

CAF - 8

AUDIT AND ASSURANCE ESSENTIALS



First edition published by
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CONCEPT AND NEED FOR AUDIT

IN THIS CHAPTER:

1. The meaning of audit
2. Statutory audit - the regulatory framework
3. International Standards on Auditing (ISAs)
4. Advantages and limitations of statutory audits
5. Chapter review

1 THE MEANING OF AUDIT

1.1 Definition and objective of audit

An **audit** is an official examination of the accounts (or accounting systems) of an entity (by an auditor).

When an auditor examines the accounts of an entity, what is he looking for?

The main objective of an audit is to enable an auditor to convey an opinion as to whether or not the **financial statements** of an entity are prepared according to an **applicable financial reporting framework**.

Financial statements – A structured representation of historical financial information, including disclosures, intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with a financial reporting framework. Financial statements have the following components (as per IAS-1):

- Statement of Financial Position (Balance Sheet)
- Statement of Profit or Loss and other comprehensive income
- Statement of Changes in Equity
- Cash Flow Statement
- Notes to the Financial Statements
- Comparative information prescribed by the standard

Applicable financial reporting framework – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

The applicable financial reporting framework is decided by:

- legislative or regulatory environment within each individual country, and
- accounting standards (for example, International Accounting Standards / International Financial Reporting Standards).

The auditor seeks to express an opinion as the result of the audit work that he does. The type of work carried out by an auditor in order to reach his opinion is described in later chapters.

1.2 Concepts of accountability, stewardship and agency

An audit of a company's accounts is needed because in companies, the owners of the business are often not the same persons as the individuals who manage and control that business.

- The shareholders own the company.
- The company is managed and controlled by its directors.

The directors have a **stewardship** role. They look after the assets of the company and manage them on behalf of the shareholders. In small companies the shareholders may be the same people as the directors. However, in most large companies, the two groups are different.

The relationship between the shareholders of a company and the board of directors is also an application of the general legal principle of **agency**. The concept of agency applies whenever one person or group of individuals acts as an agent on behalf of someone else (the **principal**). The agent has a legal duty to act in the best interests of the principal, and should be accountable to the principal for everything that he does as agent.

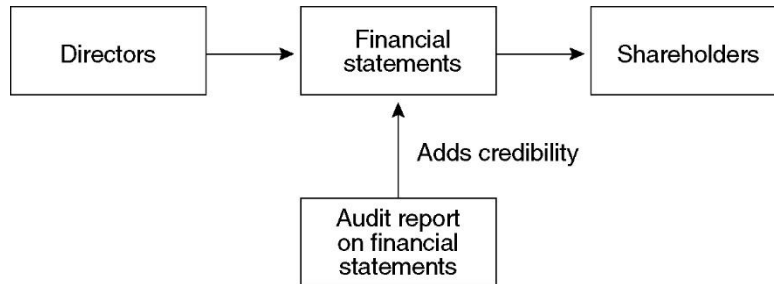
As agents for the shareholders, the board of directors should be accountable to the shareholders. In order for the directors to show their **accountability** to the shareholders, it is a general principle of company law that the directors are required to prepare annual **financial statements**, which are presented to the shareholders for their approval.

1.3 The audit report: independence, materiality and true and fair

Audit has a very long history. The concept of an audit goes back to the times of the Egyptian and Roman empires. In medieval times, independent auditors were employed by the feudal barons to ensure that the returns from their stewards and their tenants were accurate.

Over time, the annual audit was developed as a way of adding **credibility** to the financial statements produced by management. The **statutory audit** is now a key feature of company law throughout the world.

An auditor reports **to the shareholders** on the financial statements produced by a company's management.



The key features of the audit report are as follows:

- The auditors producing the report are **independent** from the directors producing the financial statements.
- The report gives an opinion on whether the financial statements “**give a true and fair view**”, or “**present fairly**” the position and results of the entity.
- The report considers whether the financial statements give a true and fair view **in all material respects**. The concept of materiality is applied in reaching an audit opinion.

Independence of the auditor

The external auditor must be **independent** from the directors; otherwise his report will have little value. If he is not independent, his opinion is likely to be influenced by the directors.

In contrast to external auditors, internal auditors may not be fully independent from the directors, although they may be able to achieve a sufficient degree of independence.

The concept of ‘internal auditors’ shall be described in details in a later chapter.

True and fair view (fair presentation)

The auditor reports on whether (or not) the financial statements **give a true and fair view**, or **present fairly**, the position of the entity as at the end of the financial period and the performance of the entity during the period. **The auditor does not certify or guarantee that the financial statements are correct.**

In preparing the financial statements, a large amount of judgement is exercised by the directors. Similarly, judgement is exercised by the auditor in reaching his opinion. The phrases ‘true and fair view’ and ‘present fairly’ indicate that a judgement is being given that the financial statements can be relied upon and have been properly prepared in accordance with an appropriate financial reporting framework.

Materiality concept

The auditor reports in accordance with the concept of **materiality**. He gives an opinion on whether the financial statements present fairly **in all material respects** the financial position and performance of the entity.

Information is material if, on the basis of the financial statements, it could influence the economic decisions of users should it be omitted or misstated.

For example, the shareholders of a company with assets of Rs.1 million will not be interested if petty cash was miscounted with the result that the amount of petty cash is overstated by Rs.100. This is immaterial. However, they will be interested if there are receivables in the statement of financial position of Rs. 200,000 which are not in fact recoverable and which should therefore have been written off as a bad debt.

Applying the concept of materiality means that the auditor will not aim to examine every number in the financial statements. He will concentrate his efforts on the more significant items in the financial statements, either:

- because of their (high) value, or
- because there is a greater risk that they could be stated incorrectly.

1.4 The statutory requirement for audit

Most countries impose a statutory requirement for an annual (external) audit to be carried out on the financial statements of most companies.

However, in many countries, smaller companies are exempt from this requirement for an audit. Other entities, such as sole traders, partnerships, clubs and societies are usually not subject to a statutory audit requirement. Small companies and these other entities may decide to have a voluntary audit, even though this is not required by law. (e.g. In Pakistan, Companies Act 2017 exempts a private company having paid up share capital not exceeding Rs. 1 million or such higher amount as may be notified by the Commission (SECP) from the legal requirements of carrying out a statutory Audit)

► Practice Question 01:

Discuss the concepts of stewardship and accountability in the context of a limited company and fair presentation (true and fair view) in relation to the financial statements.

Tutorial Notes:

When explaining stewardship, accountability, and fair presentation, keep your explanations succinct and directly address each concept. Do not drift onto unrelated topics.

Emphasize that:

- Stewardship: Directors manage resources on shareholders' behalf.
- Accountability: Directors are accountable through annual financial statements.
- Fair presentation ("true and fair view"): The financial statements should be free from material error/bias

► Solution 01:

Stewardship:

The directors have a stewardship role. They look after the assets of the company and manage them on behalf of the shareholders.

Accountability:

As agent of the shareholders, the board of directors is accountable to the shareholders. The directors show their accountability to the shareholders by preparing annual financial statements and presenting them to the shareholders for discussion and approval.

Fair presentation (True and fair view):

Although the phrase 'true and fair view' has no legal definition, the term 'true' implies free from error, and 'fair' implies that there is no undue bias in the financial statements or the way in which they have been presented. In preparing the financial statements, a large amount of judgement is exercised by the directors. Similarly, judgement is exercised by the auditor in reaching his opinion. The phrases 'true and fair view' and 'present fairly' indicate that a judgement is being given that the financial statements can be relied upon and have been properly prepared in accordance with an appropriate financial reporting framework.

2 STATUTORY AUDIT - THE REGULATORY FRAMEWORK

2.1 Appointment, removal and remuneration of auditors (section 246 CA17)

First auditor

The first auditor or auditors of a company shall be appointed by the board within ninety days of the date of incorporation of the company; and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting.

Subsequent auditors

Every company shall at each annual general meeting appoint an auditor or auditors on the recommendation of the board after obtaining consent of the auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

The Commission may appoint a person to fill the vacancy in the cases if the company fails to appoint:

- the first auditors within a period of 90 days of the date of incorporation of the company; or
- the auditors at an annual general meeting; or
- an auditor in the office to fill up a casual vacancy within thirty days after the occurrence of the vacancy; and
- appointed auditors are unwilling to act as auditors of the company.

Casual vacancy

The board will fill any casual vacancy in the office of an auditor within thirty days but, while any such vacancy continues, the surviving or continuing auditor or auditors, if any, may act.

Moreover, any auditor appointed to fill in any casual vacancy shall hold office until the conclusion of the next annual general meeting.

However, where the auditors are removed during their tenure, the board shall appoint the auditors with prior approval of the Commission.

Remuneration of the auditors

The remuneration of the auditors of a company shall be fixed:

- by the company in the general meeting
- in the case of an auditor appointed by the board or by the Commission, by the board or by the Commission, as the case may be.

2.2 Resolutions relating to the appointment or removal of auditors – s246 CA17

Whilst the Companies Act does not give specific guidance as to the resignation of auditors it does address the mechanics of resolutions relating to the appointment and removal of auditors.

The Act states:

- A notice shall be required for a resolution at a company's annual general meeting appointing as auditor a person other than a retiring auditor.
- A member or members having not less than 10% shareholding of the company will be entitled to propose any auditor for appointment whose consent has been obtained by him. A notice in this regard will be given to the company not less than seven days before the date of the annual general meeting. The company shall forthwith send a copy of such notice to the retiring auditor and will also post it on its website.
- Where an auditor, other than the retiring auditor is proposed to be appointed, the retiring auditor will have a right to make a representation in writing to the company at least two days before the date of general meeting. Such representation will be read out at the meeting before taking up the agenda for appointment of the auditor:

However, where such representation is made, it will be mandatory for the auditor or a person authorized by him in writing to attend the general meeting in person.

- Every company shall, within fourteen days from the date of any appointment of an auditor, send to the registrar intimation thereof, together with the consent in writing of the auditor concerned.

2.3 Removal of auditors

The auditor or auditors appointed by the board or the members in an annual general meeting may be removed through a special resolution.

2.4 Qualification and disqualification of auditors (Section 247 CA17)

A person shall not be qualified for appointment as an auditor—

- a) in the case of a public company or a private company which is subsidiary of a public company or a private company having paid up capital of three million rupees or more unless such person is a chartered accountant having valid certificate of practice from the Institute of Chartered Accountants of Pakistan or a firm of chartered accountants; and
- b) in the case of a company other than that specified above, unless such person, is a chartered accountant or cost and management accountant having valid certificate of practice from the respective institute or a firm of chartered accountants or cost and management accountants, having such criteria as may be specified:

It should be noted that for the purposes of (a) and (b) above, a firm where majority of practicing partners are qualified for appointment shall be appointed by its firm name to be auditors of the company.

Where a partnership firm is appointed as auditor of a company, only the partners who meet the qualification requirements as given above will be authorized to act and sign on behalf of the firm.

None of the following persons will be appointed as auditor of a company:

- a) *a person who is, or at any time during the preceding three years was, a director, other officer or employee of the company;
- b) *a person who is a partner of, or in the employment of, a director, officer or employee of the company;
- c) the spouse of a director of the company;
- d) a person who is indebted to the company other than in the ordinary course of business of such entities. The following persons will not be deemed to be indebted to the company:
 - a person who owes a sum of money not exceeding one million rupees to a credit card issuer; or
 - a person who owes a sum to a utility company in the form of unpaid dues for a period not exceeding ninety days shall not be deemed to be indebted to the company.
- e) a person who has given a guarantee or provided any security in connection with the indebtedness of any third person to the company other than in the ordinary course of business of such entities;
- f) a person or a firm who, whether directly or indirectly, has business relationship with the company other than in the ordinary course of business of such entities;
- g) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;
- h) a body corporate;
- i) a person who is not eligible to act as auditor under the code of ethics as adopted by the Institute of Chartered Accountants of Pakistan and the Institute of Cost and Management Accountants of Pakistan; and
- j) a person or his spouse or minor children, or in case of a firm, all partners of such firm who hold any shares of an audit client or any of its associated companies;

Provided that if such a person holds shares prior to his appointment as auditor, whether as an individual or a partner in a firm, the fact shall be disclosed on his appointment as auditor and such person shall disinvest such shares within ninety days of such appointment.

A person will not be qualified for appointment as auditor of a company if he is due to the above mentioned disqualifications is disqualified for appointment as auditor of any other company which is that company's subsidiary or holding company or a subsidiary of that holding company.

If, after his appointment, an auditor becomes subject to any of the disqualifications due to any reason mentioned above, he will be deemed to have vacated his office as auditor with effect from the date of disqualification.

A person who is not qualified to be an auditor of a company, acts as auditor of a company shall be liable to a penalty of level 2 on the standard scale.

The appointment as auditor of a company of an unqualified person, or of a person who is subject to any disqualifications to act as such, shall be void, and, where such an appointment is made by a company, the Commission may appoint a qualified person in place of the auditor appointed by the company.

* A reference to officer or employee will not be interpreted as reference to auditor.

2.5 Rights and duties of auditors (Section 248 & 249 of CA17)

An auditor of a company has a right:

- of access at all times to the company's books, accounts and vouchers (in whatever form they are held); and
- of access to such copies of, an extracts from, the books and accounts of the branch as have been transmitted to the principal office of the company;
- to require any of the following persons to provide him with such information or explanations as he thinks necessary for the performance of his duties as auditor:
 - i. any director, officer or employee of the company;
 - ii. any person holding or accountable for any of the company's books, accounts or vouchers;
 - iii. any subsidiary undertaking of the company; and
 - iv. any officer, employee or auditor of any such subsidiary undertaking of the company or any person holding or accountable for any books, accounts or vouchers of any such subsidiary undertaking of the company.

If any officer of a company refuses or fails, without lawful justification, the onus whereof will lie on him, to allow any auditor access to any books and papers in his custody or power, or to give any such information possessed by him as and when required, or otherwise hinders, obstructs or delays an auditor in the performance of his duties or the exercise of his powers or fails to give notice of any general meeting to the auditor or provides false or incorrect information, he shall be liable to penalty of level 3 on the standard scale.

Duties of auditor

A company's auditor will conduct the audit and prepare his report in compliance with the requirements of International Standards on Auditing as adopted by the Institute of Chartered Accountants of Pakistan.

A company's auditor must carry out such examination to enable him to form an opinion as to:

- a) whether adequate accounting records have been kept by the company and returns adequate for their audit have been received from branches not visited by him; and
- b) whether the company's financial statements are in agreement with the accounting records and returns.

The auditor will make out a report to the members of the company on the accounts and books of accounts of the company and on every financial statements and on every other document forming part of such statements including notes, statements or schedules appended thereto, which are to be laid before the company in general meeting and the report will state:

- a) whether or not they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of the audit and if not, the details thereof and the effect of such information on the financial statements;
- b) whether or not in their opinion proper books of accounts as required by this Act have been kept by the company;
- c) whether or not in their opinion the statement of financial position and profit and loss account and other comprehensive income or the income and expenditure account and the cash flows have been drawn up in conformity with the requirements of accounting and reporting standards as notified under this Act and are in agreement with the books of accounts and returns;
- d) whether or not in their opinion and to the best of their information and according to the explanations given to them, the said accounts give the information required by this Act in the manner so required and give a true and fair view:
 - i. in the case of the statement of financial position, of the state of affairs of the company as at the end of the financial year;
 - ii. in the case of the profit and loss account and other comprehensive income or the income and expenditure account, of the profit or loss and other comprehensive income or surplus or deficit, as the case may be, for its financial year; and
 - iii. in the case of statement of cash flows, of the generation and utilisation of the cash and cash equivalents of the company for its financial year;
- e) whether or not in their opinion:
 - i. investments made, expenditure incurred and guarantees extended, during the year, were for the purpose of company's business; and
 - ii. zakat deductible at source under the Zakat and Usher Ordinance, 1980 (XVIII of 1980), was deducted by the company and deposited in the Central Zakat Fund established under section 7 of that Act.

Explanation. —Where the auditor's report contains a reference to any other report, statement or remarks which they have made on the financial statements examined by them, such statement or remarks will be annexed to the auditor's report and will be deemed to be a part of the auditor's report.

Where any of the matters referred above is answered in the negative or with a qualification, the report will state the reason for such answer along with the factual position to the best of the auditor's information.

The Commission may, by general or special order, direct that, in the case of all companies generally or such class or description of companies as may be specified in the order, the auditor's report will also include a statement of such additional matters as may be so specified.

The auditor will express unmodified or modified opinion in his report in compliance with the requirements of International Standards on Auditing as adopted by the Institute of Chartered Accountants of Pakistan.

The Commission may by general or special order, direct, that the statement of compliance as contained in the Act is reviewed by the auditor who will issue a review report to the members on the format specified by the Commission.

The auditor of a company will be entitled to attend any general meeting of the company, and to receive all notices of, and any communications relating to, any general meeting which any member of the company is entitled to receive, and to be heard at any general meeting which he attends on any part of the business which concerns him as auditor:

Provided that, in the case of a listed company, the auditor or a person authorised by him in writing will be present in the general meeting in which the financial statements and the auditor's report are to be considered.

2.6 Audit report signature (s251 CA17)

The auditor's report must state the name of the auditor, engagement partner, be signed, dated and indicate the place at which it is signed.

Where the auditor is an individual, the report must be signed by him.

Where the auditor is a firm, the report must be signed by the partnership firm with the name of the engagement partner.

2.7 Audit of cost accounts (s250 CA17)

Where any company or class of companies is required under the Act to include in its books of account the particulars referred to therein, the Commission may direct that an audit of cost accounts of the company should be conducted as may be specified in the order by an auditor who is a chartered accountant within the meaning of the Chartered Accountants Ordinance, 1961 (X of 1961), or a cost and management accountant within the meaning of the Cost and Management Accountants Act, 1966 (XIV of 1966); and such auditor will have the same powers, duties and liabilities as an auditor of a company and such other powers, duties and liabilities as may be specified.

The audit of cost accounts of the company under the circumstances mentioned above will be directed by the Commission subject to the recommendation of the regulatory authority supervising the business of relevant sector or any entity of the sector

2.8 Penalty for non-compliance with the Companies Act, 2017

Company default (s252 CA17)

If a company defaults on complying with the requirements of sections 246, 247, 248 and 250, it shall be liable to a penalty of offense of level 3 on the standard scale, i.e., up to Rs. 100 million and up to Rs. 500,000 per day if the default continues.

Auditor default (s253 CA17)

If any auditor's report or review report is made, or any document of the company is signed or authenticated otherwise than in conformity with the requirements of (sections 131, 249 and 251 of the Act), or is otherwise untrue or fails to bring out material facts about the affairs of the company or matters to which it purports to relate, the auditor concerned and the person, if any, other than the auditor who signs the report or signs or authenticates the document, and in the case of a firm all partners of the firm, shall be punishable to a penalty of level 2 on the standard scale i.e., up to Rs. 500,000 and up to Rs. 1,000 per day if the default continues.

If the auditor's report is made with the intent to profit the auditor or any other person or to put another person to a disadvantage or loss or for a material consideration, the auditor shall, in addition to the penalty provided above, be punishable with **imprisonment** for a term which may extend **two years** and with a penalty which may extend to **one million rupees**.

► Practice Question 02:

Your firm is the auditor of ABD Limited (ABDL). After the acquisition of majority shareholding in HG Motors (Private) Limited (HGM), ABDL has decided to replace the existing auditors of HGM in the next annual general meeting and has approached you for appointment as HGM's auditors for the next year.

Required:

In the light of the Companies Act, 2017 explain the procedures to be followed and formalities to be complied with for appointment of your firm as the auditor of HGM. Also explain the rights of the existing auditors in this situation.

Tutorial Notes:

Carefully check which formalities are mandated in the Act (e.g., notice to registrar within 14 days).

Avoid mixing the regulatory role of the Commission with the professional institute's role.

Always confirm who must be notified and within what deadline.

► *Solution 02:***Retirement of existing and Appointment of new auditor in an AGM**

- Member(s) having at least 10% shareholding shall also be entitled to propose any auditor whose consent has been obtained.
- A notice shall be given to company at least 7 days before the date of the AGM.
- On receipt of such notice, company shall:
 - Sent a copy of notice to the retiring auditor, forthwith.
 - Post it on its website.
- Retiring auditor can make representation to company at least 2 days before AGM. It shall be read in AGM and it shall be mandatory for auditor/representative to attend the meeting.
- Company shall intimate the registrar within 14 days of appointment / removal / casual vacancy together with the consent of appointed auditor.

► *Practice Question 03:*

The external auditors are normally appointed by the shareholders at the annual general meeting (AGM) of the company. State the exceptions to this rule.

Tutorial Notes:

Keep in mind the exceptions for appointing auditors (first auditors, filling casual vacancy, Commission's intervention).

Summarize them clearly in one place.

► *Solution 03:***Exceptions:**

The Directors are allowed to:

- appoint the first auditors of a newly formed company within 90 days of incorporation.
- fill a casual vacancy; for example where the current auditors is no longer able to act.

The Commission may appoint a person as an auditor to fill the casual vacancy, if neither the shareholders nor the directors have appointed the auditors.

► *Practice Question 04:*

Comment on each of the following situations with reference to the appointment of external auditors in accordance with the requirements of the Companies Act, 2017.

- a) ABC Limited and DEF Limited are associated companies on account of common directorship. Salman and Company, Chartered Accountants (SCC) have received an offer for appointment as the auditor in ABC. Salman, a partner in SCC is the spouse of Naveen, who is an employee in DEF.
- b) All the partners of Kashif Associates are Cost and Management Accountants. The firm has received an offer for appointment as the auditor of Nihal (Private) Limited (NPL). NPL has a paid-up capital of Rs. 500,000 and 30% of its shares are held by Siyal Limited which is a public company.

Tutorial Notes:

When a question refers to appointment of auditors under the Act, precisely identify the key disqualification or qualification conditions.

Do not drift into unrelated sections on directorship or spouse shareholding if they're not relevant.

► *Solution 04:*

- (a) Salman and Company is eligible to be appointed as the auditor of ABC Limited because, Naveen is in the employment of DEF which is an associated company and such employment has not relevance in the context of appointment of an auditor.
- (b) Kashif Associates can be appointed as the auditor of NPL as qualification criteria mentioned for private companies having paid up capital of less than Rs. 3 million under Companies Act 2017 is either a CA or CMA having certificate of practice from respective institute or Firm of CAs/CMAs having such criteria as may be prescribed.

Holding of 30% shares of NPL by a public company is of no relevance.

► *Practice Question 05:*

Justify giving reasons whether the appointment of auditors in the following cases is in compliance with the requirements of Companies Act, 2017.

- a) Kashif and Company, Chartered Accountants (KC) has received an offer for appointment as the auditor of National Electricity Limited (NEL). On the request of one of the partners of KC, NEL has allowed him to pay his last month's electricity bill amounting to Rs. 150,000 in monthly instalments of Rs. 15,000 each.
- b) Zubair and Company, Chartered Accountants (ZC) has received an offer for appointment as auditor of Haroon Limited (HL). Saima, who is the wife of a partner of ZC, is the chief executive of Jameel Limited (JL). JL is an associated company of HL. Saima also holds 100,000 shares in JL.

Tutorial Notes:

For indebtedness disqualification, watch the time limit carefully. If the sum is settled within the statutory period, the appointment may be valid.

Clearly distinguish direct vs. spouse relationships, and whether any shareholding is in the client or a subsidiary/associate.

► *Solution 05:*

- a) The appointment of KCC is valid, as 90 days have not lapsed in case of outstanding bill. However, the concerned partner should be requested to settle the amount of bill before the expiry of 90 days as it will result in disqualification of KCC as auditors of NEL.
- b)
 - Appointment of Zubair and Company is valid.
 - Under the Companies Act, 2017, there is no restriction on the appointment of spouse of chief executive of an associated company as the auditor.
 - The holding of 100,000 shares by Saima is required to be disclosed at the time of appointment. Further, these shares should be disposed off within 90 days of the appointment.

► *Practice Question 06:*

Daud and Company, Chartered Accountants (DC), has received an offer for appointment as auditor of Jamal Limited (JL). Wife of Daud is a Shareholder and Director in Royal Limited (RL).

Required: In accordance with the requirements of the Companies Act, 2017, state whether and under what circumstances DC could accept the audit, under each of the following situations:

- a) JL holds 51% shareholding in RL.
- b) JL is an associated company of RL.
- c) One of the directors in JL also holds 10% shareholding in RL.

Tutorial Notes:

It's a very good question, helping you to understand the qualification or disqualification conditions for auditors in case of:

- Holding/subsidiary relationships;
- Associated company relationships;
- Spousal directorship vs. spousal shareholding.

They each have slightly different rules.

► **Solution 06:****a) JL holds 51% shareholding in RL:**

As Daud & Co. (DC) is not qualified for appointment as the auditor of RL due to directorship and shareholding of partner's wife in RL, DC cannot be appointed as the auditor of any of its holding company i.e. JL.

b) JL is an associated company of RL:

DL is ineligible to act as the auditor of JL, as the spouse of the partner holds shares in the associated company. However, since Daud's wife holds shares prior to the appointment,

DC can be appointed as auditor of JL subject to comply with the following requirements:

- Disclose this fact to JL at the time of appointment as auditor.
- Divest her investment in RL within 90 days of appointment.

The directorship of Daud's wife in RL is not relevant for the appointment of DC as the auditor of JL.

c) One of the directors in JL also holds 10% shareholding in RL:

Daud and Company can be appointed as the auditor of JL as there is no disqualification with respect to common shareholding in another company, which is neither a subsidiary nor an associated company of the prospective audit client.

► **Practice Question 07:**

Comment on each of the following situations with reference to the appointment of external auditors in accordance with the requirement of the Companies Act, 2017.

- Bilal and Company, Chartered Accountants has received an offer for appointment as auditor of Dawood Limited (DL). Ghalib, a partner in Bilal and Company holds 100,000 Term Finance Certificates of DL.
- Zain and Company, a firm of Chartered Accountants, has received an offer for appointment as auditor of Haris Limited (HL). Imran, a partner in Zain and Company is also a partner in Pure Investment Associates, a partnership firm, which owns 100,000 shares in HL.

Tutorial Notes:

Always confirm if the financial instrument in question is share capital (which triggers disqualification if held by the auditor) or something else (like TFCs).

If it's not shares, it might be permissible.

► **Solution 07:**

- According to Companies Act 2017, there is no bar on Bilal and Company to be appointed as the auditor of DL as holding of TFC's in the audit client is not prohibited under the provisions of the Companies Act, 2017.
- Zain and Company is ineligible for appointment as the auditor of HL as Imran is a partner in Pure Investment Associates, which holds share in HL which is prohibited under the Companies Act, 2017. In order to be eligible for appointment, the fact of holding of shares is required to be disclosed at the time of appointment. Further, the shares are to be disposed-off within 90 days of such appointment.

► **Practice Question 08:**

On 5 March 2018, HSB & Company, Chartered Accountants (HSB) has been offered appointment as external auditor of Tahir Limited (TL) for the year ending 31 December 2018. TL is the subsidiary of Crypto Bank Limited (CBL), which is audited by another firm of chartered accountants.

Hatim, a partner of HSB is using credit card of CBL and the balance outstanding against it on 28 February 2018 was Rs. 1.1 million. Hatim plans to clear the dues by 30 July 2018, which is well before the commencement of audit. It is expected that the audit planning activities will commence from 1 November 2018.

Required:

Comment on the above situation in the light of Companies Act, 2017.

Tutorial Notes:

Distinguish appointment date from audit commencement. The Act typically references the situation “at appointment.” Specifically check if the debt must be under a certain threshold at appointment time.

► **Solution 08:**

A person shall not be qualified for appointment as auditor if he/she is indebted to the company or any of its holding or subsidiary company other than in the ordinary course of business of such entities. Further, a person who owes a sum of money not exceeding one million rupees to a credit card issuer shall not be deemed to be indebted to the company.

Hatim’s plan that he would pay off all his dues before the commencement of audit is not valid, as the auditor appointed in the general meeting holds the office from the conclusion of that meeting until the conclusion of the next annual general meeting. If the firm intends to be appointed as the auditor of TL, Hatim would have to reduce the amount due on his credit card to less than Rs. 1 million prior to the firm’s appointment as the auditor of TL.

► **Practice Question 09:**

Under the Companies Act, 2017 identify the situations in which the Commission may appoint a person to fill the vacancy of an auditor.

Tutorial Notes:

Basic statutory knowledge about Commission’s power to fill an audit vacancy is straightforward—just be sure to memorize the triggers (first auditor, failure to appoint, casual vacancy, auditor unwilling).

► **Solution 09:**

The Commission may appoint a person to fill the vacancy in the cases if:

- The company fails to appoint the first auditors within a period of 90 days of the date of incorporation of the company;
- The company fails to appoint the auditors at an annual general meeting;
- The company fails to appoint an auditor to fill up a casual vacancy within thirty days after the occurrence of the vacancy;
- The appointed auditors are unwilling to act as auditors of the company.

► **Practice Question 10:**

- a) Under the Companies Act, 2017, state the procedure to be followed if the board of directors decides to recommend the reappointment of existing auditor for the next year.
- b) The board of directors of Alpha Limited intends to re-appoint the existing auditor for the next year. However, Javed, a shareholder of the company, wants to appoint a different auditor.

Required:

Briefly explain the procedure that Javed should follow. Also state the responsibilities of the board in this regard.

Tutorial Notes:

a) For reappointment or new appointment steps, remember:

- Consent of the proposed auditor;
- Notice to members;
- Retiring auditor's right to make representation.
- Reading out representation at the meeting.

► **Solution 10:**

a) Following procedures shall be followed for appointment of the existing auditor for the next year:

- The board shall first obtain the consent of the proposed auditor.
- A notice shall be given to the members with the notice of general meeting.
- On the appointment of the auditor the board shall ensure that, within fourteen days from the date of appointment of the auditor, an intimation is sent to the registrar thereof, together with the consent in writing of the appointed auditor

b) Procedure for shareholder(s):

Javed should follow the following process if he alone or together with other willing shareholders, holds 10% shareholdings in Alpha Limited:

- The shareholder(s) should first obtain the consent of the proposed auditor.
- A notice should be given to the company in this regard, not less than seven days before the date of the annual general meeting.

Responsibilities of the board:

The company shall forthwith send a copy of notice received from Javed to the retiring auditor and shall also post it on the company's website.

Since an auditor, other than the retiring auditor is proposed to be appointed, the board shall ensure that:

- The retiring auditor is given an opportunity to make a representation in writing to the company at least two days before the date of general meeting.
- Representation received from the retiring auditor is read out at the meeting before taking up the agenda for appointment of the auditor.

► **Practice Question 11:**

Wealthy Bank Limited (WBL) is considering to appoint external auditor for the year ending June 2020. WBL has shortlisted the following three audit firms for appointment as external auditor and has presented certain matters relating to each of them for your consideration:

Rao Arif & Company, Chartered Accountants

The firm has recently admitted a new partner who worked as CFO till June 2017, of Noor Engineering Limited, a subsidiary of WBL.

Hatim Tughlaq & Company, Chartered Accountants

One of the partners in the firm has obtained a loan from WBL of Rs. 5 million. The firm has informed that the partner would not be able to repay the loan till 2021.

Rashid Kareem & Company, Chartered Accountants

Rashid, one of the partners in the firm, has several commercial properties in Lahore. He has rented out five properties to WBL for its branch operations.

Required:

In the light of the Companies Act, 2017 discuss whether any of the above firms can be appointed as external auditor of WBL.

Tutorial Notes:

Always note cooling-off periods (I.e. 3 years) for ex-employees/officers.

For a bank client, a normal commercial loan may be within the “ordinary course of business,” thus not automatically disqualifying the auditor.

► *Solution 11:***Rao Arif & Co.**

Under the provision of Companies Act, 2017, a person who is, or at any time during the preceding three years was a director, other officer or employee of the company is not eligible for appointment as auditor. Furthermore, a person will not be qualified for appointment as auditor of a company if he is disqualified for appointment as auditor of any other company which is that company's subsidiary or holding company. Therefore, being the former CFO of WBL's subsidiary will make Rao Arif & Co. ineligible for appointment as external auditor.

Hatim Tughlaq & Co.

Under the provision of Companies Act, 2017, a person who is indebted to the company other than in the ordinary course of business of such entities cannot be appointed as the auditor. Since it is in the ordinary course of WBL to grant loan therefore Hatim Tughlaq & Co. can be appointed as external auditor WBL.

Rashid Kareem & Co.

A person or a firm who, whether directly or indirectly, cannot be appointed as auditor if it has business relationship with the company other than in the ordinary course of business of such entities. If properties are rented out in the ordinary course of business than Rashid Kareem & Co. can be appointed as the external auditor of WBL.

► *Practice Question 12:*

In the light of Companies Act 2017, describe the requirements for cost audit and person authorized to conduct it.

Tutorial Notes:

Clarify whether you are discussing cost audit vs. statutory audit. Each has distinct triggers and requirements.

► *Solution 12:*

- Where any company is required under the Act to include in its books of accounts the particulars of cost accounts.
- The Commission may direct that an audit of cost accounts of the company should be conducted in the order subject to recommendation of the regulatory authority supervising the business of relevant sector.
- The audit of cost accounts will be conducted by Chartered Accountant or Cost and Management Accountant and will have same powers, duties and liabilities as an auditor of the company.

► *Practice Question 13:*

Salman is the shareholder of Polkadot Limited (PL) and wants to appoint auditor other than the existing auditor as proposed by the board.

Required:

In the light of the Companies Act, 2017 briefly explain the process that Salman should follow in the above situation. Also discuss the requirements that PL should follow.

Tutorial Notes:

Keep reappointment vs. new appointment procedures straight: the big points are 10% shareholding to propose a new auditor, notice timelines, and the retiring auditor's right of representation.

► *Solution 13:*

Salman should follow the following process if he alone or together with other willing shareholders, holds 10% shareholdings in PL:

- The shareholder(s) should first obtain the consent of the proposed auditor.
- A notice should be given to PL in this regard not less than seven days before the date of the annual general meeting.

PL shall forthwith send a copy of notice received from shareholder(s) to the retiring auditor and shall also post it on its website.

Since an auditor, other than the retiring auditor is proposed to be appointed, PL shall ensure that:

- the retiring auditor is given an opportunity to make a representation in writing to PL at least two days before the date of general meeting.
- representation received from the retiring auditor is read out at the meeting before taking up the agenda for appointment of the auditor.

► *Practice Question 14:*

Haris & Company, Chartered Accountants was appointed as the auditor of Cactus (Private) Limited (CPL) for the year ending 31 December 2021. Haris, the only audit partner of Haris & Company, passed away on 5 September 2021. No other auditor has yet been appointed by CPL.

Required:

State the requirements of the Companies Act, 2017 for the appointment of auditor in the above situation.

► *Solution 14:*

Death of Mr. Haris has caused casual vacancy in the office of auditor. The board shall fill this vacancy in the office of auditor within 30 days. If the board fails to fill up the casual vacancy within 30 days, the commission may of its own motion or on an application made to it by the company or any of its member direct to make good the default within the specified time. In case company fails to report compliance within the specified period the commission shall appoint auditors. Any auditor appointed to fill the vacancy shall hold the office until the conclusion of the next annual general meeting.

► *Practice Question 15:*

The board of directors of Green Limited (GL) intends to re-appoint the existing auditor for the next year. However, Haider, a shareholder of the company, wants to appoint a different auditor.

Required:

Briefly explain the procedure that Haider should follow. Also state the responsibilities of GL in this regard.

Tutorial Notes:

Keep up clarity on the steps: 10% shareholding, notice, representation, board's duty to read it out, etc.

► *Solution 15:*

Haider should follow the following process if he alone or together with other willing shareholders, holds 10% shareholding in Green Limited.

- The shareholder(s) should first obtain the consent of the proposed auditor.
- A notice should be given to the company in this regard not less than seven days before the date of the annual general meeting.

Responsibilities of GL:

- GL shall forthwith send a copy of notice received from Haider to the retiring auditor and shall also post it on the company's website.

- Since an auditor, other than the retiring auditor is proposed to be appointed, GL's board shall ensure that:
 - the retiring auditor is given an opportunity to make a representation in writing to the company at least two days before the date of general meeting.
 - representation received from the retiring auditor is read out at the meeting before taking up the agenda for the appointment of the auditor.
 - within fourteen days from the date of any appointment of an auditor, an intimation is sent to the registrar thereof, together with the consent in writing of the auditor concerned.

► *Practice Question 16:*

Under the provisions of the Companies Act, 2017, list the persons from whom the auditor has a right to require such information or explanations as he thinks necessary for the performance of his duties as an auditor.

Tutorial Notes:

Remember the scope of who must provide info on request: includes subsidiary undertakings, their officers, employees, and auditors, not just the immediate company.

► *Solution 16:*

The auditor may require any of the following persons to provide him the information for the purpose of audit:

- Any director, officer or employee of the company;
- Any person holding or accountable for any of the company's books, accounts or vouchers;
- Any subsidiary undertaking of the company; and
- Any officer, employee or auditor of any such subsidiary undertaking of the company or any person holding or accountable for any books, accounts or vouchers of any such subsidiary undertaking of the company.

► *Practice Question 17:*

Aslam and Company Chartered Accountants were reappointed as the auditors of Tasty Foods Limited (TFL) for the year ending 31 December 2024. However, following the directors' election on 1 March 2024, the newly elected board decided to replace the auditors. They reasoned that Aslam and Company had served as auditors for the past decade. Consequently, the board passed a resolution to remove the auditors and tasked the Company Secretary to inform them.

Required:

As TFL's Company Secretary, how would you respond to the board of directors regarding their decision in the light of Companies Act 2017?

Tutorial Notes:

Emphasize that removing an auditor mid-term generally requires shareholder approval via special resolution, plus certain regulatory consents if mid-year removal is sought.

► *Solution 17:*

The approach taken by the board to remove the auditors is not in accordance with the correct procedure, as the current auditors cannot be simply removed through a board resolution during their tenure. Companies Act 2017 outlines the removal process of auditors, granting the ultimate power to remove an auditor to the shareholders.

Consequently, TFL is required to convene a general meeting to pass a special resolution for the appointment of a different auditor. Accordingly, a notice must be issued for a resolution at the company's general meeting to appoint someone other than the retiring auditor as the new auditor.

The notice shall also be sent to the current auditor. The auditor will have the right to represent and make a representation to the shareholders. Given that the auditors are being removed during their tenure, the board shall appoint auditors with prior approval of the Commission.

3 INTERNATIONAL STANDARDS ON AUDITING (ISAs)

3.1 The role of auditing standards

The role of the audit is to provide a high level of assurance to the users of the financial statements. This assurance will be of greater value to users if they know that the audit has been carried out in accordance with established standards of practice.

In addition, if users compare the financial statements of a number of companies, it is important that the user has confidence that consistent **auditing standards** have been applied to the audits of all of the companies.

International Standards on Auditing (known as ISAs) apply primarily to the external audit process. However, their provisions can also often be seen as good practice for relevant areas of the work of the **internal** auditor.

3.2 Introduction to IAASB and IFEA

The International Foundation for Ethics and Audit (IFEA) is a non-profit organization that supports high-quality, international standard setting in ethics, audit, and assurance in the public interest. IFEA fulfils its mission through its two standard-setting boards:

- International Auditing and Assurance Standards Board (IAASB); and
- International Ethics Standards Board for Accountants.

► *Definition: IAASB (International Auditing and Assurance Standards Board)*

The IAASB is one of the boards within IFEA. It is an independent standard-setting body that serves the public interest by setting high-quality international standards for auditing, assurance, and other related standards, and by facilitating the convergence of international and national auditing and assurance standards. In doing so, the IAASB enhances the quality and consistency of practice throughout the world and strengthens public confidence in the global auditing and assurance profession.

3.3 The process of issuing auditing standards

Responsibility for ISAs

The Institute of Chartered Accountant of Pakistan adopts the International Standards on Auditing (ISAs) issued by the IAASB. The examination of this paper is based on the knowledge of ISAs.

Developing a new ISA

The process of developing an ISA is as follows:

- A subject is selected for detailed study, with a view to eventually issuing an ISA.
- After a period of study and research, if there is agreement to proceed, an **exposure draft** is produced. The exposure draft is approved by the IAASB and then distributed widely amongst the profession and others for comment.
- Comments and proposed amendments are considered by the IAASB. The draft standard is then modified and approved by the IAASB.
- The new ISA is then published.

3.4 International Auditing Practice Statements

In addition to ISAs, the IAASB also issues International Auditing Practice Statements (IAPs). These do not have the same authority as ISAs.

IAPs aim to:

- provide help to auditors in implementing ISAs
- promote good auditing practice in general.

3.5 Preface to International Standards on Quality Management, Auditing, Review, Other Assurance and Related Services

The IAASB issues a number of other international standards, in addition to ISAs. The table below sets out these standards, including ISAs, and when the preface says they are to be applied.

Type of standard	When applied
International Standards on Auditing (ISAs)	In the audit of historical financial information
International Standards on Review Engagements (ISREs)	In the review of historical financial information
International Standards on Assurance Engagements (ISAEs)	In assurance engagements other than audits or reviews of historical financial information
International Standards on Related Services (ISRSs)	On compilation engagements, engagements to apply agreed upon procedures to information and other related services engagements
International Standards on Quality Management (ISQMs)	For all the above services

The IAASB's pronouncements do not override local laws or regulations. If local laws or regulations differ from, or conflict with, the IAASB's standards then a professional accountant should not state that he has complied with the IAASB's standards unless he has **fully complied** with all of those relevant to the engagement.

International Standards on Auditing (ISAs)

ISAs are written in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary when applied to audits of other historical financial statements.

International Standards on Quality Management (ISQMs)

ISQMs apply to all services carried out under the IAASB's **engagement standards** (ISAs, ISREs, ISAEs and ISRSs).

Other International Standards

The other international standards (ISREs, ISAEs and ISRSs) contain:

- basic principles and essential procedures (identified in bold type and by the word “**should**”), and
- related guidance in the form of explanatory and other material, including appendices.

The basic principles and procedures must be followed. In exceptional circumstances, a professional accountant may judge it necessary not to follow a relevant essential procedure in order to achieve their objectives. In these circumstances, the auditor must be prepared to justify the departure from the requirements of the standard.

3.6 ISA 200: Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing

The **objectives** of the auditor are formally specified in ISA 200 as:

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

ISA 200 **requires** the auditor to:

- comply with all **ISAs** relevant to the audit
- comply with relevant **ethical requirements**
- plan and perform an audit with ***professional scepticism**
- exercise **professional judgement** in planning and performing an audit
- obtain **sufficient appropriate audit evidence** to allow him to obtain reasonable assurance

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

Examples of Professional Skepticism

- Audit evidence that contradicts other audit evidence
- Information that bring into question the reliability of documents
- Condition that may indicate possibility of fraud

Advantages of Maintaining Professional Skepticism

Maintaining Professional Skepticism throughout the audit is necessary to reduce the risk of:

- Overlooking unusual transaction
- Over generalising when drawing conclusion from audit observation
- Using inappropriate assumptions in determining the nature, timing and extent of audit procedures and evaluating result thereof

****Professional judgment** – The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

Uses of Professional Judgement

- Materiality and audit risk
- Nature, timing and extent of audit procedures used to obtain audit evidence
- Evaluate whether sufficient appropriate audit evidence has been obtained
- Evaluation of management judgement in applying appropriate financial reporting framework
- Drawing conclusion based on audit evidence obtained. For e.g. assessing the reasonableness of the estimates by the management

Sufficient appropriate audit evidence- Sufficiency is the measure of the quantity of audit evidence. Appropriateness is the measure of the quality of audit evidence in terms of its relevance and reliability. The sufficiency and appropriateness of audit evidence are interrelated, obtaining more audit evidence may not compensate for its poor quality.

► Practice Question 18:

Aslam is a junior member of your audit team. During an informal discussion with your team members, Aslam has inquired you about the reasons of emphasizing on professional skepticism when honesty and integrity of the management is not questionable based on prior experience. Briefly respond to the inquiry of Aslam.

Tutorial Notes:

Always specify that professional skepticism:

- Prevents overlooking unusual circumstances;
- Avoids over-generalising from limited evidence;
- Encourages questioning mind for all potential misstatements.

Link it to every stage of the audit process (from planning to final review).

► *Solution 18:*

The past experience regarding honesty and integrity of the entity's management and those charged with governance is critical for the auditor. However, a belief that management and those charged with governance are honest and have integrity, does not relieve the auditor of the need to maintain professional skepticism. In fact, maintaining of professional scepticism throughout the audit helps the auditor to reduce the risks related to:

- overlooking unusual circumstances.
- over generalising when drawing conclusions from audit observations.
- using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.
- critical assessment of audit evidence.
- identification of material misstatement.

4 ADVANTAGES AND LIMITATIONS OF STATUTORY AUDITS

There are several advantages in having an external audit, but there are also some limitations.

