify the differences in names between them. Those on the first but not the second are leavers in the period. Those on the second but not the first are starters in the period. List all the starters and leavers and check that they were accurately paid for the periods.

THE CASH SYSTEM

Control objectives

- to ensure that all cash receipts are properly collected, recorded and banked
- to ensure that all cash payments are for proper purposes and have been authorised for payment
- to ensure that receipts and payments are recorded accurately and completely in the accounts

Controls over cash sales

- cash sales should be recorded when the sale is made, normally by entering the sale in a cash till and giving the customer a cash receipt (a till slip)
- the total cash received should be reconciled daily with the total till slips, and should be banked daily

Controls over banking

- receipts should be banked intact daily
- the banked amounts should be entered promptly in the cash book

Controls over cheque payments

- cheques should only be signed when suitable supporting documentation is provided. The supporting documentation should be marked as cancelled to prevent it from being used again at a later date
- there should be clearly defined levels of authorisation in respect of cheque values,

  e.g. up to $100   1 signature

  above $100   2 signatures

Bank reconciliations

- each bank account should be reconciled at least monthly

Petty cash

- an imprest system of petty cash should be maintained, with all expenditure requiring a voucher signed by a responsible official

EXAM FOCUS

The auditor will be interested in substantive testing of the year-end bank reconciliation and in obtaining a bank certificate confirming the year-end balance. These are considered later.

REPORTS TO MANAGEMENT

ISA 260 requires auditors to communicate audit matters of governance interest arising from the audit with those charged with the governance of the entity.

Typically, 'those charged with the governance' of a company are the board of directors and the audit committee (if one exists). Thus the auditor sends a letter (known as a management letter or letter of weakness) to the board or to the audit committee, highlighting relevant matters. An example management letter is shown in Appendix 4.

EXAM FOCUS

Some exam questions ask you to draft excerpts from a management letter relating to a given scenario where you need to identify the weaknesses in the internal control system. A tabular format listing the weaknesses, implication of weaknesses and recommendations is generally the best approach for this type of question.

AUDIT EVIDENCE

11

IN THIS CHAPTER

AUDIT EVIDENCE

! DEFINITION !

Audit evidence is all of the information used by the auditor in arriving at the conclusions on which the audit opinion is based.

ISA 500 requires the auditor to obtain SUFFICIENT APPROPRIATE audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

The following general principles concern the reliability of audit evidence:

LESS RELIABLE	MORE RELIABLE
Obtained from inside the entity	Obtained from independent sources outside the entity
Obtained indirectly or by inference	Obtained directly by the auditor
Oral representation	Exists in documentary form
Photocopy of a document	Original document

FINANCIAL STATEMENT ASSERTIONS

By presenting the financial statements, management are making various assertions regarding the various elements of the financial statements and the related disclosures.

Different books use different mnemonics to help you remember the various financial statement assertions:

- **C**ompleteness
- **O**ccurrence
- **D**isclosure
- **R**ights and obligations
- **A**ccuracy and valuation
- **C**ut-off
- **E**xistence

(Remember COD RACE to jog your memory.)

The auditor aims to confirm these financial statement assertions by performing audit procedures.

EXAM FOCUS

In the exam, you should use the above list to generate ideas for the audit tests to be carried out on particular transactions, account balances and disclosures. This is a key area of the syllabus.

Types of audit test

- **A**nalytical review (comparison of data with previous year, etc)
- **E**nquiry and confirmation (ask someone inside/outside the company)
- **I**nspection (of an asset, a document, or the accounting system itself)
- **O**bservation (look at a process, e.g. the client's inventory count)
- Recalc-**U**-lation (to check the mathematical accuracy of documents and records)

(Use the mnemonic AEIOU to remember these types of tests.)

ACCOUNTING ESTIMATES

! DEFINITION !

An **accounting estimate** is an approximation of the amount of an item in the absence of a precise means of measurement.

Examples of accounting estimates:

- depreciation charges (since the useful life and residual value of a non-current asset are only estimates)
- provision for a loss from a court case
- provision to meet warranty claims

The auditor should adopt one or a combination of the following approaches:

- review and test the process used by management to develop the estimate
- use an independent estimate and compare this with management's estimate
- review subsequent events which provide evidence about the estimate

THE AUDIT OF NON-CURRENT ASSETS

12

IN THIS CHAPTER

- NON-CURRENT ASSETS
- TANGIBLE NON-CURRENT ASSETS
- INTANGIBLE NON0CURRENT ASSETS
- INVESTMENTS

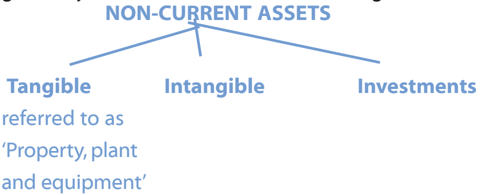
NON-CURRENT ASSETS

! DEFINITION !

Non-current assets are those assets intended for use on a continuing basis in the company's activities, not for resale.

Examples are land and buildings (tangible non-current assets), purchased goodwill (an intangible non-current asset) and a long-term investment in the shares of another company (an investment).

Non-current assets in the balance sheet are generally classified into these three categories:



All other assets, which are not intended for use on a continuing basis, must be classified as current assets.