4.1 Advantages of statutory audits

An external audit provides the following benefits:

- It increases the credibility of published financial statements.
- It confirms to management that they have performed their statutory duties correctly.
- It provides assurance to management that they have complied with non-statutory requirements, such as corporate governance requirements (where these are subject to audit or review).
- It provides feedback on the effectiveness of internal controls. Where internal controls are weak or inadequate, the auditor will give recommendations for improvement. This will assist management in reducing risk and improving the performance of the company.

Even where a statutory audit is not required, for example due to small company statutory exemption limits (in some countries), an audit will increase the credibility of published financial statements. This may be important for potential lenders to the company. Potential lenders, such as banks, may insist on the company having an audit as a pre-condition for lending money.

4.2 Limitations of statutory audits

The main limitations of an audit are as follows:

- Its cost. The cost of an audit can be very high. However, if the audit firm is already hired to carry out non-audit work such as advisory work, the additional cost of an audit may be fairly small.
- The disruption caused to a company's staff during the audit. The company's staff may be required to assist the auditors by answering questions, providing documents and other information.
- Some items in the subject matter might be estimates whose truth and fairness will not be known with certainty until some point in the future. This means the assurance opinion is ultimately subjective and judgmental.
- Most fraud will include an attempt to deliberately conceal the truth or misrepresent information.
- In order to balance cost and efficiency the auditor routinely uses sampling rather than tests every item.
- Irrespective of how robust a client's systems are they will always incorporate some degree of inherent limitation.
- Audit evidence is persuasive rather than conclusive, i.e., they persuade the auditor to believe that a particular assertion has been justified instead of providing a conclusion

► Practice Question 19:

A friend of yours has invested in the shares of Ascender Limited. On receiving the company's annual report, he made the following comments:

"The auditor has expressed an unqualified opinion. Since the auditor must have arrived at his opinion after testing majority of the transactions, therefore the financial statements are correct in all respects. Since no control deficiencies and fraudulent conduct had been reported by the auditor, I can safely invest further amount of money in the company because there is no risk that I will lose my money due to fraudulent conduct of management or misrepresentations in the financial statements."

Required:

Write a letter to your friend to remove his misconceptions related to the audit of financial statements including brief explanation of your point of view.

Tutorial Notes:

Please note that an audit is performed on a sample basis and focuses on areas of higher risk or materiality.

An unqualified opinion signals “reasonable assurance,” not absolute correctness of every figure.

Clarify the boundaries of the auditor’s responsibility regarding fraud and errors.

► Solution 19:

To: ABC

Dated: 4 September 2018

Subject: Explanation of Misstatement Related To Audit

I received your comments on the audit report of Ascender Limited and want to clarify that:

The auditor, because of inherent limitation of audit, cannot reduce audit risk to zero. Therefore, auditor provides a reasonable assurance but not absolute assurance that financial statements are free from material misstatement.

In order to provide reasonable assurance, auditor plans and performs audit procedures based on the concept of materiality and assessment of audit risk. Auditor does not aim to examine all or the majority of transactions. Based on professional judgment about the effectiveness of the selection, auditor applies audit procedures using 100% selection, specific selection or audit sampling. Thus, selective examination of specific items does not provide audit evidence about the whole population and conclusion drawn from a sample may be different if the entire population were subject to the same procedure.

The management is responsible for the internal controls for the preparation of financial statements and auditor is responsible to obtain understanding of the same in order to design audit procedures. Auditor is not required to express opinion on effectiveness of internal controls.

Furthermore, the auditor is responsible to provide reasonable assurance not the absolute assurance that financial statements as a whole are free from material misstatement, whether caused by fraud or error. As stated above, the principle of materiality will also be applied here in case of misstatement due to fraud.

The objective of a statutory audit (an external audit) is to express an opinion on the truth and fairness of the view presented by the financial statements. Its objective is not the prevention or detection of fraud.

Moreover, there is a possibility that despite all due care, the auditor is unable to detect a fraud especially those involving management override of controls.

I hope above explanations would enhance your understanding regarding auditor’s roles and responsibilities in the audit of financial statements.

Yours faithfully,

XYZ

► *Practice Question 20:*

Amjad is the chief executive and major shareholder of a newly incorporated private limited company. He has offered your firm to be the first external auditor of the company. During a meeting, he was of the viewpoint that statutory audit exists because it has been legally mandated and it does not add value to business. However, he believes that audit helps in finding all major frauds within the company.

Required:

Discuss how you will respond to the viewpoints of Amjad regarding the audit of financial statements.

Tutorial Notes:

If asked about the benefits of a statutory audit, brainstorm broadly, e.g.:

- Credibility to external stakeholders (banks, suppliers);
- Accountability for management's performance;
- Assessment of internal controls;
- Regulatory compliance;
- Identification of areas needing improvement.

The objective is to express an opinion on financial statements, not to detect every fraud.

► *Solution 20:*

Our response to the viewpoints of Amjad would be as follows:

- i. It is not correct that the statutory audit does not add value to business. In fact:
 - it increases the credibility of the financial statements. This is important to potential lenders, who may insist on the company having an audit as a pre-condition for lending money.
 - it confirms to management that they have performed their statutory duties correctly.
 - it provides assurance to management that they have complied with non-statutory requirements.
 - it helps on establishing accountability of the management, especially when the business owners (shareholders) have hired others to manage their business, as is typically in modern corporations.
 - the need for assurance also arises because there is a complexity of transactions, information and processing systems which renders difficult in determining the proper presentation without a review by an independent expert.
 - it provides feedback on effectiveness of internal controls. Where internal controls are weak or inadequate, the auditor will give recommendations for improvement. This will assist management in improving the internal controls and reducing the risk(s).
- ii. The objective of a statutory audit (an external audit) is to express an opinion on the truth and fairness of the view presented by the financial statements. Its objective is not primarily the prevention or detection of all or major fraud. In fact, it is primarily the responsibility of management to establish systems and controls to prevent or detect fraud.

Further, the auditor is concerned with fraud that might impact the financial statements and is therefore concerned with the risk of material fraud.

5 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Define the terms audit and assurance and explain the overall objectives of the independent auditor
- Describe the regulatory framework relevant to statutory audit
- Explain the roles of IFEA and the IAASB
- Describe advantages and limitations of statutory audit
- Summarise the overall responsibilities of the independent auditor and management (and those charged with governance)
- Explain the nature and scope of an audit
- Understand the terms independence, materiality and true and fair

OBTAINING AN ENGAGEMENT

IN THIS CHAPTER:

1. Obtaining and accepting a new audit engagement
2. Agreeing the terms of audit engagements (ISA 210)
3. Quality Management
4. Chapter review

1 OBTAINING AND ACCEPTING A NEW AUDIT ENGAGEMENT

1.1 Introduction

Several commercial and ethical matters should be considered by an **external** auditor when considering the acceptance of a new audit engagement. Auditors and clients must also follow the legal requirements set out in the Companies Act, 2017.

Audit practices are a business, and their objective is to make a profit. However, this does not mean that the practice should automatically accept every audit engagement that is offered to it, in order to maximise profit. Circumstances may arise where it is appropriate to decline the offer of an audit appointment, for either commercial or ethical reasons.

1.2 Accepting an audit appointment: ethical matters

The ICAP Code of Ethics [Section 320] includes procedures that auditors must follow to assure that their appointment is valid.

Note: You should refer to the later chapter on ethics for explanation of the ethical terms and principles referred to below.

Client and Engagement Acceptance (320.3 ICAP Code of Ethics)

Threats to compliance with the principles of integrity or professional behaviour might be created, for example, from questionable issues associated with the client (its owners, management or activities). Issues that, if known, might create such a threat include client involvement in illegal activities, dishonesty, questionable financial reporting practices or other unethical behaviour.

Factors that are relevant in evaluating the level of such a threat include:

- Knowledge and understanding of the client, its owners, management and those charged with governance and business activities.
- The client's commitment to address the questionable issues, for example, through improving corporate governance practices or internal controls.

A self-interest threat to compliance with the principle of professional competence and due care is created if the engagement team does not possess, or cannot acquire, the competencies to perform the professional services.

Factors that are relevant in evaluating the level of such a threat include:

- An appropriate understanding of:
 - The nature of the client's business;
 - The complexity of its operations;
 - The requirements of the engagement; and
 - The purpose, nature and scope of the work to be performed.
- Knowledge of relevant industries or subject matter.
- Experience with relevant regulatory or reporting requirements.
- The existence of quality management policies and procedures designed to provide reasonable assurance that engagements are accepted only when they can be performed competently.

Examples of actions that might be safeguards to address a self-interest threat include:

- Assigning sufficient engagement personnel with the necessary competencies.
- Agreeing on a realistic time frame for the performance of the engagement.
- Using experts where necessary.

When a chartered accountant in practice intends to rely on the advice or work of an expert, they should evaluate whether such reliance is warranted. They should consider factors such as reputation, expertise, resources available and applicable professional and ethical standards. Such information may be gained from prior association with the expert or from consulting others.

For example, in case of revaluation of fixed assets, the audit firm will check the credibility of the surveyor before placing reliance on his work.

Note that the accountant has an obligation to comply with ethical requirements continuously throughout the period of engagement. They should also review their acceptance decisions for recurring clients.

320.4 Changes in professional appointment

There might be reasons for not accepting an engagement. One such reason might be if a threat created by the facts and circumstances cannot be addressed by applying safeguards. For example, there might be a self-interest threat to compliance with the principle of professional competence and due care if a chartered accountant accepts the engagement before knowing all the relevant facts.

Communicating with the existing or predecessor accountant

A proposed accountant will usually need the client's permission, preferably in writing, to initiate discussions with the existing or predecessor accountant.

If unable to communicate with the existing or predecessor accountant, the proposed accountant shall take other reasonable steps to obtain information about any possible threats.

Communicating with the Proposed Accountant

When an existing or predecessor accountant is asked to respond to a communication from a proposed accountant, the existing or predecessor accountant shall:

- a) Comply with relevant laws and regulations governing the request; and
- b) Provide any information honestly and unambiguously.

An existing or predecessor accountant is bound by confidentiality. Whether the existing or predecessor accountant is permitted or required to discuss the affairs of a client with a proposed accountant will depend on the nature of the engagement and:

- a) Whether the existing or predecessor accountant has permission from the client for the discussion; and
- b) The legal and ethics requirements relating to such communications and disclosure, which might vary by jurisdiction.

Additional work

A chartered accountant in practice may be asked to undertake work that is complementary or additional to the work of the existing accountant. Such circumstances may give rise to potential threats to professional competence and due care resulting from, for example, a lack of or incomplete information.

A factor that is relevant in evaluating the level of such a threat is whether tenders state that, before accepting the engagement, contact with the existing or predecessor accountant will be requested. This contact gives the proposed accountant the opportunity to inquire whether there are any reasons why the engagement should not be accepted.

Examples of actions that might be safeguards to address such a self-interest threat include:

- Asking the existing or predecessor accountant to provide any known information of which, in the existing or predecessor accountant's opinion, the proposed accountant needs to be aware of before deciding whether to accept the engagement. For example, inquiry might reveal previously undisclosed pertinent facts and might indicate disagreements with the existing or predecessor accountant that might influence the decision to accept the appointment.
- Obtaining information from other sources such as through inquiries of third parties or background investigations regarding senior management or those charged with governance of the client.

► *Practice Question 01:*

Your firm is the auditor of ABD Limited (ABDL). After the acquisition of majority shareholding in HG Motors (Private) Limited (HGM), ABDL has decided to replace the existing auditors of HGM in the next annual general meeting and has approached you for appointment as HGM's auditors for the next year.

Required:

Explain the responsibilities of your firm and the existing auditors in the above situation under the Code of Ethics for Chartered Accountants.

Tutorial Notes:

Communication with the previous auditor is crucial:

Obtain the client's permission first;

Ask the outgoing auditor if there are professional reasons not to accept;

If no response or refusal, weigh the risk carefully before accepting.

► *Solution 01:***Responsibilities of our firm and of the existing auditors:**

Our firm will communicate with the existing auditors to establish if there are any matters that it should be aware of when deciding whether or not to accept the appointment. The following points should be noted in connection such communication:

- HGM permission is required for any such communication. If HGM refuses to give its permission, the appointment as auditor should not be accepted.
- If HGM does not give the existing auditor the permission to reply to any relevant questions of our firm, the appointment as auditor should not be accepted.
- If existing auditor provides the required information, our firm should assess all the available information and take a decision about whether or not to accept the audit engagement.
- If the existing auditor does not provide any information relevant to the appointment, we may accept or reject the engagement based on other available knowledge.
- Even if the existing auditor provides professional reasons to suggest that we should not accept the audit, the final decision in this regard shall be based on our professional judgment.

► *Practice Question 02:*

You are the quality management partner in an audit firm. Following independent matters are presently under your consideration:

- a) The firm has received an offer for appointment as the auditor of Hyper Limited for the year ending 30 June 2023 in place of the outgoing auditor.

Required:

Discuss the actions that the firm should take regarding communication with the outgoing auditor.

- b) Freshco (Private) Limited (FPL) has asked your firm to help them in implementation of an ERP software. Your firm has refused to accept the engagement as the firm believes that it does not have the required competencies. However, the firm has referred FPL to an IT firm which has relevant competencies. As part of arrangement, the IT firm will pay 15% of fee charged to FPL to your firm.

Required:

Identify and explain the threats to the fundamental principles of ICAP code of ethics.

Tutorial Notes:

If you can't contact the existing auditor, do other checks to ensure no ethical issues.

If you get a referral fee, it can create a self-interest threat to objectivity—explain that clearly.

► *Solution 02:*

a) The firm should take the following actions:

- Obtain the prior permission of the client, preferably in writing, to initiate discussions with the outgoing auditor.
- Request the outgoing auditor to provide known information regarding any facts or other information of which, in outgoing auditor's opinion, our firm needs to be aware before deciding whether to accept the engagement.
- If unable to communicate with the existing or predecessor accountant, the proposed accountant shall take other reasonable steps to obtain information about any possible threats.
- If the client fails or refuses to grant the outgoing auditor permission to discuss the client's affairs with our firm, consider such failure or refusal when determining whether to accept the appointment.

b) A self-interest threat to compliance with the principles of objectivity and professional competence and due care is created if a chartered accountant pays or receives a referral fee or receives a commission relating to a client. The firm may be interested in earning greater commission from referring the client and might not refer it to the firm which best meets the client's requirement.

2 AGREEING THE TERMS OF AUDIT ENGAGEMENTS (ISA 210)

2.1 Preconditions

The **objective** of the auditor, per ISA 210 *Agreeing the terms of audit engagements*, is to accept or continue an audit engagement **only when the basis upon which it is to be performed has been agreed**. This is done by:

- establishing whether the **preconditions for an audit are present**; and
- confirming that there is a **common understanding between the auditor and management**.

To establish if the preconditions for an audit are present ISA 210 **requires** the auditor to:

- establish if the financial reporting framework to be used in the preparation of the financial statements is acceptable, for example IFRS
- obtain the agreement of management that it **acknowledges and understands its responsibility (the 'premise')**:
 - for the preparation of the financial statements;
 - for internal controls to ensure that the financial statements are not materially misstated; and
 - to provide the auditor with all relevant and requested information and unrestricted access to all personnel.

Response if preconditions are not present

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. The auditor should explain what the preconditions are and that they are required in order to comply with *ISA 210 Agreeing the terms of audit engagements*. The auditor should also explain that one of the purposes of the preconditions, and agreeing the terms of the audit engagement in general, is to avoid misunderstanding about the respective responsibilities of management and the auditor.

Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement where:

- a limitation on scope is imposed by management such that the auditor would be unable to express an opinion on the financial statements, or
- the financial reporting framework to be used in the preparation of the financial statements is unacceptable, or
- management do not agree to the above responsibilities (the 'premise') stated in the preconditions.

2.2 Engagement letters

Having accepted an appointment as auditor of a client company, the audit firm should submit an engagement letter to the board of directors of the client company. The engagement letter can be seen as the basis for **the contract between the company and the auditor**.

The content of the engagement letter

The engagement letter should include details of the following:

- The objective and scope of the audit.
- The responsibilities of the auditor.
- The responsibilities of management.
- Identification of the underlying financial reporting framework.
- Reference to the expected form and content of any reports to be issued.

In addition to the above, the auditor may feel that it is appropriate to include additional points in the engagement letter, such as:

- Arrangement regarding the planning and performing the audit including the composition of an audit
- Arrangement regarding involvement of internal auditor
- Expectation that management will provide written representation
- the fact that because of the inherent limitations of an audit, and the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected even though the audit was properly planned and performed in accordance with ISAs
- To inform the auditor about events occurred after the date of auditor's report
- Any restriction of auditor's liability
- the expectation that management will provide access to all information that is relevant to the preparation of the financial statements and its disclosures
- The agreement of management to make available to the auditor draft financial statements, including all information relevant to their preparation, whether obtained from within or outside of the general and subsidiary ledgers (including all information relevant to the preparation of disclosures), and the other information if any, in time to allow the auditor to complete the audit in accordance with the proposed timetable
- the basis on which fees are computed and any billing arrangements
- a request for management to acknowledge receipt of the engagement letter and to agree to its terms
- A reference to any further agreements between the auditor and the entity
- Any obligations to provide audit working papers to other parties

► *Example:*

Explain why the auditor might wish to include each of the following points in the engagement letter:

- Basis on which fees are charged
- Outline timetable
- Formal acknowledgement of the contents of the letter
- Arrangements for the involvement of client staff

► *Answer*

Basis on which fees are charged – to ensure that there is no misunderstanding (for example that more senior staff cost more and that “time is money”). This may help to encourage the client to provide as much assistance as possible and not to insist that all work is carried out by more senior members of the team.

Outline timetable – to ensure that the client will be prepared for the arrival of the audit team (for example, draft financial statements and supporting schedules of all ready and key staff available (and not on holiday). If necessary, the audit timetable could be changed at this stage.

Formal acknowledgement of the contents of the letter – to ensure that the directors cannot later claim that they did not understand the scope of the audit and their responsibility for the financial statements.

Arrangements for the involvement of client staff – to ensure that the client is able to plan for the involvement of the necessary staff and that they are available at the required time.

Recurring audits

The engagement letter issued on the initial appointment as auditors may state that its provisions will apply to all future annual audits, until it is revised. However, ISA 210 **requires** the auditor, for recurring audits, to assess whether:

- circumstances mean that the terms of engagement need to be revised
- management need to be reminded of the existing terms of the engagement.

The ISA suggests that the following factors may indicate that the above is appropriate:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

Acceptance of a change in the terms of engagement

The entity might, in certain circumstances, ask the auditor to change the terms of the audit engagement. This might result from a genuine change in circumstances or from a misunderstanding as to the nature of an audit as originally requested. However, it could result from a situation where the auditor is unable to obtain sufficient appropriate audit evidence regarding a material item. The entity might then ask for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

ISA 210 **requires** the auditor to consider the justification for the request and whether it is "reasonable".

- If the auditor considers that it is a reasonable request, then revised terms should be agreed and recorded.
- If the auditor is unable to agree to a change of terms and is not permitted by management to continue the original audit engagement he should withdraw from the engagement and consider whether there is any obligation to report the circumstances to those charged with governance, owners or regulators.

► Practice Question 03:

Khanewal Limited (KL) has requested your firm to submit engagement letter for KL's statutory audit. The engagement partner has asked you to establish whether preconditions for the audit of KL are present.

Required:

What matters would you consider in order to ensure that preconditions for the audit exist?

► Solution 03:

In order to establish whether the preconditions for an audit are present, I will:

- determine whether the FRF to be applied in the preparation of FINANCIAL STATEMENTS is acceptable;
- obtain the agreement of management that it acknowledges and understands its responsibility:
 - for the preparation of the FINANCIAL STATEMENTS in accordance with the AFRF.
 - for such internal control as management determines is necessary to enable preparation of FINANCIAL STATEMENTS that are free from material misstatement, whether due to fraud or error.
 - to provide us with all relevant and requested information and unrestricted access to all personnel.

► *Practice Question 04:*

The audit engagement letter specifies objective and scope of audit, responsibilities of auditor and management, applicable financial reporting framework and form and contents of audit report. State any four additional matters that may be included in the engagement letter.

Tutorial Notes:

Continue your approach of clearly listing the standard points in an engagement letter (objectives, responsibilities, etc.), plus any additional clarifications (use of experts, etc.).

► *Solution 04:*

Additional matters that can be included in the engagement letter:

- Additional details on the scope of the audit, such as reference to applicable legislation, regulations, ISAs, and ethical pronouncements.
- The fact that because of the inherent limitations of an audit, and the inherent limitations of the internal control, there is an unavoidable risk that some material misstatements may not be detected even though the audit was properly planned and performed in accordance with ISAs.
- Arrangements regarding planning & performance of audit including composition of audit team
- The expectation that management will provide written representations.

► *Practice Question 05:*

Your firm has been re-appointed as the auditor of Elegant Limited (EL) for the year ended 30 June 2015. The firm has been the auditor of EL for the last five years.

Required:

- a) How would you assess whether it is necessary to send an audit engagement letter to EL for the year ended 30 June 2015?
- b) State how would you proceed If EL requests your firm to change certain terms of engagement.

Tutorial Notes:

When deciding if you need a new or revised engagement letter, watch for:

Indications the client misunderstands scope, or changes in legal/regulatory environment, management changes, etc.

If the client requests changes to terms:

Evaluate if the request is reasonable;

Possibly revise the letter;

If no agreement is possible, consider withdrawal.

► *Solution 05:*

- a) In determining the need to send an engagement letter, the firm should assess whether:
 - circumstances require a revision in the terms of engagement.
 - management need to be reminded of the existing terms of the engagement.

The following factors may indicate that the above is appropriate:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.

- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in other reporting requirements.

b) We would consider whether the request is "reasonable".

- If the request is reasonable then revised terms should be agreed and recorded in engagement letter.
- If the request is unreasonable, we should discuss the matter with the management and if the management agrees with our view point, then there is no need for amendment in the existing terms of engagement.
- If we are unable to agree to the changes and management also do not agree with our viewpoint then we would consider withdrawing from the engagement and consider whether there is any obligation to report the circumstances to THOSE CHARGED WITH GOVERNANCE, owners or regulators.

► *Practice Question 06:*

In relation to the audit report on financial statements and the contents thereof (under revised/new ISAs), discuss the appropriateness or otherwise of the following statements:

The management is only responsible for preparation of financial statements in accordance with the financial reporting framework and for such internal controls as management determines are necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

► *Solution 06:*

The statement is not appropriate, as management is also responsible for assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern.

► *Practice Question 07:*

Discuss the course of action which may be adopted by the auditor if pre-conditions of audit are not present.

► *Solution 07:*

Pre-conditions of an audit are not present:

If the pre-conditions of audit are not present, the auditor shall:

- discuss the matter with the management and explain to them what the preconditions are and why they are required.
- unless required by law or regulation, the auditor shall not accept the proposed audit engagement. If the management is unable to address the auditor's concern.

► *Practice Question 08:*

List any four situations that may require revision in the terms of audit engagement letter.

Tutorial Notes:

Only list specific triggers that lead to revising an engagement letter (change in management, ownership, size, misunderstandings, etc.). Keep them distinct from normal letter contents.

► *Solution 08:*

Situations that may require revision in the terms of engagement letter are as follows:

- Any indication that the entity misunderstands the objectives and scope of the audit;
- Any revised or special terms of the audit;
- A recent change in the senior management/ ownership;
- A significant change in nature or size of the entity's business;

► *Practice Question 09:*

State the matters which an auditor should consider to establish whether the pre-conditions for an audit are present.

Tutorial Notes:

Keep up the clarity and structure—cover acceptability of the FRF and management’s premise responsibilities thoroughly.

► *Solution 09:*

To establish if the preconditions for an audit are present, the auditor shall:

- establish if the financial reporting framework to be used in the preparation of the financial statements is acceptable; and
- obtain the agreement of management that it acknowledges and understands its responsibility (the ‘premise’):
 - for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
 - for internal controls to ensure that the financial statements are not materially misstated; and
 - to provide the auditor with all relevant and requested information and unrestricted access to all personnel.

► *Practice Question 10:*

You are the audit manager in a firm of chartered accountants. Your firm has been appointed as the auditor of a listed company, Rustam Raees Limited (RRL) for the year ending 31 December 2019. RRL has been publishing their annual financial statements within one month of the year end and have set strict deadlines for the completion of audit. Further, this year, RRL has changed its accounting policy relating to property, plant and equipment, from historical cost to revaluation model.

Required:

List the matters (related to the given scenario only) which you would like to include in the engagement letter, along with their justification.

Tutorial Notes:

- If the scenario mentions strict deadlines, highlight the need to plan for timely FS drafts and how management must provide info promptly.
- Tie your points directly to the scenario’s unique facts.

► *Solution 10:*

a) Matters to be included in engagement letter

- Being the first year of audit for our firm, arrangements concerning the involvement of predecessor auditor would be necessary.
- Use of auditor’s expert may be required as RRL has changed its accounting policy from historical cost convention to revaluation model.
- Due to strict deadlines:
 - It should be included in the engagement letter that management would make available the draft financial statements along with all relevant information in time to allow for the completion of audit in accordance with the proposed time table.
 - We need to communicate the planning and performance of the audit, including the composition of the audit team.
 - We may also consider using RRL’s internal audit department and this fact may have to be communicated through the engagement letter.

► *Practice Question 11:*

Discuss the auditor's course of action when a client requests to change the existing terms of the audit engagement.

Tutorial Notes:

Always remember the fallback: if changes to engagement terms are unacceptable and the client insists, the auditor may withdraw (unless law requires continuing).

► *Solution 11:*

The auditor should consider the justification for the request and whether it is "reasonable". If the auditor considers that it is a reasonable request and the terms of engagement are changed, the auditor and management shall agree on and record the new terms of engagement in an engagement letter.

If the auditor is unable to agree to a change of terms he should withdraw from the engagement and consider whether there is any obligation to report the circumstances to those charged with governance, owners or regulators.

► *Practice Question 12:*

In certain circumstances, an entity may ask the auditor to change the terms of the audit engagement. What should the auditor do in such a situation?

Tutorial Notes:

Similar theme: be sure to address the possibility of withdrawing and the auditor's duty to consider reporting the situation appropriately.

► *Solution 12:*

The auditor should consider the justification for the request and whether it is "reasonable". If the auditor considers that it is a reasonable request, then revised terms should be agreed upon and recorded.

If the auditor is unable to agree to a change of terms and is not permitted by management to continue the original audit engagement he should withdraw from the engagement and consider whether there is any obligation to report the circumstances to those charged with governance, owners or regulators.

► *Practice Question 13:*

According to 'ISA 210 – Agreeing the Terms of Audit Engagements', certain matters must be included in the engagement letter when agreeing to the terms of engagement. State any five of such matters.

Tutorial Notes:

Make sure you stick to the mandatory items from ISA 210 (scope, responsibilities, etc.). Additional details can appear, but first focus on what the standard explicitly requires.

► *Solution 13:*

- i. The objective and scope of the audit of the financial statements.
- ii. The responsibilities of the auditor.
- iii. The responsibilities of the management.
- iv. Identification of the applicable financial reporting framework for the preparation of the financial statements.
- v. Reference to the expected form and content of any reports to be issued by the auditor.
- vi. A statement that there may be circumstances in which a report may differ from its expected form and content.

3 QUALITY MANAGEMENT FOR AN AUDIT OF FINANCIAL STATEMENTS (ISA 220 REVISED)

3.1 Objective

The objective of the auditor is to manage quality at the engagement level to obtain reasonable assurance that quality has been achieved such that:

- The auditor has fulfilled the auditor's responsibilities, and has conducted the audit, in accordance with professional standards and applicable legal and regulatory requirements; and
- The auditor's report issued is appropriate in the circumstances.

3.2 Leadership Responsibilities for Managing and Achieving Quality on Audits

It is engagement partner's responsibility to manage and achieve quality on the audit engagement, in doing so, the engagement partner shall be sufficiently and appropriately involved throughout the audit engagement.

The engagement partner shall take responsibility for clear, consistent and effective actions including emphasizing:

- That all engagement team members are responsible for contributing to the management and achievement of quality at the engagement level;
- The importance of professional ethics, values and attitudes to the members of the engagement team;
- The importance of open and robust communication within the engagement team, and supporting the ability of engagement team members to raise concerns without fear of reprisal; and
- The importance of each engagement team member exercising professional skepticism throughout the audit engagement.

3.3 Relevant Ethical Requirements, Including Those Related to Independence

The engagement partner should:

- Have an understanding of the relevant ethical requirements, including those related to independence
- Take responsibility for other members of the engagement team
- Remain alert throughout the audit engagement. If matters come to the engagement partner's attention that indicate that a threat to compliance with relevant ethical requirements exists, the engagement partner shall evaluate the threat and take appropriate action.
- Prior to dating the auditor's report, take responsibility for determining whether relevant ethical requirements, including those related to independence, have been fulfilled.

3.4 Acceptance and Continuance of Client Relationships and Audit Engagements

The engagement partner should:

- Determine that the firm's policies or procedures for the acceptance and continuance of client relationships and audit engagements have been followed, and that conclusions reached in this regard are appropriate.
- Take into account information obtained in the acceptance and continuance process in planning and performing the audit engagement.
- Communicate the information promptly to the firm for taking necessary action, if the engagement team becomes aware of information that may have caused the firm to decline the audit engagement if the firm had that information prior to accepting or continuing the client relationship or specific engagement.

3.5 Engagement Resources

The engagement partner shall determine that:

- Sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner;
- Members of the engagement team, and any auditor's external experts and internal auditors who provide direct assistance who are not part of the engagement team, collectively have the appropriate competence and capabilities, including sufficient time, to perform the audit engagement.

If the engagement partner determines that resources assigned or made available are insufficient or inappropriate, the engagement partner shall take appropriate action, including communicating with appropriate individuals about the need to assign or make available additional or alternative resources to the engagement.

3.6 Direction, Supervision and Review

The engagement partner shall:

- Take responsibility for the direction and supervision of the members of the engagement team and the review of their work.
- Determine that the nature, timing and extent of direction, supervision and review is planned and performed and is responsive to the nature and circumstances of the audit engagement.
- Review audit documentation at appropriate points in time during the audit engagement
- Determine, on or before the date of the auditor's report, that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.
- Review the financial statements and the auditor's report, prior to dating the auditor's report.
- Review, prior to their issuance, formal written communications to management, those charged with governance or regulatory authorities.

CONSULTATIONS

The engagement partner shall:

- Take responsibility for the engagement team undertaking consultation on:
 - i. Difficult or contentious matters and matters on which the firm's policies or procedures require consultation; and
 - ii. Other matters that, in the engagement partner's professional judgment, require consultation;
- Determine that members of the engagement team have undertaken appropriate consultation during the audit engagement, both within the engagement team, and between the engagement team and others at the appropriate level within or outside the firm;
- Determine that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
- Determine that conclusions agreed have been implemented.

3.7 Engagement Quality Review

For audit engagements for which an engagement quality review is required, the engagement partner shall:

- Determine that an engagement quality reviewer has been appointed;
- Cooperate with the engagement quality reviewer and inform other members of the engagement team of their responsibility to do so;
- Discuss significant matters and significant judgments arising during the audit engagement, including those identified during the engagement quality review, with the engagement quality reviewer; and
- Not date the auditor's report until the completion of the engagement quality review

Differences of Opinion

If differences of opinion arise within the engagement team, or between the engagement team and the engagement quality reviewer or individuals performing activities within the firm's system of quality management, including those who provide consultation, the engagement team shall follow the firm's policies or procedures for dealing with and resolving such differences of opinion.

The engagement partner shall:

- Take responsibility for differences of opinion being addressed and resolved in accordance with the firm's policies or procedures;
- Determine that conclusions reached are documented and implemented; and
- Not date the auditor's report until any differences of opinion are resolved.

3.8 Monitoring and Remediation

The engagement partner shall take responsibility for:

- Obtaining an understanding of the information from the firm's monitoring and remediation process, determine its relevance and effect on the audit engagement and take appropriate action; and
- Remaining alert throughout the audit engagement for information that may be relevant to the firm's monitoring and remediation process and communicate such information to those responsible for the process.

Taking Overall Responsibility for Managing and Achieving Quality

Prior to dating the auditor's report, the engagement partner shall determine that the engagement partner has taken overall responsibility for managing and achieving quality on the audit engagement.

3.9 Documentation

In applying ISA 230, Audit Documentation, the auditor shall include in the audit documentation:

- Matters identified, relevant discussions with personnel, and conclusions reached with respect to:
 - i. Fulfilment of responsibilities relating to relevant ethical requirements, including those related to independence.
 - ii. The acceptance and continuance of the client relationship and audit engagement.
- The nature and scope of, and conclusions resulting from, consultations undertaken during the audit engagement and how such conclusions were implemented.
- If the audit engagement is subject to an engagement quality review, that the engagement quality review has been completed on or before the date of the auditor's report.

► Practice Question 14:

State any five matters that need to be considered by engagement quality reviewer (partner) while performing objective evaluation of audit of a listed company.

Tutorial Notes:

For engagement quality reviews, explicitly note:

Reviewing significant judgments and conclusions;

Checking that any differences of opinion were resolved with proper consultation.

► *Solution 14:*

The objective evaluation shall involve the following matters:

- Discussion of significant matters with the engagement partner;
- Review of the financial statements and the proposed auditor's report;
- Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and
- Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate.
- Evaluation of the Firm's independence in relation to the audit engagement;

4 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Explain the ethical considerations with respect to client and engagement acceptance and changes in professional appointment.
- Describe the requirements of ISA 210 with respect to the preconditions for accepting appointment as an auditor and also for setting up the engagement letter.
- Describe the requirements of ISA 220 (Revised) with respect to the quality management for an audit of financial statements.

PLANNING AND RISK ASSESSMENT

IN THIS CHAPTER:

1. Planning an audit: ISA 300
2. Understanding the business and materiality: ISAs 315 (Revised 2019) and 320
3. Audit risk: ISA 330
4. Fraud: ISA 240
5. Not-for-profit organisations
6. Chapter review

1 PLANNING AN AUDIT: ISA 300

1.1 Introduction to ISA 300

Overview

The **objective** of the auditor, as per ISA 300 *Planning an audit of financial statements* is to plan the audit work so that the audit will be performed **in an effective manner**. ISA 300 is written primarily in the context of recurring audits. Additional considerations in an initial audit engagement are separately identified too.

Adequate planning **benefits** the audit by:

- helping the auditor to devote appropriate attention to important areas of the audit
- helping the auditor to identify and resolve potential problems on a timely basis
- helping the auditor organise and manage the audit engagement so that it is performed in an effective and efficient manner
- assisting in the selection of staff with appropriate experience to respond to anticipated risk and the proper assignment of work to them
- allowing for the direction and supervision of staff and review of their work.

ISA 300 **requires** the auditor to:

- involve the whole **engagement team** in planning the audit
- performing procedures regarding the **continuance of the client relationship, specific audit engagement, evaluating compliance with relevant ethical requirements and independence**, in accordance with ISA 220 (revised)
- establish an understanding of the **terms of the engagement** as required by ISA 210
- establish an **overall strategy** for the audit that sets the scope, timing and direction of the audit and that guides the development of the audit plan
- develop an **audit plan** which includes a description of the nature, timing and extent of planned risk assessment procedures and planned further audit procedures
- **document** the overall audit strategy and the audit plan, including any significant changes made during the audit.

The above requirements are discussed in detail as follows:

Involvement of key engagement team members

- ISA 300 requires the engagement partner and other key members of the engagement team to be involved in planning the audit, including planning and participating in the discussion among engagement team members to enhance the efficiency and effectiveness of the planning process.

Preliminary engagement activities

The auditor shall undertake the following activities at the beginning of each audit engagement:

- Perform procedures required by *ISA 220 (revised) Quality Management for an Audit of Financial Statements* regarding the continuance of the client relationship and the specific audit engagement. This will involve establishing whether the auditor:
 - is competent to perform the engagement and has the capabilities, including time and resources, to do so;
 - can comply with relevant ethical requirements;
 - has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity; and
 - has considered significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

- Evaluate compliance with relevant ethical requirements, including independence, in accordance with ISA 220 (revised).
- Establish an understanding of the terms of the engagement, as required by ISA 210 (see chapter 2).

Planning Activities

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

- In establishing the overall audit strategy, the auditor shall: identify the characteristics of the engagement that define its scope;
- ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
- consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
- consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
- ascertain the nature, timing and extent of resources necessary to perform the engagement.

The overall audit strategy and audit plan are considered in greater detail below.

1.4 Contents of the overall audit strategy and the audit plan

The overall audit strategy

As set out above, the overall audit strategy sets the **scope, timing and direction of the audit** and **guides the development of the more detailed audit plan**. The establishment of the overall audit strategy involves the following:

- Determining the characteristics of the engagement that define its **scope** such as:
 - The financial reporting framework used (for example, international financial reporting standards)
 - Any industry specific reporting requirements
 - The location of the components of the entity (for example, there might be overseas branches).
 - The nature of the business segments to be audited, including the need for specialized knowledge.
 - The reporting currency to be used, including any need for currency translation for the financial information audited.
 - The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
 - Whether the entity has an internal audit function and, if so, whether, in which areas and to what extent, the work of the function can be used, or internal auditors can be used to provide direct assistance, for purposes of the audit.
 - The expected use of audit evidence obtained in previous audits, for example, Audit evidence related to risk assessment procedures and tests of controls.
 - The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The availability of client personnel and data.

- Ascertaining the reporting objectives of the engagement establishing deadlines for completion of work and key dates for expected communication.
- The entity's timetable for reporting such as at interim and final stages.
- The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications both written and oral including the auditor's report management letters and communication to those charged with governance.
- The discussion with management regarding the expected communication on the status of audit work throughout the engagement.
- The expected nature and timing of communication among the engagement team members including the nature and timing of team meetings and timings of the review of work performed
- Considering **important factors** which will determine the focus of the audit team's efforts, such as:
 - materiality thresholds
 - high risk areas of the audit
 - impact of assessed risk of material misstatement at the overall financial statement level on direction, supervision and review
 - the audit approach (for example, whether the auditor is planning to rely on the entity's internal controls)
 - emphasis of maintaining questioning mind and professional scepticism
 - volume of transaction and whether to rely on internal control

The above will then allow the auditor to decide on the **nature, extent and timing of resources** needed to perform the engagement. In particular, the auditor should consider:

- The selection of the engagement team and the assignment of the audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be a higher risk of material misstatement

Engagement budgeting including considering the appropriate level of time for areas where there may be higher risk of material misstatement

The audit plan

Once the overall audit strategy has been established the auditor can develop the more detailed audit plan.

The audit plan will set out:

- the procedures to be used in order to assess the **risk of misstatement** in the entity's accounting records/financial statements, and
- planned **further audit procedures** for each material audit area. These audit procedures might be in response to the risks assessed, or specific procedures to be carried out to ensure that the engagement complies with ISAs.

The audit procedures to be performed by audit team members will be those needed in order to:

- obtain sufficient appropriate audit evidence, and
- reduce audit risk to an acceptably low level.

Audit risk is considered in detail in the next section. What constitutes "sufficient appropriate audit evidence" is considered in a later chapter.

These procedures will be set out in a series of **audit programmes**. Audit programmes are sets of instructions to the audit team, specifying the audit procedures that should be performed in each area of the audit.

Documentation

The auditor shall include in the audit documentation:

- The overall audit strategy;
- The audit plan; and
- Any significant changes made during the audit engagement to the overall strategy or the audit plan along with reasons thereof.

1.5 Interim audit and final audit

Most large audits will be split into two phases. Much of the systems assessment work and transaction testing will be carried out on the **interim audit** (taking place perhaps two-thirds of the way through the year) with the balance of the work and testing of statement of financial position items taking place at the **final audit** shortly after the year end.

A number of **key benefits** may arise from spreading the work across interim and final audit such as:

- More flexible resource planning within the firm – the timing of interim audit is typically more flexible than the timing of final audit. This helps reduce demand for audit staff during ‘busy season’ (traditionally the first few months of a calendar year when many clients require their final audit to take place)
- Earlier identification of significant matters
- Shareholders and other users receive audited accounts earlier
- Increased audit efficiency

ISA 330 also states:

“The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date”.

Typical **interim audit procedures** include:

- Obtaining an understanding of the entity and its environment including its internal control.
- Determining materiality
- Response to the assessed risk of material misstatement
- Test the operating effectiveness of control
- Perform preliminary analytical procedures
- Perform substantive procedures on transaction occurred till date.

Typical **final audit procedures** include:

Substantive testing. Note that where substantive testing was performed at the interim phase auditors typically test the subsequent period between interim audit and period end

- Subsequent events Procedures
- Going concern procedures
- Final analytical procedure
- Tests to ensure conclusions formed at interim audit remain valid
- Obtaining third party confirmations such as bank letters and trade receivables confirmations
- Obtaining written representations
- ISA 330 specifically states that the following procedures can only be performed at or after the period end:
 - Agreeing the financial statements to the accounting records;
 - Examining adjustments made during the course of preparing the financial statements; and
 - Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalized.

1.6 Additional considerations in initial audit engagements

The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. For an initial audit engagement, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers;
- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan;
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances;
- Other procedures required by the firm's system of quality management for initial audit engagements (for example, the firm's system of quality management may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

Documentation

The auditor shall include in the audit documentation:

- The overall audit strategy;
- The audit plan; and
- Any significant changes made during the audit engagement to the overall strategy or the audit plan along with reasons thereof.

► Practice Question 01:

Briefly discuss the concept of 'Professional skepticism'.

► Solution 01:

Professional Skepticism:

It refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

However, it does not mean that the auditors should disbelieve everything they are told, but they should view what they are told with a skeptical attitude, and consider whether it appears reasonable and whether it conflicts with any other evidence.

► Practice Question 02:

Your firm has recently been appointed as the external auditor of Door Limited. The engagement partner has planned a meeting with the audit team to discuss the overall audit strategy and finalize the audit plan.

Required:

List the planning activities which you would need to discuss with the engagement partner regarding the issues related to first year of audit engagement.

Tutorial Notes:

First-year audits require special attention:

Communication with predecessor auditor;

Reviewing prior period FS (if available);

Understanding opening balances thoroughly;

Gaining knowledge of the client's industry, environment, and internal controls.

► *Solution 02:*

Since it will be the first time we will be auditing Door Limited, I will have to discuss the following additional matters with the engagement partner:

- Arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers;
- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan;
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances; and
- Other procedures required by the firm's system of quality management for initial audit engagements.

► *Practice Question 03:*

Briefly discuss the key benefits which may arise due to splitting of work between interim and final audit.

Tutorial Notes:

When asked for benefits of dividing audit work into interim vs. final:

Interim testing can reduce year-end pressure, identify weaknesses earlier, and expedite final completion.

Focus your answer on the advantages (time management, early detection of misstatements, etc.), not on generic procedures.

► *Solution 03:*

Key benefits that may arise from splitting the work between interim and final audit are as follows:

- More flexible resource planning within the firm (the timing of interim audit is typically more flexible than the timing of final audit. This helps to reduce demand for audit staff during 'busy season')
- Earlier identification of significant matters
- Shareholders and other users receive audited accounts earlier/Earlier completion of the audit
- Increased audit efficiency

► *Practice Question 04:*

Afaq & Co has been appointed as the auditor of Ethereum Limited (EL) in place of retiring auditor in the AGM.

Required:

List the additional matters that you should consider in the first year of EL's audit.

Tutorial Notes:

For additional matters in first-year audits:

Check if opening balances contain misstatements;

Evaluate internal control structure from scratch;

Communicate with predecessor auditor regarding significant matters and any known internal control weaknesses.

► *Solution 04:*

Planning activities to be performed by Afaq & Co.

- Arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.
- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
- Audit procedures to be performed to obtain sufficient appropriate audit evidence regarding opening balances.
- Other procedures required by the firm's system of quality management for initial audit engagement.

► *Practice Question 05:*

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides development of the audit.

Required:

For establishing an overall audit strategy:

- i. identify any eight characteristics of the engagement that define its scope.
- ii. identify any four considerations to ascertain the reporting objectives, timing of the audit and nature of communication.

Tutorial Notes:

When setting the audit strategy, thoroughly consider:

Characteristics defining scope (reporting requirements, branch locations, multi-jurisdiction, staff availability, etc.).

Reporting objectives (deadlines, communication with management or those charged with governance).

This ensures your audit plan is aligned with the engagement's scale and deadlines.

► *Solution 05:*

(i)

- The financial reporting framework used (for example, international financial reporting standards).
- Any industry specific reporting requirements
- The location of the components of the entity (for example, there might be overseas branches).
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- Whether the entity has an internal audit function and, if so, whether, in which areas and to what extent, the work of the function can be used, or internal auditors can be used to provide direct assistance, for purposes of the audit.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.

(ii)

- The entity's timetable for reporting such as at interim and final stages.
- The organization of meetings with management and those charged with governance to discuss the nature timing and extent of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications both written and oral including the auditor's report management letters and communication to those charged with governance.
- The discussion with management regarding the expected communication on the status of audit work throughout the engagement.

2 UNDERSTANDING THE BUSINESS AND MATERIALITY: ISAS 315(REVISED 2019) AND 320

Auditor's Risk Assessment Process

The auditor performs risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement. ISA 315(Revised 2019) **requires** the auditor's risk assessment procedures to include the following:

- **Inquiries** (i.e. asking questions and getting answers) of:
 - management;
 - appropriate individuals within the internal audit function if such a function exists (irrespective of whether the external auditor plans to use the work of internal audit and/or use them for direct assistance, as such inquiry will assist the external auditor's understanding of the role that internal audit plays in the monitoring of controls); and
 - others who may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.

- **Analytical procedures,**

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud

- **Observation and inspection**

Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. (for example, entity's operations, internal control manuals, entity's premises and plant facilities).

Using automated tools and techniques, the auditor may perform risk assessment procedures on large volumes of data (from the general ledger, sub-ledgers or other operational data) including for analysis, recalculations, reperformance or reconciliations.

2.1 Understanding the Entity, its Environment, Applicable Financial Reporting Framework and the Entity's System of Internal Control

The auditor is required to **identify and assess the risks of misstatement**, whether due to fraud or error, through understanding the entity and its environment, including its internal controls.

The auditor will perform risk assessment procedures to obtain an understanding of:

Entity and its environment

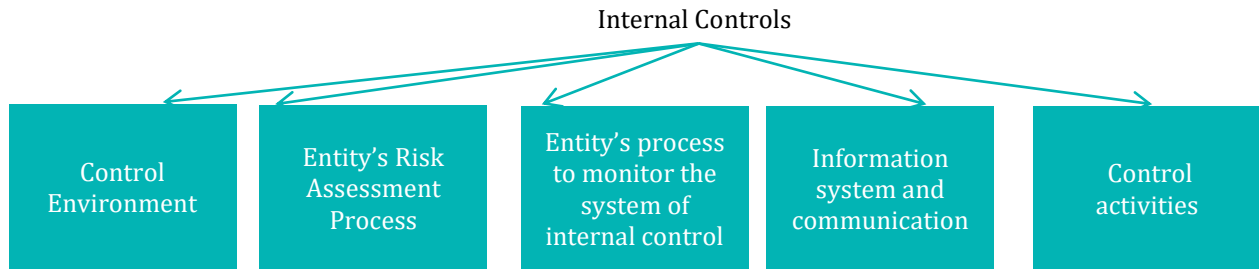
- The organizational structure, ownership and governance, and its business model, including the extent to which the business model integrates the use of IT;
- Relevant industry, regulatory and other external factors;
- The measures used internally and externally to assess the entity's financial performance.

Financial Reporting Framework

The applicable financial reporting framework, and the entity's accounting policies and the reasons for any changes;

How inherent risk factors affect susceptibility of assertions to misstatement and the degree to which they do so, in the preparation of the financial statements in accordance with the applicable financial reporting framework.

Business risks are risks occurring as a result of significant conditions, events, circumstances, actions or inactions that could affect an entity's ability to reach its objectives and carry out its strategies. Business risks can also occur as a result of setting of inappropriate objectives, strategies or goals.



Entity's Risk Assessment Process



All the remaining elements of internal controls are discussed in detail in Chapter 5; Internal control.

2.2 Understanding the accounting and internal control systems

ISA 315 (Revised 2019) **requires** the auditor to **obtain an understanding of internal controls relevant to the audit**. Although most of the entity's internal controls will relate to financial reporting, not all will be relevant to the audit.

2.3 The financial statement assertions (ISA 315(Revised 2019))

► Definition: Assertions

Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

IAASB Handbook – Glossary of terms

Modern auditing theory takes the view that the financial statements prepared by the management comprise a number of '**assertions**' or representations. These assertions are set out in ISA 315(Revised 2019) and fall into the following categories:

- Assertions about **classes of transactions and events** and related **disclosures** for the period under audit (i.e. income statement assertions)
- Assertions about **account balances** and **related disclosures** at the period end (i.e. statement of financial position assertions)

Assertions about **classes of transactions** and events and related **disclosures** are as follows:

- **Occurrence:** Transactions and events that have been recorded or disclosed have occurred and relate to the entity.
- **Completeness:** There are no unrecorded transactions, events and disclosures.
- **Accuracy:** Amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
- **Cut-off:** Transactions and events have been recorded in the correct accounting period.
- **Classification:** Transactions and events have been recorded in the proper accounts.
- **Presentation:** Transactions and events are appropriately aggregated or disaggregated and clearly described and related disclosures are relevant and understandable.

Assertions about **account balances and related disclosures** are as follows:

- **Existence:** Assets, liabilities and equity interests exist.
- **Rights and obligations:** The entity holds or controls the rights to assets, and liabilities are those of the entity.
- **Completeness:** There are no unrecorded assets, liabilities or equity interests and all related disclosures have been included.
- **Accuracy, valuation and allocation:** Assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded and related disclosures have been appropriately measured and described.
- **Classification:** Assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable.

For each financial statement item being audited, the auditor should therefore generate evidence designed to reach a conclusion on the reliability of the appropriate assertions.

Summary of assertions

About transactions/events and related disclosures	About account balances and related disclosures
Occurrence	Existence
Completeness	Rights and obligations
Accuracy	Completeness
Cut-off	Accuracy, valuation and allocation
Classification	Classification
Presentation	Presentation

► Example:

Required

Using your accounting knowledge, apply the appropriate assertions to the audit of sales of goods.

► Answer

Transaction & events and disclosure assertions:

Occurrence: All sales invoices reflected in the accounting records relate to goods despatched by the entity during the current year. The figure for “Revenue” in the financial statements agrees to the sales account in the nominal ledger.

Completeness: All goods despatched have been invoiced and all such sales invoices have been entered into the accounting records. All entries in the sales account in the nominal ledger have been included within “Revenue”.

Accuracy: All invoices have been correctly priced and discounts properly applied, and they have been accurately entered in the accounting records. The sales account in the nominal ledger has been properly added to arrive at the “Revenue” figure in the financial statements.

Cut-off: Goods despatched just before the year end have been invoiced and included in sales. Goods despatched just after the year end have not been included in sales.

Classification: All sales invoices have been posted to the sales account in the nominal ledger. “Revenue” is properly disclosed in the financial statements in the income statement (under IAS 1’s two statement format) or statement of comprehensive income (single statement format) for the current year.

Tutorial note:

The other assertions relate to assets, liabilities and equity and so are not relevant.

2.4 Risk and materiality

The auditor is **required** by ISA 315 (Revised 2019) to identify and assess the **risks of material misstatement** at both the financial statement and assertion levels.

The **financial statement level** refers to risks which are pervasive to the financial statements as a whole and which potentially affect many assertions (see below). An example might be if management have a tendency to override internal controls – this would affect all areas of the accounting systems.

The **assertion level** refers to specific objectives of the financial statements, for example, that all liabilities have been recorded and that recorded assets exist.

WHAT TO DOCUMENT

- The discussion among the engagement team and the significant decisions reached
- Key elements of the auditor's understanding, the sources of information from which the understanding was obtained and the risk assessment procedure performed
- The evaluation of the design of identified controls, and determination whether such controls have been implemented; and
- The identified and assessed risk of material misstatement at financial statement level and assertion level

ISA 320 – MATERIALITY

SCOPE:

Auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of Financial Statements

What is Materiality?

As an auditor, our objective is to provide level of confidence to the user of the financial statements. Therefore, when auditor is determining materiality the auditor should consider what could be material for user not management.

DEFINITION OF MATERIALITY

"Misstatement, including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decision of the users taken on the basis of the Financial statement."

Exam Tip: Never use the word like we "calculate" the materiality. It's not the clerical exercise. We always "determine" materiality because it is a matter of professional judgement.

The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

- Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- Understand that financial statements are prepared, presented and audited to levels of materiality;
- Recognise the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- Make reasonable economic decisions on the basis of the information in the financial statements

Determining Materiality

If the determination of materiality is not the mechanical exercise, then how should we determine materiality?

STEPS FOR DETERMINING MATERIALITY

STEP 01: Understand the ownership structure and users of the financial statements.

STEP 02: Determine the elements of the financial statements.

STEP 03: Identify the benchmark of most importance to users

STEP 04: Determine the appropriate percentage to apply to the selected benchmark

STEP 05: Determine performance materiality and clearly trivial threshold

STEP 01: Understand the ownership structure and users of the financial statements

As per the definition of materiality, auditor consider what could be material for USER. So the first step to determine materiality is to understand and identify who is the user of the financial statement.

Materiality is initially determined at planning stage so during that phase had we ever consider who the user of the FS is? As per ISA 315(Revised 2019) Auditor is required to obtain an understanding of the entity and its environment.

Auditor is required to obtain an understanding of the entity and its economic environment, the industry in which it operates, its ownership structure including the means by which the entity is financed to determine the users of the financial statements

Auditor shall also consider who receives or uses the financial statements and why an audit is required Common examples of primary users of the financial statements may include: shareholders and debt holders.

► Example:

As an audit partner you are planning the audit of A Company. While obtaining the understanding of the entity and its environment you came across with the following facts.

- Company is a listed entity
- Company does not have any external borrowing

Based on the above facts **Engagement Partner has concluded that User of the financial statements are shareholders**

► Example:

As an audit partner you are planning the audit of Company B. While obtaining the understanding of the entity and its environment you came across with the following facts.

- Company is a listed entity
- Company had obtained heavy financing from Banks
- Debt equity ratio is 80: 20

Based on the above facts **Engagement Partner has concluded that User of the financial statements are Banks / Lenders**

► Example:

As an audit Partner you are planning the audit of Company C. While obtaining the understanding of the entity and its environment you came across with the following facts.

- Company is the non for profit organization
- Company's business is to provide the education service to the Pakistan
- Company is not listed neither obtained loans from banks

Based on the above facts **Engagement Partner has concluded that User of the financial statements are member / trustee of the Company**

STEP 02: Determine the elements of the financial statements.

In the Step 01 we have determined the user of the financial statement. Now the next step is to determine the elements of financial statements such as PPE, Inventory, Borrowings, Intangible, Net asset, Total Asset, Revenue, Gross Profit, Expenses and etc.

► *Example:*

If we are doing the audit of Bank, PPE and Inventory may not be the elements of the financial statements therefore we could not determine materiality based on the PPE and Inventory.

► *Example:*

If we are doing the audit of Manufacturing Company, PPE and Inventory might be the elements of the financial statements therefore we may determine materiality based on the PPE and Inventory.

STEP 03: Identify the benchmark of most important to users

As in the step 02 there are so many elements of the financial statements. To determine the benchmark requires careful consideration of available information on the focus of the users of the financial statements.

► *Example:*

The engagement team of Company A is in the planning phase. One of the key phase of planning is to determine materiality. While obtaining the understanding of the entity and its environment you came across with the following facts.

- The entity is a listed entity in the textile business.
- The Company does not have any significant borrowing from lenders / banks
- As per the draft financial statement, Company has reported the profit
- The Company has history to pay dividend

The engagement partner has determined that due to the fact that the entity is listed and does not have any extensive borrowing therefore user of the financial statements are shareholder and shareholder focus more on Profit before tax. It is the most appropriate benchmark for the user because economic decision of the user such as sale and purchase of shares and dividend income are based on profit before tax.

► *Example:*

The engagement team of Company B is a listed entity that engaged in the business of power generation. While obtaining the understanding of the entity and its environment you came across with the following facts.

- It has been investing heavily in plant and machinery over the past years
- The investment has been financed ongoing through borrowings from banks.

Based on the above facts and circumstances, the engagement partner using the professional judgement has determined that user of the financial statements are lenders / banks.

The main focus of the readers of the entity's financial statements is net assets because if the company fails to repay the loan the bank may recover the amount by selling the assets of the Company.

Benchmark	Justification
Profit Before Tax	• Listed entity with issued equity securities • Dividend paying entity • Profit oriented entity
Revenue	• Not for profit entity • A company incurring losses

Benchmark	Justification
Cash flow from operation	Where primary user is bank and focused on the ability of the entity to repay
Expenses	- Public sector entity - Not for profit entity
Net Asset	- Unitholders of Mutual funds - Company with strategic investments having various subsidiaries and associates
Total Asset	Highly leveraged entity asses secured against financing

STEP 04: Determine the appropriate percentage to apply to the selected benchmarks

Once the appropriate benchmark is identified, a percentage is applied to assist in determination of materiality. There is a relationship and involves the exercise of professional judgement to determine a percentage to be applied to a chosen benchmark.

Following guidelines may assist the auditor to determine materiality. Please note that these percentages haven't specified by the ISA 320 expressly, rather these are some of the best practices used by a majority of audit firms worldwide.

Benchmark	Percentage
Profit Before Tax	5%
Revenue	1% to 5%
Total Asset	Up to 1%
Net Asset	Up to 3%
Expenses	3% to 5%
Cash flow from operations	3% to 5%

STEP 05: Determine Performance Materiality

Once the materiality has been determined, we will determine performance materiality.

What is Performance Materiality?

The amount set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements

How to determine performance materiality?

The determination of Performance Materiality involves the exercise of professional judgement and is not a simple mechanical calculation. We determine performance materiality by deducting from materiality the total amount of uncorrected misstatement that we anticipate identifying and that we believe management will not correct in the financial statements.

It is affected by the:

- Auditor's understanding of the entity and its environment
- Nature and extent of misstatements identified in previous audits and thereby auditor's expectation in relation to misstatements in the current period
- The reliability of Entity's internal control over financial reporting
- Increased engagement risk
- Any changes in the business

► **Example:**

The Engagement Partner has determined Materiality for Company A amounting to Rs. 5,000,000 for the current period audit and the engagement team is about to determine performance materiality next. Company is engaged in the trading of high brand clothes and there have been no significant changes in the entity's business, internal control, risks of material misstatement or management. The entity has been our client for the last five years and the uncorrected misstatements is approximately Rs. 1,500,000 in the prior years.

The engagement team determines performance materiality to be Rs. 3,500,000 (Rs. 5,000,000 - 1,500,000).

What is the use of Materiality?

Materiality is considered throughout the audit such as:

Planning

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

- Determining the nature, timing and extent of risk assessment procedures
- Identifying and assessing the risks of material misstatement; and

Performing

Determining the nature, timing and extent of further audit procedures.

Concluding

Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Materiality level for particular class of transaction, account balance and disclosure

If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

- Whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, and the remuneration of management and those charged with governance).
- The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

► *Example:*

You are in the planning phase and have determined the materiality of Rs. 5,000,000. While reviewing the draft financial statement you came across with a disclosure that company has acquired new business. The Investment appearing in the balance sheet is amounting to Rs. 1,500,000.

The engagement Senior is of the view that amount is immaterial to the financial statement as a whole, however Engagement Partner briefed that although amount is immaterial but as the company has acquired new business during the year therefore user of the financial statement focus on new business therefore a separate materiality for investment in new business shall be determined.

Revision as the audit progress

The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

Reasons for change in materiality

- Result of change in circumstances that occurred during the audit (for e.g. a decision to dispose a major part of the entity's business)
- New information
- Change in the auditors understanding of the entity and its operation as a result of performing further audit procedures

For e.g. if during the audit it appears as though actual financial result are likely to be substantially different from the anticipated period-end financial result that were used initially to determine materiality for the financial statement as a whole, the auditor revises that materiality.

► *Example:*

The Engagement team has determined the materiality in the planning phase based on profit before tax. Subsequently management informed to the audit team that Company has loss a case in the Court therefore provision should be recorded hence the profitability has been converted into losses.

Based on the information the engagement partner has revised the materiality based on the revenue.

Documentation

The auditor shall include in the audit documentation the following amounts and the factors considered in their determination:

- Materiality for the financial statements as a whole
- If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures
- Performance materiality
- Any revision of Materiality and Performance Materiality as the audit progressed

► *Practice Question 06:*

You are the training manager in a firm of chartered accountants. Prepare brief presentation for newly inducted trainees, on the following:

Materiality and Performance Materiality.

Tutorial Notes:

Distinguish overall (FS-level) materiality vs. performance materiality (lower threshold for testing to reduce risk of aggregation of smaller misstatements).

Include practical application examples: e.g., why you might use a slightly stricter benchmark in high-risk areas.

► *Solution 06:*

Materiality:

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of financial statements. The auditor keeping in view the concept of materiality gives his opinion i.e. whether the financial statements present fairly in all material respects the financial position and performance of the entity.

Performance Materiality:

Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures. Performance materiality recognises the fact that errors/omissions detected in a particular area may not breach the overall materiality level but when all the errors/omissions in all the areas is combined or added together, the overall materiality could be breached.

► *Practice Question 07:*

Determination of materiality level requires professional judgment on the part of the auditor.

- a) Briefly describe the importance of materiality in the following stages of audit:
 - i. Planning stage
 - ii. Reporting stage
- b) What aspects of materiality should be documented by an auditor in the working papers?

Tutorial Notes:

Stress that materiality:

Planning stage: helps determine nature, timing, and extent of testing;

Reporting stage: final evaluation of misstatements for deciding if FS are true and fair.

Documentation: must show how you established the figure and any adjustments made during the audit.

► *Solution 07:*

(a)

- i. **Planning stage** – The concept of materiality is used in determining the nature, timing and extent of further audit procedures;
 - ii. **Reporting stage** – The materiality concept is used in evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.
- (b) The auditor shall document the following aspects of materiality:
- i. Materiality for the financial statements as a whole;
 - ii. Performance materiality;
 - iii. Basis of computing materiality; and
 - iv. Any revision of (i) to (ii) as the audit progresses

► *Practice Question 08:*

Apart from profit before tax, list any four benchmarks which can be used to determine the materiality at the financial statement level.

Tutorial Notes:

If profit is volatile or not the main metric, consider total revenue, gross margin, net assets, or equity.

Articulate why you choose a particular benchmark (e.g., in a not-for-profit, revenue or expenses may be more relevant than profit).

► *Solution 08:*

The following can be the benchmark for determining materiality:

- Gross profit
- Total expenses / Total Revenue
- Total equity
- Total assets / Total Liabilities

► *Practice Question 09:*

Discuss the term 'performance materiality' and the purpose for which it is used.

Tutorial Notes:

Performance materiality is set below overall materiality to reduce the likelihood that individually immaterial errors will aggregate into a material misstatement.

Indicate it guides sample sizes and testing thresholds.

► *Solution 09:*

Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole or at less than the materiality level for particular classes of transactions, account balance or disclosures.

Performance materiality is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements or in classes of transactions, account balance or disclosures exceeds the materiality as a whole.

► *Practice Question 10:*

You are the manager responsible for the audit of a newly incorporated company, Trojan Limited (TL). Following are the extracts from the first draft financial statements of TL for the year ended 31 December 2019:

	Rs. in million
Revenue	12,000
Profit before tax	72
Total assets	13,000
Total liabilities	7,000

Since this is the first year of operation, the profit before tax was quite low. However, as per the management's projection, the profit before tax would grow exponentially over the next three years.

Your audit team has determined the materiality on the basis of profit before tax for the year ended 31 December 2019. In view of the audit team profit before tax is the main performance indicator for TL's board of directors.

Required:

Discuss the appropriateness of the benchmark used by your team in determining the materiality and suggest the alternative(s) available to your team.

Tutorial Notes:

Always consider the company's nature and financial results. If current profits are not a stable measure, pick another benchmark.

Justify your choice in context (e.g., first-year entity with minimal earnings might use total assets or revenue).

► *Solution 10:*

Information is considered material if its omission could influence the economic decision of the users taken on the basis of the financial statements. Only considering the board of director as the only users of financial statements for determining materiality is not correct.

Furthermore, since TL is a newly established entity, use of 'profit before tax' will not be a good benchmark as current year profit is low because of first year of operation. Further, considering a benchmark on the basis of future profitability is also not correct.

If materiality is still to be determined based on 'profit before tax', it will result in a low materiality level, which will require performing detailed testing. By setting a lower materiality the audit team would also increase their sensitivity to a potential misstatement.

Alternatively, assets or revenue may be considered to be an appropriate benchmark, in the determination of materiality. The audit team however, based on their audit strategy and approach, may consider other appropriate benchmarks (e.g. total expenses, net assets etc.).

► *Practice Question 11:*

Your firm is the statutory auditor of Teak Pakistan Limited (TPL) for the year ended 30 June 2020.

During the final review of audit work, your audit team informed you that TPL uses a third-party software for its payroll. While checking the tax calculation, they identified an error in the calculation of monthly tax deduction from salary. The audit junior who performed the test, extrapolated the error over the entire population. This resulted in an overall short deduction of Rs. 920,985. She concluded that the error was not material because this amount was less than the audit materiality set at the financial statement level i.e. Rs. 1,000,000.

Further, she discussed this matter with the TPL's management who has agreed to deduct the differential amount from the salary of the next month and will deposit it into government exchequer. Therefore, she concluded that no accounting adjustment is required for the year ended 30 June 2020.

Required:

- i. Briefly discuss the conclusion made by audit junior regarding materiality of the transaction and recording of the error.
- ii. State additional steps that you would suggest to your audit team. (Implications on audit report are not required)

Tutorial Notes:

Qualitative factors matter: e.g., a tax or legal compliance issue, even if numerically small, can't be dismissed solely on the basis of overall materiality.

Discuss any potential compliance, regulatory, or user perception concerns.

► *Solution 11:*

Discussion on conclusion: Since the auditor has extrapolated the error over the entire population, he should obtain sufficient evidence that the misstatement or deviation also affects the rest of the population.

Steps to be performed:

- Investigate the nature and cause of the error i.e. whether the errors identified are an indication of system errors.
- Investigate whether the problem lies within one transaction only, or it affected multiple transactions or affected any specified period.

Discussion on conclusion:

The conclusion drawn by the audit junior is not correct, as there may be other errors which when aggregated, may result in a material misstatement.

It may also be an indication of similar errors in the accounting software.

The accounting treatment suggested by the management is also not correct, because payable to FBR and receivable from employees have been understated at year-end.

Steps to be performed:

- Involve the IT specialist for obtaining assurance on the proper functioning of the accounting software.
- Consider whether there are any fines or penalties which need to be accounted for in the financial statements.
- Discuss with the management to record the short deduction as receivable from employees and payable to FBR.

► Practice Question 12:

You are the audit manager responsible for the audit of Beachwood Textile Limited (BTL). At the planning stage, your audit team has assessed that there is no significant risk of material misstatement due to fraud and management override of controls. The audit team's assessment is based on the fact that BTL has been an audit client of the firm for the last 10 years and no material misstatement had been reported in the previous years.

Required:

Guide your audit team with regard to their assessment of risk.

Tutorial Notes:

- Tailor your answer to the question's phase (e.g., "planning stage" vs. "responsive procedures upon fraud suspicion").
- Always incorporate professional skepticism explicitly: at planning, you consider the possibility of material fraud even if no prior misstatements were found.
- Distinguish between known or suspected fraud procedures vs. general risk assessment.

► Solution 12:

When planning and performing an audit, we should adopt an attitude of professional skepticism. We should have an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

We should recognise the possibility that a material misstatement due to fraud could exist, notwithstanding our past experience of the honesty and integrity of the entity's management and those charged with governance.

Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk. Irrespective of our assessment of the risks of management override of controls, we shall design and perform the audit procedures for management override of controls.

Assessing the risk of fraud as non-significant is also not correct based on the presumption that BTL has been the firm's client for the last 10 years and no material misstatement had been reported in the previous years. The audit team should identify and assess the risk of material misstatement due to fraud at the financial statement level and at the assertion level. Furthermore, the audit team shall consider that there is a risk of fraud in revenue recognition which may result in a material misstatement unless justifiably rebutted.

► **Practice Question 13:**

Consider the following information of two companies:

Particulars	Company A (Listed Textile Company)			Company B (Unlisted Cement Company)		
	2023	2022	2021	2023	2022	2021
	----- Rs. in million -----			----- Rs. in million -----		
Financial information						
Net assets	4,645	4,008	3,998	571	665	566
Revenues	15,877	16,119	12,566	1,014	1,810	979
Profit before tax	864	768	690	(16)	145	71
Other information						
Uncorrected misstatements in prior years	-	9	-	-	-	-
Debt equity ratio	10:90	Not relevant		85:15	Not relevant	

Required:

Using the information provided above:

- calculate the materiality at the financial statements level for each company separately for the year ended 30 June 2023.
- discuss the reasons for selection of appropriate benchmark for calculation of materiality in (a) above.
- briefly discuss how the performance materiality will be calculated for Company A.

Tutorial Notes:

- Always address prior uncorrected misstatements: you might reduce performance materiality to account for prior errors.
- Justify the chosen benchmark for different industries (listed vs. unlisted, stable profit vs. fluctuating, etc.).

► **Solution 13:****a) The materiality for Company A:**

5% of profit before tax = 864 million × 5% = Rs. 43.2 million (other % for PBT may also be considered)

The materiality for Company B:

3% of net assets = 571 million × 3% = Rs. 17.1 million (any percentage up to 3%)

b) Reasons for selection of each company's benchmark**Company A:**

- Understand the ownership structure and users of the financial statements:

Since Company A is a listed company that is mainly financed by equity, the primary users of the financial statements are the shareholders.

- Identify the benchmark of most importance to users:

Profit before tax is the most appropriate benchmark for the shareholders because they base their economic decisions (such as buying and selling shares and receiving dividend income) on profit before tax. Secondly, profit before tax is also selected as a benchmark for Company A due to its consistent history of profitable operations and lack of any significant volatility.

Company B

- i. Understand the ownership structure and users of the financial statements:

Since Company B is an unlisted company that has obtained significant lending from financial institutions (with debt constituting 85% of its financing), the primary users of the financial statements are its lenders and owners.

- ii. Identify the benchmark of most importance to users:

Net assets are the most appropriate benchmark for the lenders because if the company fails to repay the loan, the bank may recover the amount by selling the company's assets. Furthermore, profit before tax and revenue have been very volatile and thus cannot be employed as a benchmark for determining materiality.

c) Performance materiality:

Since in the previous years, the uncorrected misstatements were around Rs. 9 million, the auditor will subsequently reduce the materiality to account for uncorrected misstatements. As a result, the performance materiality will be Rs. 34.2 million (43.2 – 9). This will be further reduced to take the effect of any undetected misstatements.

► **Practice Question 14:****Part (a)**

You are the audit manager responsible for overseeing the audit of Candy Crafts Limited (CCL), a listed company, for the year ending 30 September 2024. The audit team, assigned in August 2024, gathered the following financial data, with the 2024 figures estimated based on quarterly financial statements prepared by CCL:

	2024	2023	2022
	----- Rs. in million -----		
Revenue	10,000	9,500	8,700
Profit before tax	2,235	1,980	1,905
Net assets	9,900	8,800	8,400
Debt to equity ratio	9:91	11:89	10:90

Required:

Calculate the materiality at the financial statement level. Also, discuss the reasons for the selection of the appropriate benchmark.

Part (b)

On 25 September 2024, a fire incident occurred at CCL, resulting in damage to some of the plant, machinery and inventory. This led to the impairment of the damaged plant and machinery and the write-down of the damaged inventory to its net realizable value. At year-end after incorporating these adjustments, the estimated figures have actualized, and they now stand at: revenue of Rs. 9,000 million, profit before tax of Rs. 50 million, and net assets of Rs. 7,700 million.

Required:

Discuss the impact of the additional information on the materiality calculated in (a) above.

► *Solution 14:*

Part (a)

Given that CCL is a listed entity and the debt-to-equity ratio is 9:91, it has very limited external borrowing. This suggests that main users of the financial statements are shareholders.

As CCL is expected to report profits and since the primary users of the financial statements are shareholders, they tend to focus more on profit and the dividends paid based on it. Therefore, profit before tax can be used as a benchmark for determining materiality.

Since profit before tax is used as benchmark, 5% should be applied for determining materiality. Consequently, materiality calculated at the planning stage would be Rs. 111.75 million.

Part (b)

The impairment loss and inventory write-down have wiped out the entire CCL's profit before tax. Therefore, any materiality now calculated on it would be too low, and the audit procedures to be performed by the auditor would increase drastically.

The auditor needs to revise the materiality calculated earlier. The auditor should now consider revenue as the benchmark for calculating materiality, as the revenues have been fairly stable over the past three years.

Since revenue is being considered the benchmark then 1% of revenue should be used for determining materiality. Therefore, the revised materiality calculated would be Rs. 90 million.

As the revised materiality level is lower than the materiality previously calculated, the auditor shall determine whether it is necessary to revise performance materiality and whether the nature, timing, and extent of the further audit procedures remain appropriate.

3 AUDIT RISK: ISA 330

3.1 Risk-based approach to auditing

As discussed above, a key feature of modern auditing is the 'risk-based' approach that is taken in most audits. At the planning stage, as required by ISA 315(Revised 2019), the auditor will identify and assess the main risks associated with the business to be audited. He will prepare an overall audit strategy and an audit plan, as required by ISA 300, to focus the audit work on the high risk areas.

This area of risk assessment is also covered by ISA 330 *The auditor's responses to assessed risks*. The **objective** of ISA 330 is to gather adequate appropriate audit evidence about assessed risks of material misstatement, by designing and putting in place appropriate responses to the risks.

3.2 Responses to assessed risks: ISA 330

At the **financial statement level** these "responses" are overall ones, which may include:

- emphasising to the audit team the need to maintain an attitude of professional scepticism
- assigning more experienced staff
- Providing more supervision
- the use of experts
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- changing the nature, timing and extent of audit procedures (for example, performing more substantive procedures at the final rather than at the interim audit, or obtaining more "persuasive" audit evidence).

The assessment of the risks at this level and therefore the auditor's response is very much affected by the auditor's assessment of the **control environment**. An effective control environment will be likely to increase the auditor's confidence in controls in all areas and allow him to carry out more procedures at the interim audit and to carry out less **tests of detail**. Both of these terms are considered in later chapters.

At the **assertion level** these "responses" take the form of further audit procedures, discussed in detail in later chapters. Audit procedures can take the form of **tests of controls** and/or **substantive procedures**.

In summary, the auditor is required to:

- assess the risks involved in the audit
- plan the audit work so that any material misstatements are identified and corrected if necessary.

This should then ensure that a 'true and fair view' is presented by the financial statements.

3.3 The audit risk model

A standard audit risk model is available to help auditors identify and quantify the main elements making up overall audit risk.

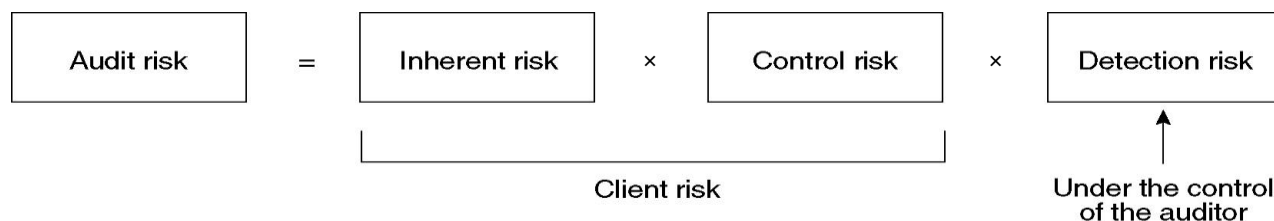
► Definition: Audit risk

The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

IAASB Handbook – Glossary of terms

Audit risk is the risk (chance) that the auditor reaches an inappropriate (wrong) conclusion on the area under audit. The audit risk is derived from errors arising out of inherent risk which are not prevented/detected by entity's internal controls and are not detected by further audit procedures. For example, if the audit risk is 5%, this means that the auditor accepts that there will be a 5% risk that the audited item will be misstated in the financial statements, and only a 95% probability that it is materially correct.

The audit risk model can be expressed as follows:



This model can be stated as a formula:

$$AR = IR \times CR \times DR$$

where:

AR = audit risk IR = inherent risk

CR = control risk, and DR = detection risk.

Risks are expressed as proportions, so a risk of 10% would be included in the formula as 0.10.

Inherent risk

► Definition: Inherent risk

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

IAASB Handbook – Glossary of terms

Inherent risk is the risk that items may be misstated as a result of their inherent characteristics. Inherent risk may result from either:

- the nature of the items themselves. For example, estimated items are inherently risky because their measurement depends on an estimate rather than a precise measure; or
- the nature of the entity and the industry in which it operates. For example, a company in the construction industry operates in a volatile and high-risk environment, and items in its financial statements are more likely to be misstated than items in the financial statements of companies in a more low-risk environment, such as a manufacturer of food and drinks.

When inherent risk is high, this means that there is a high risk of misstatement of an item in the financial statements.

Inherent risk operates independently of controls. It cannot be controlled. The auditor must accept that the risk exists and will not 'go away'.

Auditor shall:

For each identified risk of material misstatement at the assertion level, the auditor is required:

- to assess the likelihood and magnitude of material misstatement. The auditor will take into account how and the degree to which:
- Inherent risk factors affect the susceptibility of relevant assertions to the misstatement
- Risk of material misstatement at the financial statement level affect the assessment of inherent risk for the risks of material misstatement at the assertion level
 - whether identified risks of material misstatement are significant risks.
 - whether substantive procedures alone cannot provide sufficient appropriate audit evidence for any of the risks of material misstatements at the assertion level.

It is the combination of likelihood and magnitude that will determine where inherent risk is assessed on the spectrum of inherent risk. For the inherent risk to be determined as a significant risk, it does not require to be high up on the scale for both likelihood and magnitude, even one will do

Significant risk: is an identified risk of material misstatements for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risks.

► *Examples of Events or Conditions that May Give Rise to the Existence of Risks of Material Misstatement at assertion level*

Inherent Risk Factor - Complexity

- Operations that are subject to a high degree of complex regulation.
- The existence of complex alliances and joint ventures.
- Accounting measurements that involve complex processes.

Inherent Risk Factor - Subjectivity

- A wide range of possible measurement criteria of an accounting estimate. For example, management's recognition of depreciation or construction income and expenses.
- Management's selection of a valuation technique or model for a non- current asset, such as investment properties.

Inherent Risk Factor - Change

- Operations exposed to volatile markets, for example, futures trading.
- Going concern and liquidity issues including loss of significant customers.
- Changes in the industry in which the entity operates.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Entities or business segments likely to be sold.
- Changes in key personnel including departure of key executives.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.
- Application of new accounting pronouncements.
- Impact of new legislation related to environmental protection.

Control risk

► *Definition: Control risk*

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

IAASB Handbook – Glossary of terms

Control risk is the risk that a misstatement would **not** be prevented or detected by the **internal control systems** that the client has in operation.

In preparing an audit plan, the auditor needs to make an assessment of control risk for different areas of the audit. Evidence about control risk can be obtained through 'tests of control'.

The initial assumption should be that control risk is very high, and that existing internal controls are insufficient to prevent the risk of material misstatement. However, tests of control may provide sufficient evidence to justify a reduction in the estimated control risk, for the purpose of audit planning. Tests of control are covered in detail in a later chapter.

Detection risk

► Definition: Detection risk

The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

IAASB Handbook – Glossary of terms

Detection risk is the risk that the **audit testing procedures will fail to detect a misstatement** in a transaction or in an account balance. For example, if detection risk is 10%, this means that there is a 10% probability that the audit tests will fail to detect a material misstatement.

Detection risk can be lowered by carrying out more tests in the audit. For example, to reduce the detection risk from 10% to 5%, the auditor should carry out more tests.

In preparing an audit plan, the auditor will usually:

- **set** an overall level of audit risk which he judges to be acceptable for the particular audit,
- **assess** the levels of inherent risk and control risk, and then
- **adjust** the level of detection risk in order to achieve the overall required level of risk in the audit.

In other words, the detection risk can be managed by the auditor in order to control the overall audit risk that can be reduced by increasing testing, and reducing detection risk.

► Example:

An auditor has set an overall level of acceptable audit risk in respect of a client of 10%. Inherent risk has been assessed at 50% and control risk at 80%.

Required

- a) Explain the meaning of a 10% level of audit risk.
- b) What level of detection risk is implied by this information?
- c) If the level of audit risk were only 5%, how would this affect the level of detection risk and how would the audit work be affected by this change?

► Answer

- a) A 10% level of audit risk means that the auditor will be 90% certain that his opinion on the financial statements is correct (or there is a 10% risk that his opinion will be incorrect).
- b) $AR = IR \times CR \times DR$
 then $DR = AR / (IR \times CR)$
 $DR = 0.10 / (0.50 \times 0.80)$
 Therefore, $DR = 0.25 = 25\%$
- c) If AR is reduced to 5%, DR would now be 12.5%. More audit work will be needed to achieve this lower level of detection risk.

3.4 Exam technique: identifying risks

In the exam, you could be presented with an audit scenario and a requirement to identify and explain the risks in this scenario. You should view such a scenario as containing a number of “clues”. These clues will be matters which would impact on the auditor’s assessment of the inherent, control and, possibly, detection, risks at this particular client. Your answer needs to demonstrate that you can spot these clues (identify) and understand why they represent risks (explain).

► *Example: identifying risks*

Your assurance firm is the auditor of Risky Sounds, a retailer selling hi-tech recording equipment. Risky Sounds was started up just under a year ago by its sole shareholder and director, Sam Smith. Sam has employed a series of book-keepers to help him with the accounting records and financial statements, and the most recent one has just left. In order to start up the business Sam re-mortgaged his house and, in addition, took out a business loan. As a condition of continuing to provide the loan, the bank has asked to be provided with a copy of the annual financial statements.

Required

Identify the risks in the above scenario and explain why they are risks.

► *Answer*

Hi-tech recording equipment. Any hi-tech product is likely to become obsolete very quickly, as more advanced products come on to the market. There is therefore a risk of obsolete inventory, which will need to be written down, and ultimately, if the entity cannot keep up with trends, the business may not be able to continue in existence.

Started up just under a year ago. Any start-up business is inherently risky, as many businesses fail in their first year. Also, this must mean that the first set of annual financial statements is due (a problem, given the lack of a book-keeper). Also, this creates detection risk, as the assurance firm will also be unfamiliar with the business and no prior year figures will be available for comparison.

Sole shareholder and director. This may give Sam personal motivation to misstate the figures. There is also no other (perhaps, more experienced) director to keep Sam in check and ensure that he is making sound business decisions. This could increase the risk of business failure.

A series of book-keepers. This perhaps indicates that Sam is putting undue pressure on his book-keeper (perhaps to misstate the figures) or that the business is so chaotic that the book-keepers have perhaps all despaired of ever being able to put a decent accounting system in place. Either of the factors indicates a high risk of misstatement (intentional or otherwise).

The most recent book-keeper has just left. Again, this indicates a high risk of misstatement in the financial statements as there is currently no book-keeper to prepare them. Even assuming that one is recruited, he will be unfamiliar with the business and any accounting systems.

Mortgage and bank loan. Both of these give Sam possible personal motivation to misstate the figures to ensure that the business does not go under and his home is safe from repossession.

► *Practice Question 15:*

The auditor is required to identify and assess the risk of material misstatement at both the financial statement and assertion levels. State what is meant by risk at financial statement level and assertion level. Give one example of risk at each level.

Tutorial Notes:

Financial statement level risks are those which are pervasive to the financial statements as a whole. You should state that such risks affect many “accounts” instead of many “assertions”.

As regards assertion level risks, explain that these risks relate to specific objectives of the financial statements.

► *Solution 15:*

Financial Statement Level: Risks at financial statement level are those which are pervasive to the financial statements as a whole and which potentially affect many assertions.

Example: If management has a tendency to override internal controls it would affect all areas of the accounting system.

Assertion Level: Risk at assertion level are those which relate to specific objectives of the financial statements.

Example: All liabilities have not been recorded and all recorded assets exist.

► **Practice Question 16:**

You are the Audit Manager on the audit of Durable Cement Limited (DCL). The information contained in the planning document includes the following:

- i. DCL is presently operating in poor general economic conditions and is also faced with tough competition, due to the availability of low priced imported cement.
- ii. In addition to the wholesalers, DCL supplies cement directly to various government departments and real estate developers. The sale is authorized by the credit control department; however, payments from government departments are often delayed.
- iii. During the year, DCL has made investment in securities of unlisted public companies.
- iv. A long-term loan was obtained in 2007 to finance the existing plant. The amount is repayable in 10 annual instalments.
- v. DCL operates a non-funded gratuity scheme for its employees.

Required:

Assess the inherent risks (high, low or moderate) along with appropriate justification, related to the following assertions:

- Valuation of factory plant	- Valuation of trade receivables
- Ownership right of finished goods inventory	- Valuation of unlisted securities
- Accuracy of long-term finance	- Valuation of provision for gratuity

Tutorial Notes:

How to assess risk properly:

If assigning High Risk, provide specific justification (e.g., economic downturn → higher receivables risk).

Ownership risk = Physical possession ≠ legal ownership. Address contractual obligations.

Common mistakes to avoid:

Stating risk levels without justification.

- Confusing inherent risk (nature of account) with control risk (effectiveness of controls).

► **Solution 16:**

S. No.	Assertion	Assessment of inherent risk	Justification
A	Valuation of factory plant	High	Due to poor economic conditions, there is a risk that the value of plant may be impaired. Inherent risk is also high due to the complexity and subjectivity involved in calculation of impairment loss.
B	Valuation of trade receivables	Low/Moderate	The valuation assertion for trade receivable and allowance for doubtful debts is affected by judgments. However as the debts from Government departments are usually secured, the chances of bad debts are low.
C	Rights to ownership of finished goods Inventory.	Low/Moderate	Cement bags are usually kept in company's premises (Godowns) and in the absence of any other information the ownership of inventory can be verified.

S. No.	Assertion	Assessment of inherent risk	Justification
D	Valuation of unlisted securities	High	Determination of fair value is complex, and involves subjectivity and judgment in the absence of any market quotations.
E	Accuracy of long term finance	Low	Third party confirmation i.e., bank confirmation is available therefore inherent risk is low.
F	Valuation of provision for gratuity	High	Due to complexity and subjectivity involved in the calculation of provision for gratuity.

► **Practice Question 17:**

You are the audit manager of the Educational University (EU) for the year ended 31 December 2015. EU has a student base of 2,500 students. It follows a policy of receiving 50% of the fees at the start of the semester and 50% in the middle of the semester. However, 10% discount is allowed to those students who pay the entire amount in advance. The cost of course material is included in the fees. The semester starts in December and June each year. You have noticed that 30% of the students who were registered in December 2015 had not claimed the course material till 31 December 2015.

Required:

Discuss the audit risks in the above scenario and how you would deal with them.

Tutorial Notes:

- Focus on course material which was not taken rather than the whole scenario.
- Identify risks of inappropriate recording of fee income and discount
- Identify risks from the university's point of view rather than from the perspective of the auditor.
- Identify the steps required to deal with the situation.

► **Solution 17:**

Audit risk

There is a risk that revenue from fees income and sale of goods is misstated due to following reasons:

- Fees income may be recognised immediately on receipt of fees rather than recognised on monthly basis as the services are rendered.
- Discounts given to students may not be accounted for properly, resulting in overstatement of revenue.
- There is a risk that revenue related to sale of course material is inappropriately classified as part of the university fees, as a result of which it may have been recognised proportionately on the basis of time (services provided).
- Entire revenue from sale of course material may not be recognised

► **Practice Question 18:**

You are the audit senior responsible for the audit of Dragon Pakistan Limited (DPL), a listed company. DPL operates in the pharmaceutical industry which is highly regulated by the government and heavy fines are placed on any non-compliance of the regulations.

The main product of DPL is Drug A. The raw material for the production of Drug A is imported from Switzerland. Drug A has been underperforming for a number of years and is currently sold at low margins. Last year, a competitor introduced a much-improved version of Drug A.

Considering the tough competition, all the companies in the pharmaceutical industry including DPL have to continuously carry out research activities for development of new drugs and improvement of the existing drugs.

Required:

- Outline the business risks that exist in DPL.
- Identify and briefly discuss the financial statement line items that could be misstated as a result of the business risks outlined in (a) above.

Tutorial Notes:

- Ensure you apply proper exam techniques, such as structuring your answers well, covering all key points, and providing clear justifications where necessary. Use professional terminology and avoid unnecessary details.