TANGIBLE NON-CURRENT ASSETS

IAS 16 sets out the accounting for the measurement and depreciation of tangible non-current assets:

- choice of stating property, plant and equipment at cost or valuation
- depreciation applies the accruals concept by allocating the cost/valuation of an asset over its estimated useful life

Audit tests centre around the financial statement assertions described earlier:

- Completeness – are all non-current assets included?
- Occurrence – did all transactions take place?
- Disclosure – is disclosure of property, plant and equipment in accordance with IAS 1 and IAS 16?
- Rights and Obligations – do the assets belong to the company?
- Accurate valuation – are the reported values accurate and appropriate?

- Cut-off – are transactions reported in the correct accounting period?
- Existence – do the assets exist at the balance sheet date?

Control will be improved if the company maintains a non-current asset register. The auditor should test the entries in this register if he wishes to rely on it as a control:

- vouch additions in the period
- vouch disposals in the period
- check depreciation calculations

INTANGIBLE NON-CURRENT ASSETS

In the balance sheet, separate disclosure is recommended under the following headings:

- goodwill
- development costs
- concessions, patents, licences, trade marks and similar rights and assets
- payments on account of intangible assets

Development costs

- IAS 38 requires that all research costs must be written off as incurred
- Development costs should generally be written off, but should be capitalised if:
  - **P**robable future economic benefits
  - **I**ntention to complete the project
  - **R**esources exist to complete the project
  - **A**bility to use or sell the project output
  - **T**echnically feasible
  - **E**xpenditure can be measured reliably

(Use the mnemonic PIRATE to remember these conditions.)

If the company has capitalised any development costs, the auditor must assess whether the necessary conditions do apply.

INVESTMENTS

A non-current asset investment is held for the long-term (more than one year). If an investment is held for the short-term, then it is classified as a current asset.

IAS 39 requires most financial assets to be stated at fair value (or at cost if fair value cannot be reliably measured).

Use the standard CODRACE financial statement assertions to identify appropriate audit tests. The most important aspects will be:

- **Existence** – agree recorded investments with ownership documents (e.g., share certificates), verifying that the company's name is present
- **Valuation** – where investments are stated at fair value, agree value (e.g., to year-end stock market prices, or by assessment of the accounts of the

company the investment is in)

- **Disclosure** – ensure appropriate split between non-current assets and current assets. Written management representations may be necessary

The auditor must ensure that all investment income, rights issues, bonus issues, etc have been received and accounted for by the company.

THE AUDIT OF RECEIVABLES, PREPAYMENTS, BANK AND CASH

13

IN THIS CHAPTER

- AUDIT OF RECEIVABLES
- CONFIRMATION OF ACCOUNTS RECEIVABLE
- AUDIT OF BANK AND CASH
- BANK LETTER

AUDIT OF RECEIVABLES

The auditor should examine the year-end reconciliation that reconciles the balance on the receivables control account to the total of the balances on the receivables ledger:

- check contras with the payables ledger
- check the authorisation for debts written off
- enquire into balances that appear to be in dispute or old

An aged receivables analysis shows the breakdown of the total receivables balance. Comparison of the percentages in each category with the previous year will indicate if debtors are taking longer to pay, so that perhaps a larger allowance for doubtful debts is required.

CONFIRMATION OF ACCOUNTS RECEIVABLE

Seeking direct confirmation of accounts receivable by carrying out a debtors circularisation is a key test for the auditor to gain evidence about the existence (and other details) of trade receivables.

The auditor selects a sample of year-end customer balances from the client's receivables ledger. A letter is sent to each customer selected, asking them to confirm the balance they believe to be owing as at the year-end. See Appendix 4 for an example wording of the letter.

The letter may ask for **positive** confirmation, i.e. please respond whether you agree or disagree, or **negative** confirmation, i.e. please only respond if you disagree. Positive confirmations are the norm.

AUDIT OF BANK AND CASH

This section includes:

- bank account balances
- petty cash balances

There are two stages to the audit of bank account balances:

1. obtain a bank confirmation letter – see below
2. reconcile the bank's balance with the cash book balance

The client is likely to have prepared bank reconciliations for each bank account. These should be vouched, following through reconciling items to bank statements after the year-end.

Petty cash balances may be counted on a surprise basis, but the auditor should not spend too long on this area since risk is likely to be low, and the amounts involved likely to be immaterial to the financial statements as a whole.

BANK LETTER

In some developed countries, the wording of a standard request letter has been agreed between the auditing profession and the clearing banks. The letter should be authorised by the client, then sent by the auditor to the client's bankers, to arrive around two weeks before the confirmation date (usually the balance sheet date). The bank's reply is sent directly to the auditor.

The bank letter is an original document, in written form, received from an independent third party external to the client, so the quality of the audit evidence is high.

EXAM FOCUS

You must be able to describe the auditor's procedures in carrying out a confirmation of accounts receivable to gain evidence about the trade receivables figure, and in requesting a bank letter to gain evidence about the bank account figure.

THE AUDIT OF INVENTORIES

14

IN THIS CHAPTER

- THE IMPORTANCE OF INVENTORY
- ATTENDANCE AT THE INVENTORY COUNT
- VALUATION OF INVENTORY

THE IMPORTANCE OF INVENTORY

Inventory is a very important area of the audit since:

- the inventory figure is likely to be material
- there can be a high risk of material misstatement, particularly where the inventory is specialist in nature, or where a significant degree of estimation is required to assess the quantities of inventories held (e.g., piles of coal)

As a result, inventory is often audited by relatively senior members of the audit team.

ATTENDANCE AT THE INVENTORY COUNT

Where inventory is material to the financial statements, ISA 501 requires that the auditor should attend the physical inventory count unless impracticable.