► *Solution 18:*

(a) Business Risk	(b) Financial Statement Assertions
DPL has to comply with very strict regulations and any non-compliance would result in heavy fines.	Liabilities may be understated relating to undisclosed penalties. A contingent liability may not be disclosed in the financial relating to any legal action taken by regulator against DPL.
DPL's competitor has introduced a new product which has caused DPL to reduce its selling price.	Since DPL is selling Drug-A at lower margin, its inventory might need to be recorded at lower of cost or net realizable value. Since DPL is a listed entity and the revenues are decreasing, DPL may overstate its revenue or understate its expenses. If the revenues keep on decreasing DPL's property, plant and equipment may need to be tested for impairment.
DPL has to continuously carry on research projects.	If the criteria for development cost (or intangible asset) has not been met research cost might be inappropriately recorded as development cost.
Due to significant imports of raw material DPL is exposed to foreign currency risk because of the fluctuation in exchange rates.	There is a risk that trade payables may not be translated using the correct exchange rate. Exchange gains and losses may not be calculated correctly.

► *Practice Question 19:*

Your firm is the auditor of Adventure Travel (Private) Limited (APL) which offers a wide range of adventure sports services such as paragliding, parasailing and scuba diving. APL follows high safety standards to avoid any unfortunate events. However, during the year, one of its paragliding trips was affected due to bad weather which caused severe injuries to its clients. Immediately after this unfortunate incident, APL has invested heavily in further upgrading its equipment to prevent happening of such incident in future. The entire investment has been financed through a bank loan.

You have been informed that due to overwhelming response towards adventure trips, number of tour operators have launched the same services at significantly low prices as compared to APL; however, all these new tour operators are not following as high safety standards as are being followed by APL.

Considering the increased competition, APL has recently widened its scope of business and introduced:

- booking of air tickets and hotel rooms on behalf its clients at a discounted rate. APL is entitled to a commission, if bookings are made through APL. The commission on booking is recorded when the payment has been received.
- "Book now and Pay later" instalment scheme for all of its services.

Required:

- a) Identify the matters that you will consider while obtaining an understanding of APL and its environment.
- b) Identify and discuss the business risks and the related audit risks from the above scenario.

Tutorial Notes:

Be clear about scope elements (e.g., nature of operations, locations, deadlines) versus reporting and communication factors (e.g., timeline for deliverables, communication with management).

- Keep each item distinct; don't combine different considerations under one heading.

► **Solution 19:**

- a) The auditor should consider the following matters while obtaining understanding of APL and its environment. This will involve following factors:
 - Obtaining the understanding of the tourism industry in which APL operate.
 - Inquire specific laws and regulation applicable on tourism industry.
 - Understand APL's operations, the range of services it offers and its dynamics.
 - Obtain the ownership structure, management structures and types of current and planned investments.
 - Assess APL's selection and application of accounting policies, including whether they are appropriate for its business and consistent with the industry and the applicable financial reporting framework.
 - Obtain understanding of APL's strategies of managing the tough competition and assess the business risk which may result in risks of material misstatement.
 - Review the APLs financial performance.

S #	Business risk	Audit risk
(i)	Breach of the safety standards may result in litigation against APL. Due to the increasing competition, any such incident will also affect APL's reputation.	Liabilities of APL might be understated as a result of non- recognition of the provision in respect of the litigation. The disclosure regarding contingencies may not adequately disclose the effects of the pending litigation.
(ii)	Frequent upgradation of equipment is required to prevent accidents.	The frequent upgradation of equipment might decrease the useful life of the equipment or might need to be charged off instead of capitalizing them.
(iii)	APL's competitor has introduced similar products at a low price which has affected APL's revenue.	If the revenues keep on decreasing, APL's equipment may need to be tested for impairment.
(iv)	Due to bank loan, APL will now have to manage its debt load and all the terms and conditions of that loan.	In order to meet bank's covenants, APL may overstate its revenue or understate its expenses to depict a better picture to its lenders.
(v)	There is a risk that a client may cancel its booking. Dealing with cancellation will also effect revenue flow of APL.	There is a risk that APL may recognise commission as revenue even when the criteria for recording of commission is not met.
(vi)	It seems that APL may also face cash flow challenges as it would have to pay its debt on time, whereas it would be receiving money from its customers later on. There is also a risk that APL may offer credit to those customers who are not financially viable and would not be able to pay on time.	There is a risk that receivable from customers is overstated and a provision for doubtful customers has not been recorded.

► *Practice Question 20:*

Comment on the validity of each of the following statements:

- i. Inherent risk can be lowered by a strong control environment and oversight by the entity.
- ii. The audit risk is derived from errors arising out of inherent risk which are not prevented/detected by entity's internal controls.
- iii. Detection risk can be lowered by carrying out more substantive tests in the audit.
- iv. Higher inherent risk leads to higher detection risk. Consequently, it increases overall audit risk.
- v. At an audit client, inherent risk has been assessed at 50% and control risk at 80%. To achieve an overall level of acceptable audit risk of 10%, the detection risk would be 25%.

Tutorial Notes:

Revisit the audit risk model: $\text{Audit Risk} = \text{Inherent} \times \text{Control} \times \text{Detection risk}$.

Lower detection risk by increasing scope of testing or using more effective procedures.

A higher inherent risk doesn't automatically mean a higher detection risk; you can adjust your approach to keep overall audit risk acceptable.

► *Solution 20:*

- i. This statement is not correct. Inherent risk operates independently of controls. It cannot be controlled. The auditor must accept that the risk exists and will not 'go away'.
- ii. This statement is not complete as the audit risk is derived from errors arising out of inherent risk which are not prevented/detected by entity's internal controls and are not detected by further audit procedures.
- iii. This statement is correct. Detection risk can be managed by the auditor in order to control the overall audit risk, by increasing substantive procedures, therefore reducing detection risk.
- iv. This statement is not correct. It is not necessary that if the inherent risk is high then the detection risk will also be high because a strong control environment may reduce the risk. However, the detection risk is adjusted in order to achieve the overall required level of risk in the audit.
- v. This statement is correct because of the following: $AR = IR \times CR \times DR$
Then $DR = AR / (IR \times CR)$ $DR = 0.10 / (0.5 \times 0.80)$
And therefore, $DR = 25\%$

► *Practice Question 21:*

Your firm is the auditor of Ninja Foods Limited (NFL) for the year ended 30 June 2022. NFL is a food chain having restaurants located in all major cities of Pakistan. NFL specializes in Pan-Asian cuisine and has Japanese, Thai and Chinese food on its menu.

Following information has been gathered by the audit team:

- i. Some of the ingredients used in the food products offered to customers are imported. On 31 August 2022, the government has banned import of luxury food items which includes most of the imported items used in the NFL's most selling items. NFL currently has stock of these imported items which fulfil its requirement of next one month only.
- ii. 70% of the customers pay in cash while the remaining 30% pay through credit/debit cards. Furthermore, 55% of the customers' visits are on weekend. All cash collection on weekend is deposited in the bank on the very next working day.
- iii. NFL follows a policy in which all the expired stock is to be placed in separate store room, which can then be adequately destroyed. In the internal audit report, it has been highlighted that two of the restaurants were not following this policy.
- iv. During the year ended 30 June 2022, NFL's profits have been reduced by 30% mainly due to rising electricity prices, increase in interest rates on long term loan, decrease in demand of the product due to recession in the economy and increase in raw material prices due to rupee devaluation.

Required:

- a) Identify the key audit risks in the above scenario. (Ignore the risk related to going concern)

Tutorial Notes:

- Avoid overlooking these areas by reviewing legal compliance requirements, assessing inventory for expiration risks, confirming covenant terms, evaluating asset carrying values for impairment, and checking exchange differences. Make sure your answers address these specific risk areas with relevant audit procedures.

► **Solution 21:**

Cash collection:

Majority of the collection is in cash which is to be held at an outlet for up to 2 days, therefore there is a risk of misappropriation in cash.

Inventory:

- The existing inventory of NFL might not be used because of its perishable nature and decline in demand. Therefore, there is a risk that the inventory may not be recorded at lower of cost or its net realizable value.
- The expired inventory is also not properly identified at some of the outlets, therefore, there is a risk that the inventory may not be written-off.

Fines and litigation:

- Since proper control are not being followed at two outlets, there is a risk that fines might be imposed by the government authority on inspection.
- There is a risk that expired stock might be used which may cause illness to the consumer.
- There is a risk that provision might not be recorded for the possible fines or litigation or disclosed as a contingency.

Interest based loans:

- NFL has obtained interest-based loans. Due to the increasing interest rates, there is a risk that NFL may be in breach of covenants.
- There is also a risk that interest accrual may not be properly recorded.
- Due to the adverse operational and economic condition, there is a risk that management may fraudulently misstate the financial statements.

Impairment of Assets:

- Due to the decrease in demand, there is a risk that property, plant and equipment may need to be considered for impairment.

Foreign exchange translation:

- Since NFL imports ingredients, there is a risk there might not be proper recording of foreign exchange gain or loss.
- There is also a risk that inventory might be translated using incorrect exchange rate.

► **Practice Question 22:**

Your firm is the statutory auditor of Astore Limited (AL), a listed company, for the year ended 31 December 2022. AL deals in fast moving consumer goods (FMCG). In recent times, the FMCG sector has experienced significant growth with numerous new players entering the market and established companies expanding their operations, resulting in a fiercely contested industry. AL has consistently endeavoured to meet ever-evolving needs and preferences of consumers by adapting to changes in the market.

Effective this year, AL has commenced importing raw materials for its new category of consumer products. Some of these raw materials have a short-shelf-life and could become harmful if used after their expiration date.

However, AL has successfully captured the attention of consumers with its exceptional finished products in this category, resulting in significant increase in sales.

During the year, AL has commenced the expansion of its production facilities and the implementation of an ERP system to integrate its operations with financial reporting process. These initiatives are being financed through additional borrowing facilities.

Required:

Identify and discuss the business risks and the related audit risks from the above scenario. (12)

Tutorial Notes:

Remember that auditors have a right to seek information not only from the main company's directors, officers, and employees but also from its subsidiary undertakings, including any officer, employee, or auditor of those subsidiaries. Failing to mention these broader powers can lead to incomplete answers. Always consider the entire corporate group's structure and ensure you identify all parties from whom necessary information can be requested.

► *Solution 22:*

S. No	Business Risk	Audit Risk
1.	Growth available in the FMCG sector results in a fierce competition which may lead to price wars and a decline in profitability. Government may place restrictions on import of raw material which would affect its sales.	Increased competition and any restrictions on imports can lead to lower prices, lower sales, and lower profitability. AL might overstate the revenue or understate the expenses for maintaining its share price on the stock exchange.
2.	FMCG sector always needs to adapt to consumer preferences and generally these products have a short shelf life, which may cause certain products cross their expiry date or not being profitable.	Since consumer preferences are rapidly changing and products have a short shelf life, there is a risk that the products which have crossed their expiry date might not be recognised at a lower of cost or net realizable value.
3.	Raw material for one of the products is imported, therefore, it is subject to changes in currency exchange rates and can impact the cost of imports.	There is a risk that the inventory may not have been recognised using the exchange rate of that date when the risk and rewards were transferred.
		There is also a risk that the closing payables in foreign currency may not be re-translated using the exchange rate of the year-end date. Similarly, the same effect also needs to be taken in the foreign exchange gain or loss.
		Since the raw material is being imported, there is a risk that the raw material which has departed from the foreign country and has not reached Pakistan, is not recorded as stock in transit.
4.	In case, expired raw material is used after its expiration date, it could severely affect its consumers.	There is a risk that an incident might have occurred which needs to be disclosed as a contingency or a provision might need to be recorded.

S. No	Business Risk	Audit Risk
5.	AL has obtained borrowing facilities for the expansion of its production facility. There is a risk that the demand has not been correctly estimated which may result in underutilization of the facility.	Since borrowing facilities have been used for the expansion of AL's production facility, there is a risk that borrowing cost might not have been correctly capitalized in the cost of the asset.
	AL has also obtained borrowings for this expansion project which might cause liquidity issue or effect the profitability and earnings ratios of the shareholders.	There is also a risk of incorrect estimation of useful life of assets resulting in an incorrect depreciation charge. There is also a risk that costs that should have been charged as revenue expenditure have been recognised as capital expenditure.
		There is a risk that the bank covenants might be breached and the loan might not be properly classified.
6.	Improper or incomplete implementation could affect the business decision taken on the basis of the data generated by the ERP.	There is a risk that ERP might not be correctly capitalized and amortized. Due to improper implementation account balances may not be correctly brought forward and there may be misstatements in the overall accounting records.

► **Practice Question 23:**

An auditor is required to identify and assess the risks of material misstatement at both the financial statement and assertion levels. Briefly discuss the risk at financial statement level and provide two examples of such risk.

Tutorial Notes:

Provide more than one risk at financial statement level.

► **Solution 23:**

The financial statement level refers to risks that are pervasive to the financial statements as a whole and which potentially affect many assertions.

Following are the examples:

- Management having a tendency to override internal controls – this would affect all areas of the accounting systems.
- Lack of management competence or lack of oversight over the preparation of the financial statements may have a pervasive effect on the financial statements and may require an overall response by the auditor.

► **Practice Question 24:**

The audit team has started planning for the audit of Rustam Limited (RL), a sports product manufacturer, for the year ended 30 June 2023.

RL holds contracts with two well-known international sports brands, Sportify and Xcelerate, for manufacturing their sports equipment. The majority of RL's sales comprise export to these two brands. The audit team has observed and documented the following matters for the review of the audit manager:

i. Sportify's Sponsorship and Production Impact

Sportify served as the main sponsor of a top-ranked football team associated with a German football club, a partnership that came to an end on 31 December 2022. Consequently, one of RL's production units remained non-operational for six months during the year and at the year-end. This unit was established in 2020 with the specific intention of meeting Sportify's product demand. RL intends to sell the inventory produced for Sportify within the local market. However, there is a prevalence of cheaper counterfeits of RL products available in the market.

ii. Xcelerate's Production Outsourcing and Industry Developments

Xcelerate specializes in selling sports kit and protective gear for high-impact sports. Xcelerate has outsourced its production to various manufacturers, one of which is RL. Recent injuries have prompted increased awareness and regulations concerning the reliability of such protective gear. Xcelerate has recently issued a press release that five severe injury incidents occurred which involved its products and they are investigating it. Further, Xcelerate is expected to undergo an acquisition by another company operating within the same segment, with the transaction likely to finalize by November 2023.

Required:

Discuss the business risks and the related audit risks from the above scenario.

Tutorial Notes:

- Differentiate between audit risk and business risk and don't use both terms interchangeably.
- Make sure to identify:
 - the business risk associated with the acquisition of Xcelerate, resulting in a failure to identify the related audit risk.
 - the business risk related to major revenue being derived from export and the related audit risk.

► Solution 24:

S. No.	Business Risk	Audit Risk
1.	The German football club's decision to part ways with Sportify has led to a reduction in production during the year. Further, one of the units specifically designed for this purpose has been shut down. There is a business risk that the investment might not be recovered if the demand is not generated in coming years.	The closure of the unit due to low demand raises concerns that the written-down value of the plant might drop below its discounted cash flows. As a result, there is an audit risk that the plant may be impaired and its impairment testing is not done properly.
2.	The increase in finished goods inventory poses a business risk for RL, as there is uncertainty about RL's ability to recover its investment in working capital for the products manufactured for Sportify. Moreover, the prevalence of significantly cheaper counterfeit products in the market adds to this risk, potentially hindering inventory sales.	Since RL may not be able to sell the inventory produced for Sportify, they may have to significantly reduce the selling price such that the cost of the inventory exceeds its net realizable value. There is an audit risk that inventory is overvalued.
3.	In case, any injury occurs due to the fault of the RL manufacturing process, there is a risk that Xcelerate might stop or reduce its orders from RL.	There is a risk that an injury incident might have occurred due to a fault of a product produced by RL, which needs to be disclosed as a contingency or a provision might need to be recorded.
4.	Since the major revenue of RL is derived through export sales, it exposes it to fluctuation of exchange rates resulting in unanticipated changes in the amount received for its sales.	There is also a risk that the closing receivables in foreign currency may not be re-translated using the exchange rate of the year-end date. Similarly, the same effect also needs to be taken in the foreign exchange gain or loss.
5.	The decline in production during the year and subsequent to the year-end indicates the business risk of continuity of operations. This risk is further increased as Xcelerate is to be taken over by some other company, which may or may not continue with RL.	The related audit risk is an inappropriate use of the going concern assumption by RL which may affect the basis of preparation as well as the auditor's opinion in the audit report.

► *Practice Question 25:*

You are an audit senior on the audit of Health Care Limited (HCL) for the year ended 31 December 2023.

HCL is a well-established entity in the pharmaceutical sector. Operating in a highly competitive environment, it manages manufacturing facilities across Pakistan and abroad. A distinctive aspect of HCL's corporate governance lies in its board of directors, which primarily consists of family members. This approach also extends to operational roles, with family members assuming key positions within HCL.

Required:

Using the above information, discuss the matters that you would consider while obtaining an understanding of HCL and its environment related to:

- ownership structure
- governance structure
- regulatory requirements
- relevant industry factors

Tutorial Notes:

Discuss matters related to ownership structure and governance structure.

► *Solution 25:*

As an audit senior tasked with obtaining an understanding of Health Care Limited (HCL) and its environment, following key areas must be thoroughly considered:

Ownership Structure:

- Investigate the ownership structure to understand the extent of family involvement and the potential influence of key shareholders on decision-making.
- Determine the distribution of ownership among family members, institutional investors, and other stakeholders.
- Evaluate any potential conflicts of interest arising from the concentration of ownership and control within the family.

Governance Structure:

- Analyse the composition and effectiveness of the board of directors, especially considering the predominance of family members.
- Evaluate the independence of board members and the presence of any governance mechanisms to mitigate conflicts of interest.
- Assess the roles and responsibilities of family members serving as CEOs and other positions and their impact on corporate governance practices.

Regulatory Requirements:

- Identify and understand the regulatory environment governing pharmaceutical companies in Pakistan and any other jurisdictions where HCL operates.
- Ensure compliance with applicable accounting standards, company laws, and regulations relevant to the pharmaceutical industry.
- Review HCL's history of regulatory compliance and any significant legal or regulatory issues faced in the past.

Relevant Industry Factors:

- Gain insights into the competitive landscape of the pharmaceutical sector in Pakistan and abroad.
- Assess the impact of industry dynamics, such as market competition, pricing pressures, technological advancements, and regulatory changes, on HCL's operations and financial performance.
- Consider the company's strategies for innovation, research and development, product diversification, and market expansion.

► Practice Question 26:

You are part of the audit team for Metal (Private) Limited (MPL), a rapidly growing, family-owned manufacturing company specializing in industrial machinery, for the year ended 30 June 2024. During the year, MPL expanded its operations by opening a production facility in a new region with low operational costs. It was expected that MPL would continue to demonstrate fast-paced growth at the new facility as well. However, this new facility has faced significant challenges, including delays in production, higher-than-expected costs, and quality control issues. These issues have led to an accumulation of inventory at the new facility.

In response, MPL has decided to establish a separate internal audit function for this new facility and is conducting interviews for a Chief Internal Auditor and two support positions. Management is under significant pressure to demonstrate the success of the new facility to directors and other stakeholders.

Required: Discuss the inherent and control risks present in the scenario.

► Solution 26:**Inherent Risk:**

- i. The expansion to a new region with low operational costs presents inherent challenges, such as unfamiliarity with the regulations of the region. These issues increase the risk of material misstatement related to compliance with laws and regulations.
- ii. The delays in production and quality control issues have led to an accumulation of inventory, heightening the risk of obsolescence or overvaluation. Valuation of inventory involves judgment and estimate which inherently carries a higher risk of misstatement.
- iii. Management is under significant pressure to show the success of the new facility to stakeholders. This pressure increases the risk of aggressive accounting practices or misstatements, particularly in areas like revenue recognition and inventory valuation.

Control Risk

- i. MPL is establishing a separate internal audit function for the new facility. However, since this function is still in development, the effectiveness of internal controls at the new facility is uncertain. This lack of an established control environment increases the risk that material misstatements may not be detected or corrected in a timely manner.
- ii. MPL is a family-owned business, which introduces a higher risk of management override of controls. In family-owned businesses, decision-making often remains concentrated among a few key individuals, typically family members. A family member with significant influence might pressure accounting staff to manipulate financial results to present a more favourable view of the new facility's performance.

4 FRAUD: ISA 240

4.1 Overall Responsibility of management and those charged with governance

With respect to the audit and contrary to what many members of the public think, it is management and those charged with governance which are responsible for:

- Prevention and detection of fraud
- Preparation of the financial statements
- Design and implementation of effective internal controls – for example authorising payments above a certain amount, monthly bank reconciliation and a monthly trade payables control account reconciliation.

They are also responsible for:

- Providing the auditor with:
 - Access to information relevant to the preparation of the financial statements
 - Additional information relevant to the audit
 - Unrestricted access to persons whom the auditor needs access to in order to complete the audit
- Providing written representations to the auditor at the end of the audit (see later chapter for details)

4.2 Fraud and the role of the external auditor

Fraud is an **intentional act** by one or more persons, involving the use of deception to gain an unjust or illegal advantage.

Fraud is distinguished from **error**. Error results from a genuine mistake or omission, and is **not intentional**.

The objective of a statutory audit (an external audit) is to express an opinion on the truth and fairness of the view presented by the financial statements. Its objective is **not** primarily the prevention or detection of fraud. The auditor will be concerned with fraud only to the extent that it might impact on the view shown by the financial statements. He will therefore be concerned with the risk of **material fraud**. This is discussed below in the context of ISA 240.

It is primarily the responsibility of management to establish systems and controls to prevent or detect fraud (and errors). These systems and controls may then be monitored by internal audit. Internal audit may also be required by management to specifically review the entity's exposure to error or fraud or to undertake a special investigation to look into suspected error or fraud.

4.3 The auditor's responsibilities relating to fraud: ISA 240

The role of the external auditor with regard to fraud is covered by ISA 240. The auditor's responsibilities relating to fraud in an audit of financial statements.

The **objectives of the auditor** under ISA 240 are the same as for any other area: to identify and assess the risks of **material misstatement** and to obtain sufficient appropriate evidence about those risks through appropriate audit procedures. He must also respond appropriately to fraud or suspected fraud identified during the audit.

However, it is particularly important in relation to fraud that the auditor maintains an attitude of **professional scepticism** as required by ISA 200. ISA 240 states that:

- unless the auditor has reason to believe the contrary, he may accept records and documents as genuine; and
- where responses to inquiries of management are inconsistent, the auditor shall investigate the inconsistencies (as this could indicate potential fraud).

Two types of fraud are identified by ISA 240: **fraudulent financial reporting** and **misappropriation of assets**.

Fraudulent financial reporting includes:

- manipulating, forging or altering accounting records or supporting documentation which form the basis of the financial statements
- misrepresenting or intentionally omitting events or transactions from the financial statements
- intentionally misapplying accounting principles,

Fraudulent financial reporting often involves **management override of controls**.

Misappropriation of assets includes:

- embezzling receipts (for example, diverting them to personal bank accounts)
- stealing physical assets (such as inventory) or intellectual property (for example, by selling “trade secrets” to a competitor)
- causing an entity to pay for goods and services not received (for example, by the creation of fictitious suppliers)
- using an entity’s assets for personal use.

Presumed significant risk on revenue recognition

Material misstatement due to fraudulent financial reporting relating to revenue recognition often results from an overstatement of revenue through for example, premature revenue recognition or recording of fictitious revenues. It may result also from an understatement of revenue through for example improperly shifting revenues to a later period. The risk of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressure or incentive on management to commit fraudulent financial reporting through inappropriate revenue recognition in case of listed entities. The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

Management override of controls

Management is in a unique position to perpetrate fraud because of management’s ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

Irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to:

- a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:
 - i. Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
 - ii. Select journal entries and other adjustments made at the end of a reporting period; and
 - iii. Consider the need to test journal entries and other adjustments throughout the period.
- b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatements due to fraud. In performing this review, the auditor shall:
 - i. Evaluate whether the judgements and decisions made by management in making the accounting estimates included in the financial statements, even, if they are individually reasonable, indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud. If so, the auditor shall re-evaluate the accounting estimates taken as a whole; and
 - ii. Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year.
- c) for significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity or its environment and other information obtained during the audit, the auditor shall evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

Procedures to identify risk of material misstatement

ISA 240 **requires** the auditor to perform the following procedures to identify the risks of material misstatement due to fraud:

- Make enquiries of management in respect of:
 - their assessment of the risk of material fraud
 - their process in place for identifying and responding to the risks of fraud including any specific risks of fraud identified or likely to exist any communications within the entity in respect of fraud (including to employees regarding management's views on business practices and ethical behaviour).
 - Management's communication, if any, those charged with governance regarding its processes for identifying and 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 behaviour.
- Make inquiries of management and others within the entity as to whether they have any knowledge of any actual, suspected or alleged frauds and to obtain views about the risks of fraud.
- Inquiries with those charged with governance
 - Obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud and the internal control that management has established to mitigate these risks.
 - 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.
- Make inquiries of internal audit.

- Evaluate any unusual or unexpected relationships identified in performing analytical procedures (covered in a later chapter) which might indicate a risk of material fraud.
- Evaluate information obtained from other risk assessment procedures to see if any **fraud risk factors** are present.

4.4 Fraud risk factors relating to misstatements arising from fraudulent financial reporting and misappropriation of assets

ISA 240 states that fraud involves:

- **Incentive or pressure to commit fraud** – for example, management may be under pressure from sources outside or inside the entity to achieve an expected (and perhaps unrealistic) earnings target or financial outcome. This may be necessary to trigger a management bonus, or to avoid breaching a loan covenant.
- **The opportunity to commit fraud** – for example, a perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.
- **Rationalisation for committing a fraudulent act.** Some individuals may possess an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. For example, someone may feel aggrieved that they did not receive a bonus they think they were entitled to and hence rationalise theft as taking ‘what is owed’.

The following are examples of risk factors relating to misstatements arising from fraudulent financial reporting and misappropriation of assets.

	Fraudulent Financial Reporting	Misappropriation of Assets
Incentives / Pressures	• Financial stability or the profitability of entity is threatened by economic, industry or entity operating conditions such as: - high degree of competition or market saturation accompanied by declining margins - high vulnerability to rapid changes such as changes in technology, product obsolescence, or interest rates - significant declines in customer demand and increasing business failures in either the industry or overall economy - operating losses making the threat of bankruptcy, foreclosure or hostile takeover imminent - recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth - rapid growth or unusual profitability especially compared to that of other companies in the same industry - new accounting, statutory or regulatory requirements	• Personal financial obligations • Adverse relationship between the entity and employees with access to cash or other assets susceptible to the theft, may be created due to: - known or anticipated future employee layoffs - recent or anticipated changes to employees' compensation and benefit plans - promotions, compensation or other rewards inconsistent with expectations.

	Fraudulent Financial Reporting	Misappropriation of Assets
	- Excessive pressure on management to meet the requirements or expectation of third parties due to: - profitability or trend level expectations of external third parties including expectations created by management in for example, overly optimistic press releases or annual report messages - need to obtain additional debt or equity financing to stay competitive including financing of major research and development or capital expenditures - marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements - perceived or real adverse effects of reporting poor financial results on significant pending transactions such as business combinations or contract awards. - Information available indicates that personal financial situation of management or those charged with governance is threatened by entity's financial performance due to: - significant financial interests in the entity - significant portions of their compensation (such as bonuses, stock options and earn out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position or cash flow - personal guarantees of debts of the entity - Excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.	
Opportunities	- Significant related party transaction not in the ordinary course of business or with related entities not audited or audited by another firm. - Assets, liabilities, revenue, expenses based on significant estimates that involve subjective judgements or uncertainties that are difficult to corroborate - Significant, unusual or highly complex transactions, especially those close to period end that pose 'substance over form' questions.	Large amount of cash on hand or processed Inventory items that are small in size and high in value or are in high demand Easily convertible assets e.g. diamonds, bearer bonds or computer chips Fixed assets which are small in size, marketable, or lacking observable identification of ownership

	Fraudulent Financial Reporting	Misappropriation of Assets
	- Monitoring of management is not effective due to: - Domination of management by single person or small group without compensating controls - Oversight by those charged with governance over the financial reporting process and internal control is not effective. - Internal control components are deficient as a result of the following: - inadequate monitoring of the controls, including automated controls and controls over interim financial reporting - high turnover rates or employment of staff in accounting, information technology or the internal audit function that are not effective - accounting and information systems that are not effective, including situations involving significant deficiencies in internal control	- Inadequate controls over assets such as: - inadequate segregation of duties or independent checks - inadequate oversight of senior management expenditures such as travel and other reimbursements - inadequate management oversight of employees responsible for assets - inadequate job applicant screening of employees with access to assets - inadequate record keeping with respect to assets - inadequate system of authorization and approval of transactions - inadequate physical safeguards over cash, investments, inventory or fixed assets - lack of complete and timely reconciliations of assets - lack of timely and appropriate documentation of transactions - lack of mandatory vacations for employees performing key control functions - inadequate management understanding of information technology which enables IT employees to perpetrate a misappropriation - inadequate access controls over automated records, including controls over and review of computer systems event logs
Attitudes / Rationalizations	Communication, implementation, support, or enforcement of entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards that are not effective.	Disregard for the need of monitoring or reducing risk related to misappropriation of assets

	Fraudulent Financial Reporting	Misappropriation of Assets
	• Nonfinancial management's excessive participation or preoccupation with the selection of accounting policies or the determination of significant estimates • Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend	Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee
	• A practice by management of committing to analysts, creditors or other third parties to achieve aggressive or unrealistic forecasts • Management failing to remedy known significant deficiencies in internal control on a timely basis. • Low morale among senior management. • The owner-manager makes no distinction between personal and business transactions • Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality. • Relationship between management and the current/predecessor auditor is strained as exhibited by the following: - frequent disputes with the current or predecessor auditor on accounting, auditing or reporting matters - Unreasonable demands on the auditor such as unrealistic time constraints regarding the completion of the audit or the issuance of the auditor's report - Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance • Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement	Changes in behavior or lifestyle that may indicate assets have been misappropriated Tolerance of petty theft

4.5 Examples of circumstances that indicate the possibility of fraud

The following are examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including:

- Missing documents.
- Documents that appear to have been altered.
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.
- Significant unexplained items on reconciliations.
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships – for example, receivables growing faster than revenues.
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity's records and confirmation replies.
- Large numbers of credit entries and other adjustments made to accounts receivable records.
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger.
- Missing or non-existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank statement.
- Missing inventory or physical assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

Problematic or unusual relationships between the auditor and management, including:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
- Undue time pressures imposed by management to resolve complex or contentious issues.
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
- Unusual delays by the entity in providing requested information.

- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- An unwillingness to address identified deficiencies in internal control on a timely basis.

Other

- Unwillingness by management to permit the auditor to meet privately with those charged with governance.
- Accounting policies that appear to be at variance with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changed circumstances.
- Tolerance of violations of the entity's code of conduct.

► Example:

Ayeza has been appointed as the Chief Internal Auditor of Shayan & Co. She made the following observations in the first quarter of the year ending December 31, 2016. Which of the following matters are alarming and need her immediate attention?

- The accountant keeps the original invoices in the approvals file and sends the photocopies of invoices and approvals to the cashier for payment
- The accounts payable employee has not taken a leave of absence 3 years in a row
- The number of payslips issued to employees are in excess of the number of employees maintained by Human Resource Department
- All above

► Answer

The answer is "(d) all above" due to the following reasons:

- The accountant can forge the photocopies of invoices & approvals and pocket in the differential amount through collusion with the supplier
- When a key employee of the finance department does not take a leave of absence it shows he is overriding internal controls or making forged payments and do not want others to find out in his absence
- If there are more payslip issued than the number of employees as per Human resource department record, it shows that there are ghost employees and the payroll employee is misappropriating cash.

4.6 Communications to Management and Those Charged with Governance

When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter is brought to the attention of the appropriate level of management as soon as practicable, even if the matter is considered inconsequential. Whilst determination of an appropriate level of management is a matter of professional judgment, ordinarily the appropriate level of management is at least one level above the person(s) who appear to be involved with the suspected fraud.

Whilst *ISA 260 communication with Those Charged with Governance* is outside the scope of the CAF-9 syllabus you should be aware that there may be instances where it is appropriate for the auditor to communicate with Those Charged with Governance regarding an actual or suspected fraud. Ordinarily such instances would always include cases where management were involved in the fraud or suspected fraud, but the auditors may also judge that cases where those other than management were involved also need communicating.

In the exceptional circumstances where the auditor has doubts about the integrity or honesty of management or those charged with governance, the auditor may consider it appropriate to obtain legal advice to assist in determining the appropriate course of action.

► **Practice Question 27:**

Your firm is the auditor of Cell Phones (Private) Limited (CPPL), which operates a chain of mobile phone retail outlets. About 25% of shareholding in CPPL is owned by Anwar and his wife. Anwar is the Chief Executive of CPPL and also looks after the finance and operations of the company. There are five other directors and each of them holds 15% shares in CPPL.

The Internal Audit Function comprises of three senior officers who are graduates. Their duties include checking of accounting records, physical stock taking, preparation of bank reconciliations, reviewing payments and verification of fixed and current assets.

During the planning phase, Anwar stressed the need for early completion of audit, in order to be able to submit the audited financial statements for seeking a long term finance. He was of the view that internal audit working papers would be of enormous help in performing and early completion of the audit.

Required:

Identify and briefly describe the fraud risk factors in the above scenario.

Tutorial Notes:

What to Do: Identify key fraud risks, including lack of segregation of duties (CEO control), financing pressure, early audit completion request, and inventory obsolescence due to rapid technological changes. Clearly explain why each risk exists and its impact on financial statements. Link risks to audit procedures, such as testing inventory valuation and management override controls.

What to Avoid: Do not list risks without explanation, overlook inventory obsolescence, or ignore audit implications. Ensure all risks are clearly linked to misstatements and audit responses.

► **Solution 27:**

a) Fraud Risk Factors:

Rapid Changes in Technology:

Products like mobile phones are likely to become obsolete very quickly, as more advanced products come on to the market. The company faces a threat due to rapid changes in technology; therefore the management may be inclined to manipulate the accounting records.

Lack of Segregation of Duties/ Dominance of management by a single person:

As Anwar is the Chief Executive and is also responsible for finance and operations of the company, this gives him a personal motivation to misstate figures to show improved performance.

Long Term Loan:

As the company has applied for long term loan, it may be inclined to manipulate the figure to show better financial position to the bank.

Demand for early completion of audit:

The demand by Anwar for early completion of audit creates undue suspicion because such pressures are sometime applied to distract the auditor from his responsibilities.

► **Practice Question 28:**

While reviewing the audit files of four different clients you confronted the following situations:

- i. Due to tough competition in the market, the company has been unable to increase the prices of its products since last 5 years.
- ii. Addition to intangible assets, amounting to Rs. 500 million include research cost of Rs. 10 million which is duly supported by invoices from suppliers.
- iii. During the last three years, the Chief Executive and higher management has been earning handsome bonuses, based on the profitability of the company.

- iv. Physical stock take on 31 December 2014 included goods sold but not despatched amounting to Rs. 52 million. The delivering of goods was stopped on the request of a distributor. Upto 20 January 2015, the distributor has taken delivery of goods amounting to Rs. 2 million.

Required:

- a) In each of the above situations, identify with justification whether it represents a risk of fraud.
- b) Describe what actions are to be taken by an auditor on identifying a fraud risk factor.

Tutorial Notes:

What to Do: Clearly justify fraud risk factors:

Profitability pressure may lead to financial manipulation.

Profit-based bonuses can incentivize misstatements.

Recording undelivered sales may indicate overstated revenue.

Distinguish errors from fraud (e.g., minor research cost misclassification is an error, not fraud).

When a fraud risk is identified, outline appropriate auditor responses, such as heightened skepticism, additional procedures, and professional judgment.

What to Avoid: Do not misinterpret scenarios (e.g., unshipped goods inflating inventory rather than revenue). Avoid generic answers—connect risks to financial misstatements and audit impact.

► **Solution 28:**

a)

i. Inability to increase the prices of its products since last 5 years

The Company's profitability is under threat due to increased competition therefore the management may be inclined to manipulate the accounting records.

ii. Research costs wrongly capitalized

It is an error and is not indicative of fraud, as research costs is only 2% of the total amount capitalized and the underlying records were duly supported by invoices from the suppliers.

iii. Bonuses linked with profitability

It is a fraud risk factor as it is evident that management is receiving profit related bonuses, therefore the management may be inclined to manipulate the accounting records.

iv. Goods sold but not dispatched

It is a fraud risk factor as it seems that management has tried to inflate the sales in order to deceive financial statement users, an apparent intention behind this action can be to overstate the profits of the company.

b) Course of action:

In response to assessed risk of material misstatement due to fraud, the auditor shall:

- Emphasize to the Audit team the need to maintain an attitude of professional skepticism.
- Assign more experienced staff or increased supervisor of staff.
- To the extent not already done, the auditor shall obtain an understanding of the entity's related controls, relevant to such risks.
- evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and
- Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures.
- Design and perform further audit procedures whose nature, timing and extent of audit procedures are responsive to the assessed risk of material misstatements.

► *Practice Question 29:*

Because of its ability to exert influence, management is in a position to perpetrate fraud and prepare fraudulent financial statements.

- a) Identify six different ways in which fraud may be committed by management through overriding of controls.
- b) Briefly state the audit procedures which may be performed to identify the risks of material misstatement due to fraud.

Tutorial Notes:

What to Do: Focus on how management may commit fraud by overriding controls, not just misappropriation of assets. Include altering records, concealing facts, and manipulating financial reporting. When discussing audit procedures, emphasize identifying risks of material misstatements due to fraud, such as analysing unusual journal entries, reviewing estimates, and assessing management bias.

What to Avoid: Do not limit fraud to asset theft—consider financial statement manipulation. Avoid discussing substantive procedures or fraud risk mitigation instead of risk identification.

► *Solution 29:*

- a)
 - i. Forging or altering accounting records or supporting documentation which form the basis of the financial statements.
 - ii. Misrepresenting or intentionally omitting events or transactions from the financial statements.
 - iii. Intentionally misapplying accounting principles.
 - iv. Concealing or not disclosing, facts that could affect the amounts recorded in the financial statements.
 - v. Engaging in the complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
 - vi. Embezzling receipts (for example, diverting them to personal bank accounts)
- b) The auditor is required to perform the following procedures to identify the risks of material misstatement due to fraud:
 - Make inquiries of management in respect of:
 - their assessment of the risk of material fraud ;
 - their process in place for identifying and responding to the risks of fraud ;
 - any specific risks of fraud identified or likely to exist;
 - any communications within the entity in respect of fraud (including to employees regarding management's -views on business practices and ethical behaviour).
 - Make inquiries of management and others within the entity as to whether they have any knowledge of any actual, suspected or alleged frauds and to obtain views about the risks of fraud.
 - Evaluate any unusual or unexpected relationships identified in performing analytical procedures which might indicate a risk of material fraud.
 - Evaluate information obtained from other risk assessment procedures to see if any fraud risk factors exist.

► *Practice Question 30:*

- a) Discuss the external auditor's responsibility relating to fraud in an audit of financial statements.
- b) Sometime the management's attitude towards the audit/auditors is indicative of the possibility of material misstatement in financial statements due to fraud. Give four examples of such attitude/circumstances.
- c) You are the auditor of Information Limited (IL), which is engaged in the development of customized software. During the last three years IL has become the leading software developer in the industry due to completion of large number of projects.

During the initial meeting the client has informed that:

- IL has achieved a growth of 60% as compared to the growth target of 30% set for the financial year ended 30 June 2016 and the board of directors are considering to distribute 25% of the profit to the management staff as performance bonus.
- one of the competitors has shown its willingness to acquire IL.

Required:

Identify the fraud risk factors in the above situations.

Tutorial Notes:

What to Do: Clearly state that the auditor's primary responsibility is to express an opinion on financial statements, not to detect fraud. Explain how fraud detection is linked to assessing material misstatements but is not the auditor's direct duty. When identifying management attitudes indicative of fraud, focus on resistance to audit, reluctance to provide information, dominance in decision-making, and pressure on auditors.

What to Avoid: Do not describe fraud risk assessment procedures instead of the auditor's responsibility. Avoid listing generic fraud risk factors when asked specifically about management's attitude.

► **Solution 30:**

- a) The objective of a statutory audit (an external audit) is to express an opinion on the truth and fairness of the views presented by the financial statements. The auditor is not primarily responsible for the prevention or detection of fraud.

The auditor will be concerned with fraud only to the extent that it might impact on the view shown by the financial statements. He will therefore be concerned with the risk of material fraud.

The auditor should maintain an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Further, he must respond appropriately to fraud or suspected fraud identified during the audit.

- b) Management's attitude towards the auditor which may indicate the possibility of a material misstatement includes:
- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
 - Undue time pressures imposed by management to resolve complex or contentious issues.
 - Unusual delays by the entity in providing requested information.
 - An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- c) Rapid growth or unusual profitability.
- Significant portions of key management personnel's compensation i.e. bonus being contingent upon achieving aggressive targets for operating results.
 - Pressure on management to show good profitability considering the proposed acquisition.

► **Practice Question 31:**

You have been assigned the audit of Sukkur Limited (SL), a listed company, for the year ended 31 December 2016. The company engaged in the business of manufacturing security equipment for the local market. During the planning phase, while reviewing the previous year's audit file, you have noted that in 2015, due to introduction of many new equipment in the market and changes in technology, SL faced stiff competition and its market share reduced from 45% to 35%.

However, the management has now informed you that SL has made significant investment in technology which has helped the company to increase the market share to 38% in 2016.

The following information has been extracted from the draft financial statements:

Extracts from the statement of comprehensive income			
	2016 (draft)	2015 (audited)	2014 (audited)
	-----Rs. in million -----		
Revenue	10,742	9,703	9,650
Cost of sales	8,050	7,177	6,740
Financial charges	750	600	350
1 Profit before tax	1,550	1,601	2,260
Extracts from the statement of cash flows			
Cash flows from operations	(3,361)	(1,948)	(585)
Cash flows from financing activities	4,000	3,500	1,500

Required:

- Identify any four fraud risk factors in the above scenario.
- Identify four audit risks which the auditor should consider while planning the audit.

Tutorial Notes:

What to Do: Clearly distinguish fraud risk factors (conditions that increase the likelihood of fraud, such as management incentives, override of controls, or financial pressure) from audit risk (the risk of issuing an incorrect opinion). When discussing audit risks, ensure they are specific to the given scenario and not generic risks like inherent, control, or detection risk.

What to Avoid: Do not confuse fraud risk factors with audit risks. Avoid providing general definitions of audit risk components when the question requires scenario-based analysis.

► **Solution 31:**

a) Fraud risk factors in the scenario are:

- high degree of competition or market saturation, accompanied by declining margins and profitability.
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
- Excessive pressure exists for management to meet the requirements or expectations of third parties due to the need to obtain additional debt financing to stay competitive.
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting profitable operation.

b) Audit risks

- Risk of fraudulent financial reporting by Management override of controls:

In view of the declining earnings trend and declining margin and increase in financing the management may be inclined to fraudulent financial reporting by overstating the revenues or understating the expenses.

- Risk of impairment in value of property, plant and equipment:

Due to introduction of new technology there is a possibility that value of existing plant and machinery is impaired.

- Risk of overstatement of existing inventory:

Due to change in technology, the demand for SL's products has been affected and there is a possibility that its realizable value of inventory may have declined and a provision for obsolescence may be required.

iv. Risk of overstatement in value of debtors:

In view of the negative operating cash flows, it seems that SL has not been able to generate operating cash flows despite increase in sale, which might indicate that debtors are either doubtful or not recoverable.

► *Practice Question 32:*

You are the audit manager responsible for the audit of Clocks (Private) Limited (CPL). While reviewing the draft planning document prepared by the audit senior, you observed that he has assessed risk of material misstatement due to fraud and risk of management override of control as low due to the fact that CPL has been an audit client of the firm for the last 10 years and no material misstatement had been reported in the previous years.

Required:

- a) Draft an email to be sent to the audit senior to guide him with regard to the above matter.
- b) Suggest appropriate procedures with regard to risk of material misstatement due to fraud.

Tutorial Notes:

What to Do: Emphasize that fraud risk is always relevant, regardless of past experience, and cannot be assumed low. Link to ISA 240, highlighting the importance of professional skepticism and the unpredictable nature of fraud risk. When suggesting procedures, focus on planning-stage procedures, such as evaluating fraud risk factors, reviewing journal entries, assessing management bias, and incorporating unpredictability in audit tests.

What to Avoid: Do not assume low fraud risk based on past audits. Avoid listing fraud detection procedures instead of planning-phase risk assessment procedures.

► *Solution 32:*

- a) Email to job-in-charge

To: Audit Senior

Date: 07 September 2017

Subject: Risk of material misstatement due to fraud and management override of control

I have reviewed the draft planning document prepared by you and I want to bring your attention to the risk of material misstatement due to fraud and management override of control.