The client may carry out a **periodic** inventory count, e.g. annually at or close to the year-end, or a **continuous** inventory count where (say) monthly counts are carried out throughout the year.

Before the count

- review the previous year's working papers
- review the client's instructions concerning the count issued to the counters
- identify any problem areas and discuss them with the client

During the count	**After the count**
• make limited test counts to check the accuracy of the count • make notes of any damaged or possibly obsolete inventories • record document numbers for subsequent test of cut-off – see below • reach a conclusion as to whether the count was carried out satisfactorily	• check that damaged/obsolete inventories are included in the review exercise to value such goods at their net realisable value • having recorded the number of the last Goods Received Note and last Despatch Note prior to the count, check that cut-off is correct by inspecting sales and purchases records • check that inventory records (if any) are adjusted to reflect the actual numbers counted during the inventory count.

VALUATION OF INVENTORY

IAS 2 requires that all inventories must be valued at the lower of cost and net realisable value (NRV).

Cost = Purchase cost of materials and labour, plus attributable production overheads (based on normal level of activity)

NRV = Actual or estimated selling price, less all further costs to completion, and all costs to be incurred in marketing, selling and distributing the product

Where a number of identical goods have been purchased, a costing method such as FIFO or average cost may be used to determine the costs of the items in inventory at the year-end.

Items must be written down to NRV if this is below cost. Typical situations are:

- an increase in costs or a fall in selling price (e.g., computers)
- physical deterioration (e.g., food going stale)
- obsolescence (e.g., clothes going out of fashion)
- a decision to sell some items as loss leaders
- errors in production or purchasing

EXAM FOCUS

You must be clear about the two separate tasks facing the auditor:

- does the inventory exist? Attend the inventory count to find out
- is the inventory correctly valued? Apply the IAS 2 principles

The two tasks are inter-related, i.e. the auditor can identify damaged or dusty (slow-moving) inventories at the count, and then confirm that these inventories have been written down to NRV in the valuation exercise.

THE AUDIT OF LIABILITIES AND CAPITAL

15

IN THIS CHAPTER

LIABILITIES

! DEFINITION !

Liabilities are present obligations of an entity to transfer economic benefits arising from past transactions or events.

A liability should be recognised if it is probable that an outflow of economic benefits will result from the settlement of a present obligation, and the amount at which the settlement will take place can be measured reliably.

If the recognition criteria are not satisfied, then the liability should not be recognised, but may be disclosed in a note as a contingent liability.

The auditor will find it harder to audit liabilities than assets since the related cash flow for a liability has not yet occurred. The usual CODRACE financial statement assertions can be tested, with particular emphasis on Completeness.

Key audit tests

- review cashbook after the year-end for payments that indicate that liabilities existed at the year-end
- review the reconciliation of the payables ledger control account to the total of the individual payables ledger balances
- for a sample of suppliers, perform a reconciliation of year-end supplier statements to payables ledger balances

EXAM FOCUS

A creditors circularisation is usually not necessary. The client's suppliers will send regular statements to the client, stating the amount owed. There would be nothing to be gained from circularising these suppliers, since they would only confirm the figures already on the statements.

CONTINGENT LIABILITIES

Where the likelihood of payment is only **possible** rather than **probable**, then this is a contingent liability rather than an actual liability. Contingent liabilities are disclosed in a note to the accounts; actual liabilities are recognised in the accounts.

To identify contingent liabilities, study the bank letter received from the bank, and examine the client's correspondence with their lawyers. Consider including these matters in the representation letter to be required from the directors at the end of the audit.

SHARE CAPITAL AND RESERVES

IAS 32 requires that **issued share capital** must be classified as equity or as a liability, depending on the substance of the contractual arrangement. Thus, for example:

- ordinary shares are shown as equity on the balance sheet
- redeemable preference shares are shown as liabilities on the balance sheet

The auditor should check that this classification has been made properly in accordance with IAS 32, and should note any changes in issued share capital in the year and check these to the cash book, board minutes, register of shareholdings, etc.

Possible categories of reserves to be disclosed include:

- share premium account
- revaluation reserve
- other reserves
- retained earnings

IAS 1 requires that the financial statements must contain a statement of changes in equity for the year:

	Share capital	*Share premium account*	*Other reserves*	*Retained earnings*	*Total equity*
	$	$	$	$	$
Balance at 1 Jan	x	x	x	x	x
Share issue	x	x			x
Revaluation of freehold			x		x
Transfer			x	(x)	
Profit for the year				x	x
Dividends				(x)	(x)
Balance at 31 Dec	x	x	x	x	x

The auditor must check that all movements on reserves are in accordance with IASs and relevant legislation.

AUDIT SAMPLING AND COMPUTER ASSISTED AUDIT TECHNIQUES

16

IN THIS CHAPTER

- AUDIT SAMPLING
- COMPUTER ASSISTED AUDIT TECHNIQUES (CAATS)

AUDIT SAMPLING

! DEFINITION !

Audit sampling involves the application of audit procedures to less than 100% of the items within a class of transactions or account balance such that all the individual items have a chance of selection. This enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form a conclusion about the population from which the sample is drawn.