When planning and performing an audit, we should adopt an attitude of professional skepticism. We should have an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

We should recognise the possibility that a material misstatement due to fraud could exist, notwithstanding our past experience of the honesty and integrity of the entity's management and those charged with governance.

Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk. Irrespective of our assessment of the risks of management override of controls, we shall design and perform the audit procedures for management override of controls.

If you require any further information on the above, please do not hesitate to contact me

Yours faithfully,

XYZ

- b) Following are the procedures for risk of material misstatement due to fraud:
- i. Make enquiries of management in respect of:
 - their assessment of the risk of material fraud;
 - processes in place for identifying and responding to the risks of fraud; and
 - any specific risks of fraud identified or likely to exist.
 - ii. Make inquiries of management and others within the entity as to whether they have any knowledge of any actual, suspected or alleged frauds and to obtain views about the risks of fraud.
 - iii. Make inquiries of internal audit.
 - iv. Evaluate any unusual or unexpected relationships identified while performing analytical procedures which might indicate a risk of material fraud.
 - v. Evaluate information obtained from other risk assessment procedures to see if any fraud risk factors are present.

► **Practice Question 33:**

Green Limited (GL) is a listed company engaged in the manufacturing of garments and apparels. During the audit planning meeting for the year ending 31 March 2018, the Chief Financial Officer of GL has provided the following information:

- a) GL was previously exporting all its production under the brand name of 'Wearables'. However, it has been facing the issue of decline in export orders and therefore has decided to start focusing on the local market. Accordingly, it has made an agreement with BL, according to which GL's products would be sold to BL who would market them through BL's retail outlets spread throughout Pakistan. A director of GL holds major shareholding in BL.
- b) Two of the directors of GL holding 16% and 13% shares in GL have informed the Board that they intend to sell their entire shareholding in GL in order to concentrate on some of their other businesses.
- c) While discussing some of the internal control deficiencies in the payroll processing department, which were raised in the previous year's management letter, the CFO has informed that the matter has been referred to the internal audit department but is pending because of the illness of the Chief Internal Auditor.

Required:

- a) Identify fraud risk factors in the above scenario.
- b) Describe what actions an auditor should take on identifying a fraud risk factor.

Tutorial Notes:

What to Do: When identifying fraud risk factors, do not just copy facts from the question—explain why each fact increases fraud risk (e.g., financial pressure may lead to revenue manipulation). In recommending auditor actions, provide a comprehensive response, including applying professional skepticism, increasing substantive procedures, reviewing journal entries, and assessing management estimates.

What to Avoid: Avoid listing facts without justification. Do not provide incomplete or vague auditor responses—ensure all actions directly address the identified fraud risks.

► **Solution 33:**

a) **Fraud risk factors:**

Significant decline in customer demand:

Due to significant decline in demand of foreign customers, the management may be inclined to show improved results by manipulating the accounting records.

Significant related party transactions:

Significant related party transactions between GL and BL would provide an opportunity for engaging in fraudulent financial reporting.

Sale of shares by director:

The directors' intention to sell their shareholding in GL provides them an incentive to manipulate the annual profits so that they can achieve the maximum possible gain from the sale of shares.

Non-implementation of last year's external auditor's recommendations:

Management failure to place controls against weaknesses identified by the external auditor on timely basis shows the management's attitude towards the improvement of internal controls and consequently it increases the risk of fraud.

b) Course of action:

In response to assessed risk of material misstatement due to fraud, the auditor shall:

- emphasize to the Audit team the need to maintain an attitude of professional skepticism.
- assign more experienced staff or increased supervision of staff.
- to the extent not already done, the auditor shall obtain an understanding of the entity's related controls, relevant to such risks.
- evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings.
- incorporate an element of unpredictability in determining the nature, timing and extent of audit procedures.
- design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risk of material misstatements.

► Practice Question 34:

Following matters arose during the performance of test of details on sales:

- i. Three invoices of superstores could not be found in the record room. The staff explained that it would require a lot of time to find them and requested your team to select some other invoices. Scrutiny of the ledger revealed that total amount of these missing invoices was Rs. 6 million.
- ii. Five of the invoices issued to distributors were booked at the rate of Rs. 1,725 per carton instead of Rs. 1,275 per carton. The quantity involved was 3500 cartons.

Required:

Explain how you would resolve the above issues.

(Impact on the audit report is not required)

Tutorial Notes:

What to Do: Never accept missing invoices without investigation. Explain that the absence of audit evidence raises suspicion and requires further inquiry. The auditor should insist on locating the invoices, perform alternative procedures (e.g., supplier confirmations, bank statements), and assess the risk of fraud or misstatement.

What to Avoid: Do not blindly accept management's suggestion to select other invoices. Avoid failing to explain the auditor's response, such as escalating concerns, increasing sample size, or reporting limitations.

► *Solution 34:*

- The audit team should not accept other invoices as a sample in replacement of the three misplaced invoices. It should try to perform alternate audit procedures to verify those sales. If that is not possible, the team should request the management to find those invoices. Otherwise it should be considered as a misstatement.
- The audit team should investigate whether the missing invoices represent a control weakness or indicative of fraud and evaluate its impact on the overall audit accordingly.
- As for the sale recorded with incorrect rates, the management should be asked to reduce the sales by Rs. 1,575,000.
- The audit team should also investigate whether the invoices recorded at incorrect rate represent control weakness, due to which the management was unable to detect the error in the invoices previously.
- The audit team must obtain a high degree of certainty that such misstatement is not representative of the population for which it may need to perform additional audit procedures.
- If it is established that the misstatement is representative of the population, the audit team should project the misstatements found in the sample to the entire population of the stratum and consider increase in the extent of substantive testing and the nature of testing.

► *Practice Question 35:*

The auditor should be cognisant of the fact that fraudulent financial reporting often involves management override of controls. State any four techniques which the management may use for fraudulent financial reporting.

► *Solution 35:*

a) Fraud can be committed by management overriding controls using techniques such as the following:

- Recording fictitious journal entries.
- Inappropriately adjusting / changing assumptions and judgments used previously to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing or not disclosing facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions / unusual transactions to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

► *Practice Question 36:*

Briefly describe any five inquiries that the auditor may make for identifying the risk of material misstatement due to fraud.

► *Solution 36:*

The auditor may make the following inquiries to identify the risk of material misstatement due to fraud:

- Management's 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 and 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 behaviour.
- Enquire whether they have knowledge of any actual, suspected or alleged fraud affecting the entity

► **Practice Question 37:**

Your firm is the external auditor of Avian Limited (AL), a listed company, for the year ending 31 March 2020. AL is engaged in the business of construction and selling of construction material.

During the planning stage, the audit team has noted the following points for your consideration:

- AL's CEO aggressively follows up with the departmental heads for meeting the financial targets established by the directors. Performance of senior management at AL is measured in terms of year-on-year profit growth. There is an internal audit division of AL and it reports directly to the CEO.
- AL is facing difficulties in fulfilling its contracts for supply of building blocks due to a sudden rise in the cost of raw material, however no provision has been made in the financial statements.

AL's CFO explained that provision has not been made as amount cannot be determined with certainty now and therefore provision will be made next year, if required. Audit team was of the view that the provision has not been made because it would significantly affect the profitability of the company.

Required:

Briefly discuss the possible 'fraud risk factors' from the above scenario.

Tutorial Notes:

What to Do: Clearly explain how each fraud risk factor contributes to potential misstatements. Emphasize subjective judgment areas (e.g., estimates, valuations) and management incentives (e.g., pressure to maintain profitability). Ensure responses are detailed and linked to financial statement risks.

What to Avoid: Do not just identify fraud risks—explain their impact. Avoid missing key risks like management bias in financial reporting and subjective estimates, which increase fraud potential.

► **Solution 37:**

Aggressive targets for departmental heads

CEO aggressively follows up with the departmental heads for achieving the targets set by those charged with governance. It seems that there is an excessive pressure on management to meet financial targets established by the directors therefore they may be under undue pressure to misstate the financial statements.

Performance measurement of senior management

Since the performance of the senior management is measured in terms of year-on-year profit growth they would have an incentive to fraudulently misstate the financial statements to obtain bonuses or increments.

Internal audit department reports to CEO

Reporting of internal audit department to the CEO will impair their independence. Therefore this deficiency in internal control structure would give an opportunity for fraudulent financial reporting.

Significant subjective judgements Determination of the provision required for onerous contract may require significant subjective judgements on part of the management. There is an opportunity for the management to misstate the recognition of expenses and liabilities.

Furthermore, since the performance is measured in terms of year-on-year profit growth, management would have an opportunity to achieve those targets by not recording the required provision.

Not recording provision

Justification of the CFO does not seem correct as information regarding rise in the cost of raw material can easily be obtained from the market. The fraud risk factor further increases with the fact that the audit team also suspects that the provision has not been recorded to maintain the profitability.

Maintaining the profitability

Excessive interest by management in maintaining the profitability and earning trend represents the management's attitude which would increase the fraud risk.

► *Practice Question 38:*

State any four actions that an auditor should take on identification of a fraud risk factor.

Tutorial Notes:

- What to Do: When assessing fraud risk, always:
- Understand the entity's internal controls related to identified risks.
- Evaluate accounting policies, especially those involving subjective estimates and complex transactions, as they may indicate fraudulent reporting.
- Reassess material misstatement risk and adjust audit procedures accordingly, ensuring they are responsive to newly identified risks.
- What to Avoid: Do not overlook internal control assessment or accounting policy evaluation. Avoid failing to adjust audit procedures based on fraud risk reassessment.

► *Solution 38:*

In response to assessed risk of material misstatement due to fraud, the auditor shall:

- emphasize to the audit team the need to maintain an attitude of professional skepticism.
- assign more experienced staff or increased supervision of staff.
- to the extent not already done, the auditor shall obtain an understanding of the entity's related controls, relevant to such risks.
- evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective
- measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings.

► *Practice Question 39:*

Your firm is the auditor of Monero Limited (ML).

ML's financial statements were issued on 28 February 2021. However, after receiving a High Court judgement on 2 March 2021, ML's management assesses its impact and has decided to revise its financial statements.

Required:

Discuss the documentation that is necessary to be included in the audit working file regarding the above matter.

Note: Audit procedures are not required.

Tutorial Notes:

Ensure that all new or additional audit procedures performed in response to fraud risk are properly documented. Maintain detailed records of audit evidence obtained to support findings and conclusions. Clearly document the conclusions reached, ensuring they are directly linked to the procedures performed and evidence reviewed. Proper documentation strengthens the audit trail and supports the auditor's professional judgment.

► *Solution 39:*

If, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document:

- the circumstances encountered;
- the new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and
- when and by whom the resulting changes to audit documentation were made and reviewed.

► *Practice Question 40:*

- a) You are the audit senior on the audit of Nano Footwear Limited (NFL) for the year ending 31 March 2021. NFL is in the business of making a wide variety of footwear products. Your review of the last year working papers and initial meeting with the NFL management have revealed the following:
- i. Due to a high influx of low priced Chinese products in the local market, NFL has been experiencing a decline in customers' demand and high degree of competition. The sales managers have been given aggressive sales targets during the year which are their key performance indicators and are considered in their annual appraisals.
 - ii. All the management and policy decisions such as human resources, accounting estimates and procurement are taken by the CEO himself.

Required:

Briefly discuss the possible 'fraud risk factors' from the above scenario.

- b) Discuss what actions that an auditor should take on identification of the fraud risk factors.

Tutorial Notes:

(a)

- When identifying fraud risk factors, go beyond listing them—discuss their impact on financial statements. Properly classify fraud risks under incentive, pressure, opportunity, or attitude, as this helps in assessing their significance. Pay attention to excessive involvement of the CEO in accounting estimates, as it may indicate management override of controls.
- Upon identifying a fraud risk factor, the auditor should incorporate unpredictability in audit procedures, ensuring fraud risks are not easily concealed. Audit procedures should be tailored to the assessed risk of material misstatement, considering the nature, timing, and extent of further testing. Additionally, auditors must evaluate accounting policies, especially for subjective and complex transactions, to detect potential earnings manipulation.

► *Solution 40:*

a)

i. Pressure on the sales managers to meet sales target:

Since the performance of the sales manager is measured in terms of sales, they would have an incentive to fraudulently record the fake sales at year end to meet their targets in order to obtain bonuses or increments.

ii. Aggressive sales targets:

Sales managers are given aggressive sales target, which might not be attainable. Therefore, sales managers would be under pressure to achieve those targets by recording fake sales at year end to meet their targets.

iii. Decline in customers' demand:

Decrease in customers' demand due to cheap alternatives, the management would have under pressure to overstate the revenue or book fictitious revenue transactions.

iv. Domination of the management by a single person:

All the management decisions including those related to HR and accounting estimate are dominated by the CEO. Due to his dominant position, there is an opportunity for the CEO to override control and involve in any fraudulent activity.

v. Excessive involvement of CEO in application of accounting estimates:

The authority of adoption of accounting estimates should be with the CFO and not with the CEO. CEO's excessive involvement in the adoption of accounting estimates indicates his attitude which may lead to fraudulent financial reporting.

- b) In response to assessed risk of material misstatement due to fraud, the auditor shall:
- emphasize to the audit team the need to maintain an attitude of professional skepticism.
 - assign more experienced staff or increased supervision of staff.
 - obtain to the extent not already done, an understanding of the entity's related controls, relevant to such risks.
 - evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings.
 - incorporate an element of unpredictability in determining the nature, timing and extent of audit procedures.
 - design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risk of material misstatements.
 - consider revising the materiality level.

► *Practice Question 41:*

State the auditor's responsibility for identifying, detecting and responding to fraudulent activities.

Tutorial Notes:

- Auditors do have a responsibility to identify and assess the risks of material misstatement due to fraud, even though they are not responsible for preventing it. When fraud is detected or suspected, auditors must communicate their findings to those charged with governance, ensuring that management and stakeholders are aware of potential risks. Proper assessment and reporting of fraud risks are essential to maintaining audit integrity and professional skepticism.

► *Solution 41:*

Responsibilities of auditors for fraud in an audit of financial statements:

The auditor is concerned with fraud only to the extent that it might impact on the view shown by the financial statements. He will therefore be concerned with the risk of material fraud. This is to identify and assess the risks of material misstatement and to obtain sufficient appropriate evidence about those risks through appropriate audit procedures. He must also respond appropriately to fraud or suspected fraud identified during the audit. It is particularly important in relation to fraud that the auditor maintains an attitude of professional skepticism.

Auditor should communicate to those charged with governance concerning the detection or possibility of fraud.

► *Practice Question 42:*

Your firm has been appointed as the statutory auditor for Team Textile Limited (TTL) for the year ending 31 March 2024. TTL operates an extensive network of retail outlets across the country. Recently, TTL has encountered challenges such as market saturation and declining profit margins within its sector. In response, TTL has implemented several cost-reduction strategies, which include reducing employee wages and benefits, among other cost saving measures.

TTL, a company with high leverage, faces additional challenges due to the country's exponential rise in interest rates, a consequence of high inflation rate. In light of these financial pressures, the key shareholders of TTL are considering divesting their majority stake in the company as a strategy to diversify their investments.

Following the CEO's recommendation, TTL has shifted from the cost model to the fair valuation model for all its properties, including the retail outlets. The CEO is actively working with independent valuers to ascertain the fair value of TTL's properties. Furthermore, on 1 March 2024, TTL entered into a bill and hold agreement with one of its customers. This agreement is anticipated to substantially increase TTL's revenue for the year.

Required:

Identify and discuss the fraud risk factors in the given scenario.

Tutorial Notes:

- Identifying fraud risk factors is not enough—provide a detailed discussion on how each factor increases the risk of financial misstatement or fraud. Consider significant pending transactions, such as the sale of shares, which may create pressure to manipulate financial statements. Reduction of employee wages during high inflation can indicate financial distress, increasing the likelihood of misstated expenses or liabilities. Additionally, the CEO's direct involvement in accounting policy decisions and valuation processes raises concerns about management override of controls and potential earnings manipulation.

► *Solution 42:***Fraud Risk Factors:**

- Due to challenges such as market saturation and declining profit margins, the management may be under pressure to engage in fraudulent financial reporting, potentially through overstating revenues or understating expenses.
- The significant pending transactions related to the sale of shares, coupled with the potential adverse effects of reporting poor financial results, may pressurize the management to show better financial results.
- TTL's high leverage and the rise in interest rates pose a risk of breaching loan covenants. This situation may exert excessive pressure on management to fraudulently misstate financial statements to appear compliant with these covenants.
- The reduction of employee wages despite high inflation could result in adverse relationship between employees and management, providing employees incentive and rationalization to misappropriate the company's assets.
- The CEO's involvement in recommending accounting policy and active engagement with valuers, particularly in determining the significant estimates, may indicate a management attitude that favours fraudulent financial reporting. This behaviour could be motivated by a desire to show a better picture of the company to potential buyers and lenders.
- The decision to enter into a bill and hold agreement at the year-end could be an opportunity to record the next period's revenue in the current period. This strategy introduces complexity in determining the actual completion of performance obligations.

► *Practice Question 43:*

Briefly describe any five inquiries that the auditor may make for identifying the risk of material misstatement due to fraud.

► *Solution 43:*

The auditor may make the following inquiries to identify the risk of material misstatement due to fraud:

- Management's 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 and 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 behaviour.
- Enquire whether they know any actual, suspected, or alleged fraud affecting the entity.
- For those entities that have an internal audit function, enquires within the function to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud.

5 NOT-FOR-PROFIT ORGANISATIONS

5.1 Auditing of not-for-profit organisations (NFPOs)

In any audit or review, it is important to understand the entity and its environment. A key aspect of an audit or review may be the objective that the entity is trying to achieve.

- In commercial organisations, the objective is to make a profit for the shareholders.
- In the case of not-for-profit organisations (NFPOs), the objective is very different. It is usually the provision of a service to society as a whole or to a group in society. Examples are charities, clubs and societies and publicly-owned organisations.
- The service provided by an NFPO will have to be provided within the constraints of the resources it has at its disposal. In other words, an NFPO will seek to achieve its objective as far as possible with the money and other resources available.

► Example: Charity

A charity organisation is an example of an NFPO:

- It has certain defined beneficiaries, since it was established for the purpose of providing benefits to them.
- It raises funds from the public.
- It seeks to spend those funds as effectively as possible to help its beneficiaries.

NFPOs may be required to have an audit performed under local law, or may choose to have an audit performed on a voluntary basis in order to add credibility to their financial statements.

The difference in the objectives of an NFPO, compared with the objectives of a commercial company, will influence the approach to the audit.

In addition, there may be specific auditing and reporting requirements set out in local law for certain types of NFPOs. This may also influence the audit work performed and the form and content of the opinion issued.

If the NFPO requests an audit to be performed on a voluntary basis, or requires a review to be carried out, the scope of the work and the nature of any report issued will be agreed in advance between the auditor and the NFPO.

5.2 NFPOs: the audit approach

The auditor should recognise the specific features of the NFPO. However, it is important to realise that the auditor is still performing an audit, and the overall **structure** of the audit of an NFPO will be similar to the audit of a commercial organisation. However, the detail of the audit will probably differ.

The main points to bear in mind with the audit of an NFPO are summarised below. These are general principles. They should be modified as appropriate to reflect the circumstances of each particular NFPO.

Audit area	Comments
Planning	Consider: • the objectives and scope of the audit work • any local regulations that apply • the environment in which the organisation operates • the form and content of the final financial statements and the audit opinion • key audit areas, including risk.

Audit area	Comments
Risk	Carry out an audit risk analysis under the usual headings of inherent risk, control risk and detection risk: • inherent risk (reflecting the nature of the entity's activities and the environment) • control risk (internal controls, and the risk that these may be inadequate: controls over cash collection and cash payments may be a key area for an NFPO such as a charity, because large amounts of cash may be collected from the public by volunteers) • detection risk (the risk that the auditor will fail to identify any material error or misstatement in performing the audit).
Internal control	Key areas of internal control in an NFPO might include: • segregation of duties (although this may be difficult in a small NFPO with only a few employees) • authorisation of spending • cash controls • controls over income (donations, cash collections, membership fees, grants) • the use of funds only for authorised purposes.
Audit evidence	• A substantive testing approach (rather than a systems based approach) is likely to be necessary in a small NFPO, because of weaknesses in its internal control system. • Key areas may include: - the completeness of recording transactions, assets and liabilities - the possibility of misuse of funds. • Analytical procedures may be used to 'make sense' of the reported figures. • There should be a review of the final financial statements, including a review of the appropriateness of the accounting policies.
Reporting	• If a report on an NFPO is required by law, the standard external audit report may be applicable. • If the audit is performed on a voluntary basis, the report needs to reflect the agreed objective of the audit. However, it is good practice for the report to follow the general structure laid down by ISA 700 (see later chapter)

Other factors to consider include:

- Cash may be significant in small NFPOs and controls are likely to be limited.
- Income could be a risk area, particularly where money is donated or raised informally.
- There may be a limitation on the scope of the audit if obtaining audit evidence is a problem.
- There may be a lack of predictable income or identifiable relationship between expenditure and income which could make analytical review less appropriate.
- Restricted funds may exist where the organisation is only allowed to use certain funds for specific purposes.
- There may be sensitivity to key statistics such as the proportion of revenue used in administration (particularly for a charity).

► *Example: identifying inherent risks*

A charitable organisation relies for its funding on donations from the general public, which is mainly in the form of cash collected in the streets by volunteers and cheques sent in by post to the charity's head office. Wealthy individuals occasionally provide large donations, sometimes on condition that the money is used for a specific purpose.

The constitution of the charity specifies the purpose of the charity, and also states that no more than 15% of the charity's income each year may be spent on administration costs.

Required

Identify the inherent risks for this charitable organisation that an auditor of its financial statements would need to consider.

► *Answer*

Inherent risks are risks that cannot be removed by the application of controls. In the case of this charity, there are several risks for which it would be difficult, or perhaps impossible, to devise and apply internal controls.

1. Volunteers collecting cash from the general public may keep for themselves some or all of the cash they collect.
2. There are no controls that can ensure that all the money received by the charity is properly recorded. This is because there are no sales invoices against which receipts of income can be checked.
3. When money is given to the charity for spending on a specific purpose, there are no controls to ensure that the money is actually spent on its intended purpose.
4. Similarly there are no controls to ensure that the money collected by the charity is spent on the purposes specified in the constitution of the charity.
5. There are possibly no controls to ensure that money spent on administration is actually recorded as administration costs. The charity may get round the restriction on administration spending by classifying items of expense incorrectly.

You may think that controls to remove these risks could be devised and implemented, but given the nature of charitable organisations it is doubtful whether any of the above risks could be suitably controlled in practice. If these are inherent risks that cannot be controlled, the auditor will need to take a view on the following.

- The nature and extent of audit checks that should be carried out to obtain assurance that the financial statements do not contain any material misstatement.
- Whether any audit checks are possible that would give the auditor such assurance. For example, it would be difficult to devise audit checks into the completeness of reported income. If suitable audit checks cannot be applied, the auditor would have to consider including a comment in the audit report to the effect that it has not been possible to verify the completeness of the reported income for the charity in its financial statements.

► *Practice Question 44:*

Ameer Welfare Trust (AWT) is engaged in providing education and three daily meals to the underprivileged citizens of the society. Donation collection kiosks have been established at various public spots which collect donations predominantly in cash.

The constitution of AWT states that administration costs should not exceed 10% of its income. Due to this restriction, AWT has employed only one accountant who works on part time basis

The constitution further requires AWT to maintain separate bank accounts for donations collected for education and meals. Donors are requested to mention the purpose of donation. Donation received for a specific purpose cannot be spent for any other purpose.

Required:

Identify the risks which AWT's auditor would need to consider.

► *Solution 44:*

- There is a risk of embezzlement in cash collection and inventory.
- Donation for food are recorded in donation for education account and vice versa.
- Contributions are spent on other than intended purpose.
- There is a risk that the money spent on administration is not recorded as administration cost and is misclassified.
- Since only one person is responsible for managing the accounts, there is a lack of segregation of duties and hence risk of fraud and error may arise.
- Since there is no full time person to look after the accounts, there is a risk that transactions are not recorded on a timely basis.

► *Practice Question 45:*

Khyber Foundation (KF) is a non-profit organization engaged in providing medicines and medical equipment free of cost or at substantially discounted rates to the underprivileged people of the society. KF has obtained the approval from the relevant regulatory authorities to operate as a non-profit organization. Therefore, KF is entitled to tax exemption subject to conditions that administrative expenses do not exceed 15% of total donations and all withholding taxes are duly deposited with the taxation authorities.

During the financial year 2020-21, KF has received cash donations from the following three sources:

- Corporate entities through banking channel;
- Donation boxes placed in various retail shops; and
- Collection kiosks placed in the major shopping malls as part of donation campaign in Ramadan.

KF has also received medical equipment from donors which are recorded at fair value.

Medicines and medical equipment are given only on a valid doctor's prescription. This facility is also available to KF's employees.

KF has employed two accountants who are pursuing their bachelor's degree. Both of them are responsible for recording receipts, making payments, managing inventory and reporting to the trustees.

Required:

Identify the risks which KF's auditor would need to consider.

Tutorial Notes:

Ensure all tax-related and compliance risks are properly identified and addressed. Failure to withhold taxes correctly can lead to the loss of tax credit eligibility. If administrative expenses exceed the allowed limit, the organization may lose its tax-exempt status. Delayed recording of transactions increases the risk of misstatements and weakens financial oversight. Additionally, withholding taxes must be deposited on time, as non-compliance may result in penalties and regulatory scrutiny.

► *Solution 45:*

- i. There is a risk of embezzlement of cash collected from donation boxes as no receipt is generated for cash collected in donation box.
- ii. Cash collected at kiosks may be embezzled by personnel collection cash donations; therefore, cash is highly susceptible to theft.
- iii. There is an inherent risk that the donation income may be overstated by overvaluing the donation in kind.
- iv. There is a risk that the management may miss-classify administration spending by classifying items of expense incorrectly.

- v. Since there is no qualified accountant, there is a risk that:
 - proper withholding of taxes may not be done leading to ineligibility of tax credit.
 - transactions are not recorded on a timely basis.
 - withholding taxes are not timely deposited with the taxation authorities.
- vi. Since only two employees are responsible for recording all transactions including inventory management, there is a lack of segregation of duties and hence risk of:
 - fraud and error may arise.
 - theft of medicines may arise;
- vii. The medicines may be issued to the employees or other beneficiary without fulfilling the requirements.

6 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Describe the purpose and process of planning and explain professional scepticism
- Differentiate between the audit strategy and audit plan
- Describe the need and what is involved in understanding the entity and environment
- Explain the concepts of materiality and performance materiality
- Explain the audit risk model and define the terms inherent risk, control risk and audit risk
- Distinguish between fraud and error, summarise the respective responsibilities of management and the auditor with respect to fraud
- Explain the auditor's approach to the risk or material misstatement due to fraud
- Summarise the key points of auditing not-for-profit organisations

EVIDENCE AND SAMPLING

IN THIS CHAPTER:

1. Audit evidence: ISA 500
2. Audit documentation: ISA 230
3. Audit sampling: ISA 530
4. Chapter review

1 AUDIT EVIDENCE: ISA 500

1.1 General principles of gathering audit evidence

ISA 500 *Audit evidence* sets out the **objective** of the auditor as being to design and perform audit procedures in such a way to enable him to:

- obtain **sufficient, appropriate** audit evidence
- to be able to draw **reasonable** conclusions
- on which to base his audit opinion.

Following on from this, the auditor is **required** by ISA 500 to **design and perform appropriate audit procedures for the purpose of obtaining sufficient, appropriate audit evidence.**

Other **requirements** of ISA 500 are as follows:

- Consider the **relevance and reliability** of the information to be used as audit evidence.
- If information to be used as audit evidence has been prepared using the work of a **management's expert**:
 - evaluate the competence, capabilities and objectivity of that expert
 - obtain an understanding of the expert's work, and
 - evaluate the appropriateness of his report as audit evidence.
- When using **information produced by the entity** evaluate whether the information is sufficiently reliable (accurate, complete, precise and detailed).
- Use effective means of **selecting items for testing** (covered in detail later in this chapter under ISA 530 *Audit sampling*).
- If audit evidence from one source is **inconsistent** with that obtained from another source, or the auditor has **doubts over the reliability of evidence** – consider:
 - what additional audit procedures are needed, and
 - the effects on any other aspects of the audit.

1.2 Sufficient and appropriate audit evidence

Sufficient relates to the **quantity** of evidence.

Appropriate relates to the **quality** (relevance and reliability – see below) of the evidence.

The auditor will need to exercise professional judgement on both of these aspects; the quantity and the quality of evidence.

- When is there enough evidence to support a conclusion?
- What is the quality of a given piece of evidence, and is this sufficient to justify the audit opinion?

1.3 The quality of audit evidence

Relevant

There are a number of general principles set out in ISA 500 to assist the auditor in assessing the relevance of audit evidence. These can be summarised as follows:

- **Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure**, and, where appropriate, the assertion under consideration. E.g. Relevance may be affected by the direction of testing, say when testing for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure.

On the other hand, when testing for understatement, testing the recorded accounts payable would not be relevant, but rather testing subsequent disbursements, unpaid invoices, suppliers' statements and unmatched receiving reports may be relevant.

- **A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others.** E.g. Inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off.
- Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. **Relevant audit evidence would include identifying conditions that indicate performance of a control, and deviation conditions.** The presence or absence of those conditions can then be tested by the auditor.
- Substantive procedures are designed to detect material misstatements at the assertion level. **Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.**

Reliable

There are a number of general principles set out in ISA 500 to assist the auditor in assessing the reliability of audit evidence. These can be summarised as follows:

- **Audit evidence is more reliable when it is obtained from independent sources outside the entity under audit.**
- **Internally generated audit evidence is more reliable when the related controls are effective.**
- **Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.** For example, observation of the operation of a control by the auditor is more reliable than inquiry about the operation of that control.
- **Audit evidence is more reliable when it exists in documentary form.** This could be paper, electronic or other medium. For example, a written record of a meeting made at the time is more reliable than a subsequent oral representation of the matters discussed.
- **Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies,** or documents that have been filmed, or otherwise transformed into electronic form. This is because the reliability of those other forms may depend on the controls over their preparation and maintenance.

1.4 Procedures for generating audit evidence

A number of audit testing procedures are available to the auditor as a means of generating audit evidence. Note that:

- more than one procedure may be used in collecting evidence in a particular area.
- not all procedures may be appropriate to a given objective of the audit.

The auditor should select the most appropriate procedures in each situation. ISA 500 identifies seven main testing procedures for gathering audit evidence:

- Inspection (of an item)
- Observation (of a procedure)
- Inquiry (of a personnel)
- External confirmation
- Recalculation
- Re-performance

- Analytical procedures.

For your exam, you need to learn this list of audit procedures and what each of them means. A case study-type exam question may ask you to discuss which audit procedures would be most appropriate for obtaining audit evidence in a specific situation.

The table below explains these seven main procedures, and gives examples of how they are used and applied.

Procedure	Explanation/application
Inspection (looking at an item)	• Of tangible assets • Of entries in accounting records • Of documents (e.g. invoices)
Observation	• Watching a procedure (e.g. physical inventory counts, distribution of wages, opening of mail) • Limited to the point in time when the observation takes place • The person performing the procedure may act differently when being observed
Inquiry	• Seeking information from knowledgeable persons inside or outside the entity, • Evaluating responses to those enquiries, and • Corroborating those responses with other audit evidence
External confirmation	• A specific type of inquiry – seeking confirmation from a third party (e.g. a bank or trade receivable)
Recalculation	• Checking the mathematical accuracy of documents or records (e.g. adding up the list of year-end trade receivables)
Reperformance	• Independently carrying out procedures or controls, which were originally performed by the client (e.g. reperforming the aging of year-end trade receivables)
Analytical procedures	• Evaluating and comparing financial and/or non-financial data for plausible relationships and investigating unexpected fluctuations • For example, comparing last year's gross profit percentage to this year's and ensuring any change is in line with expectations

► *Example:*

An auditor wishes to:

- test that the plant and equipment recorded in the financial statements of the client does actually exist
- confirm the accuracy of the figures for the directors' bonuses
- understand the nature of an unusual payment recorded in the cash book.

Required

State which one of the audit testing procedures set out in the table above would be **most** useful to the auditor in each of the above contexts.

► *Answer*

- (Physical) inspection. The best way of getting the evidence of non-current assets is to go and look at them.
- Recalculation. The figures for bonuses computed by the client can be checked by recalculating what they should be.
- Inquiry (of management). The auditor should ask management to explain the nature of the unusual item, and should expect a satisfactory answer which can be corroborated by other evidence.

1.6 Types of audit procedures

In order to gather audit evidence on the above financial statement assertions, the auditor will have to choose what types of procedures to carry out. ISA 500 identifies the following types of procedures:

- Tests of controls
- Substantive procedures

Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Substantive procedures are designed to detect material misstatements at the assertion level.

In general, the auditor will carry out tests of controls to assess the system under audit. If those tests show that the system is working effectively then he will carry out a reduced amount of substantive procedures. If the results are poor then he will carry out more substantive procedures. Substantive procedures include both **tests of detail** and **analytical procedures**.

Tests of controls and substantive procedures are considered in detail in later chapters.

► Practice Question 01:

State any two factors which the auditor should consider to ensure reliability of audit evidence.

► Solution 01:

Auditor should consider source of audit evidence, effectiveness of related controls, form of audit evidence etc.

► Practice Question 02:

Briefly describe how an auditor evaluates the sufficiency of audit evidence

Tutorial Notes:

When evaluating the sufficiency of audit evidence, consider factors beyond professional judgment. Assess the risk of financial misstatement, materiality of items, and strength of internal controls. Higher risk areas require more extensive evidence to ensure reliability.

► Solution 02:

Factors to be considered by auditor in deciding sufficiency of audit evidence:

The decision relating to sufficiency of audit evidence depends upon the judgment of the auditor. Apart from professional judgment, following factors are also relevant in determining the sufficiency of audit evidence.

- i. the seriousness of the risk that the FINANCIAL STATEMENTS might not give a true and fair view; when this risk is high, more audit evidence will be required
- ii. the materiality of the item
- iii. the strength of the internal controls in the client's accounting systems

► Practice Question 03:

State the factors which may assist the auditor in assessing the reliability of audit evidence.

Tutorial Notes:

The reliability of audit evidence depends on its source and nature. Evidence from independent sources is stronger than internally generated evidence. Documents directly obtained by the auditor and original records are more reliable than copied or inferred information.

► *Solution 03:*

Reliability of audit evidence is dependent on the following factors:

- Audit evidence is more reliable when it is obtained from independent sources outside the entity under audit.
- Internally generated audit evidence is more reliable when the related controls are effective.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form.
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies.

2 AUDIT DOCUMENTATION: ISA 230

2.1 Audit documentation (audit file)

Audit documentation is the record of:

- audit procedures performed
- audit evidence obtained, and
- conclusions reached.

Terms such as **audit working papers** are also used.

The **audit file** is one or more folders (or other storage media) in physical or electronic form, containing the records that comprise the audit documentation for the whole engagement.

The **objective** of the auditor in respect of ISA 230 *Audit documentation* is to prepare documentation that provides:

- a **sufficient and appropriate record** of the basis for the auditor's report, and
- evidence that the audit was **planned and performed in accordance with ISAs** and applicable legal and regulatory requirements.

ISA 230 **requires** the auditor to prepare documentation **on a timely basis**, sufficient to enable an experienced auditor, with no previous connection with the audit to understand:

- the **nature, timing and extent of the audit procedures** performed
- the results of the audit procedures and the audit evidence obtained, and
- significant matters arising during the audit and the conclusions reached thereon.

The auditor is also **required** to document:

- discussions of all significant matters
- how any inconsistencies with the final conclusion on significant matters were resolved
- and justify any departure from a basic principle or relevant procedure specified by an ISA.

2.2 Reasons for preparing sufficient and appropriate audit documentation

Preparing sufficient and appropriate audit documentation on a timely basis helps to:

- **enhance the quality of the audit**, and
- **facilitate the effective review and evaluation of the audit evidence** obtained and conclusions reached, before the audit report is finalised.

Documentation **prepared at the time the work is performed** is likely to be **more accurate** than documentation prepared later.

Other purposes of audit documentation include the following.

- Assisting the audit team to plan and perform the audit.
- Assisting supervisors in directing and supervising audit work.
- Ensuring members of the audit team are accountable for their work.
- Keeping a record of matters of continuing significance to future audits.
- Enabling an experienced auditor, with no previous connection with that audit, to conduct quality reviews or other inspections i.e. by understanding the work that has been performed and the conclusions that have been reached.

2.3 The form, content and extent of audit documentation

Audit documentation may be recorded on **paper**, or on **electronic or other media**. The audit documentation for a specific engagement is assembled in an **audit file**. The precise contents of the audit file varies, depending on the nature and size of the client and the complexity of the audit processes required to reach a conclusion but will include:

- audit programs
- analyses
- summaries of significant matters
- letters of confirmation and representation
- checklists, and
- correspondence.

All audit working papers should clearly show the following (where relevant):

- The name of the client
- The accounting date
- A file reference
- The name of the person preparing the working paper
- The date the paper was prepared
- The name of any person reviewing the work and the extent of such review
- The date of the review
- A key to 'audit ticks' or other symbols used in the papers
- A listing of any errors or omissions identified
- A conclusion on the area.

► *Illustration: Audit working paper*

Client:	ABC Limited					WP Reference: TP 3.1
Subject:	Trade payables		Prepared by:	DG	Date:	13.4.X4
Period end:	31 March 20X4		Reviewed by:	TR	Date:	17.4.X4
Objective:	To ensure trade payables is fairly stated (valuation)					
Work performed:	Selected a sample of 5 trade payables balances as at 31 March and reconciled the supplier statements to the year end trade payables ledger. Reconciling items were vouched to source documentation.					
Results:						
Client		Payables ledger		Supplier stmt.		Difference
		Rs.		Rs.		Rs.
X Ltd	>	1,000 00		1,000 00		✓
Y Ltd	>	2,500 00		2,500 00		✓
Z Ltd	>	1,320 00		1,420 00	100 00	Note 1
M Ltd	>	625 00		625 00		✓
N Ltd	>	400 00		1,200 00	800 00	Note 2
		5,845 00		6,745 00		
		▲		▲		
Note 1:	Vouched to credit note - timing difference, no adjustment needed					
Note 2:	Invoice from N Ltd had not been accounted for and adjustment is required.					
		Dr Purchases		Rs. 800		
		Cr Trade payables		Rs. 800		
Conclusion:	After making the adjustment described above, trade payables is fairly stated.					
Key		✓		Agreed		
		▲		Cast (additions checked)		
		>		Agreed to payables ledger		

Assembly of the final audit file

The auditor is **required** to assemble the **final audit file(s)** on a timely basis after the date of the auditor's report. Not more than 60 days after the date of auditor's report. This usually excludes drafts of working papers or financial statements, or notes that reflect incomplete or preliminary thinking. After the assembly of the final audit file has been completed, the auditor **must not delete or discard audit documentation** before the end of its retention period (see below).

Modifications in the documentation

If it does become necessary to modify existing or add new documentation after this stage, the auditor is **required** to document:

- when and by whom the modifications were made
- the reasons for making them.

If **exceptional circumstances arise after the date of the audit report**, such that the auditor:

- has to **perform new or additional procedures**, or
- reaches new conclusions

the auditor is **required** to document:

- the circumstances
- the new or additional procedures performed, audit evidence obtained, conclusions reached and their effect on the auditor's report, and
- when and by whom the resulting changes to audit documentation were made and who reviewed them.

2.5 Ownership, custody and confidentiality

Ownership of the audit documentation rests with the auditor. The working papers **do not** form part of the accounting records of the client, and do not belong to the client.

The auditor needs to decide how long to keep the audit files. ISA 230 requires a minimum period of **five years** from the date of the audit report

Auditing standards require the auditor to ensure that working papers are kept safe and their contents are kept **confidential**. Information should only be made available to third parties in accordance with ethical guidelines (described in an earlier chapter).

► Practice Question 04:

While reviewing the final audit file of XYZ Limited for the year ended 30 June 2014, you have identified that certain amendments were made in the final audit file after the date of the auditor's report.

Required:

Comment on the above situation in the light of International Standards on Auditing.

Tutorial Notes:

Once the final audit file is assembled, auditors cannot delete or discard documentation before the retention period ends. Any modifications must be clearly documented, including the reason, timing, and person responsible. This prevents unauthorized changes to audit conclusions.

► Solution 04:

- i. After the assembly of the final audit file has been completed, the auditor must not delete or discard audit documentation before the end of its retention period.
- ii. However the changes to document can be made if:
 - the changes are deemed necessary.
 - there are exceptional circumstances in which the auditor has to perform new or additional procedures or reaches new conclusions.
- iii. If it appears that it was necessary to modify existing or add new documentation after this stage, the auditor is required to document:
 - when and by whom the modifications were made.
 - the reasons for making them.
- iv. If exceptional circumstances arise after date of audit report; auditor is required to document:
 - the circumstances
 - the new or additional procedures performed, audit evidence obtained, conclusions reached and their effect on the auditor's report, and
 - when and by whom the resulting changes to audit documentation were made and who reviewed them.

► *Practice Question 05:*

- a) State the auditor's responsibility in respect of 'Assembly of final audit file'.
- b) The audit report of Salim Limited was signed on 30 April 2016. After issuance of the audit report, the auditor was informed that a major debtor has become bankrupt.

Required:

Specify the matters that the auditor would be required to document in the above situation.

Tutorial Notes:

Auditors must assemble the final audit file promptly after signing the audit report. If new information arises (e.g., a debtor's bankruptcy), auditors should document circumstances, new procedures, additional evidence, and its impact on the audit report.

► *Solution 05:*

- a) The auditor is required to assemble the final audit file(s) on a timely basis after the date of the auditor's report. This usually excludes drafts of working papers or financial statements, or notes that reflect incomplete or preliminary thinking. After the assembly of the final audit file has been completed, the auditor must not delete or discard audit documentation before the end of its retention period.
- b) In such case the auditor is required to document:
 - the circumstances;
 - the new or additional procedures performed, audit evidence obtained, conclusions reached and their effect on the auditor's report; and
 - when and by whom resulting changes to audit documentation were made and who reviewed them.

► *Practice Question 06:*

In a recent audit engagement, the audit manager completed the final assembly of audit file. Subsequently, the audit partner expressed the intention to remove certain review remarks.

Required:

Discuss whether the audit partner can remove his review remarks.

Tutorial Notes:

Audit partners cannot remove review remarks after the final assembly of the audit file unless there are exceptional circumstances requiring new procedures. Any changes must be fully documented, ensuring transparency and compliance with auditing standards.

► *Solution 06:*

After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

The partner shall only do so if exceptional circumstances arise after the date of the audit report, such that the auditor has to perform new or additional procedures, or reaches new conclusions.

► *Practice Question 07:*

State any four reasons for preparing sufficient and appropriate audit documentation.

Tutorial Notes:

Audit documentation serves multiple purposes, including:

Enhancing audit quality and supporting conclusions.

Facilitating review and accountability among audit team members.

Providing a reference for future audits and quality control reviews.

Do not fail to mention these key documentation purposes.

► *Solution 07:*

- i. Enhance the quality of the audit.
- ii. Facilitate the effective review and evaluation of the audit evidence obtained and conclusions reached before finalization of the audit report.
- iii. Assist the audit team in planning and performing the audit.
- iv. Ensure that members of the audit team are accountable for their work.
- v. Maintain a record of matters of continuing significance to future audits.
- vi. Enable an experienced auditor, with no previous connection with that audit, to conduct quality control reviews or other inspections.

3 AUDIT SAMPLING: ISA 530

3.1 Definitions

Audit sampling (sampling)

The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

Population

The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Sampling risk

The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

In the case of a TOC, that controls are more effective than they actually are, or in the case of a TOD, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

In the case of a TOC, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Non-sampling risk

The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

Anomaly

A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

Sampling unit

The individual items constituting a population. The sampling units might be physical items.

Statistical sampling

An approach to sampling that has the following characteristics:

- i. Random selection of the sample items; and
- ii. The use of probability theory to evaluate sample results, including measurement of sampling risk.

Non-Statistical Sampling: A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling. (also known as **judgemental sampling**) is any sampling technique not based on probability theory. Instead, it is based on a judgemental opinion by the auditor about the results of the sample.

Stratification

The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

Tolerable misstatement

A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality, as defined in ISA 320, to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

Tolerable rate of deviation

A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

3.4 Sample design, size and selection of items for testing

If an audit sampling exercise is to be effective – if sampling risk is to be reduced and therefore detection risk reduced – the sample must be designed in an appropriate way.

When designing a sample, the auditor is **required** by ISA 530 to:

- consider the purpose of the audit procedure and the population from which the sample will be drawn
- determine a sample size sufficient to reduce sampling risk to an acceptably low level
- select items for the sample in such a way that each sampling unit in the population has an equal chance of selection.