Audit sampling is usually preferable to testing all items, because:

- it would be prohibitively expensive and time-consuming to test every single item
- users of the financial statements are looking for reasonable assurance, not 100% accuracy
- full substantive testing of the accounting records will not verify that all transactions are recorded (i.e., it does not prove completeness)

However audit sampling is not appropriate if:

- population is small
- all transactions in a particular area are of great monetary significance
- population is non-homogeneous

There are three steps in audit sampling:

DESIGN THE SAMPLE

EVALUATE THE SAMPLE

SELECT THE SAMPLE

Designing the sample

- the auditor must choose between statistical and non-statistical sampling. Statistical sampling involves random selection of a sample and then the use of probability theory to evaluate the sample results. Any other sampling approach is non-statistical sampling
- note that a selective testing approach such as examining all items over a certain amount, or all items that look unusual, is not sampling, so that the results cannot be projected to the entire population

Selecting the sample

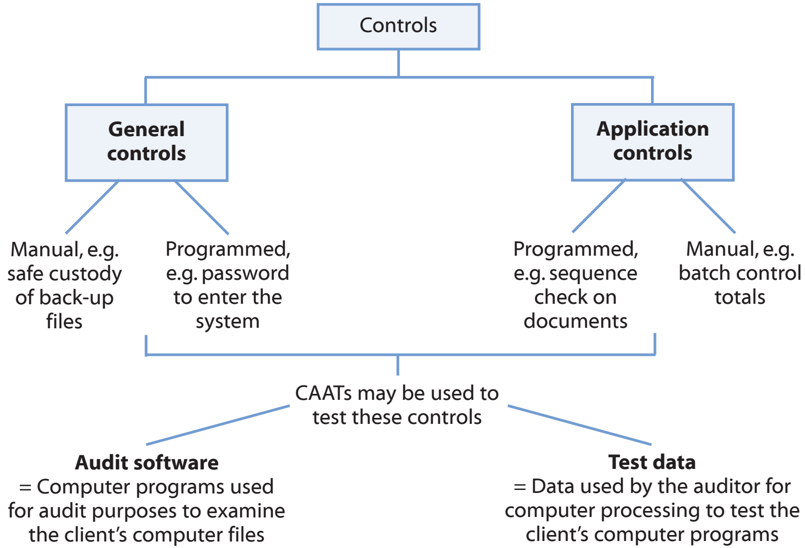
- statistical sampling requires random selection, e.g. using random number tables or a computer program to generate random numbers
- non-statistical sampling requires the auditor to use his judgement to select the sample items to be representative of the population

Evaluating the sample results

- the auditor carries out audit procedures on each item selected and documents the results. Errors identified in the sample are then projected across the population as a whole
- if the projected error exceeds the tolerable error, then the assessment of the relevant characteristic of the population needs to be revised

COMPUTER ASSISTED AUDIT TECHNIQUES (CAATs)

The diagram below indicates the controls in a computer information system.



Advantages of using CAATs

- effective way of testing programmed controls
- can test a large number of items quickly and accurately
- can test the actual accounting system rather than printouts which claim to come from the system
- once established, CAATs are a cost-effective means of gathering audit evidence

GOING CONCERN

17

IN THIS CHAPTER

- THE GOING CONCERN CONCEPT
- EVALUATION OF GOING CONCERN

THE GOING CONCERN CONCEPT

! DEFINITION !

Under the **going concern assumption**, an entity is assumed to be continuing in business for the foreseeable future, with neither the intention nor the necessity of liquidation or ceasing trading.

IAS 1 requires that an entity should prepare its financial statements on a going concern basis, unless:

- management intends to liquidate the entity or to cease trading, or
- management has no realistic alternative but to liquidate the entity or to cease trading

When preparing financial statements, IAS 1 requires that the management should assess whether there are significant doubts about an entity's ability to continue as a going concern, and that any such doubts must be disclosed in a note to the accounts.

The auditor's responsibility is to consider the appropriateness of management's use of the going concern assumption, and whether there are adequate disclosures regarding uncertainties about the entity's ability to continue as a going concern.

EVALUATION OF GOING CONCERN

In a company where profits are high, cashflows are positive, finance is in place, and there is no obvious exposure to massive losses, management's assessment of the company's going concern status is likely to be rapid, and the auditor's review will similarly be rapid.

However, if doubts exist, the auditor's evaluation of management's assessment will be more extensive.

Typical indicators of going concern problems

- net current liabilities
- necessary borrowing facilities not agreed
- significant liquidity or cashflow problems
- substantial operating losses
- inability to pay debts (e.g., tax payments) as they fall due
- loss of key management or staff
- loss of key suppliers or customers

Typical audit procedures

- review cashflow forecasts and post-year-end management accounts to analyse trends in performance
- assess the state of the industry in which the client operates
- review correspondence with major customers, suppliers and the bank for evidence of disputes
- discuss management's assessment with key managers and obtain written representations where appropriate

The appropriate wording of the audit report when the going concern status is unclear will be dealt with in a later chapter.

AUDIT FINALISATION AND THE FINAL REVIEW STAGE

18

IN THIS CHAPTER

- OVERALL REVIEW OF FINANCIAL STATEMENTS
- SUBSEQUENT EVENTS
- MANAGEMENT REPRESENTATIONS
- UNADJUSTED AUDIT DIFFERENCES

OVERALL REVIEW OF FINANCIAL STATEMENTS

The auditor's opinion is on the financial statements as a whole, so before formulating his opinion the auditor must bring together all the detailed work that he has carried out on each audit area, and review the financial statements as a whole.

Overall review:

- compliance with statute and accounting standards?
- appropriate accounting policies?
- consistent with the auditor's knowledge of the business?
- do the financial statements as a whole give a true and fair view?

These matters are traditionally covered by filling in comprehensive checklists relating to the accounts.

SUBSEQUENT EVENTS

! DEFINITION !

Subsequent events are events occurring and facts discovered between the period end and the laying of financial statements before members.

The accounting for subsequent events must follow IAS 10:

- adjusting events are adjusted for in the financial statements
- non-adjusting events are disclosed in a note

Up to the date of the audit report, the auditor must watch out for subsequent events that might require adjustment or disclosure in the financial statements.

After the date of the audit report, the auditor has no duty to search for subsequent events. However, if he does learn of subsequent events, he should discuss the matter with the directors and consider whether amended financial statements are necessary.

MANAGEMENT REPRESENTATIONS

! DEFINITION !

Management representations are representations made by management to the auditor during the course of the audit, either unsolicited or in response to specific enquiries.

Representations from management are a source of audit evidence. ISA 580 requires that the auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

An example of a management representation letter is shown in Appendix 4. The letter is addressed to the auditor, contains the necessary information, is signed by senior board members, and is normally dated on the same day as the audit report.

UNADJUSTED AUDIT DIFFERENCES

During the course of the audit, the auditor will have identified errors within the account balances and transactions. The auditor must persuade management to adjust the accounts for material errors, otherwise a qualified audit report must be given.

Errors that are individually immaterial should be recorded on a summary of audit differences. This will reveal whether errors that are individually immaterial accumulate to require an adjustment that is material.

EXTERNAL AUDIT REPORTS AND OTHER EXTERNAL REPORTS

19

IN THIS CHAPTER

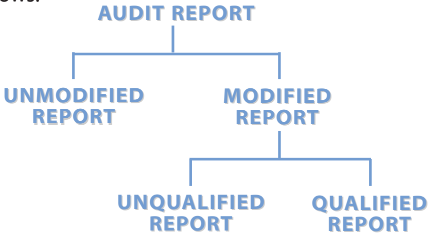
- THE AUDIT REPORT
- THE QUALIFIED AUDIT REPORT
- REVIEW REPORTS

THE AUDIT REPORT

The standard audit report contains the following elements:

- Title, identifying the addressee
- Introductory paragraph, identifying what has been audited
- Respective responsibilities of management and auditors
- Description of the audit work
- Opinion – whether the financial statements give a true and fair view in accordance with the identified financial reporting framework (e.g. IFRSs)
- Auditor's signature and address
- Date

The structure of a full audit report is shown in Appendix 1. The standard type of report in which the auditor reports that he is happy with the accounts is called an **unmodified** report (traditionally it has been referred to in the UK as an unqualified report). These terms are linked as follows:



An unmodified report is the standard wording. A modified report is any change from the standard wording:

- a modified but unqualified report means that the auditor is happy that the accounts give a true and fair view, etc, but he wishes to add an emphasis of matter paragraph highlighting a matter affecting the financial statements
- a modified and qualified report means that the auditor is not happy with some aspect of the accounts.

THE QUALIFIED AUDIT REPORT

Reason for qualification	Not material	Material, but pervasive	Material and pervasive
Limitation of scope The auditor is not able to carry out all the audit procedures that he believes are necessary	Do not qualify	Qualify 'except for'	Disclaimer of opinion
Disagreement The auditor disagrees with an accounting treatment or disclosure	Do not qualify	Qualify 'except for'	Adverse opinion

A pervasive qualification affects the view given by the financial statements as a whole. In a disclaimer of opinion, the auditor does not know whether the financial statements give a true and fair view. In an adverse opinion, the auditor believes that the financial statements do not give a true and fair view.

The auditor should think carefully before giving a qualified audit report, since this may have serious implications for the client. Normally the client will be willing to make the changes requested by the auditor to avoid the need for a qualification

REVIEW REPORTS

ISRE 2400 (previously called ISA 910) covers engagements to review financial statements. The review report gives negative assurance, ie the reviewer reports whether anything has come to their attention to indicate that the financial statements do not give a true and fair view.

This should provide some comfort to the user, as in most cases the reviewer can be expected to identify material anomalies/errors or highlight risks in particular areas.

INTERNAL AUDIT REPORTS AND INTERNAL REVIEW REPORTS

20

IN THIS CHAPTER

- REVISION OF INTERNAL AUDIT
- TYPES OF REPORT

REVISION OF INTERNAL AUDIT

Chapter 5 looked at the role and functions of internal audit activity. You should be familiar with the typical investigations of:

- corporate governance matters
- business risk control
- operational audits (e.g., VFM)

Internal audit is part of the overall control environment established by the directors. A properly functioning internal audit department is part of good corporate governance. Internal audit enables management to perform proper risk assessments by properly understanding the strengths and weaknesses of all parts of the control systems in the business.

While the appointment of external auditors to a large company is compulsory in most countries, internal auditors need only be appointed if management choose to do so.

TYPES OF REPORT

The wording of an external audit report is strictly governed by auditing standards and related guidance. However there is no such regulation of internal audit reports. Typical elements would be:

- **Title**, identifying the addressee (normally the audit committee)
- **Executive summary**
- **Summary of key findings** and recommendations, including agreed action (responsibilities and timescales)
- **Appendices** of additional information and analyses

EXAM FOCUS

As there are no specific regulations for you to learn in this area, it is generally common sense. Make sure that you know the principles of good report writing and how to apply them in a practical situation.