The auditor will therefore have to make a number of **key decisions**:

- the sampling approach to be used (statistical or non-statistical)
- the characteristics of the population from which the sample is to be drawn
- the sample selection method
- what constitutes a misstatement or deviation
- the 'tolerable' misstatement or rate of deviation
- the 'expected' misstatement or rate of deviation.

Statistical sampling or non-statistical sampling?

Statistical sampling techniques are now widely used in auditing. However, not all audit practices are convinced of their value and worth.

The benefits of statistical sampling techniques are as follows:

- Statistical sampling provides an objective, mathematically precise basis for the sampling process.
- The required sample size can be calculated precisely (using statistical probability techniques).
- There may be circumstances where statistical sampling is the only means of auditing efficiently (for example, in the case of very large 'populations' of items).

The disadvantages of statistical sampling techniques are as follows:

- A degree of training and technical expertise is required if auditors are to use statistical sampling techniques effectively.
- This requires an investment in the necessary training for audit staff.
- Sample sizes may be larger than under a judgemental approach, thus increasing the time (and the cost) involved in the audit.
- Some auditors take the view that it is preferable to rely on the skill, experience and judgement of the auditor, rather than on mathematical/statistical models.

The characteristics of the population from which the sample is to be drawn

The population is defined by ISA 530 **as the entire set of data from which a sample is to be selected and about which the auditor wishes to draw conclusions.**

The population from which a sample is to be drawn should be appropriate for the audit objective to be achieved, and the population should be complete. (In other words, all relevant items must be included in the population.)

For example, if the objective of the audit testing is to confirm the accuracy of trade receivable balances, the population should include **all** trade receivables balances as at a specified date. Alternatively, the audit objective might be more limited in scope – perhaps to confirm the accuracy of those trade receivables balances in excess of Rs.500,000. The population should then consist of all receivables balances over Rs.500,000.

The sample selection method

ISA 530 requires auditors to select a sample in such a way that each item in the population (each ‘sampling unit’) has an equal chance of being selected.

A wide range of sample selection methods is available to the auditor:

- **Random sampling:** All items in the population have an equal chance of selection. This is typically achieved by the use of random numbers to select items for testing.
- **Systematic sampling:** With systematic sampling, a random starting point is chosen from the population and then items are selected with a standard gap between them (for example, every 10th item). For example, suppose that a sample will be 10% of the items in a population and the items in the population can be arranged in a sequence, such as listed in invoice number order, or account number order or date order. A systematic sample would be to select one of the first 10 items in the list at random, and then to select every 10th item in the list for testing in order to obtain the 10% sample.
- **Haphazard sampling:** The auditor selects the sample on an arbitrary basis, for example, choosing any 100 invoices from a file. This is not a scientifically valid method and the resulting sample may contain a degree of bias. It is therefore not recommended for use with statistical sampling techniques.
- **Block sampling:** The auditor selects a complete block of sampling units from the population (for example all invoices of the month of May).

Selecting Items for testing to obtain Audit Evidence

An effective test provides appropriate audit evidence to an extent that, taken with other audit obtained or to be obtained, will be sufficient for the auditor’s purpose. In selecting items for testing the auditor is required by paragraph 7 to determine the relevance and reliability of information to be used as audit evidence; the other aspect of effectiveness (sufficiency) is an important consideration in selecting items to test. This means available to the auditor for selecting items for testing are:

- a) Selecting all items (100% examinations)
- b) Selecting specific items; and
- c) Audit sampling

The application of any one or combination of these means may be appropriate depending on the particular circumstances, for example, the risks of material misstatement related to the assertion being tested, and the practicality and efficiency of the different means.

Selecting All Items

The auditor will decide that it will be not appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100% examination is unlikely in the case of test of controls; however, it is more common for test of details. 100% examination may be appropriate when, for example:

- The population constitutes of small number of large value items
- There is a significant risk and other means do not provide sufficient appropriate audit evidence
- The repetitive nature of calculation or other process performed automatically by an information system makes 100% examination cost effective.

Selecting Specific items

The auditor may decide to select specific items from population. In making this decision factors that may be relevant include the auditor's understanding of the entity, the assessed risk of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- *High value or key items:* The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristics for example items that are suspicious, unusual, particularly risk prone or that have a history.
- *All items over a certain amount:* The auditor may decide to examine items whose recorded value exceeds a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- *Items to obtain information:* The auditor may examine items to obtain information about certain matters such as the nature of the entity or the nature of the transactions.

While selective examinations of specific items from a class of transactions or account balance will often be an efficient means of obtaining audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population accordingly selective examination of items does not provide audit evidence on concerning the remainder of the population.

Stratification

- Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.
- When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.
- The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population. For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).
- If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

What constitutes a misstatement or deviation

ISA 530's requirement for the auditor to consider the purpose of the audit procedure means that the auditor needs a clear understanding of what constitutes a misstatement or deviation.

For example, if the purpose of the audit procedure is to gain evidence on the accuracy of the statement of financial position figure for trade receivables, an error involving the posting of an invoice to a wrong customer account does not affect the statement of financial position total and has no impact on the objective of the testing. (The total trade receivables will not be wrong. Only the balances on the individual accounts of two customers will be wrong.)

The meanings of "misstatement" and "deviation" are only set out in ISA 530 in the context of "tolerable" misstatements or rates of deviations.

Sample Size – Test of details

- The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.
- The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Factors influencing sample size	Effect on sample size
1. Increase in auditor's assessment of the risk of material misstatement	Increase
2. No of sampling units in population	Negligible
3. Increase in use of other substantive procedures for same assertion	Decrease
4. Stratification of population	Decrease

Sample Size – Test of Controls

Factors influencing sample size	Effect on sample size
1. Increase in extent to which auditor's risk assessment takes into account relevant controls	Increase
2. Increase in expected rate of deviation of the population to be tested	Increase
3. No of sampling units in population	Negligible

3.5 Performing audit procedures on the sample

When designing a sample, the auditor is **required** by ISA 530 to:

- perform appropriate audit procedures on each item selected
- **if the audit procedure is not applicable to the selected item, the auditor must perform the procedure on a replacement item.** For example, the auditor might select a sample of cheques to test for evidence of authorisation. One of these might be a cheque which has been cancelled. Provided the cheque has been legitimately and properly cancelled then the auditor may choose another cheque number to test in its place
- if the auditor is unable to get the desired results after applying the procedure (or a suitable alternative) to the selected item (for example, because a document has been lost), that item must be treated as a misstatement/deviation.

The auditor is also **required** to:

- investigate the **nature and cause** of any misstatements/deviations and evaluate their possible effect.
- Investigation of the nature and cause of the misstatements/deviations may lead the auditor to conclude that the problem lies within one time period, type of transaction, or location (for example, perhaps when a temporary member of staff was being employed). In this case he might decide to extend audit procedures performed on that time-period/type of transaction/location.

- if the auditor considers the misstatement or deviation to be an **anomaly** he must obtain a high degree of certainty about this and perform additional audit procedures to obtain sufficient evidence that the misstatement or deviation does not affect the rest of the population.
- An anomaly is defined by ISA 530 as a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

3.6 Projecting misstatements and evaluating the results of audit sampling

The auditor is **required** to evaluate:

- the results of the sample. For **tests of details** this will include projecting the misstatements found in the sample to the entire population
- whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. If the conclusion is that it has not then the auditor will need to consider carrying out additional audit procedures.

The auditor wants to reach a conclusion about the population as a whole from the results of the sample. As required above, for **tests of details** this will mean using the sample results to estimate the likely misstatement that exists in the population. This is done by **extrapolating** the error found in the sample over the whole population.

► Example:

The results of tests of detail on a sample of receivables balances recorded as Rs.2,000,000 indicate that the correct balances should be Rs.1,950,000.

The total of balances for similar items has been recorded as Rs.10,000,000.

Required

Explain:

- what the auditors might conclude about the projected misstatement in the population of trade receivables
- the relevance of the concept of tolerable misstatement in this situation.

► Answer

- The misstatement in the sample is Rs.50,000 (Rs.2,000,000 - Rs.1,950,000).

The misstatement rate in the sample is 2.5% (50,000/2,000,000). Extrapolating this over the population as a whole, the projected misstatement is that total trade receivables contain errors of Rs.250,000 (Rs.10,000,000 × 2.5%) and trade receivables should therefore be stated at Rs.9,750,000 (Rs.10,000,000 - Rs.250,000).

- The auditor will compare the projected misstatement in the population to his pre-set tolerable misstatement. If the tolerable misstatement in the population was, say, Rs.300,000 then the error is, in effect, not material and could be ignored.

For tests of controls, the sample deviation rate will be the projected deviation rate for the whole population. An unexpectedly high sample deviation rate may cause the auditor to review the assessed risk of misstatement and therefore increase the extent of tests of detail to be performed.

► Practice Question 08:

Briefly Describe the term 'systematic sampling'.

Tutorial Notes:

Systematic sampling requires a random starting point, followed by item selection at a fixed interval. It ensures structured coverage of a population, reducing the risk of bias. You mention both random selection of the first item and fixed interval selection thereafter.

► *Solution 08:***Systematic sampling:**

It is a method of sampling whereby a random starting point is chosen from the population and then items are selected with a standard gap between them (for example, every 10th item).

► *Practice Question 09:*

What are the matters which the auditor should consider while designing an audit sample, determining its size and selecting the sampling units?

Tutorial Notes:

When designing an audit sample, consider audit objectives and population characteristics. The sample should be large enough to minimize risk and randomly selected to ensure equal chance of inclusion. Solely linking sample size to risk level is insufficient.

► *Solution 09:*

When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

The sample size should be sufficient to reduce sampling risk to an acceptably low level.

The auditor shall select items for the sample in such a way that each sampling unit in the population has an equal chance of selection.

► *Practice Question 10:*

- a) List any four ways in which the debtor balances may be stratified.
- b) You are the audit in-charge on the audit of Opportunity Limited (OL). OL deals in fast moving consumer goods. For sending of confirmations, an audit team member has stratified the debtors as follows:

Category A	Balances exceeding Rs. 50 million	12 customers
Category B	Balances below Rs. 50 million	100 customers
Category C	Balances below Rs. 10 million	280 customers
Category D	Balances below Rs. 1 million	600 customers

During a meeting some of the team members have expressed divergent views, as follows:

- i. Verification of balances of category A and B will provide sufficient coverage and evidence; therefore there is no need to cover other categories.
- ii. Selection should be done on haphazard basis, as under this method all items of population have equal chance of selection.
- iii. Selection of sample should be done systematically, whereby items constituting 10% of the amounts in each category should be selected in descending order.

Required:

Discuss the appropriateness of options discussed in the meeting and give your suggestion in this regard.

Tutorial Notes:

Audit sampling should be designed effectively to cover all material risk areas.

Ignoring lower-value debtors (Categories C & D) could overlook material misstatements.

Haphazard selection does not ensure equal representation; use random sampling instead.

Systematic sampling involves a random starting point and equal intervals, not just selecting a percentage of transactions.

► *Solution 10:*

- a) Ways in which debtors population may be stratified are as under:
- By product
 - By customers or category of customers
 - Geographically
 - Terms of sales such as credit terms/Aging
 - By values
- b) Views expressed by the team member:
- i. The view that if verification of balances of category A and B is carried out then there is no need to perform further procedures is not correct as the results of audit procedures applied to items in category A and B will only provide evidence about the items that make up that category (stratum).
 - ii. The auditor should obtain sufficient appropriate audit evidence regarding items in categories C & D as these can also be material.
 - iii. The view that sampling should be carried out on haphazard basis to ensure equal chance of selection is not correct as such assurance is only ensured by using random sampling, i.e. use of random numbers to select items.
 - iv. The view related to systematic sampling is not correct, as selection of 10% items is not systematic sampling. Systematic sampling involves, selection of first item on random basis and then items are selected with a standard gap between them (for example, every 10th item).

Suggestion:

Both haphazard and systematic sampling may be used in the normal manner, either with or without stratification. However, these methods cannot be used in the manner as suggested by the team members because it may result in extensive testing on immaterial items, thereby increasing the cost which may not be efficient. It may also be appropriate to use random sampling to ensure all items in a population have an equal chance of selection.

► *Practice Question 11:*

You are the audit senior at FSY Limited (FSY) for the year ended 30 June 2018. FSY manufactures and supplies toys to wholesalers, super stores and distributors. Different prices are charged from each customer depending upon their credit rating and amount of purchases.

Your team has made a plan for test of details for verification of sales. The sampling of invoices would be made as per the following plan:

- i. Sales reported in the financial statements is Rs. 800 million net of sales returns. This would be used for determining the sample size.
- ii. 50% of the net sales represents sales to distributors, 40% to super stores and 10% to wholesalers.
- iii. FSY sells its toys to 10 super stores only, who are invoiced on a monthly basis. The audit team would test all the invoices of June and December because invoices prepared close to period end are more prone to overstatement. In addition, 2 invoices would be checked for each of the other 10 months.
- iv. 100 sales invoices to distributors and wholesalers would be selected haphazardly from invoice files. The number of invoices to be checked has been determined considering that expected rate of deviation is low. The expectation regarding rate of deviation is based on the fact that overall audit risk has been assessed as low.

Required:

Identify the weakness in the sampling approach planned by the audit team and suggest appropriate changes.

Tutorial Notes:

When performing sampling for sales verification, ensure the selection method is statistically valid and representative:

Use gross sales instead of net sales for sample determination.

Selecting only invoices from specific months may lead to biased results—test sales across the entire year.

Haphazard selection introduces bias; use random or stratified sampling instead.

Select samples from sales ledgers, not invoice files, to prevent omission of unrecorded transactions.

► **Solution 11:**

S. No.	Weakness in sampling approach	Recommendations
(i)	The audit team had used net sales for calculating the sample size.	Sample should be representative of the population, which in this case is 'sales'. Therefore, sampling should be based on gross sales.
(ii)	Testing all the invoices of June and December, being specific selection, will not enable the auditor to project the results to entire population.	Total super stores invoices issued in a year are 120 and the sales of superstores constitute 40% of the total sales, therefore, the audit team may consider testing all the invoices of the super stores. Audit team could use statistical sampling so that results can be projected to entire population. Furthermore, the risk of overstatement of sales near the year-end may be catered through other tests such as cut off test of sales.
(iii)	Haphazard selection of 100 invoices is a non-statistical selection and risk of auditor biasness is very high. It will not enable the auditor to project the results to entire population.	In view of low risk, it appears that the team considers random sampling appropriate under the given circumstances, but in order to make the process efficient opted for haphazard selection. The sales to distributors and wholesalers is around 60%. Therefore, use of statistical sampling would be more appropriate so that results could be projected to entire population.
(iv)	Selection of invoice from the files instead of selecting from the sales ledger.	There is a risk that those transactions would not be identified for which files are not made. Hence, the selection should be made from the ledger for occurrence and accuracy and from delivery record for completeness and cutoff.
(v)	Distributors and wholesalers have been clubbed together for determining the sample size. They are likely to have different characteristics.	If sales to distributors and wholesalers have different characteristics, then they should be considered separately as two strata for calculating the sampling size and selecting the sample.
(vi)	In performing test of details on sales, expected misstatement is based on expected deviation rate. In case of sales expected misstatement cannot be based on overall risk assessment.	The inherent risk for sales is generally considered to be high, therefore setting the expected misstatement should not be set as low without considering the inherent risk. The following will be considered while setting expected misstatement: Subjectivity involved • Results of risk assessment and test of controls • Results of audit procedures applied in prior • period warrants such a use; or • Results of other substantive procedures

► *Practice Question 12:*

State two advantages and two disadvantages of statistical sampling.

Tutorial Notes:

Statistical sampling provides objective selection and measurable precision, but it requires technical expertise and training. Auditors should balance efficiency with reliability, ensuring they apply proper methodology to draw valid conclusions.

► *Solution 12:*

Advantages of statistical sampling:

- Statistical sampling provides an objective, mathematically precise basis for the sampling process.
- The required sample size can be calculated precisely (using statistical probability techniques).

Dis-advantages of statistical sampling:

- A degree of training and technical expertise is required if auditors are to use statistical sampling techniques effectively.
- This requires an investment in the necessary training for audit staff.

► *Practice Question 13:*

State the advantages of sampling using stratification and discuss how misstatements are projected where stratification is used.

Tutorial Notes:

When using stratified sampling, divide the population into distinct sub-groups with similar characteristics. Project misstatements separately for each stratum and combine them to assess the overall financial impact. Misstatements should never be generalized across all groups without proper weighting..

► *Solution 13:*

Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

► *Practice Question 14:*

Briefly discuss 'Non-sampling risk' and 'Anomaly' in respect of audit sampling. Also, provide an example for each of them.

Tutorial Notes:

Non-sampling risk refers to errors in audit judgment, such as misinterpreting evidence or using inappropriate procedures. An anomaly is an isolated error, like a one-time entry mistake. Auditors must differentiate between systemic issues and individual errors.

► *Solution 14:*

The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Examples of non-sampling risk include the use of inappropriate audit procedures, misinterpretation of audit evidence, and failure to recognise a misstatement or deviation.

A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population. Examples of anomaly can be one-off transposition error in an accounting entry and error in recording an accounting entry due to very rare system breakdown.

► *Practice Question 15:*

To ensure the effectiveness of an audit sampling exercise and to reduce the sampling risk, the sample must be appropriately designed. State three factors to consider while designing the sample.

Tutorial Notes:

A well-designed audit sample must:

Consider the purpose of audit procedures and characteristics of the population.

Ensure sufficient sample size to minimize sampling risk.

Use random selection to provide every item an equal chance of selection.

Do not miss discussing these key considerations.

► *Solution 15:*

- i. Consider the purpose of the audit procedure and the population from which the sample will be drawn.
- ii. Consider the characteristic of the population from which the sample will be drawn.
- iii. Consider the nature of the audit evidence sought from the sample.
- iv. Determine a sample size sufficient to reduce sampling risk to an acceptably low level.
- v. Select items for the sample in such a way that each sampling unit in the population has an equal chance of selection.

4 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Describe the general principles of gathering audit evidence
- Explain the terms sufficient and appropriate
- Discuss different procedures for generating evidence and its relative quality
- List and explain the financial statement assertions
- Describe different types of audit procedures
- Explain what audit documentation is and why it is prepared
- Describe the form, content and extent of audit documentation
- Explain the use of computer-based audit working papers
- Summarise documentation ownership rules, custody and confidentiality
- Explain audit sampling, statistical sampling, sampling risk and non-sampling risk
- Describe how samples are designed and items selected for testing
- Understand how to project misstatements and evaluate the results of audit sampling

INTERNAL CONTROL

IN THIS CHAPTER:

1. The importance of internal control
2. The elements of internal control
3. Limitations of internal control systems
4. Evaluation of controls and audit risk assessment
5. Chapter review

1 THE IMPORTANCE OF INTERNAL CONTROL

1.1 The auditor's assessment of internal controls

The auditor is required by ISA 315 (revised 2019) to **make an assessment of risk**. This is made at both the financial statement level and at the assertion level.

The auditor is then required by ISA 330 to **respond to those risks**. The overall responses in relation to the financial statement level risks were discussed in a separate chapter.

The responses at the assertion level involve the auditor selecting appropriate audit procedures. The choice of audit procedures will depend on the auditor's assessment of both:

- inherent risk, and
- control risk.

This chapter looks at this requirement in detail and considers how the auditor's assessment of internal controls will influence his selection of the approach to the audit.

1.2 The meaning of internal control

Internal control may be defined as the process designed, put in place and maintained to provide assurance of a reasonable level regarding the achievement of the objectives of an entity. These objectives relate to the reliability of the financial reports, the efficiency and effectiveness of operations and adherence to relevant and applicable laws and regulations.

The following points should be noted from this definition:

- It is the responsibility of management to 'design' and put in place a suitable system of internal controls.
- Internal controls are designed to deal with financial risks, operational risks and compliance risks.
- Since internal controls are established by management, the auditor has to accept what controls there are. However, he can assess and evaluate the controls, and will plan his audit on the basis of his assessment.

1.3 How the auditor uses internal controls

Modern auditing is, wherever possible, based on a 'systems' based approach. With this approach, the auditor **relies** on the accounting systems and the related controls to ensure that transactions are properly recorded.

- His assumption is that if the systems and the internal controls are adequate, the transactions should be processed correctly.
- The audit emphasis is therefore, as much as possible, on the systems processing the transactions rather than on the transactions themselves.

Before the auditor can rely on the systems and controls that are in place, he must establish what those systems and controls are, and carry out an evaluation of the effectiveness of the controls.

In other words, the systems-based audit approach is based on the premise that accounting systems and their related internal controls are sufficient to record transactions properly. However, the auditor should first test the controls, in order to satisfy himself that this approach to the audit is valid.

The degree of effectiveness of an internal control system will depend on the following two factors:

- The **design of the internal control system** and the individual internal controls. Is the control system able to prevent material misstatements, or is it able to detect and correct material misstatements if they occur?
- The proper **implementation of the controls**. Are the controls operated properly by the client's management and other employees?

The outcome of this evaluation helps the auditor to assess **control risk** – which is one of the key elements in the audit risk model (described in an earlier chapter).

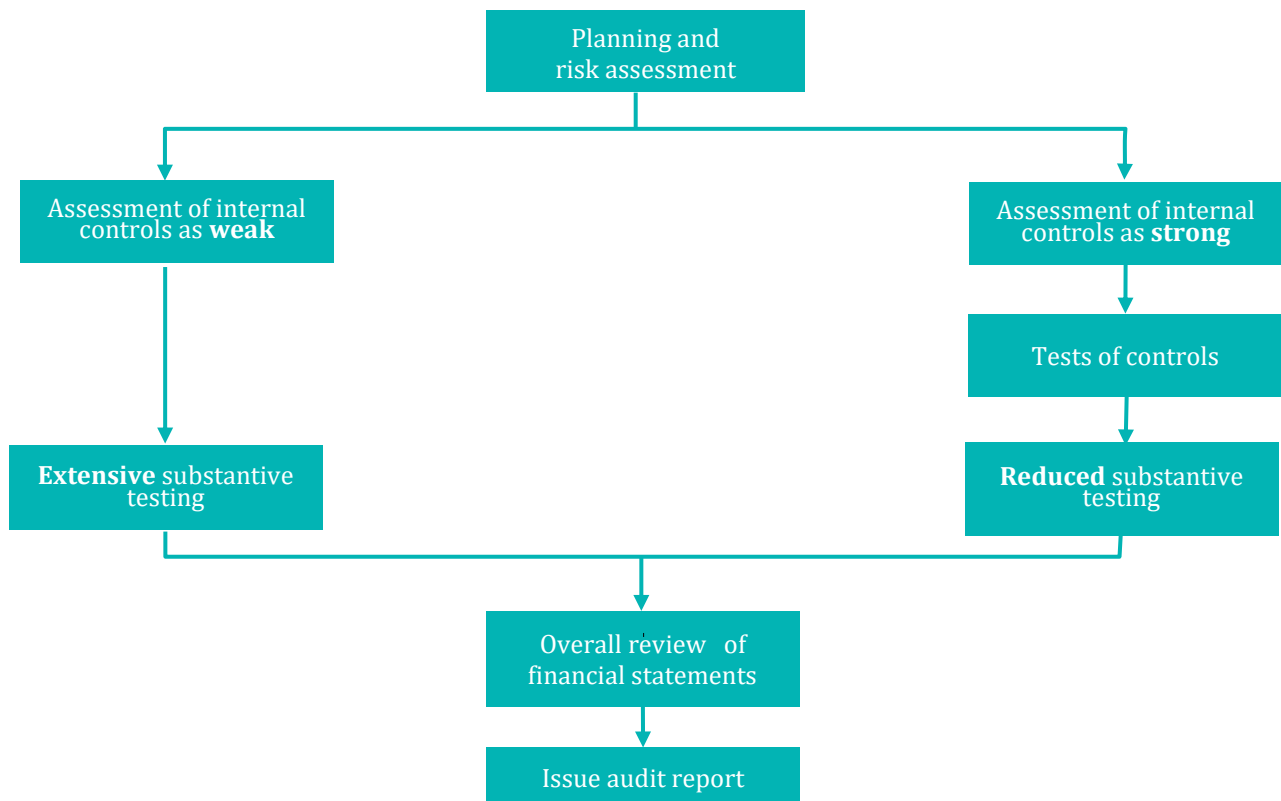
1.4 Summary of the audit approach: tests of controls or substantive tests?

As far as possible, the auditor will **rely** on the internal controls that are in operation. However, all internal control systems have inherent limitations, and controls can never be 'perfect' and 100% certain to be effective. It will therefore never be possible for the auditor to rely on them completely.

The auditor must therefore:

- test the underlying internal control systems themselves, using **tests of controls**, and
- perform some tests on the transactions and balances in the financial statements.
- As discussed in a previous chapter, these tests on transactions and balances are referred to as **substantive procedures**:
- Where the auditor concludes that the system of controls is ineffective, and that the controls therefore cannot be relied on, he will have to carry out extensive substantive procedures. When an audit relies heavily on substantive procedures, the approach to the audit is called a **transactions-based approach**.
- If the auditor judges that the internal controls are strong, he will carry out tests on the controls (in order to verify his opinion about them) and should need a smaller amount of substantive testing. When an audit is based mainly on a favourable assessment of the internal controls, the approach to the audit is called a **systems-based approach**.

The diagram below summarises the audit approach.



2 THE ELEMENTS OF INTERNAL CONTROL

2.1 The five elements of internal control system

ISA 315 (revised 2019) identifies five elements which together make up the internal control system.

These are:

- The control environment
- The entity's risk assessment process
- The entity's process to monitor the system of internal control
- The information system and communication
- Control activities

ISA 315 (revised 2019) requires the auditor to:

- gain an understanding of each of these elements as part of his evaluation of the control systems operating within an entity; and
- document the relevant features of the control systems together with his evaluation of their effectiveness.

Once this understanding has been gained, the auditor should confirm that his understanding is correct by performing '**walk-through**' tests on each major transaction type (for example, revenue, purchases and payroll).

Walk-through testing involves the auditor selecting a small sample of transactions and following them through the various stages in their processing in order to establish whether his understanding of the process is correct.

2.2 The control environment

The 'control environment' is often referred to as the general 'attitude' to internal control of management and employees in the organisation.

The control environment includes the views, awareness and actions of management regarding an entity's internal control. It also includes the governance and functions of management and asserts the premise of an organisation. It is the basis for good internal control, providing guidance and structure.

The control environment includes the following elements:

- Communication and enforcement of integrity and ethical values
- Commitment to competence
- Participation of management
- Management's philosophy and operating style
- Organisational structure
- Assignment of authority and responsibility
- Human resource policies and practices

A strong control environment is typically one where management shows a high level of commitment to establishing and operating appropriate controls.

The existence of a strong control environment cannot guarantee that controls are operating effectively, but it is seen as a positive factor in the auditor's risk assessment process. Without a strong control environment, the control system as a whole is likely to be weak.

2.3 The entity's risk assessment process

Within a strong system of internal control, management should identify, assess and manage business risks, on a continual basis. Significant business risks are any events or omissions that may prevent the entity from achieving its objectives.

Identifying risks means recognising the existence of risks or potential risks. Assessing the risks means deciding whether the risks are significant, and possibly ranking risks in order of significance. Managing risks means developing and implementing controls and other measures to deal with those risks.

ISA 315 (revised 2019) requires the auditor to gain an understanding of these risk assessment processes used by the client company's management, to the extent that those risk assessment processes may affect the financial reporting process.

Risks can arise or change due to circumstances such as:

- changes in the entity's operating environment
- new personnel
- new or revamped information systems
- rapid growth
- new technology
- new business models, products or activities
- corporate restructurings
- expanded foreign operations
- new accounting pronouncements.

2.4 Monitoring of controls

It is important within an internal control system that management should review and monitor the operation of the controls, on a systematic basis, to satisfy themselves that the controls remain adequate and that they are being applied properly, relevant to the preparation of the financial statements. ISA 315 (revised 2019) requires the auditor to obtain an understanding of this monitoring process.

2.5 The information system and communication

This aspect of the auditor's work will involve identifying and understanding the following:

- the entity's principal business transactions;
- how these transactions and other events relevant to the financial reporting process are 'captured' (identified and recorded) by the entity;
- the processing methods, both manual and computerised, applied to those transactions;
- the accounting records used, both manual and computerised, to support the figures appearing in the financial statements; and
- the processes used in the preparation of the financial statements.

2.6 Control activities

Control activities are the policies and procedures, other than the control environment, used to ensure that the entity's objectives are achieved. They are the application of internal controls.

Control activities are the specific procedures designed:

- to prevent errors that may arise in processing information, or
- to detect and correct errors that may arise in processing information.

Categories of control activities (internal controls)

- **Performance reviews.** These include reviews and analyses of actual performance against budgets, forecasts and prior period performance. . They include supervision by management of the work of subordinates, management review of performance and control reporting (including management accounting techniques such as variance analysis).
- **Information processing.** A variety of controls are used to check the **accuracy, completeness and authorisation of transactions.**
- **Physical controls.** These include controls over the physical security of assets and records to prevent unauthorised use, theft or damage. Examples include limiting access to inventory areas to a restricted number of authorised personnel, and requiring authorisation for access to computer programs and data files.
- **Segregation of duties.** This control involves assigning different people the responsibilities of authorising and recording transactions and maintaining the custody of assets. This reduces the likelihood of an employee being able to both carry out and conceal errors or fraud. This type of control is explained further below.
- **Authorisation.** Whether transaction is authorised by the approved person

► Example: Control activities

One part of the sales system at Dolally operates as set out below:

- Orders are received by telephone. On receipt of an order a clerk enters the details into the system.
- The system checks that the goods are available and, if so, a despatch note is produced and e-mailed to the distribution centre.
- Distribution centre staff pack the goods and despatch them with two copies of the despatch note.
- On receipt of the goods the customer signs the despatch notes and one copy is returned to the accounts department at Dolally.
- The accounts department flag up the despatch note on the system to indicate that the goods have been delivered and the system automatically produces an invoice and e-mails it to the customer.
- An exception report of un-invoiced despatch notes is produced weekly.

Required

Set out an example of each of the above five types of control activities set out in ISA 315 (Revised 2019) as they might operate in Dolally's system.

► Answer

Performance reviews: Management should compare budgeted sales to actual sales on a monthly basis (provided that the budgets are reliable, this would detect where significant sales had not been recorded).

Information processing – application: Manual follow up of the exception report of un-invoiced despatch notes.

Information processing – general IT: Controls over the development and testing of the sales system to ensure it will lead to accurate processing (such as documentation and testing of any changes to programs).

Physical controls: Access controls over the sales price master files such as access only being possible via a high-level password, known only to senior employees (such as the sales director) (as invoices are produced automatically by the system it is important that the integrity of this file is maintained).

Segregation of duties: Different employees should be responsible for taking and inputting orders, despatching goods and flagging up the despatch note.

Tutorial note:

There are a number of other possible examples other than those set out above.

The auditor shall obtain an understanding of the control activities component, through performing following risk assessment procedures:

- a) Identifying controls that address risks of material misstatement at the assertion level in the control activities component.
- b) Based on controls identified above, identify IT applications and the other aspects of the entity's IT environment that are subject to risks arising from the use of IT.
- c) For such IT application and other aspects of the IT environment, identifying the related risks arising from the use of IT and the entity's general IT controls that address such risks.

2.7 Internal controls in IT systems: general controls and application controls

Internal controls within IT systems can be categorised into general controls and specific application controls.

General IT controls

General IT controls are policies and procedures that **relate to many different applications** (such as revenue, purchases and payroll). They support the effective functioning of application controls (explained later) by ensuring the continued proper operation of IT systems.

Because these general IT controls will apply to most or all of the entity's IT applications, if general IT controls are weak, it is unlikely that the processing undertaken by the system will be complete and accurate.

The auditor will therefore firstly review and test the general IT controls, in order to reach a conclusion on their effectiveness. This will enable him to assess the control risk attached to the entity's IT systems as a whole. If control risk is assessed as low he will then move on and test application controls, in order to decide if he can rely on specific systems and reduce his substantive testing.

Many of the general controls apply to large computer systems that are written, developed and maintained by the client company. However, some general controls also apply to smaller entities and users of off-the-shelf accounting software.

The main categories of general controls that an auditor would expect to find in a computer-based information system are:

- controls over the development of new computer information systems and applications
- controls over the documentation and testing of changes to programs
- the prevention or detection of unauthorised changes to programs (for example, by an employee committing fraud or by a 'hacker' accessing the system)
- controls to prevent the use of incorrect data files or programs
- controls to prevent unauthorised amendments to data files
- controls to ensure that there will be continuity in computer operations (and that the system will not 'break down' and cease to be operational).

► Examples of general controls

Examples of each of these categories of general controls are set out in the table below:

Control area	Controls
Development of computer-based information systems and applications	• New computer systems may be designed and developed for a 'computer user' (the client company) by an in-house IT department or by an external software company. • Appropriate IT Standards should be used when designing, developing, programming and documenting a new computer system. • There should be controls to ensure that tests are carried out on new systems before they are introduced.

Control area	Controls
	• A new computer system design should be formally approved by the system 'user'. • There should be a segregation of duties between the designers and testers of systems. • Staff should be given training in the use of a new system before they use it for 'live' operations.
Documentation and testing of program changes	• When a computer system is operational, it may be necessary to update and amend some of the programs in the system. There should be suitable general controls over the development of new versions of programs. • There should be controls to ensure that formal testing procedures on new program versions before they are used for 'live' operations • All new versions of programs must be authorised at an appropriate level of management. • Staff should be given training, where appropriate, in the use of a new program version before they use it for 'live' operations.
Prevention or detection of unauthorised program changes	• There is a risk that new programs will be introduced without proper authorisation. The risks are particularly serious in companies that have large purpose-written computer systems, and where the computer systems are operated on large computers (mainframe computers or minicomputers) in a centralised computer centre. • There should be a segregation between the tasks of programmers (who write new programs) and computer operators (who use the programs). • There should be full documentation of all program changes.
	• There should be restricted access to programs (program files), and only authorised programmers should have access to them. • Program logs should be maintained, to record which programs and which versions are used. • There should be virus protection for programs (using anti-virus software) and there should be back-up copies of all programs (in the event of 'malicious' changes to programs used in operations).
Prevention of the use of incorrect programs or data files	• In large computer systems, there may be several versions of a program at any time, not just one 'current version'. For example, when a new version is written, the 'old' version may be kept. It is important to ensure that the correct version of the program is used.
	• Computer operating staff should be suitably trained, and should follow standard operating procedures for checking the version of the program they are using. • Job scheduling: there should be formal job scheduling in large computer centres, and a job schedule should specify the version of the program to be used. • Supervision. Supervisors should monitor the activities of operating staff. • Reviews by management. Management should carry out periodic reviews, to make sure that the correct versions of programs are being used.
Prevention of unauthorised amendments to data files	In addition to the risk that there may be unauthorised access to program files and unauthorised amendment of programs, there is also a risk that data files will be accessed without authorisation (by an employee or an external 'hacker'). • Physical access to computer terminals may be restricted to authorized employees.

Control area	Controls
	- Access to programs and data files may be restricted using passwords. There should be rigorous checks by management to ensure that a password system is being used effectively by employees (so that passwords are not easy to 'guess') - Firewalls (software and hardware) can be used to prevent unauthorised external access via the internet.
Ensuring continuity of operations	When problems occur in a computer system, the system may be at risk of ceasing to function. This could happen if there is physical damage to computer equipment or files, or if program files or data files are 'corrupted' or altered without authorisation.
	- There should be controls over maintaining secure second copies of all programs and data files ('back-up copies'). The back-up copies can be used if the original copies are damaged or corrupted. - There should be measures for the protection of equipment against fire, power failure and other hazards. - The company should have disaster recovery plans, such as an agreement with another entity to make use of its computer centre in the event of a disaster such as a fire or flood. - The company should make suitable maintenance and service agreements with software companies, to provide 'technical support' in the event of operating difficulties with the system.

Application controls

Application controls apply to the processing of **individual applications** (such as revenue, purchases or payroll). These controls help to ensure that transactions occurred, are authorised and are completely and accurately recorded and processed. These controls could be manual or computerised, depending on the system in question. Examples include:

- Existence Check:** Data are entered correctly and agree with valid predetermined criteria. An **existence check** is similar, but the program checks the actual existence of a particular code.
- For example, in a payroll system, input transactions may include a department code for each employee. Department codes may be B, C and P. A program check can be carried out on the department code for all input transactions, and if the code is not B, C or P, an error report will be produced.

Range Check: Data should be within a predetermined range of values. For example, inventory codes may be within the range 2000 – 3999. If so, the program can be written so that it checks the inventory code for every transaction, and produces an error report if the code is not within that range.

Sequence Check: the documents are sequentially numbered

Completeness Check: A field should always contain a data rather than zero or blank

Duplicate check: New transactions are matched to those previously input to ensure that they have not already been entered

Batch total: Verification that total of values, items or documents of output matched with the total of values, items or documents of input.

A batch total is a form of **control total**. Transaction data is input to the computer system in batches, and a control total is calculated. It may simply be a total of the number of transactions in the batch. The batch total is input to the computer system for processing, and the computer program will check the batch total that has been input with its own batch total count.

The program will report any discrepancy between batch total and its own batch total, as an error report.

Batch totals can be useful in helping to make sure that every transaction in a batch is actually input for processing and is actually processed.

Check digits

Check digits are checks within a computer program on the validity of key numerical codes, such as customer codes, supplier codes and employee identification numbers.

When check digits are used, every code is given an extra digit, the check digit. This is a unique digit obtained from the other digits in the code.

An example might illustrate how check digits operate. In this example, a Modulus 11 check digit system is used, where the check digit can be any of 11 'numbers' – 0 to 9 or X (10).

The basic coding system is for a five-digit code, and a sixth digit (the check digit) will be added to complete the code. Suppose that a customer's five-digit code is 23467. The check digit is calculated as follows (in the Modulus 11 system).

Code digit	Weighting	
2	× 6	12
3	× 5	15
4	× 4	16
6	× 3	18
7	× 2	14
		75
Check digit = 2	× 1	2
		77

In a Modulus 11 system, the check digit is given a weighting of 1, and it is calculated so that the total of all the digits in the code multiplied by their weightings will add up to a multiple of 11. In this example, the multiple of 11 is 77, and the check digit 2 makes the total add up to 77.

The six-digit customer code is therefore 234672.

A computer program can carry out a mathematical check on the code for every transaction input for processing. The program will check that the total of the code digits, when weighted as shown above, is a multiple of 11.

If the weighted total is not a multiple of 11, there must be an error in the code. This means that the computer program will detect any errors in input data for the particular code, and will not process the transaction. Instead, the program will output an error report, so that the error can be investigated and corrected.

► Example: Segregation of duties

The purchasing of inventory involves several different tasks. Someone has to initiate a purchase requisition for a new supply of inventory. Someone has to place a purchase order with a supplier. Someone has to check that the items are delivered by the supplier. Someone has to record the amount payable in the accounting system, and someone has to make the payment at the appropriate time.

Control risks include the risks that inventory will be ordered when it is not needed, that the supplier will not deliver any inventory or will deliver the incorrect quantity, or that the supplier will be paid too much or will be paid for items that he has not delivered.

A segregation of duties can help to reduce these risks:

Transaction stage	Responsibility
Initiation – Replenishment of inventory item is required	Warehouse staff financial statement stores staff
Purchase order – Item ordered	Purchasing officer. The purchasing officer is able to check the material requisition from the stores staff

Transaction stage	Responsibility
Custody – Item received	Goods inwards officer. The items actually delivered are checked physically and counted. This is a check that items have actually been delivered in good condition, as stated in the supplier's delivery note
Recording – Invoice received, checked and processed	Accounts clerk. The invoice from the supplier is checked against the delivery note and the original purchase order. The amount payable is recorded in the accounts system.
Payment – Invoice is paid	Cashier. The amount payable to the supplier is eventually paid by a different person in the accounts department.

Additional controls will also be applied. For example, there should be authorisation controls, and both the placing of a purchase order with the supplier and the payment to the supplier should be authorised at an appropriate level of management.

2.8 System logs

A log file is a file that records events taking place in the execution of a system. This generates an audit trail that can be used to understand the activity of the system and to diagnose problems.

Logs are essential for understanding the activities of complex systems and for analysing a system's performance, particularly where there is little user interaction.

Examples of system logs include:

- Which user logged-in, when and where from
- Failed log-in attempts
- Who accessed and amended data in a file
- Changes made to a program – what, when and by whom
- When employees entered and left the building
- Black box flight recorders
- CPU speed
- Broadband speed
- Which web pages a user accessed
- Attempted cyber intrusions

All of the above logs provide essential information that can assist in analysing and improving a system's performance.

2.9 Recording internal control systems

The need to record internal control systems

The auditor must gain an understanding of each of the five elements that make up the client's internal control system. This is to enable the auditor to carry out an evaluation of the systems and to conduct an audit risk assessment. The outcome of this assessment and evaluation will establish his overall approach to the audit – whether it will be systems-based or transactions-based.

The auditor's work on internal control is therefore an important element of gathering audit evidence, because it influences the direction that the audit work will take. As with all other significant audit evidence, it must be properly documented in the audit working papers – probably in the permanent audit file.

Recording methods

The principal methods available to the auditor for recording internal control systems are:

- narrative notes
- questionnaires
- systems flowcharts

Narrative notes

Narrative notes are a written description of the control system and the controls that are in place. They are used mainly to make a record of the control activities involved in processing transactions.

Narrative notes are simple to prepare, but can become lengthy. They may be time-consuming to prepare initially. When narrative notes are long, it may also be time-consuming to update them when the system or the controls change.

Ideally, narrative notes should be written clearly, but should not be longer than necessary to provide a full description.

Questionnaires

Questionnaires are widely used by auditors to document systems. Questionnaires can be prepared in advance as standard documents. They are also ideally suited for use by the auditor in an electronic form, which means that standard questionnaires are available and ready for use on the auditor's laptop computer.

A questionnaire is a list of questions about controls in a particular aspect of operations or accounting.

There are two main types of questionnaire. Each has a different objective. They are:

- the internal control questionnaire (ICQ)
- the internal control evaluation questionnaire (ICEQ).

Internal control questionnaire (ICQ)

An internal control questionnaire (ICQ) is designed to establish whether appropriate controls exist, that meet specific control objectives. Each question requires a 'Yes' or a 'No' answer, and deals with a particular type of control. The auditor has to establish the answer to each of the questions, and fill in the questionnaire.

ICQs are usually drawn up in such a way that:

- a 'Yes' answer to a question indicates a control strength, and
- a 'No' answer to a question indicates a control weakness.

For example, the following ICQ questions might be included in a questionnaire dealing with procedures for assessing the credit-worthiness of potential new customers:

Are credit references taken on all potential new customers?	YES/NO
Are credit limits set for customers?	YES/NO

► Example:

As part of his evaluation of internal controls, the auditor wishes to establish each of the following:

- That the correct product prices are charged on sales invoices to customers.
- That raw materials delivered are of the correct specification and in the correct quantity.

Required

Draft ICQ questions that could be used to establish the existence of appropriate controls.

► Answer

(a)	Is a check carried out to match the price on a sales invoice to the official price list?	YES/NO
(b)	Are raw materials counted and checked against the purchase order when the materials are delivered?	YES/NO

An ICQ not only provides the auditor with a means of recording the system and its controls; it also assists with the evaluation process. The auditor can review the Yes/No answers to gain an overall picture of the reliability of the system under review.

The ICQ approach above has the advantage of producing a document that is relatively simple for the auditor to complete. So the questionnaire can often be completed by a relatively junior member of the audit team. However, the questionnaire can become lengthy (with a large number of questions) and so time-consuming to complete.

Checking ICQs

Instead of preparing new internal control questionnaires each year, it is often more practical and sensible to take the ICQs from the previous year's audit, check their accuracy and where appropriate bring them up to date. To do this the following steps should be taken:

- Obtain the ICQs from the previous year's audit file.
- Look at any control weaknesses that are indicated in these ICQs and find out whether the client entity has taken any action during the year to deal with them.
- Check the accuracy of each ICQ through a series of checks and enquiries: review the system documentation, interview the staff responsible for the controls and carry out walk-through tests. Identify the controls that apply and compare these with the findings in the ICQ. Make any amendments and updates as necessary.
- Having obtained an up-to-date set of ICQs, assess whether control weaknesses exist.

Internal control evaluation questionnaire (ICEQ)

In recent years the auditing profession has responded to this by developing a second type of questionnaire, the internal control evaluation questionnaire (ICEQ).

The idea behind the ICEQ is to draw up a small number of **key control questions** designed to establish whether major weaknesses may exist in a control system:

- Using an ICQ, the auditor is looking for 'good news' and expects to find particular controls in place.
- Using an ICEQ, the auditor is on the look-out for 'bad news' and the possibility that controls may be weak.