NOT-FOR-PROFIT ORGANISATIONS

21

IN THIS CHAPTER

- CHARITIES
- OTHER NOT-FOR-PROFIT ORGANISATIONS
- AUDIT APPROACH

CHARITIES

The most examinable form of not-for-profit organisation (NFP) is a charity. So far, this book has concentrated on the audit of profit-seeking companies. The main differences between the audit of an NFP and a company are as follows:

- the exemptions from audit for charities are often tighter than for companies generally
- charity accounts may have to be in a prescribed format that is different from companies
- charities tend to be tax exempt
- charities often rely heavily on cash donations and grants for their income

As with company audits, larger charities should have a strong internal control system that auditors may be able to rely on to reduce the amount of their substantive procedures required.

OTHER NOT-FOR-PROFIT ORGANISATIONS

You should be prepared to discuss the audit of an NFP other than a charity, for example:

- a sports club
- a political or religious organisation
- a pension fund
- a government-funded body (e.g., a local government body or a housing association)

You do not need to know any detail of the legal framework for such bodies. Apply your common sense to the scenario provided, and think of the income and expenses, assets and liabilities that would be encountered by the auditor.

AUDIT APPROACH

In principle, the approach to auditing an NFP should be exactly as studied so far, in accordance with auditing standards. The same ideas of audit planning, risk assessment, testing of controls, etc can be applied to auditing an NFP.

Income

Income can be a serious problem for the auditor, since it is usually accounted for on a cash basis, with little accompanying documentation. Detailed analytical procedures and written representations from managers can assist, but the auditor may struggle to gain sufficient audit evidence of the completeness of income.

Expenditure

The NFP is likely to have certain stated aims, so expenditure must be consistent with these aims.

Audit report

A limitation of scope qualification will be inevitable if the auditor cannot prove the completeness of income.

APPENDIX 1: THE STANDARD UNQUALIFIED AUDIT REPORT

THE STANDARD UNQUALIFIED AUDIT REPORT

The wording of the standard unqualified audit report for a company that complies with international accounting standards (IASs and IFRSs) is structured as follows.

Independent auditor's report to (appropriate addressee)

We have audited the accompanying financial statements of XYZ Ltd which comprise …… and other explanatory notes.

Management's responsibility for the financial statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes ……

Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require ……

An audit involves performing procedures ……

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

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of XYZ Ltd as of 31 December 20X2, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

(Auditor's signature) *(Auditor's address)*

(Date)

APPENDIX 2: ACCOUNTING STANDARDS

ACCOUNTING STANDARDS

At Paper 2.6 you are assumed to have the accounting knowledge required for Paper 2.5. For the International stream you should therefore ensure that you understand the following International standards:

IAS 1 Presentation of Financial Statements
IAS 2 Inventories
IAS 7 Cash Flow Statements
IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10 Events after the Balance Sheet Date
IAS 11 Construction Contracts
IAS 12 Income Taxes
IAS 14 Segment Reporting
IAS 16 Property, Plant and Equipment
IAS 17 Leases
IAS 18 Revenue
IAS 20 Accounting for Government Grants and Disclosure of Government Assistance
IAS 23 Borrowing Costs
IAS 24 Related Party Disclosures

IAS 27 Consolidated and Separate Financial Statements
IAS 28 Investments in Associates
IAS 31 Interests in Joint Ventures
IAS 32 Financial Instruments: Disclosure and Presentation
IAS 33 Earnings Per Share
IAS 34 Interim Financial Reporting
IAS 36 Impairment of Assets
IAS 37 Provisions, Contingent Liabilities and Contingent Assets
IAS 38 Intangible Assets
IAS 39 Financial Instruments: Recognition and Measurement
IAS 40 Investment Property

IFRS 1 First-Time Adoption of International Financial Reporting Standards
IFRS 3 Business Combinations
IFRS 5 Non-Current Assets Held for Sale and Discontinued Operations

APPENDIX 3: AUDITING STANDARDS OVERVIEW

AUDITING STANDARDS OVERVIEW

The ACCA publish a list of the examinable documents for each exam in the 'Exam Notes' section of student accountant and on the ACCA website. You should check the latest list before you sit the exam.

ISA 200 Objective and General Principles Governing an Audit of Financial Statements

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

The auditor should comply with relevant ethical pronouncements (e.g., the ACCA Rules of Professional Conduct) and should conduct the audit in accordance with ISAs (UK and Ireland).

ISA 210 Terms of Audit Engagements

The auditor and client should agree on the terms of the engagement, which should be recorded in writing. The auditor will send an engagement letter to the client, asking the client to sign and return a copy of the letter.

ISA 230 Documentation

The auditor should prepare working papers which are sufficiently complete and detailed to provide an overall understanding of the audit.

ISA 240 The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements

The primary responsibility for the prevention and detection of fraud rests with the directors and management of the company.

The responsibility of the auditor is to carry out procedures to obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud (intentional) or error (unintentional).

ISA 250A Consideration of Laws and Regulations in an Audit of Financial Statements

It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations.

The auditor must obtain a general understanding of the legal and regulatory framework applicable to the entity in order to obtain reasonable assurance that the financial statements are free from material misstatements caused by non-compliance with laws and regulations.

ISA 260 Communication of Audit Matters with Those Charged With Governance

'Governance' refers to the role of persons entrusted with the supervision, control and direction of an entity. In the UK, for example, those charged with governance include the directors and the members of the audit committee (where one exists).

The auditor should communicate (i.e. have a two-way dialogue) with those charged with governance all matters of governance interest that arise from the audit. The auditor will send a management letter to the client shortly after such matters are identified.

ISA 300 Planning an Audit of Financial Statements

The auditor should plan the audit so that it will be performed effectively. Planning involves establishing the overall audit strategy and developing the audit plan.

ISA 315 Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement

The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements. Such 'risk assessment procedures' include enquiries of management, analytical procedures, observation and inspection.

ISA 320 Audit Materiality

The auditor's opinion is on whether the financial statements give a true and fair view. Information is material if it changes the view given by financial statements, so that users may make different economic decisions. In judging whether misstatements are material, the auditor must consider both the amount (quantity) and nature (quality) of the item.

ISA 330 The Auditor's Procedures in Response to Assessed Risks

ISA 315 requires the auditor to carry out risk assessment procedures. ISA 330 provides guidance to the auditor in response to the results of the risk assessment. For example, the auditor may decide to change the nature, timing or extent of audit procedures to be carried out.

ISA 402 Audit Considerations Relating to Entities Using Service Organisations

A client may use an external organisation for activities relevant to the audit, rather than carry out the activities in-house. For example, the information processing may be sent to an external computer bureau.

The auditor must consider how an entity's use of a service organisation affects the entity's internal control so as to identify and assess the risk of material misstatement and to design and perform further audit procedures.

ISA 500 Audit Evidence

'Audit evidence' is all the information used by the auditor in arriving at his audit opinion. The auditor is required to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

The auditor must obtain audit evidence to test the management assertions embodied in the financial statements.

ISA 501 Audit Evidence - Additional Considerations for Specific Items

Attendance at physical inventory counting

When inventory is material to the financial statements, the auditor should attend the physical stock count unless impracticable.

Procedures regarding litigation and claims

The auditor should carry out audit procedures to become aware of any litigation and claims involving the entity which may result in a material misstatement of the financial statements, e.g. review correspondence with lawyers, enquire of management.

Valuation and disclosure of long-term investments

The auditor should obtain sufficient appropriate audit evidence, e.g. obtaining copies of financial statements of unquoted investments to determine whether the directors' valuation is reasonable.

Segment information

The auditor's opinion is on the financial statements as a whole, so the auditor is not required to give an opinion on the truth and fairness of any segmentation of the overall figures. However he must obtain sufficient appropriate evidence that the presentation and disclosure of segmental information is in accordance with the applicable financial reporting framework.

ISA 505 External Confirmations

External confirmation is the process of obtaining audit evidence by seeking a representation of information directly from a third party. Common examples are confirmation of bank balances from the company's bankers, accounts receivable balances from the company's debtors, and inventories held by third parties.

The auditor should determine whether the use of external confirmations is necessary, in the light of the assessed risk of material misstatement in the relevant account balance.

The auditor may use positive or negative confirmation requests, or a combination of both.

ISA 510 Initial Engagements - Opening Balances

The auditor should obtain sufficient appropriate audit evidence that the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated.

ISA 520 Analytical Procedures

Analytical procedures are evaluations of financial information made by a study of the relationships among both financial and non-financial data.

Analytical procedures can be used:

- at the planning stage of the audit, as risk assessment procedures to obtain an understanding of the entity

- at the testing stage of the audit, as substantive procedures
- at the overall review stage at the end of the audit.

ISA 530 Audit Sampling and Other Means of Testing

The choice of appropriate audit procedures to obtain audit evidence is a matter of the auditor's professional judgment in the circumstances. Often the auditor will choose to test only a sample of items from a particular population.

ISA 540 Audit of Accounting Estimates

An 'accounting estimate' is an approximation of the amount of an item in the absence of a precise means of measurement. Examples are depreciation charges or allowances for doubtful debts.

The auditor should adopt one or a combination of the following approaches:

- review and test the process used by management to develop the estimate
- use an independent estimate for comparison
- review subsequent events

ISA 560 Subsequent Events

The auditor must ensure that all events up to the date of the audit report that may require adjustment of, or disclosure in, the financial statements have been identified.

ISA 570 Going Concern

IAS 1 requires that management must assess whether there are significant doubts about an entity's ability to continue as a going concern. ISA 570 requires the auditor to consider the appropriateness of management's use of the going concern assumption.

ISA 580 Management Representations

The auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

The auditor should arrange to receive a representation letter from management at the end of the audit. This must be dated on or before the date of the audit report, since it forms part of the audit evidence from which the audit opinion was decided. See Appendix 4 for an example of a representation letter.

ISA 610 Considering the Work of Internal Audit

The external auditor should obtain a sufficient understanding of internal audit activities to identify and assess the risks of material misstatement of the financial statements and to design and perform further appropriate audit procedures.

ISA 620 Using the Work of an Expert

The auditor is knowledgeable about general business matters, but he cannot be expected to have the expertise of a different profession. The auditor may therefore consider the work of an expert in reaching his audit opinion e.g., a surveyor could value land and buildings, or a lawyer could give a legal opinion on a controversial matter.

The auditor should evaluate the competence and objectivity of the expert in his work.

ISA 700 The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements

ISA 700 covers circumstances where an unqualified opinion is given and modification of the auditor's report is not necessary. The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole. See Appendix 1 for the wording of the standard unqualified audit report.

If the auditor believes that the financial statements do give a true and fair view, but he wishes to highlight a going concern problem or other significant uncertainty, then he should issue an unqualified opinion with an emphasis of matter paragraph added (normally after the opinion paragraph).

If there is a material (but not pervasive) limitation on the scope of the auditor's work or disagreement with management, then the report should be qualified 'except for' the relevant matter.

A pervasive limitation on scope leads to a disclaimer of opinion. A pervasive disagreement leads to an adverse opinion.