Like an ICQ, an ICEQ contains a (shorter) list of questions, for which the answer is Yes or No. A questionnaire is normally designed so that a Yes answer indicates good controls and a No answer indicates weak controls.

An earlier example showed how ICQ questions might be written, relating to controls over the creditworthiness of customers. An ICEQ approach in this same area might consider just one key control question, as follows:

Is there reasonable assurance that goods can only be despatched to authorised customers whose account balance is within their credit limit?	YES/NO

Although the ICEQ approach typically produces a document that is shorter than an ICQ, ICEQs may suffer from the disadvantage that the questions are less precise and may need more knowledge and experience on the part of the auditor to answer them.

Choosing which type of questionnaire to use is a matter of preference for the auditor or the audit firm.

As in the case of the ICQ, the ICEQ approach also serves a dual purpose for the auditor – both to record and to evaluate the internal control system.

Systems Flowcharts

Systems flowcharts provide a representation of accounting systems in the form of a diagram. For each type of transaction, they show the documents generated, the processes applied to the documents and the flow of the documents between the various departments involved. Flowcharts therefore show the flow of work by showing how documents are transferred within a system (and filed) and how they are used.

As they are in the form of a diagram, flowcharts present an immediate visual impact of the system. This can sometimes help the auditor to identify weaknesses in controls more easily than by reading narrative notes.

However, some expertise is needed to draw a good flowchart and to use it to assess the effectiveness of controls. In addition, although flowcharts work well with standard accounting systems and transactions, they may not be appropriate for documenting specialised areas of accounting.

► **Practice Question 01:**

You are the training manager in a firm of chartered accountants. Prepare brief presentation for newly inducted trainees, on the following:

- a) Control Environment and its elements
- b) Walk through tests and why these are performed

Tutorial Notes:

The Control Environment defines the overall attitude and culture of an organization toward internal controls. Ensure responses cover all key elements, such as integrity, competence, management philosophy, organizational structure, and HR policies. In Walk-through tests, the auditor traces transactions through the system to confirm their understanding—this is not the same as testing the effectiveness of controls.

► **Solution 01:**

a) Control Environment and its elements

The 'control environment' is often referred to as the general 'attitude' to internal control of management and employees in the organization.

The elements of control environment includes the following:

- Communication and enforcement of integrity and ethical values
- Commitment to competence
- Participation of those charged with governance.
- Management's philosophy and operating style
- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and practices

b) Walk through tests:

Auditor is required to gain an understanding of the various elements of the internal control system operating within an entity.

Once this understanding has been gained, the auditor should confirm that his understanding is correct by performing 'walk-through' tests on each major transaction type (for example, revenue, purchases and payroll). Walk-through testing involves the auditor selecting a small sample of transactions and following them through the various stages in their processing in order to establish whether his understanding of the process is correct.

► *Practice Question 02:*

Classify the following controls as preventive, detective, or corrective controls. Give brief reasons to justify your answers.

- i. Training on applicable policies, department policy/ procedures
- ii. Batch totals
- iii. Segregation of duties
- iv. Contingency planning
- v. System logs
- vi. System backup

Tutorial Notes:

When classifying controls as preventive, detective, or corrective, provide clear justifications. For example, training is preventive as it minimizes errors, while batch totals are detective as they identify discrepancies. Avoid contradictions—trained employees do not detect or correct errors but prevent them through compliance with policies.

► *Solution 02:*

i. Training on applicable policies, department policy/ procedures:

It is a preventive controls, as the individuals are trained to perform their duties as per the applicable policies and procedures that are in place.

ii. Batch totals:

It is a detective control as program will report any discrepancy between the manually counted batch total and its own batch total, as an error report.

iii. Segregation of duties:

It is a preventive control as it involves assigning different people the responsibilities of authorizing and recording transactions and maintaining the custody of assets. This reduces the likelihood of an employee being able to both carry out and conceal errors or fraud.

iv. Contingency planning:

It is a corrective control as it involves the corrective measures to be adopted in case of any mishap.

v. System logs:

It is a detective control as this generates an audit trail that can be used to understand the activity of the system and to diagnose problems.

vi. System backup:

It is a corrective control as it will involve any retrieval measures in case of any damage to the original data.

► *Practice Question 03:*

International Standards on Auditing require an auditor to evaluate the control environment and assess its effectiveness. State the factors that the auditor should consider in evaluating the control environment.

Tutorial Notes:

Evaluating the control environment requires considering management's participation, ethical values, control culture, and HR policies. Avoid listing internal controls instead of factors influencing control effectiveness.

► *Solution 03:*

In evaluating the control environment, the auditor should consider such factors as:

- management participation in the control process, including participation by the board of directors

- management's commitment to a control culture
- the existence of an appropriate organization structure with clear divisions of authority and responsibility;
- an organization culture that expects ethically-acceptable behaviour from its managers and employees; and
- appropriate human resources policies, covering recruitment, training, development and motivation, which reflect a commitment to quality and competence in the organization.

► **Practice Question 04:**

Following IT related controls are being employed at Vision Limited:

- The general ledger system is automatically updated with sub-ledger transactions (e.g. Accounts Receivable) every night through batch processing.
- The system automatically maintains second copies of all programs and data files.
- Access to programs and data files is restricted using passwords.
- Invoices that are entered into the system are physically counted.
- Firewalls (software and hardware) are installed to restrict unauthorized access.
- Screen warnings are displayed as regards incomplete processing.
- Vision Limited has service level agreements with reliable software companies, for technical support.
- Review of output against expected values.

Required:

- In respect of each control, determine whether it is a preventive, detective or corrective control.
- Also classify each of the above between general IT controls and application controls.

Tutorial Notes:

Classify IT controls correctly as preventive, detective, or corrective and differentiate General IT controls (GITC) from Application controls. Avoid selecting multiple classifications for the same control, as only one category applies per control type.

► **Solution 04:**

S.No	Controls	(a)	(b)
		Type of controls	General / Application
(i)	The general ledger system is automatically updated with sub-ledger transactions (e.g. Accounts Receivable) every night through Batch processing.	Preventive	Application controls
(ii)	The system automatically maintains second copies of all programs and data files.	Corrective	Application controls
(iii)	Access to programs and data files is restricted using passwords.	Preventive	General IT controls
(iv)	Invoices are physically counted that are entered into the system.	Detective	Application controls
(v)	Firewalls (software and hardware are installed to restrict unauthorized access).	Preventive	General IT controls
(vi)	Screen warnings about incomplete processing.	Detective	Application controls
(vii)	Service level agreements.	Corrective	General IT controls
(viii)	Review of output against expected values.	Detective	Application controls

► *Practice Question 05:*

Identify any four types of information that can be extracted from system logs.

Tutorial Notes:

When explaining data encryption techniques, ensure you differentiate between symmetric (shared secret key) and asymmetric (public/private key) encryption. Be specific about system logs—do not include unrelated IT performance metrics like CPU speed.

► *Solution 05:*

Information that can be extracted from system logs include:

- i. Which user logged-in, when and where from
- ii. Failed log-in attempts
- iii. Who accessed and amended data in a file
- iv. Changes made to a program – what, when and by whom

► *Practice Question 06:*

List six physical access controls over an IT system.

Tutorial Notes:

List only physical access controls such as door locks, surveillance, alarms, and biometric scanners. Do not mix in logical controls like passwords or multi-factor authentication.

► *Solution 06:*

Physical access controls over an IT System might include:

- i. Doors and door-locks
- ii. Alarms
- iii. Surveillance camera or video
- iv. Cables that allow a user to lock a laptop to a desk
- v. Fingerprints readers to log-in to a system
- vi. Lockable briefcase

► *Practice Question 07:*

You are working in IT department of a firm of Chartered Accountants.

Required:

- a) In the context of control activities explain what is included in 'Performance reviews'.
- b) Specify any four main categories of general controls that an auditor would expect to find in a computer based information system.

Tutorial Notes:

When discussing performance reviews, include variance analysis, budget comparisons, and trend assessments.

► *Solution 07:*

- a) Performance reviews – In the context of control activities, performance review includes:
 - analyses of actual performance against budget and forecasts;
 - analyses of actual performance against prior period performance
 - control reporting and variance analysis

- b) The main categories of general controls that an auditor would expect to find in a computer based information system are:
- controls over the development of new computer information systems and applications
 - controls over the documentation and testing of changes to programs
 - the prevention or detection of unauthorised changes to programs (for example, by an employee committing fraud or by a 'hacker' accessing the system)
 - controls to prevent the use of incorrect data files or programs

► *Practice Question 08:*

Discuss the effects on Application controls where General IT controls are ineffective.

Tutorial Notes:

If General IT Controls (GITC) are weak, application controls may also fail. However, strong manual user procedures can sometimes compensate. Do not fail to recognise this distinction instead of assuming all application controls become ineffective.

► *Solution 08:*

Weaknesses in general IT controls may result in IT application controls becoming ineffective. However it is possible that manual procedures exercised by users may provide effective controls at the application level.

► *Practice Question 09:*

Differentiate between General IT controls and Application controls. Also give two examples of each type of control.

Tutorial Notes:

Clearly differentiate between General IT Controls (GITC) (overall system integrity, e.g., passwords, backups) and Application Controls (specific program safeguards, e.g., validation checks). Provide relevant examples for both.

► *Solution 09:*

General IT controls	Application controls:
General IT controls aim to establish a framework of overall control over the computer information system's activities to provide a reasonable level of assurance that the overall objectives of internal controls are achieved.	Application controls are the specific controls over the relevant applications maintained by the computer. The purpose of application controls is to establish specific control procedures over a particular application. In order to provide reasonable assurance that all transactions are authorized and recorded, and are processed completely, accurately and on a timely basis.

► *Examples of General IT controls:*

- Segregation of duties
- Password protection
- Virus checks
- Backup copies

► *Examples of Application controls:*

- Authorisation controls e.g. data is input only by authorized personnel
- Control totals
- Batch controls
- Authorisation controls e.g. restriction on printing of document.

► **Practice Question 10:**

You have been assigned the audit of Pacific Shipping Limited (PSL) for the year ended 31 December 2017. During the audit, you have noted that the invoicing system was not operational for four days in January 2017. Upon inquiry, you were informed that some changes were made by one of the three programmers working in the IT department, merely on the request of a sales officer.

The change caused the whole invoicing system to malfunction and it had to be closed down. During these four days, all invoices were generated manually.

Required:

Identify any three control weaknesses in the above situation and suggest any two mitigating controls against each weakness.

Tutorial Notes:

When identifying control weaknesses, avoid misclassifying manual invoicing as a weakness—it is a contingency measure. Suggested controls should cover change authorization, system testing, and backup policies.

► **Solution 10:**

Control weakness	Suggested control
It appears that changes are made in the system without proper authorization.	- All changes must be authorized at an appropriate level. - Change requisition, assessment and approval should be properly documented. - Log of changes in program must be maintained and reviewed at an appropriate level periodically to ensure that no unauthorized changes in the programs are made. - There should be restricted access to program files and only authorised programmers should have access to them.
It appears that there was lack of testing in the offline environment prior to the implementation, which resulted in the malfunction of the system.	- No change shall be made in live environment. All changes made in the program should first be tested in offline environment. - Impact of change on existing functioning must be assessed before implementing the change.
It appears that due to unavailability of last updated backups or improper backup policy, the invoicing system was not operational for four days.	- Backup policy as per needs of the PSL must be in place. - Recorded backups must be restored periodically to assess their effectiveness.

► **Practice Question 11:**

- Briefly describe what is a system log file and give any four types of information that may be generated by a system log.
- Differentiate between General IT controls and Application controls.
- Advanced Limited (AL) uses an in-house developed integrated system for all its accounting and operational needs. AL has been facing following issues in transaction processing:
 - While processing a batch of 50 purchase invoices, it was noticed that 3 invoices of suppliers were posted twice in the accounts.
 - Some instances have been identified in which AL's accountant had posted the amount received from the customers in some other customer's account due to a typing error of the customer code.
 - While processing the payments, the accountant often fails to mention the cheque number, due to which it takes a lot of time to trace the payment in bank statement.
 - While recording inventory movement, the accountant had used incorrect inventory codes. Since those codes did not exist, the system posted the transaction in suspense account.

Required:

Identify and briefly describe one specific application control in respect of each of the above type of errors, to reduce the risk of such errors.

Tutorial Notes:

Define system logs as audit trails of system activity and mention relevant information captured, such as log-in attempts, file modifications, and system alerts. Ensure clear distinction between General IT controls (system-wide) and Application controls (specific to software functions).

► **Solution 11:**

a) A system log is a file that records events taking place in the execution of a system. This generates an audit trail that can be used to understand the sequence of activities of the system and to diagnose problems.

- Types of information that may be generated by a system log are:
- Which user logged-in, when and where from
- Failed log-in attempts
- Who accessed and amended data in a file
- Changes made to a program – what, when and by whom
- When employees entered and left the building
- Black box flight recorders
- CPU speed
- Broadband speed
- Which web pages a user accessed
- Attempted cyber intrusions

b)

General IT controls	Application controls
General IT controls aim to establish policies and procedures for overall control over the computer formation system's activities such as development, changes in program and data files. It provides a reasonable level of assurance that the overall objectives of internal controls are achieved.	Application controls are the specific controls over the relevant applications maintained by the computer. The purpose of application controls is to establish specific control procedures over a particular application. In order to provide reasonable assurance that all transactions are authorized and are processed completely, accurately and on a timely basis.

c)

i. Control Totals

Control total means the total value for all the transactions input. This total is given by the computer prior to processing. The total given by the computer is checked with the total taken manually.

ii. Check Digits

AL can use check digits with the customer code to prevent the posting of amounts in in-correct customer account. Check digits forms part of the account code which allows the computer program to check the validity of the code.

iii. On-Screen Prompts

On-screen prompts are displayed on the computer screen when a compulsory field in the data entry form is not filled.

iv. Existence Check

Existence check could be written into the system to ensure that the program will look at the value for a particular item of data in the input transaction, and if it is invalid, it will produce an error report and will not process the transaction.

► *Practice Question 12:*

Mention any four general controls over development of new computer information systems and applications.

Tutorial Notes:

When developing new IT systems, controls should include formal approvals, proper documentation, segregation of duties, and thorough testing before implementation.

► *Solution 12:*

Following general control may be considered while developing a new computer systems or applications:

- Appropriate IT Standards should be used when designing, developing, programming and documenting a new computer system.
- There should be controls to ensure that tests are carried out on new systems before they are introduced.
- A new computer system design should be formally approved by the system 'user'.
- There should be a segregation of duties between the designers and testers of systems.

► *Practice Question 13:*

Plover Limited has recently developed an integrated system for maintaining its financial records. During testing, following input and processing errors were identified in the system:

Input errors

- i. A non-existent product number was mentioned on the online order form.
- ii. Inward movement of inventory was recorded in some other inventory account.

Processing errors

- i. Salaries of few employees were processed twice.

Required:

Identify and briefly describe one application control in respect of each of the above type of errors that would have been effective in either preventing or detecting the error.

Tutorial Notes:

Application controls such as existence checks, control totals, and check digits should be used to prevent data input errors and duplicate transactions. Ensure the correct control is applied to each scenario.

► *Solution 13:***Input Errors****i. Existence check:**

Existence check can be written into a computer program to test the validity of input data. The program looks at the value for a particular item of data in the input transaction, and if it is invalid, it produces an error report and will not process the transaction. A program check can be carried out on the product code for all order forms, and if the code is not within the defined list, an error report will be produced.

ii. Check digit:

PL can use check digits with the inventory codes to prevent the posting of in-ward movement in in-correct inventory account. Check digits are controls within a computer program on the validity of key numerical codes, such as customer codes, supplier codes and employee identification numbers. When check digits are used, every code is given an extra digit, the check digit. This is a unique digit obtained from the other digits in the code.

Processing Errors

i. Control total:

PL may use control total, batch total or hash total to prevent duplicate processing of salary. Control totals may be used when several transactions are input for processing at the same time. Control total means the total value for all the transactions input. This total is given by the computer prior to processing. The total given by the computer is checked with the total taken manually.

► Practice Question 14:

- Differentiate between general IT controls and application controls.
- The internal auditor of Cyprus (Private) Limited has identified some discrepancies in the sales revenue. After investigation, it was identified that some unknown changes were made to the master price-list which resulted in such discrepancies.

Required:

Suggest any three general IT controls and three application controls to prevent occurrence of such error.

Tutorial Notes:

When differentiating General IT Controls (GITC) and Application Controls, ensure GITC applies system wide, while Application Controls apply to specific functions. Avoid confusing the two.

► Solution 14:

a)

General IT controls	Application controls
General IT controls aim to establish a framework of overall control over the computer information system's activities to provide a reasonable level of assurance that the overall objectives of internal controls are achieved.	Application controls are the specific controls over the relevant applications maintained by the computer. The purpose of application controls is to establish specific control procedures over a particular application to provide reasonable assurance that all transactions are authorized and are processed completely, accurately on a timely basis.

b) Examples of general IT controls:

- Physical access to computer terminals may be restricted to authorized employees.
- Access to programs and data files may be restricted using passwords. There should be rigorous checks by management to ensure that a password system is being used effectively by employees (so that passwords are not easy to 'guess')
- Firewalls (software and hardware) can be used to prevent unauthorized external access via the internet.

Examples of application controls:

- Management review of master files and standing data
- Regular updates of master files
- Review log files for changes made in master files

► Practice Question 15:

The management of Rose (Private) Limited (RPL) seeks your guidance for the following matters:

- RPL is developing a sales invoicing system both for its cash and credit customers. The system would record customer's name, email address, cell number, NTN number etc. at the time of sale.

Required:

Briefly discuss any four application controls, with the help of examples, which should be incorporated in the system to ensure completeness and accuracy of data.

- b) RPL's office has recently been damaged by fire causing a system downtime for five days.

Required:

Advise any three general controls to RL which may ensure continuity of its operations in future.

Tutorial Notes:

For data entry controls, mention auto-fill functions, validation checks, and mandatory fields. When discussing disaster recovery, highlight offsite backups and contingency planning.

► **Solution 15:**

- a)
- i. Data input should be kept at minimum. For example, data of repeat customer should be auto retrieved on entering their phone number.
 - ii. Data should not exceed a predetermined amount. For example, if the sale amount exceeds the allowed credit limit the data would be rejected for further verification.
 - iii. A field should always contain data and not zeros or blanks. For example, the record should not be saved unless data is entered in all the fields like phone number, email address etc.
 - iv. Programmed checking of the data validity in accordance with predetermined criteria/format. For example, the system will not process record if non- numeric character is entered in amount field or the system will pop up an alert if less than 13 numbers are entered in the CNIC field, etc.
- b)
- i. There should be measures for the protection of equipment against fire, power failure and other hazards.
 - ii. There should be controls over maintaining secure second copies of all programs and data files ('back-up copies'). The back-up copies can be used if the original copies are damaged or corrupted.
 - iii. The company should have disaster recovery plans, such as an agreement with another entity to make use of its computer centre in the event of a disaster such as a fire or flood.

► **Practice Question 16:**

List any six examples of system logs.

Tutorial Notes:

List system log examples that track logins, data modifications, program changes, and security alerts.

► **Solution 16:**

Examples of system logs include:

- i. Which user logged-in, when and where from
- ii. Failed log-in attempts
- iii. Who accessed and amended data in a file
- iv. Changes made to a program – what, when and by whom
- v. When employees entered and left the building
- vi. Black box flight recorders

► **Practice Question 17:**

Discuss any five IT General Controls relating to program change management.

► **Solution 17:**

- i. Tests are carried out on program changes before they are introduced.
- ii. All new versions of programs must be authorised at an appropriate level of management.
- iii. All changes to the existing program should be formally approved by the system 'user'.

- iv. There should be a segregation of duties between the designers and testers of systems.
- v. There should be full documentation of all program changes.

► **Practice Question 18:**

Bright Edge Technologies (BET), a rapidly growing tech gadgets retailer, operates both online and through physical stores. BET has recently expanded its product range and entered new markets. However, with this expansion, BET has experienced an increase in customer complaints. The two most common issues faced by customers are as follows:

- i. Customers have reported receiving invoices with incorrect discounts applied.
- ii. Customers have complained of receiving the same order twice.

Required:

For each of the above issues, suggest three controls that can be implemented by BET.

Tutorial Notes:

Don't neglect the following controls:

- Implement a system where discount rules are automatically applied based on predefined criteria.
- Once a dispatch note is prepared the order should be marked as closed.
- Use an integrated order management system that automatically tracks and manages orders across all stages of processing.
- Use an order management system that flags duplicate orders based on customer information, order details, and timestamps.
- Introduce a policy where discounts above a certain threshold require a manual review or approval from a supervisor.

► **Solution 18:**

Discount management

- i. Regularly review and update discount rules in the system to ensure they are current and accurate.
- ii. Introduce a policy where discounts above a certain threshold require a manual review or approval from a supervisor. This can catch errors before invoices are sent out.
- iii. Implement segregation of duties for checking that correct discount has been applied.
- iv. Implement a system where discount rules are automatically applied based on predefined criteria (e.g., customer type, order size, promo codes). This reduces human error in calculating discounts.
- v. Introduce automated checks to verify invoice accuracy against price lists and discount policies before sending them out to customers.

Order management

- i. Ensure each order is assigned a unique ID so that it could be tracked.
- ii. For every sales order, a dispatch note should be produced (manually, or generated by the system from the order details). Goods should not be dispatched to customers without a dispatch note.
- iii. Once a dispatch note is prepared the order should be marked as closed.
- iv. Use an integrated order management system that automatically tracks and manages orders across all stages of processing. This system can alert staff to pending orders and ensure none are missed.
- v. Implement a system check to verify if an order ID is already being processed before allowing it to proceed further.
- vi. Use an order management system that flags duplicate orders based on customer information, order details, and timestamps.

3 LIMITATIONS OF INTERNAL CONTROL SYSTEMS

3.1 Reasons why internal controls may be ineffective

Internal control systems are never fool proof. All systems, no matter how effective they may appear to be, have several limitations:

- Human error may result in incomplete or inaccurate processing which may not be detected by control systems.
- It may not be cost-effective to establish certain types of controls within an organisation.
- Controls may be in place, but they may be ignored or overridden by employees or management.
- Collusion may mean that segregation of duties is ineffective. Collusion means that two or more people work together to avoid a control, possibly for the purpose of committing fraud.

Although modern auditing is based on testing the systems and controls rather than transactions, auditors will never rely solely on such tests in reaching a conclusion. This is because of the limitations inherent in **all** control systems. Auditors will always supplement their work on systems with some testing of transactions and balances themselves (substantive testing). The amount of substantive testing will depend on the auditor's evaluation of the effectiveness of the controls.

3.2 Problems for small entities

Many of the control activities that are typically found in a large company may be inappropriate for a small entity because they are too costly or impractical.

Segregation of duties is an obvious example of this. It is difficult to segregate duties in a small company with only a few employees. The same individual has to carry out a variety of different tasks.

Often, control systems in small entities are based on a high level of involvement by the directors or owners. Authorisation and performance review controls, with the owner-manager personally authorising many transactions, might therefore be a key feature of control systems in small entities. The active involvement of an owner-manager might mitigate risks arising from a lack of segregation of duties.

However, because of the likely active involvement of the owner-manager the attitudes and actions of that person will be key to the auditor's risk assessment. There is unlikely to be a written code of conduct so a culture of integrity and ethical behaviour, as demonstrated by management example, will be important.

However, the auditor will often see this management involvement as only a partial substitute for 'normal' control systems. The following problems may arise when control systems rely excessively on the involvement of senior management.

- There may be a lack of evidence as to how systems are supposed to operate. The auditor will need to rely more on enquiry than on review of documentation.
- There may be lack of evidence of controls. (How does the auditor know that the controls exist and are being applied?).
- Management may override other controls that are in place.
- Management may lack the expertise necessary to control the entity effectively.
- There is unlikely to be any independent person within the management team as there would be within "those charged with governance" in a large entity.

When auditing a small entity, the auditor needs to understand and evaluate whatever controls are in place and plan his audit work accordingly. It is likely that a lower level of reliance will be placed on controls in a smaller entity, and that a large amount of substantive testing will therefore be required.

► *Practice Question 19:*

TS Limited is a small software house. Due to the nature of the business no significant human resources are required except the programmers and system analysts. The Managing Director (MD) oversees all the operations. Besides the programmers and system analysts there is only one manager, who reports to the MD.

Required:

Describe the key characteristics of such organisations with respect to internal controls and the risk which the auditor may face in such audits.

Tutorial Notes:

Small organizations often lack segregation of duties and formal internal audit functions. Auditors should highlight the risks of management override and limited documentation instead of focusing solely on IT roles.

► *Solution 19:*

Many of the control activities that are typically found in a large company such as segregation of duties, internal audit etc. may be inappropriate for a small entity because they are too costly or impractical for such smaller organizations. Often, control systems in small entities are based on a high level of involvement by the directors or owners.

Following audit risks may arise when control systems rely excessively on the involvement of senior management:

- i. There may be a lack of evidence as to how systems are operating.
- ii. There may be lack of evidence of controls.
- iii. Management may override controls that are in place.
- iv. Management may lack the expertise necessary to control the entity effectively.

► *Practice Question 20:*

Briefly discuss the key characteristics of small sized organizations with respect to internal controls and risks which the auditor may face in such audits.

Tutorial Notes:

Logical access controls must include authorization, authentication, and accountability mechanisms, not just passwords. In small organizations, auditors should highlight the risk of management override and lack of formalized control

► *Solution 20:*

Many of the control activities that are typically found in a large company such as segregation of duties, internal audit etc. may be inappropriate for a small entity because they are too costly or impractical for such smaller organizations. Often, control systems in small entities are based on a high level of involvement by the directors or owners.

Following audit risks may arise when control systems rely excessively on the involvement of senior management:

- There may be a lack of evidence as to how systems are operating.
- There may be lack of evidence of controls.
- Management may override controls that are in place.
- Management may lack the expertise necessary to control the entity effectively.

► *Practice Question 21:*

State any five problems that may arise when control systems rely excessively on the involvement of senior management.

► *Solution 21:*

- i. There may be a lack of evidence as to how systems are supposed to operate. The auditor will need to rely more on inquiry than on review of documentation.
- ii. There may be a lack of evidence of controls. The auditor may not know that the controls exist and are being applied.
- iii. Management may override other controls that are in place.
- iv. Management may lack the expertise necessary to control the entity effectively.
- v. There is unlikely to be any independent person within the management team as there would be within “those charged with governance” in a large entity.
- vi. Senior management may not have the time or detailed knowledge to effectively monitor all aspects of the control system, leading to gaps in reporting and oversight

4 EVALUATION OF CONTROLS AND AUDIT RISK ASSESSMENT

4.1 The purpose of evaluating controls

Having established the control systems that are in place, and having recorded them in the audit working papers, the auditor should now evaluate the controls and establish their effectiveness. The results of this evaluation will allow the auditor to identify the control risk (which is an element of audit risk). The auditor can then decide on a systems-based or a transactions-based approach to the audit.

The evaluation of accounting and control systems is a two-stage process. The auditor will need to establish:

- Whether controls are effective 'on paper'. This means that if it can be assumed that the controls are applied properly in practice, are they sufficient?
- Whether the controls are applied properly, and so whether they are actually working and operating effectively. Controls may be adequate if they are applied properly, but in practice they might not be applied as they should be. This aspect of the auditor's evaluation is described in more detail in a later chapter on tests of controls.

4.2 The evaluation process

The auditor should obtain a general picture of the effectiveness of the controls established by management, by reviewing his documentation of the internal control system. This is the evaluation of the controls 'on paper'.

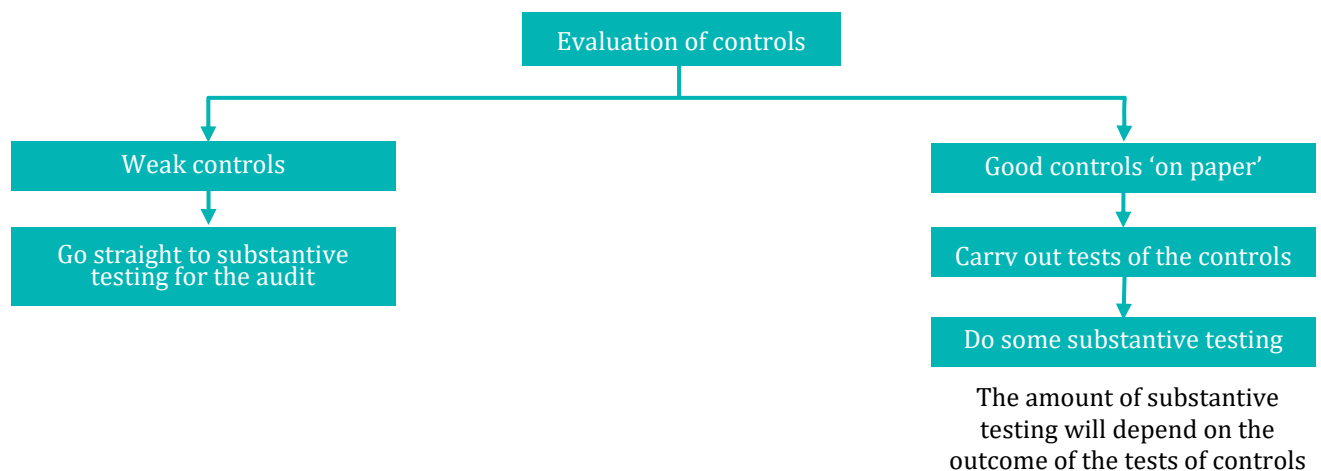
If this 'paper' review of the controls indicates that major weaknesses exist, the auditor will probably take the view that the audit approach will have to focus on tests of transactions (substantive tests) rather than on tests of controls (a systems-based approach). A systems-based audit approach will not be appropriate if there is a high level of control risk.

If the auditor's initial assessment of the control systems shows that those systems are weak, then he will move straight to substantive testing and will not bother to carry out tests of controls.

Even if the controls appear to be acceptable on paper, the auditor cannot rely on them and perform a systems-based audit unless he is confident that the controls are actually working. In this situation, the next stage in the audit process is to carry out **tests of controls**.

If the outcome of the tests of controls indicates that controls are actually operating effectively, the audit can be systems based, with a reduced amount of substantive testing. Remember that the auditor will always need to perform **some** substantive testing – because of the inherent limitations in any system of internal controls.

In view of this ISA 330 **requires** that substantive procedures are carried out for each **material class of transactions, account balances and disclosure**. These terms are considered in a later chapter on substantive procedures.



4.3 Management letter

Whilst the requirements of ISA 265 '*Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*' are outside the scope of this syllabus you do need to know that it is common practice for the external auditor to prepare a 'management letter' for the client.

A management letter is a report typically presented in columnar fashion detailing weaknesses observed in the client's system of internal controls. Remember though that the identification of control weaknesses is a by-product of performing the external audit rather than the objective of an audit.

► *Illustration: Management letter*

Weakness	Possible effect	Recommendation	Management's response
Details of employees leaving the company are sent on an e-mail from the personnel department to payroll without subsequent confirmation.	There is no check to ensure that all e-mails sent are actually received in the payroll department. This could result in payments being made to former employees.	Introduce a control to ensure all e-mails are received. Personnel should use sequentially-numbered e-mails. Payroll should send a confirmation for each 'leaver email' received.	Agreed. New control to be installed immediately.

5 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Understand the meaning, importance and relevance of internal control
- Understand how the auditor assess and uses internal controls
- Explain the five elements of internal control
- Discuss the limitations of internal controls
- Explain the different types of controls
- Evaluate internal controls and explain the impact of this evaluation on the auditor's risk response
- Describe different methods used for recording internal control systems including narrative notes, questionnaires and flowcharts
- Design basic questionnaires including internal control questionnaires and internal control evaluation questionnaires
- State the benefits and limitations of each method of recording internal controls

TESTS OF CONTROLS

IN THIS CHAPTER:

1. Tests of controls and the main transaction cycles
2. The sales system
3. The purchases and expenses system
4. The payroll system
5. The bank and cash system
6. The inventory system and non-current assets
7. Other issues with tests of controls
8. Data Analytics and Automated Tools in audit
9. Chapter review

1 TESTS OF CONTROLS AND THE MAIN TRANSACTION CYCLES

1.1 Planning tests of controls

The auditor takes a systems-based approach, wherever possible. He focuses on testing the systems and internal controls that produce the financial reporting figures, rather than the figures themselves. If the systems and the controls are satisfactory, the figures produced by the systems should be reliable.

Two conditions are necessary before the auditor can adopt a systems-based approach:

- The systems and controls in place should be **designed** to minimise the risks of misstatements. The auditor carries out this check of controls in his procedures for the documentation and evaluation of the controls.
- The systems and controls should actually **operate** effectively. The auditor gains evidence that the controls operate in practice by performing **tests of control**.

1.2 The major transaction cycles

The auditor will focus much of his audit work on the major '**transaction cycles**' which taken together cover the majority of the day-to-day transactions of the business.

The major transaction cycles are:

- sales (revenue),
- purchases, and
- payroll.

These three transaction cycles will have a direct effect on both the statement of financial position and the income statement (two statement format) or statement of comprehensive income (one statement format). Tests of control are also applied to key statement of financial position headings linking into the main transaction cycles:

- bank and cash
- inventory, and
- revenue and capital expenditure (non-current assets).

Much of this chapter presents lists of risks, control objectives, suitable controls and tests of controls, for different aspects of the main transaction cycles. These lists are not complete or comprehensive, instead they are intended to provide detailed guidance about how tests of control may be designed and applied.

1.3 Controls and tests of controls in the exam

The exam paper may include a scenario based question that describes a transaction cycle of a client entity. You may be required to identify suitable internal controls and tests of controls that would be appropriate. Alternatively, you may be required to comment on control weaknesses in the system.

The following sections of this chapter describe in general terms the control objectives, controls for achieving those objectives and ways of testing the effectiveness of those controls, for each of the main transaction cycles. Remember however that in the exam itself you may be required to apply these general concepts to a specific scenario.

You may find it useful to think about controls and tests of controls in terms of:

- Risks. What are the risks that weaknesses in the transaction processing system could mean that the financial statements do not give a true and fair view?
- What should be the control objective? What is the purpose of having controls? What should the control be intended to achieve, or prevent? The objective of controls should be to eliminate or reduce the risk.
- Having established the reason for needing controls, the next step is to devise controls that will help to achieve the control objective.

- An auditor should be aware of the control objectives for each of the transaction cycles, and should assess the effectiveness of the controls that the client entity has in place to achieve those objectives. (If there are obvious weaknesses in the controls, the auditor should notify these to the client entity's management).
- If the auditor is satisfied that the controls seem adequate, he should devise tests to establish whether they work in practice. The auditor therefore devises and carries out tests of control.

Tests of control should therefore be seen within the context of:

- Risks
- Control objectives
- Controls
- Tests of those controls.

If you are required to suggest suitable tests of controls in answer to an exam question, you should be able to explain **why** the control is needed and how the test will establish the effectiveness of the control. It may help you to present tests of controls in a tabular form in your answer, as follows:

Test of control	Reason for the control

2 THE SALES SYSTEM

2.1 Elements of the sales system

Excluding the collection of payments from credit customers, the main elements of the sales accounting system may be classified as follows:

- Receiving orders from customers
- Dispatching the goods and invoicing customers
- Recording sales and amounts receivable in the accounts

For each of these elements of the system, we can identify risks, control objectives, design internal controls and devise ways of checking whether the controls are applied in practice (tests of control).

2.2 Customer ordering

Risks

So what are the risks in a system of receiving and processing customer orders? The following list is not complete, but contains some of the risks.

- Orders may be accepted from new customers and new customers may be given credit, without checking the customer's references or without formal authorisation of a credit account for the customer with a credit limit.
- Orders may be accepted from existing customers that take them over their credit limit.
- Some orders are overlooked and are not processed. Some orders are processed twice.
- The customer is given a price discount without proper authorisation.
- Sales made to customers which are not authorised customer
- Sales made to customer which are not approved

Control objectives

Suitable control objectives may therefore be as follows:

- Giving credit to new customers and existing customers must be controlled, and must be consistent with company policy.
- All orders from customers are processed correctly. Orders should not be processed if they would take the customer above his agreed credit limit.

Principal controls

Suitable controls may be as follows:

- There should be a segregation of duties, and the individuals who process orders from customers should not also carry out credit reference checks on new customers or credit limit checks on existing customers. The latter could be done manually by reference to a file of approved credit limits, or it could be a programmed control whereby the system will only accept an order if the customer will still be within his credit limit.
- All new customer accounts, and their credit limit, should be authorised.
- Orders should be recorded on sequentially-numbered documents or the system should allocate sequential numbers to documents.
- For every sales order, a despatch note should be produced (manually, or generated by the system from the order details). Goods should not be despatched to customers without a despatch note.

Tests of control

How might an auditor test whether these controls are actually applied in practice? The client can assist the auditor by collecting evidence that the controls have been applied. One way of doing this is to use the customer order document to record that checks have been completed; for example, by providing space on the order form for individuals to sign their name or write their initials as confirmation that they have carried out a particular task.

Here are some suggested tests of control:

- The auditor can establish which individuals take orders and process them, and which individuals carry out credit reference checks on new customers and credit limit checks on existing customers. The auditor could observe these individuals to see if procedures are being properly followed. In an IT system he could use test data to check that orders which would take a customer over his credit limit would be rejected by the system.
- Further evidence that credit checks have been carried out can be checked by looking at the signatures or initials of credit checking staff on customer orders or by using test data as described above.
- Evidence that new customer accounts have been approved should be checked by looking for the signature of the manager giving the authorisation on the appropriate approval document.
- The auditor can look at lists of customer orders, sequentially numbered, and confirm that for every customer order there is a despatch note number. Alternatively, for an integrated IT system, he can follow test data through from order to despatch note and confirm that sequences are complete by viewing documents on screen.

It is important to remember that this list of controls and tests of controls is not complete, but it may help you to understand the process by which tests of control are carried out, and the way in which they should give the auditor the evidence that he needs for a systems-based approach to the audit. You need to take care in the exam that the controls or tests of controls you suggest are appropriate to the system described, taking careful note of which parts of the system are manual and which are IT-based. The control objectives will be the same for both types of systems – it is the specific controls (and therefore also tests of controls) that will sometimes be different.

2.3 Despatch of goods and invoicing

The same approach can be applied to the despatch of goods and invoicing.

Risks

Here are some of the risks in this part of the sales system:

- For some customer orders, goods are not despatched, or the goods are despatched twice.
- Goods are despatched to customers who do not have sufficient credit (either because no credit terms have been agreed, in the case of a new customer, or because the order takes an existing customer above his credit limit).
- Invoices are not produced for goods that have been despatched to some customers.
- Customers may claim that they did not receive the goods that have actually been delivered to them.
- Returns from customers are not properly recorded, so that the client company does not know the correct figure for sales net of sales returns.

Control objectives

Control objectives may therefore be as follows:

- Goods should be despatched for every authorised customer order.
- Goods should not be despatched twice, for the same sales order.
- Customers should acknowledge the receipt of goods.
- For every despatch note, there must be an invoice.
- Invoices should be for the correct amount.
- For all goods returned by customers, there must be an authorised credit note.

Principal controls

Suitable controls may be as follows:

- Despatch notes or Goods Delivery Notes (GDNs) should be numbered sequentially, and should be attached to a copy of a specific customer order. The GDN should be signed by an authorised member of the despatch staff. Sequential numbering of GDNs allows a check to be made that all deliveries can be accounted for.
- Customers should sign a delivery note for the receipt of goods, as confirmation of receipt.
- The signed delivery note should be attached to a copy of the despatch note and customer order. Copies of these documents should be transferred to the accounts department after despatch, so that a sales invoice can be produced.
- Each sales invoice should be linked to a copy of the despatch note and customer order or produced automatically from them.
- Sales invoices should be sequentially numbered or the system should allocate sequential numbers to documents.
- There should be a segregation of duties, and the individuals who despatch goods should not be the same as those who prepare sales invoices or process the customer orders.
- Credit notes should be sequentially numbered and authorised.
- There should be periodic checks by someone in the accounts staff on the accuracy of invoices or strong IT controls to ensure the accuracy of invoices.

Tests of control

The auditor needs to test whether these controls operate properly. Here are some suggested tests of control:

- Some delivery notes should be checked to confirm that customers do sign them.
- The auditor can check that the segregation of duties does exist.
- There should be a check to ensure that all GDNs have been sequentially numbered, and that if there is any non-sequential numbering of GDNs an error report has been produced by the system to explain the reason for the error.
- The auditor should check that (sequential) lists of invoices show a customer order number and a despatch note number.
- The auditor should check a list of credit notes to make sure that they cross-refer to a sales invoice number.
- Credit notes should be checked to make sure that they contain the authorisation signature of the appropriate manager or have been raised, on the computer, only by a member of staff with authority to do so.
- The auditor can observe the despatch process in operation.
- There should be documentary evidence that a member of the accounts staff has carried out arithmetical checks on the accuracy of invoices. Alternatively, the auditor may prove that there are strong IT controls which will ensure the accuracy of invoices by checking the calculations himself.

Remember that for each test of control, there should be a purpose. In other words, what control is being tested and how does the test succeed in doing this? For example:

Test of control	Reason for the control
Review error reports on non-numerical sequencing of GDNs and ask about action taken to investigate or deal with the error.	Test to ensure that all GDNs have been in numerical sequence, and if not that errors can be satisfactorily explained.

Test of control	Reason for the control
Test a sample of GDNs for the customer's signature	To ensure that the customer did receive the goods and has acknowledged receipt.
Observe the despatch process	To check that goods are despatched only where a GDN exists and that the goods actually despatched correspond with the details on the GDN.
Observe the credit checking process	To ensure that authorisation is not given for the despatch of goods if this would take the customer over his credit limit.

2.4 Recording sales and accounting

Again, a similar approach can be taken in identifying tests of control for the recording of sales in the accounting system.

Risks and control objectives

Here are some of the risks and control objectives in this part of the sales system:

- There is a risk that invoices and credit notes may not be recorded in the accounting system. A control objective is to ensure that they are all recorded.
- There is a risk that invoices and credit notes are recorded in the wrong customer accounts. A control objective is to prevent this from happening, or to detect errors when they do occur.
- There is a risk that debts may be written off as uncollectable ('bad') without proper consideration. A control objective is to make sure that this does not happen.

Principal controls

Suitable controls may be as follows:

- Invoices and credit notes should be sequentially numbered.
- Regular statements should be sent to customers.
- Control account reconciliations should be carried out on trade receivables.
- Bad debts must be authorised.
- There are procedures for identification and follow-up of overdue accounts and unpaid invoices.

Tests of control

Here are some suggested tests of control:

- Lists of invoices and credit notes can be checked to make sure that there is sequential numbering or documents can be viewed on screen.
- There should be a segregation of duties between the individuals who prepare and send out invoices, and individuals who collect payments, and individuals who follow up late payments.
- The auditor can check that statements are produced and despatched to customers.
- The auditor can look for documentary evidence that control total checks have been made.
- There should be documentary evidence that proper authorisation is given for a debt to be written off as bad.
- There should be individuals responsible for collecting overdue debts, and evidence of their work. Alternatively, the auditor might check that an exception report is regularly produced by the system, listing all overdue debts, and look for evidence that this is followed up.

► *Practice Question 01:*

Mention any six tests of controls which an auditor may perform in respect of dispatch of goods and invoicing in an organisation where all related documents are prepared manually.

Tutorial Notes:

For dispatch and invoicing controls, responses should focus on matching orders to delivery, obtaining customer acknowledgments, and verifying invoice details. Do not incorrectly assume dispatch notes are prepared from sales invoices—it is the other way around. Also, avoid listing credit control measures, as they are unrelated to dispatch controls.

► *Solution 01:*

- Check whether appropriate segregation of duties exist.
- Check whether all invoices and GDNs are pre-numbered.
- Check that invoices show a customer order number and a dispatch note number.
- Check the signature of customers on delivery notes to confirm the acceptance of the customers.
- Check that credit notes are cross-referred to a sales invoice number.
- Observe the dispatch process in operation.
- Obtain documentary evidence that a member of the accounts staff has carried out arithmetical checks on the accuracy of invoices.
- Check the credit notes to ensure that they contain the authorization signature of the appropriate manager.

► *Practice Question 02:*

You are the job-in-charge on the audit of Sambar (Private) Limited (SPL), engaged in production and marketing of textile products.