ISA 701Modifications to the Independent Auditor's Report

ISA 701 explains what wording for the audit report should be used when a modified report is necessary.

ISA 710 Comparatives

The auditor should obtain sufficient appropriate audit evidence that comparative figures are free from material misstatements and are appropriately incorporated in the financial statements for the current period.

ISA 720 Other Information in Documents Containing Audited Financial Statements

The 'Annual Report' document will contain the audited financial statements, as well as a directors' report, chairman's report, and a number of other statements and reviews. The auditor must read this other information to identify any material inconsistencies with the audited financial statements.

If the auditor does identify any material inconsistencies, he should seek to resolve the problem.

APPENDIX 4: EXAMPLE LETTERS USED IN AUDITING

EXAMPLE LETTERS USED IN AUDITING

(i) Professional etiquette letter

(ii) Engagement letter

(iii) Management letter

(iv) Debtors circularisation letter

(v) Letter of representation

(i) Professional etiquette letter

- sent to the previous auditor to enquire if there are any reasons why the audit should not be accepted
- the client's permission must be obtained before sending the letter

ACCOUNTANTS AND CO
14 The Crescent, Grimsby

To: Tickers and Co
Market Place
Grimsby

31 August 20X2

Dear Sirs

Audit of Smudge Ltd

We have been invited by the directors of Smudge Ltd to become the auditors of the company in your place.

Please inform us of any circumstances that may affect our decision to be nominated as the auditors of this company.

Yours faithfully

Accountants and Co

(ii) Engagement letter

- sent to the client before audit work commences, to set out the terms of the engagement to avoid misunderstandings.

ACCOUNTANTS AND CO
14 The Crescent, Grimsby

To: The Directors
Smudge Ltd
High Street
Grimsby

20 September 20X2

Dear Sirs

Audit of Smudge Ltd

The purpose of this letter is to set out the basis on which we are to act as auditors of Smudge Ltd and the respective areas of responsibility of the directors and of ourselves.

Responsibilities of directors and auditors

XXXX

Scope of audit

XXXX

Other services

XXXX

Fees

XXXX

Applicable law

XXXX

Agreement of terms

Once it has been agreed, this letter will remain effective, from one audit appointment to another, until it is replaced. We shall be grateful if you would confirm in writing your agreement to these terms by signing and returning the enclosed copy of this letter, or let us know if they are not in accordance with your understanding of our terms of engagement.

Yours faithfully

Accountants and Co

....

We agree to the terms of this letter

....

Signed for and on behalf of Smudge Ltd

(iii) Management letter

- alternatively called the letter of weakness, internal control memorandum, constructive service letter, etc
- sent to the client setting out weaknesses in the system of internal control, soon after completion of the audit procedures that identified the problem

ACCOUNTANTS AND CO
14 The Crescent, Grimsby

Private and confidential

To: The Directors
Smudge Ltd
High Street
Grimsby

1 December 20X2

Dear Sirs

Audit of Smudge Ltd for the year ended 31Dec 20X2

In accordance with our normal practice, we are writing to you with regard to matters arising out of our audit for the year ended 31 December 20X2 which we consider should be brought to your attention.

The matters detailed in this report reflect matters coming to our attention during the course of the audit. They are not intended to be a comprehensive statement of all weaknesses that may exist or of all improvements that could be made.

Weakness

XXXX

Implication

XXXX

Recommendation

XXXX

We would be pleased to discuss these points with you at your earliest convenience.

Yours faithfully

Accountants and Co

(iv) Debtors circularisation letter

- the auditor chooses the debtors to be circularised, then arranges for the client to sign the letters on their notepaper, which the auditor then mails out. Replies are sent directly to the auditor.

SMUDGE LTD
High Street, Grimsby

10 January 20X3

To: ABC Ltd
10 High Road
Grimsby

Dear Sirs

Confirmation of indebtedness

In accordance with the request of our auditors, Accountants and Co, we shall be obliged if you will confirm directly to them your indebtedness to us at 31 December 20X2 which, according to our records, amounted to $2,500.00 as shown by the enclosed statement.

If you agree with the balance shown, please sign this letter in the space provided below and return it intact DIRECTLY TO OUR AUDITORS in the enclosed reply paid envelope.

If you disagree with the balance, please notify our auditors, giving full details of the difference.

We thank you for your co-operation in this matter.

Yours faithfully

Smudge Ltd

……………………………………………………….

Reply to: Accountants and Co
14 The Crescent
Grimsby

The balance shown above is correct/incorrect*.

Signature: ……..………
Position: ………………

Date: …………..

Details of difference: ………………………………..

*Please delete as appropriate

(v) Letter of representation

- the auditor prepares the initial draft of the letter of representation and then presents it to the directors for them to sign and return to the auditor

SMUDGE LTD

High Street, Grimsby

20 March 20X3

To: Accountants and Co

14 The Crescent

Grimsby

Dear Sirs

Audit for the year ended 31 December 20X2

We confirm to the best of our knowledge and belief, having made appropriate enquiries of other directors and officials of the company, the following representations given to you in connection with your audit of the financial statements for the year ended 31 December 20X2.

(a) We acknowledge as directors our responsibility for the financial statements. We believe that the financial statements are free from material misstatements and give a true and fair view.

(b) There have been no events since the balance sheet date which necessitate revision of the figures in the financial statements or inclusion of a note thereto.

(c), (d) …….. (as required)

As minuted by the board of directors at its meeting on ……………… (date)

………..………... (Chairman)

………..…...……(Finance Director)