Your team has performed a walkthrough of the sales and receivable process which is summarized as follows:

- i. SPL has employed a Sales Representative (SR), who is responsible for finding new customers and taking orders from all customers.
- ii. Orders are recorded on a pre-numbered order form duly signed by the customers. After taking the customer order, SR mentions the maximum credit limit and credit time after verbally confirming them with the Director Operations, on the order form. SR then forwards one copy of the order form to the warehouse and another copy to the Factory Accountant (FA).
- iii. Warehouse supervisor dispatches the completed order from the warehouse, accompanied by a manually prepared pre-numbered delivery note. He keeps a copy of delivery note and sends another to FA.
- iv. FA manually prepares a pre-numbered invoice using the details mentioned on the order form. FA also ensures that the customer should not exceed the maximum credit limit after the new order. FA normally sends one copy of invoice to the customer along with the delivery note and keeps the second copy along with the order form in the record of accounts department. However, due to delay in receiving the order information, invoice is sometime sent after the delivery.
- v. Each Friday, FA inputs the week's invoices into the computerized accounting software. At each month end, FA prepares age analysis and follows-up with customers who have not paid within their credit time.

Required:

Identify the control weaknesses in sales and receivable process of SPL along with their possible effects and give your recommendations to SPL.

Tutorial Notes:

When assessing sales and receivables process controls, focus on credit risk, completeness of invoicing, and accuracy of dispatches. Ensure that credit limits are documented and verified before processing orders. Many responses failed to mention the need for customer acknowledgment of deliveries and the importance of real-time age analysis for receivables management.

► *Solution 02:*

S. No.	Control weakness	Possible effects	Recommendations
(i)	No formally approved credit list exists.	Goods may be supplied to customers with a poor credit rating. This may increase the risk of bad debts and financial losses.	All new customers should undergo a credit reference check before being accepted as new customers. Credit limits should be set for all customers and it should be reviewed on a periodic basis every month to avoid selling goods on credit to risky customers.
(ii)	Credit limit is confirmed verbally.	SR may mention the limit which was not mentioned by Director Operations as no documentary evidence exist.	Communication regarding the confirmation of credit limit should be appropriately documented.
(iii)	Credit limit is not checked with accounts department before forwarding the customer order to warehouse for processing.	New production order may be issued for goods which are not required to be produced. Goods may be dispatched to customers who have already availed their credit limit.	SR should ask the credit balance of the customer from FA prior to forwarding it to the warehouse.
(iv)	There seems to be no process to match the GDN to the original order prior to dispatch.	Incorrect quantity of goods may be dispatched which may affect goodwill as well as revenue.	Before orders are dispatched, the warehouse supervisor should also compare the quantity and quality of goods with the original order.
(v)	There seems to be no procedures to ensure the completeness and accuracy of invoices.	The company could suffer financial loss if invoices are not raised or are not timely raised or are prepared inaccurately.	All GDNs should be matched to the invoice and filed together. On a periodic basis FA should perform a review of un-invoiced GDNs to ensure all dispatches have been invoiced. The customer order file should be reviewed periodically in order to confirm that the order, GDN and invoice details are matched with each other.
(vi)	No acknowledgment from customer is obtained after the delivery of the order.	Customer may falsely claim that delivery has not been made.	The person responsible for delivery should obtain customer acknowledgment on delivery order.
(vii)	Invoices are not prepared on the basis of GDN.	There may be a mismatch in the quantity of goods delivered and invoiced.	Invoice should be prepared after checking the quantity from the GDN and price from the customer order.

S. No.	Control weakness	Possible effects	Recommendations
(viii)	Ledgers are not updated on a timely basis.	Due to this delay there is a possibility that some of the invoices or receipts may go un-recorded. Ledgers would not reflect updated balances, due to which sales may be made to customers who have fully utilized their credit limits or vice versa.	All the invoices and receipts should be recorded when they are prepared and deposited/ received.
(ix)	Updated age analysis may not be available when the Director Operations decides on the credit limit to be given to the customer.	Sales may be made to those customers who are already overdue for a long time.	Age analysis should be readily available. Director Operation should also review the age analysis as he is the one who is setting the credit limits.
(x)	Debtors are only followed up on periodic basis.	Delayed follow up of overdue accounts may lead to bad debts.	Debtors should be followed up whenever their invoices are becoming due or they are close to the expiry of their credit limits.

3 THE PURCHASES AND EXPENSES SYSTEM

3.1 Elements of the purchases and expenses system

Excluding the procedures for making payments to suppliers, the main elements of the accounting system for purchases and other expenses may be classified as follows:

- Placing orders
- Receiving goods (or services) and receiving invoices
- Recording and accounting for purchases and expenses.

The same basic approach to devising tests of control can be taken as for the sales system. The risks, control objectives, controls and tests of control listed here are not comprehensive. They are intended to show you the approach that can be taken.

Again, the control objectives will be the same for all systems, but the controls and therefore tests of controls, are likely to differ to some extent between manual and IT systems.

3.2 Placing orders

Risks

So what are the risks in a system of ordering goods or services from suppliers? The following list is not complete, but contains some of the risks:

- Orders for goods or services are made without approval or authorisation.
- Orders may be placed with suppliers who are not on the 'approved list'.
- For large orders, suppliers are not asked to submit tenders. When suppliers are asked to tender, the order might not be given to the supplier quoting the lowest price.

Control objectives

Suitable control objectives may therefore be as follows:

- All purchase orders must be properly authorised.
- Orders should not be placed with 'non-approved' suppliers.
- Competitive price quotations should be obtained for all large orders.

Principal controls

Suitable controls may be as follows:

- There should be a segregation of duties. Individuals who make a requisition for new supplies of inventory should not be the individuals who place the order with the supplier.
- Purchase orders should be sequentially numbered.
- There should be a procedure for placing suppliers on the 'approved list'. In an IT system, physical controls must exist over access to the master file of approved suppliers.
- All orders must be placed with suppliers on an approved list. The purchase order may include an 'approved supplier reference number'. In an IT system the system must only be able to address orders to approved suppliers as on the master file.
- Orders above a certain value must be authorised by a senior manager, who should confirm that competitive tenders have been obtained from suppliers.

Tests of control

Here are some suggested tests of control:

- The auditor can check that the segregation of duties does exist.
- The auditor can look at lists of sequentially-numbered purchase orders or view documents on screen. Alternatively, he could submit test data in the form of an order and check it is allocated the next number in the sequence.
- The auditor should ask management to provide documentary evidence that the procedure for placing suppliers on the approved list operates as intended. In an IT system, the controls over the master file of approved suppliers will need to be tested.
- Purchase orders can be checked to make sure that they contain an approved supplier reference number.
- Large orders can be checked for management authorisation.

3.3 Receiving goods and invoices

Risks and control objectives

Here are some risks and control objectives for this part of the purchases transaction cycle:

- There is a risk that goods may be accepted from a supplier without having been ordered. Or suppliers may claim to have delivered goods, but may actually not have done so. A control objective is therefore to make sure that all receipts of goods are recorded and checked against a purchase order.
- There is a risk that the company may fail to claim discounts from suppliers for orders above a certain size, or as regular customers of the supplier. A control objective should be that discounts are given by suppliers where these are available.
- There is a risk that suppliers may invoice for goods that have not actually been provided. A control objective is to prevent this from happening, or detect when it does happen.

Principal controls

In this area there is little difference between manual and IT systems as this part of an IT system will be dependent on controls over the physical receipt of goods and invoices, which will be carried out by employees as opposed to by a computer program. Suitable controls may be as follows:

- A copy of all delivery notes should be retained, with a signature of the member of staff who took receipt and checked the goods.
- Goods received notes should be produced for each delivery, from the delivery note or after a physical count of the items received.
- A member of the accounts staff or purchasing staff must be responsible for checking discounts allowed by suppliers.
- There should be a segregation of duties between the individuals who take delivery of goods, those who place the orders and those who record the purchase invoices in the accounting system.
- All purchase invoices should be checked against a purchase order and a goods received note.

Tests of control

Here are some suggested tests of control:

- The auditor should check that delivery notes, goods received notes and purchase invoices are matched with each other. There should be evidence that they have been checked against each other; for example, the person making the check should sign or initial the purchase invoice.
- The auditor should look for any evidence that invoices, purchase orders or goods received notes cannot be properly matched (indicating that the controls are not working in practice and a control objective is not being achieved).

- The auditor should look for documentary evidence that discounts are checked and claimed from suppliers when available.
- The auditor should check that the segregation of duties does exist.

3.4 Recording and accounting for purchases and expenses

Risks and control objectives

Here are some risks and control objectives for this part of the purchases transaction cycle:

- There is a risk that purchase invoices will be recorded for goods or services that were not provided. A control objective is to make sure that this does not happen.
- There is a risk that purchase invoices will be incorrectly recorded in the accounts of suppliers. A control objective is to identify and correct any such errors that may occur.
- There is a risk that credit will not be claimed from suppliers for goods returned. A control objective is to make sure that credit is taken for purchase returns.

Principal controls

Suitable controls may be as follows:

- Purchase invoices must be checked against purchase orders before they are recorded in the accounts. If the purchase order number is not printed on an invoice, it should be written on the invoice by the individual making the check or entered onto the system alongside the invoice details.
- Regular statements should be received from suppliers, and the balance on the statement should be checked against the account balance in the trade payables ledger.
- There should be regular control account reconciliations for trade payables.
- A debit note should be created each time that goods are returned to a supplier. Debit notes should be sequentially numbered and matched with the supplier's credit note when it is received. An IT system could produce a regular exception report of unmatched debit notes for follow up by an employee.

Tests of control

Here are some suggested tests of control:

- The auditor should look for evidence that purchase invoices are matched against purchase orders. Evidence may be provided by a signature or initials on the purchase invoice of the individual making the check or by checking references on screen.
- There should be evidence that statements from suppliers are checked and approved. Again, evidence may be provided by a signature or initials on statements of the individual making the check.
- The auditor should look for documentary evidence of control account reconciliations.
- The auditor should be able to check a list of sequentially-numbered debit notes, cross-referenced to a supplier's credit note.

► Practice Question 03:

You have been assigned to plan the test of controls in respect of receiving of goods and invoices from suppliers of Bhurban Limited. In this regard, you are required to identify the following:

- a) The related risks
- b) Controls that you expect to see to address the above risks
- c) Audit procedures that you need to perform to test the controls

Tutorial Notes:

When identifying risks related to receiving goods and invoices, focus on risks like unauthorized acceptance of goods, failure to claim supplier discounts, or invoicing for unreceived goods. Avoid detailed substantive procedures, as they are not required for control risk identification. In control design, ensure a clear distinction between company-implemented controls and auditor-performed tests of controls.

When testing controls, do not simply repeat control descriptions—explain how the auditor checks whether controls are functioning effectively.

► Solution 03:**a) Risks:**

Risks related to receiving of goods and invoice from suppliers are as follows:

- Goods may be accepted from a supplier without having been ordered.
- The company may fail to claim discounts from suppliers despite being due.
- Supplier may raise invoices for goods that have not actually been received/purchased.
- Goods received from suppliers are of inferior quality.

b) Related controls

Suitable controls may be as follows:

- A copy of all delivery notes should be retained, with a signature of the member of staff who took receipt and checked the goods.
- Goods received notes should be produced for each delivery, from the delivery note or after a physical count of the items received.
- A member of the accounts staff or purchasing staff must be responsible for checking discounts allowed by suppliers.
- There should be a segregation of duties between the individuals who take delivery of goods, those who place the orders and those who record the purchase invoices in the accounting system.
- All purchase invoices should be checked against a purchase order and a goods received note.

c) Tests of control

- Ensure that goods received notes, purchase orders and purchase invoices are matched with each other.
- Confirm from documentary evidence that discounts are claimed from suppliers when available.
- Check that the segregation of duties does exist.

► Practice Question 04:

You are audit senior at Advanced Limited (AL) which is engaged in the business of assembling and marketing of consumer electronics. The process followed by AL for procurement is as follows:

- a) Store Department generates a numerically sequenced purchase requisition (PR), when the quantity falls below re-order level. PR shows the name of goods and quantity required and is signed by the store officer. The approved PR is forwarded to the Purchase Department for procurement.
- b) Purchase Department has a list of suppliers which was prepared in 2015 by including all the suppliers who had supplied goods to AL during the previous five years. Later, some suppliers were added to the list on the recommendation of the store manager.
- c) When a PR is received, the five most experienced suppliers are contacted and purchase order (PO) is issued to the most experienced supplier provided he agrees to supply the goods on the same price which was paid by AL on the latest purchase. The PO is issued in the form of an email by the purchase manager. A copy of the email is also sent to the store manager and the finance manager. In case of large or unusual purchases, PR and PO are also authorised by the store manager prior to sending the email.

- d) On receiving the goods, the store officer agrees the goods dispatch note (GDN) of the supplier with the PO to ensure that description of goods is the same as were ordered by AL. An acknowledged copy of GDN is given to the supplier and another copy is sent to the accounts department.
- e) Store Department prepares sequentially numbered Goods Received Note (GRN), which is signed by the store officer after counting the goods received. Entry in the stores ledger is made on the basis of GRN.
- f) On receiving the invoice, purchase is recorded by the accounts department after comparing the quantity received as per the GDN with PO and the invoice.

Required:

Identify the weaknesses in the internal control system of AL and their possible effects and give your recommendations to AL.

Tutorial Notes:

When assessing procurement controls, do not just repeat process steps from the question—identify actual weaknesses such as lack of supplier vetting, absence of PO numbering, and payments based on unverified GDNs. Many responses missed critical weaknesses, like outdated supplier lists and absence of purchase quotations. Clearly explain why these weaknesses increase risk and propose specific remedial actions.

► **Solution 04:**

S. No.	Control weakness	Possible effect	Recommendation
(i)	The list prepared by the purchase department has not been approved by anyone other than the purchase department.	There might be suppliers on the list who are not competent enough to make the supply.	There should be a formal process of approving the list and also for placing the suppliers on the approved list.
(ii)	List has not been updated since 2015.		The list of the suppliers should be updated on a regular basis.
(iii)	Lack of proper criteria for selecting suppliers as presently suppliers are added to the list without considering their financial soundness, experience, etc.	Purchases may be made from unreliable suppliers.	The criteria for addition of new supplier should be comprehensive which should cover both financial and technical capabilities of the suppliers.
(iv)	Purchase requisitions are processed merely on the initials of the stores officer. /There is no formal process of reviewing the purchase requisition received from store department.	This could lead to inappropriate purchases, i.e. in terms of type of goods or their quantity.	All purchase requisitions should be authorized by the store manager as well as the user department.
(v)	Purchase orders are not pre-numbered as they are issued in the form of email.	Liabilities for goods received may not be recorded or may be recorded more than once if there is no sequential numbering.	PO should be pre-numbered or be issued in sequential order controlled by a computer system.
(vi)	Quotations are not obtained from the supplier before placing the orders.	Purchases may be made at a higher price or discounts may not be availed.	Prior to ordering of goods the shortlisted suppliers should be asked to submit the quotations, which should be reviewed by the purchase committee.

S. No.	Control weakness	Possible effect	Recommendation
(vii)	High value or other than routine purchases are only authorized by the purchase manager and store manager.	This leads to lack of segregation of duties which may result in inefficiencies.	A purchase committee comprising of senior officials should be formed to oversee purchases above a certain amount.
(viii)	There is no system of quality inspection.	Sub-standard goods may be received.	Proper inspection should be carried out before accepting the goods.
(ix)	Although GRN has been prepared by the store department, payment has been made on the basis of GDN instead of GRN.	There is a possibility of incorrect payment to the supplier.	Before payment, supplier's invoice should be reconciled with GRN and PO.
(x)	Inventory and payable are recorded upon receipt of invoice only.	Cut off errors may arise i.e. where goods are received but invoice is received after year end.	Inventory/payables should be recorded on the basis of GRN.

4 THE PAYROLL SYSTEM

4.1 Elements of the payroll system

A similar approach can be taken to designing tests of controls in the payroll system. Elements of the payroll system may be classified as follows:

- Calculating gross wages and salaries
- Recording wages and salaries payable in the accounts
- The calculation of tax and other deductions from wages and salaries
- The payment of wages and salaries.

Some risks, control objectives, principal controls and tests of control are suggested below for each element of the payroll transaction cycle. However, the control objectives, principal controls and tests of control are now presented in tabular form, for ease of reading.

4.2 Calculating gross wages and salaries

Risks

- Wages and salaries may be paid to individuals who are not employees.
- Employees may be paid for work they have not done.
- Gross wages and salaries could be calculated incorrectly.
- Taxation and other deductions could be calculated incorrectly.

Control objectives

- Ensure that only 'real' employees are paid: for example, wages or salaries should not continue to be paid to former employees who have now left, or that payments are not made to 'phantom' employees.
- Ensure that employees are paid only for work they have done: for example, to make sure that employees are not paid for overtime work if they have not done it.
- Ensure that gross pay, deductions (tax and other deductions) and net pay are calculated correctly.

Examples of control objectives	Examples of principal controls	Tests of control
Wages and salaries should not be paid to individuals who are not employees.,	There should be a segregation of duties: the individual responsible for preparing wages and salaries should not be the person who actually pays them.	The auditor can check that the segregation of duties does exist.
	The gross pay for each individual employee should be authorised by an appropriate person.	The auditor should check that departmental payroll lists are properly authorised.
	There should be formal authorisation of new employees.	Documentation for authorising new employees and putting them on the payroll file (manual or computerised) should be checked.
Salaries should be calculated correctly.	There should be formal personnel records, giving details of each employee and his or her	The payroll file should be checked.

Examples of control objectives	Examples of principal controls	Tests of control
	rate of pay, and dates of starting and leaving employment.	
Employees paid time-based wages should only be paid for time they have worked.	There should be time sheets for hourly-based employees, and these should be authorised by an appropriate supervisor.	Time sheets can be checked. These should include the signature of the manager or supervisor confirming the hours worked by the individual employee.
	Alternatively, a clock card system might operate.	For a clock card system, the auditor will need to test the controls in operation (such as to ensure that employees cannot clock in for each other).
Payments should not be made except for work done and unless properly authorised. Payroll calculations should be accurate.	A senior manager should check the total payroll cost each week or month, to make sure that the total amount does not appear excessive. In a computerised payroll system, exception reports might also be produced, for example, reporting gross wages over pre-set parameters and then followed up by management.	Authorised payroll lists should be checked. These should contain the signature or initials of the manager who checked the list. Test data could be used to check that the exception reporting system is working properly. Exception reports could be reviewed for evidence of follow up (e.g. annotated explanations).
	Bonus payments to individuals must be authorised.	Check a sample of bonus payments to ensure that the payments are properly calculated and authorised.

4.3 The calculation of tax and other deductions

Examples of control objectives	Examples of principal controls	Tests of control
Taxation and other deductions from pay should be calculated correctly.	Payroll procedures (IT or manual) should provide for the deduction of all appropriate deductions, using up-to-date rates of tax.	The auditor can review any manual procedures for calculating deductions, and the tax rates used. In an IT system, general IT controls will be important to check that the system was properly developed, tested and implemented. Test data could be used and results compared to independently calculated figures.
Voluntary deductions from pay (for example, for pension contributions) should only be made with the consent of the employee.	Senior management should check the total amount of deductions each week or month.	The auditor can check that a senior manager has approved total deductions, evidenced by his or her signature on the appropriate document.
	All voluntary deductions must be authorised in writing by the employee, and this written authorisation should be kept in the payroll file.	The payroll file can be checked against the calculation of deductions in employee wages or salaries, to confirm that voluntary deductions are authorised.

4.4 Recording wages and salaries payable in the accounts

Risk and control objective

The principal risk is that gross pay, deductions and net pay may not be properly recorded in the accounts. The control objective should therefore be to ensure that gross pay, deductions and net pay are all properly and accurately recorded in the accounts.

Examples of control objectives	Examples of principal controls	Tests of control
Gross pay, deductions and net pay should be properly and accurately recorded in the accounts.	The accounts are prepared from payroll data that has been approved by a senior manager.	There should be evidence that the payroll has been formally approved. (In an integrated IT system, the nominal ledger accounts will be automatically updated.)
	Accounting for payroll should be completed within a strict timescale.	There should be checks on the procedures for recording payroll and the time within which the work is done.
	There should be control accounts for payroll, with regular reconciliations between control totals and the payroll records of all individual employees.	There should be documentary evidence of control account reconciliations and review of these reconciliations.

4.5 Payment of wages and salaries

Risks

- Incorrect amounts of net pay could be paid over to employees.
- Incorrect amounts of deductions could be paid over to the authorities.
- Payment could be made to the wrong employee.

Examples of control objectives	Examples of principal controls	Tests of control
The correct amounts of net pay should be paid to employees.	When wages and salaries are paid by automated bank transfer, the list of payments should be authorised by an appropriate manager.	Authorised lists of payments can be checked.
The correct amount of deductions is paid to the appropriate authority (for example, the tax authority).	There should be formal procedures and a formal timetable for the payment of deductions, and recording payments in the accounts.	The procedures for payments of deductions and manual recording of payments in the accounts can be checked. (In an integrated IT system, the nominal ledger accounts will be automatically updated for deductions.)
Payments of net wages and salaries are made only to the proper person (the employee).	Bank statements should be used to check that payments have been properly recorded in the accounts.	Evidence of bank reconciliation checks can be obtained.

Examples of control objectives	Examples of principal controls	Tests of control
Payments are correctly recorded in the accounts.	There should be controls within the accounting system to ensure that there is reconciliation between total amounts payable and total paid.	The accounts can be checked to confirm that payrolls each week or month (total payable and total paid) are reconciled. Again, this will not be necessary in an integrated IT system, provided that the auditor is satisfied that the system is working properly, perhaps by processing a “dummy” payroll run.

Note: The suggested control objectives, controls and tests of control in the above table assume that all wages and salaries are paid by bank transfer. When payments of wages are in cash, or where casual labour is paid in cash, additional controls will be needed.

4.6 Possible control weaknesses in a payroll system

Remember that in the exam, you may be asked to identify control weaknesses in a payroll system, given information about procedures in a client entity described in a scenario based question. The following are possible weaknesses that may exist.

- Weaknesses in the system for recording time spent at work. When employees are paid by the hour, there will be a system of ‘clocking on’ and ‘clocking off’, typically using employee identity cards and a time recording device. Alternatively, employees may be required to arrive at work at a given time, and use identity cards and a recording device to record their arrival at work. The risk is that employees will ‘clock on’ on behalf of a colleague, using the identity card that the colleague has given him. (A control to prevent this from happening is that the ‘clocking on’ process should be carried out using biometric attendance system where attendance of the employee will be marked by recognising him/her through his facial image, finger prints, iris prints or voice)
- Overtime payments may not be properly authorised. Is the overtime authorised? If so, has the amount of the payment been checked and authorised?
- Responsibility for making the payroll payments. The actual payments of wages and salaries (often direct payments through the banking system) may be made by a junior person in the accounts department without proper authorisation.
- The payroll lists for each department may not be properly authorised. This creates a risk that payments may be made to ‘phantom’ employees.

Some weaknesses in a payroll system may be risks that are common to other types of IT system too, for example:

- Weaknesses in the use of passwords. An IT system may use passwords to prevent unauthorised access to files and records. However, the passwords used may be ‘guessed at’, particularly if they are names of family members or domestic pets, or names included in home addresses.
- Passwords should be difficult to guess (ideally a combination of letters and numbers) and should be changed regularly.
- Weaknesses in the use of e-mails. Important information may be sent by e-mail. However, since the information is not on paper (in ‘hard copy’ form) there is a greater risk that it will be overlooked or forgotten. In a payroll system, notification that employees have left their job may be sent to the payroll department by e-mail. If the e-mail is not acted upon, there is a risk that former employees will continue to be paid, even after they have left.

► *Practice Question 05:*

You have been assigned to plan the test of controls in respect of salaries and wages. In this regard you are required to identify the following:

- a) Possible control weaknesses in overtime payments
- b) Principal controls over payment of overtime

Tutorial Notes:

When identifying weaknesses in overtime payments, include lack of proper authorization, incorrect overtime rates, and manipulation of time records. Corresponding controls should ensure proper authorization, biometric or supervised time tracking, and reconciliation with salary records. Avoid detailing audit testing steps, as this question only required control weaknesses and their mitigation.

► *Solution 05:*

- a) Following are the possible weaknesses that may exist in overtime payments:
 - There may be weaknesses in the system for recording time spent at work. When employees are paid on the basis of time, there will be a system of 'time-in' and 'timeout', typically using employee identity cards and a time recording device. The risk is that employees will 'clock on' on behalf of a colleague, using the identity card that the colleague has given him.
 - Overtime payments may not be properly authorized which includes situation where a person works overtime without proper authorization.
 - Incorrect rates of overtime may be used.
- b) Principal controls over payment of overtime:
 - List of overtime payment (time or the amount) should be signed by person duly authorized in this regard by the organization.
 - A overtime rates should be checked by a person authorized in this regard by the organization.
 - The process of recording time should be monitored either by an authorized supervisor or by the use of bio-metric machine.
 - It should be ensured that the amount of overtime is correctly incorporated in the salary sheets and deductions therefore if any have been appropriately made.

► *Practice Question 06:*

State any three controls which would ensure that wages and salaries are not paid to the ghost (fake) employees.

Tutorial Notes:

To prevent salary payments to fake employees, controls should include formal authorization of new hires, segregation of duties in payroll processing, and payroll reconciliations. Many responses failed to mention that salary authorization should be verified and reviewed periodically.

► *Solution 06:*

- There should be a segregation of duties: the individual responsible for preparing wages and salaries should not be the person who actually pays them.
- The gross pay for each individual employee should be authorised by an appropriate person.
- There should be formal authorisation of new employees.

5 THE BANK AND CASH SYSTEM

5.1 Risks and control objectives

Bank and cash is often one of the most sensitive areas of an audit, in the sense that it is the asset which is most likely to be misappropriated. However, it may not be an area of high audit risk in practice, because the client company should be aware of the potential high level of risk and should therefore set up appropriate control systems.

Auditors will be particularly interested in establishing that **all** receipts belonging to the organisation have been recorded – **completeness** is a key assertion in the area of cash receipts.

The term 'cash' is used below to mean both notes and coins, and also money in a bank account. Many entities try to reduce the risks of misappropriation of cash (banknotes) by arranging receipts and payments through their bank.

Cash payments are also an area of potential risk. Payments might be made to unauthorised persons, or individuals might be paid more than they should be paid.

Some control objectives for cash might therefore be as follows:

- All money received is recorded.
- All money received is banked.
- All money held as cheques, notes and coins is properly safeguarded.
- All payments are properly authorised.

5.2 Principal controls and tests of control

Some of the principal controls for cash, and tests of those controls, are suggested below:

Control objectives	Principal controls	Tests of control
All money received is recorded	There should be segregation of duties. The handling of cash should be kept separate from other accounting functions.	Check that segregation of duties does exist.
	Controls over receipts by post There should be supervision of the opening of mail. There should be a listing of all money received. Mail and cheques should be date-stamped.	Controls over receipts by post Observe that mail opening and cash handling procedures are being followed. Check amounts recorded as receipts from customers against the remittance advices (document from the customer confirming the amount paid).
	Cash sales Only a restricted number of employees should be authorised to receive cash. Cash tills and till rolls should be used to record cash sales. Another person should check the actual cash received against the till roll total.	Cash sales Check amounts in receipt books or on till rolls to paying-in slips, the cash book and bank statements. Check whether bankings are made daily. Check payments out of cash takings, if any.

Control objectives	Principal controls	Tests of control
	Restrict the employees who are able to receive cash If the till rolls are not produced, receipts should be given for cash receipts, and a copy of receipts retained. Receipts should be sequentially numbered.	Check for evidence that till roll totals or receipts totals are checked against cash received by an authorised person.
All money received is banked	There should be daily banking, if possible. The amount of cash payments received should be recorded, and subsequently checked against the amount banked.	Check the frequency of banking receipts. Check that receipts are recorded in the cash book and that the bank statement matches the cash receipts recorded on a daily basis.
Proper safeguards should exist over money held	Bank There should be established procedures for opening new bank accounts. There should be restrictions on individuals authorised to prepare and hold cheques. There should be safe custody of cheque books. In a manual system there should be no pre-signed cheques. In an IT system there must be strong physical controls over access to pre-signed cheques, such as being kept in a safe until the next payment run and batch and control totals used over cheque numbers.	Bank Confirm that new bank accounts have only been opened under established procedures. Observe which individuals are involved with company cheques. Enquire as to custody of cheque books and check to see whether any cheques are blank and pre-signed. In an IT system, observe a payment run and that pre-signed cheques are removed from the safe immediately before being printed and returned immediately afterwards. Arrange for a cheque to be missed out of the run and ensure the system flags it up as missing.
	Cash Notes and coin should be kept in a secure place, such as a safe. Only a very limited number of employees should have access to the cash. Receipts of cash and payments of cash must be recorded.	Cash Review the nature of cash payments made. Observe cash custody procedures.
All payments should be properly authorised, made to the correct person and are properly recorded	Cheque payments Cheque requisition forms should be used to request payments, backed by supporting documentation.	Cheque payments Review paid cheques for payee, date, amount and signature.

Control objectives	Principal controls	Tests of control
	Cancellation of documentation once cheque has been prepared. There should be established authority levels for cheque signing (usually two signatures required for cheques above a certain amount). Payments must be recorded promptly. All cheques must be numbered sequentially.	Agree payments in the cheque book or BACS listing to entries in the accounting records, bank statements and supplier statements. Review the documents supporting requisitions for payment. Review the sequence of cheque numbers (see also above under safeguarding pre-signed cheques).

5.3 Petty cash

Control objectives

There should be several control objectives for petty cash.

- To avoid or reduce the risk of petty cash being stolen.
- To ensure that all spending out of petty cash is properly authorised.
- To ensure that only the correct amounts of cash are withdrawn from the bank to go into petty cash.
- To ensure that all spending out of petty cash is accounted for.

Controls

The controls that commonly apply to petty cash systems (where the imprest system is used) are as follows.

- The maximum amount held in petty cash should be restricted to about one month of petty cash spending. This is to avoid holding unnecessarily large amounts of cash that might be stolen.
- Petty cash should be kept in a locked cash box in the office safe, or if there is no safe in a locked drawer in the accountant's desk. This is a basic physical control over cash.
- All withdrawals of petty cash should be recorded on a petty cash voucher and vouchers must be sequentially numbered. This is to prevent the fraudulent withdrawal of cash and failures to record cash withdrawals.
- All petty cash spending should be authorised in advance by a properly authorised person (and not by the person withdrawing the cash). Authorisation should be indicated by signing and dating the petty cash voucher which is kept in the petty cash box until the petty cash is 'topped up' the next time and the petty cash expenses are recorded in the petty cash book.
- Receipts should be provided for petty cash spending and attached to the petty cash voucher.
- When money is withdrawn from the bank to 'top up' petty cash, the amount of the cheque for the cash withdrawal should be checked against the total of the petty cash vouchers in the petty cash box. The amount of cash withdrawn should equal the total on the petty cash vouchers since the previous cash withdrawal from the bank.
- There should be occasional checks of petty cash by a senior person (not the person responsible for holding and issuing petty cash) to ensure that the person responsible for holding petty cash has not been taking money fraudulently.
- There should be a system for the regular recording of petty cash expenses in the petty cash book. Each entry in the petty cash book should include the voucher number, to provide a check that all expenses are recorded (a check on completeness).

► *Practice Question 07:*

Suggest any five controls to prevent misappropriation of petty cash.

Tutorial Notes:

For petty cash controls, responses should highlight restricting cash held, requiring proper authorization, and conducting periodic surprise checks. Do not overlook the need to limit cash holdings to one month's expenses and having senior staff conduct periodic reviews to prevent misappropriation.

► *Solution 07:*

- i. The maximum amount held in petty cash should be restricted to approximately one month of petty cash spending. This is to avoid holding unnecessarily large amounts of cash that might be stolen.
- ii. All petty cash spending should be authorized in advance by a properly authorized person (and not by the person withdrawing the cash). Authorization should be indicated by signing and dating the petty cash voucher.
- iii. All withdrawals of petty cash should be recorded on a petty cash voucher and vouchers must be sequentially numbered. This is to prevent the fraudulent withdrawal of cash and failures to record cash withdrawals.
- iv. Receipts should be provided for petty cash spending and attached to the petty cash voucher.
- v. There should be occasional checks of petty cash by a senior person (not the person responsible for holding and issuing petty cash) to ensure that the person responsible for holding petty cash has not been taking money fraudulently.

6 THE INVENTORY SYSTEM AND NON-CURRENT ASSETS

6.1 The inventory system

Inventory is often a 'material' aspect of the financial statements and can also be a relatively high risk area. Consequently, the auditor will usually want some assurance as to controls in place for inventory.

The tests of control suggested below do **not** repeat tests which have been dealt with in respect of sales and purchases. The tests here focus on other aspects, primarily inventory movements and security. Audit work on the accuracy, valuation and allocation of inventory is normally performed at the substantive testing stage and will be dealt with in a later chapter.

The main **risks** associated with inventory are as follows:

- Inventory records are inaccurate.
- Inventory may be stolen or damaged.
- Inventory may be valued at incorrect amounts.
- Too little inventory may be held, so that customers' orders cannot be fulfilled.
- Too much inventory may be held, and therefore too much money tied up.

Control objectives	Principal controls	Tests of control
Recording inventory Inventory records should be complete, accurate and include only items belonging to the company. All inventory movements should be recorded and authorised.	There should be segregation of duties (ordering inventory, custody of inventory, accounting for inventory). There should be proper documentation for all issues of inventory from the store. All goods received should be checked and recorded Appropriate inventory records should be properly maintained.	The auditor can look for evidence that inventory movements (as recorded in the inventory department) agree with despatch documents and goods received documents. The auditor should look for documentation providing evidence that inventory movements are properly authorised.
Physical safeguards Inventory is protected against loss and damage.	There should be restricted access to storage areas. Regular inventory counts should be performed using appropriate procedures.	The auditor should look for compliance with access restrictions. The auditor should obtain confirmation that periodic inventory counts are performed, and that counts are checked against records of what inventory levels should be.
Valuation Inventory should be correctly valued at the lower of cost and net realisable value.	IAS 2 should be applied. There should be procedures for identifying obsolete and slow moving inventory items.	The auditor should look for evidence of how inventory valuations are reviewed, in order to apply the principles of IAS 2.
Inventory management Appropriate levels of inventory should be held at all times.	There should be maximum and minimum inventory levels for all inventory items of value.	The auditor should carry out a review for excessive inventory levels (possibly via exception

Control objectives	Principal controls	Tests of control
	There should be appropriate re-order levels and re-order quantities.	reports in an IT system). (This check is often performed in conjunction with the inventory count or 'stock take'). The auditor should also monitor the frequency of out-of-stock situations.

6.2 Non-current assets

The main **risks** associated with non-current assets are as follows:

- Non-current assets which the company does not need could be ordered.
- Expenditure on non-current assets may be recorded at incorrect amounts, or as revenue instead of capital expenditure.

Control objectives	Principal controls	Tests of control
Authorisation All expenditure on non-current assets should be properly authorised.	Appropriate authorisation procedures should be in place. Documentation and analysis should be produced to support (capital) expenditure requests. There should be approval procedures for the payment of invoices to the suppliers of non-current assets.	Many tests of control for the purchase of non-current assets are similar to those for the purchase of inventory items. The auditor should also look for documentary evidence of capital expenditure authorisations.
Recording All expenditure on non-current assets should be properly recorded. Expenditure should be properly analysed as capital or revenue.	Invoices must be analysed and account codes entered on the invoices. Management should review the analysis of purchased items as capital or revenue items, to ensure compliance with standard accounting practice.	The auditor should check the capital/revenue analysis of invoices. The auditor should check that entries are made in the non-current asset register.

► Practice Question 08:

You are the CFO of a newly incorporated company which has recently established five super markets in the city. One of your responsibilities is to implement internal controls.

List six key controls:

- over cash sales and cash handling;
- to reduce possibility of misappropriation of inventory.

Tutorial Notes:

For cash handling in supermarkets, mention timely cash deposits, secured cash registers, and locks for safekeeping. For inventory protection, ensure responses include surprise physical counts, surveillance cameras, and access controls. Do not rely solely on monthly checks—real-time measures are equally important.

► *Solution 08:*

a) **Key controls on cash sales and cash handling:**

- i. Responsibility to receive cash should be clearly identified.
- ii. Proper locks should be provided to each person responsible for handling cash.
- iii. Cash should be kept in a locked and secure area until it is deposited.
- iv. Cash registers and credit card machines should be balanced at least once a day.
- v. Proper policies should be made to deal with cash shortages/excesses.
- vi. Timely deposit of cash should be ensured.
- vii. Cash register should be used to record cash sales.
- viii. Transfers of cash from one person to another should be kept at a minimum.

b) **Controls to reduce possibility of misappropriation of inventory**

- i. Adequate segregation of duties or independent checks.
- ii. Adequate system of authorization and approval of transactions (for example, in purchasing, movement between locations etc.)
- iii. Use of door locks and surveillance cameras.
- iv. Surprise physical count and timely reconciliation of inventory items.
- v. Mandatory vacations for employees performing key control functions.
- vi. Periodic rotation of employees.
- vii. Restricted storage area.
- viii. Different entry and exit doors.
- ix. Access controls over automated records, including controls over and review of computer systems event logs.
- x. Job applicant screening of employees with access to assets.

► *Practice Question 09:*

Cardano Limited (CL) is engaged in the business of assembling motor bikes. CL has a fully integrated Computerised Accounting System (CAS). You have been given responsibility for reviewing the internal controls relating to procurement. In this respect, you have gathered the following information:

Ordering of inventory:

- Approved supplier's list is maintained in CAS. The list was last reviewed for changes two years ago. However, during the intervening period, any supplier whose performance is not satisfactory is timely removed from the list. As a control measure, the list is accessible and editable only by the employees of Procurement Department (PD).
- The Inventory Control Department (ICD) of CL generates a numerically sequenced Purchase Requisition (PR), when the quantity of a particular inventory item reaches re-order level. PR is electronically forwarded within the CAS to the PD.
- For all regular and routine orders, PD reviews the PR and selects a supplier from the approved supplier's list. A Purchase Order (PO) having a unique sequential order number is then generated for the selected supplier.
- For large or out of the ordinary purchases, a tendering process is carried out by the PD. Procurement Manager invites tenders through an advertisement in newspaper and the supplier offering the lowest price is selected by the Procurement Manager in consultation with Head of Procurement.

Receiving of inventory:

- When inventory items are received, the officer in ICD confirms that the inventory agrees to the PO. The CAS is then updated to confirm receipt of inventory and an electronic numerically sequenced Good Received Note (GRN) is generated. The physical inventory items are then transferred to store.

Required:

Identify any six weaknesses in the internal control system of CL and their possible effects. Also give your recommendations to overcome these weakness to CL.

Tutorial Notes:

For procurement control weaknesses, responses should include lack of supplier evaluation, absence of formal approvals, and inadequate price comparisons. Do not miss mentioning that GDNs were not part of documentation and that there was no system for quality inspection. Control recommendations should prioritize supplier screening, segregation of duties, and periodic updates to supplier lists.

► **Solution 09:**

S. No.	Control weakness	Possible effect	Recommendation
(i)	The list has not been reviewed since the last two years.	CL may miss out some more competent supplier(s) then the existing one.	The suppliers list should be regularly updated in which new supplier(s) should be added.
(ii)	Suppliers' list is editable by all the employees in PD.	Any changes made to the suppliers list may go unnoticed.	Supplier list should only be editable by the person who is authorized to make changes. The change log should be reviewed on a regular basis for changes. All the changes made in supplier list must be approved the appropriate authority.
(iii)	Supplier selected without asking for quotation.	CL may be paying higher prices to the suppliers. There is a risk that CL may fail to claim discounts from supplier(s).	Quotations from at least three suppliers should be invited. A member of the purchasing staff must be responsible for checking discounts allowed by suppliers.
(iv)	There is no segregation of duties in the ordering process.	This could lead to inappropriate purchases, i.e. in terms of type of goods or their quantity.	All routine purchase requisition should be approved by the store manager. There should be a purchase committee and all large purchases should first go through the purchase committee. All orders exceeding a certain amount should require an approval from finance department.
(v)	Suppliers are selected merely on the basis of prices offered.	Goods may be ordered which may not fulfil the technical requirements. The supplier may not have the capacity to fulfil the orders.	Suppliers should also be screened for the quality of the goods being offered. Such as obtaining quality certifications from the supplier. Volume requirements should also be considered when selecting a supplier as well as their financial stability (credit reference checks).
(vi)	There is no system of quality inspection.	Sub-standard goods may be received.	Proper inspection should be carried out before accepting the goods.

► *Practice Question 10:*

Your firm is the statutory auditor of Naltar Dairy Limited (NDL) for the year ended 31 December 2022. NDL manufactures and sells various dairy products including ice-cream.

The audit team is currently planning to perform the test of controls in respect of the ice-cream division's inventory. Following information has been provided by the management:

- i. Upon receipt of inventory at the warehouse, a process is performed to ensure its accurate verification by counting, matching it with purchase orders, performing quality inspection, entering it into the inventory system and proper storing it in a designated area of the warehouse.
- ii. On a weekly basis, the warehouse manager, Fahad Baqer, randomly selects a warehouse area for inventory counting. By rotating the designated areas, each area is counted at least once every quarter. This count is carried out in a manner that prevent the warehouse staff from knowing the expected quantity of items in each area. Furthermore, the inventory is also inspected for damages and expiry dates to ensure product quality.
- iii. Fahad conducts a comparative analysis between the inventory count and quantity of items in the inventory system. If any differences arise, he delegates the same counting task to a separate team for rechecking. Once it is established that the count is correct, adjustments are recorded after the approval of Fahad himself and the finance manager.

Required:

Identify the controls relating to the existence of inventory and suggest the test of controls to be performed to verify that the controls are operating effectively.

Tutorial Notes:

When testing inventory existence controls, focus on physical counts, purchase order verification, and periodic stock reviews. Do not mention unnecessary controls instead of those directly related to inventory existence. Tests of controls should include observing stock counts, verifying past inventory reconciliations, and ensuring all areas are counted at least once per quarter.

► *Solution 10:*

Control	Test of controls
Inventory is counted and matched to a PO on arrival at the warehouse.	- When performing onsite test counts during the audit, observe the inventory receipt process as explained by the management. - Select a sample of inventory received throughout the year and agree to the PO.
Inventory counts are performed on a weekly basis.	- Attend a sample of counts throughout the audit to observe the client process. - During attendance, verify the selection of areas, the instructions given, and the process of the recounts performed. - Select previous weekly recounts performed during the year and review the documentation of the counts performed.
Each area is counted once in every quarter.	- Select a sample of areas and verify that they were counted at least once in each quarter. - Inquire whether there is a process to ensure that each area is counted once in each quarter.
Inventory adjustments are approved by the warehouse manager and finance manager.	- Select a sample of adjustments throughout the year and ensure that revision in the system has been made after the approval of the warehouse and the finance manager. - Review whether the adjustments are backed with the supporting documentation of inventory count.

► *Practice Question 11:*

ABC & Co, Chartered Accountants, has been appointed as the auditor of FoodPro Limited (FPL). While obtaining an understanding of accounting and financial reporting process, the audit semi senior has documented the following for the review of audit senior:

- i. FPL utilizes an off-the-shelf accounting system for recording and processing its transactions. The general ledger and trial balance are extracted from the system, while draft financial statements are manually prepared on spreadsheets by the accountant.
- ii. Transactions are initially recorded on manual vouchers. Manual vouchers are reviewed, checked, and approved by the chief accountant. Once the voucher is approved, it is sent for data entry.
- iii. Data entry is carried out by junior accountants from various terminals, based on information received from data owners such as sales, purchases, and payments. Data entered by junior accountants is automatically processed by the system without any further manual intervention.
- iv. Inventory valuation sheets are provided by the warehouse manager at month-end to be posted in the system as balancing entries to calculate monthly consumption of materials and cost of sales.

Required:

Identify any five control weaknesses and suggest a related control to strengthen the system.

Tutorial Notes:

For financial reporting controls, responses should emphasize the use of an integrated accounting system, accuracy of data entry, and oversight of financial statement preparation. Many responses focused only on segregation of duties without addressing broader control issues such as the risk of incorrect inventory valuation and incomplete financial reporting.

► *Solution 11:*

There are certain control weaknesses in the financial reporting process adopted by FoodPro Limited which are documented as under:

i. Integrated system

The Company is not using an integrated accounting system where all activities are mapped and integrated and data is entered by process owners to ensure completeness, accuracy, and timeliness. There is a risk of incomplete and inaccurate information being entered by the junior accountants.

Related Control:

The Company should use an integrated accounting system that allows data entry at the point of origin to reduce the risk of errors in standalone data entry and duplication of efforts and resources.

ii. Control over Data Input

The information being entered by junior accountants based on approved manual vouchers is not being checked for accuracy and completeness of data entry. There is a risk that data entered is incomplete or inaccurate.

Related Control:

Manual vouchers should be pre-numbered and data entered in the system should use the same sequence or numbering to ensure completeness of data entry. There should be some review of input data by an independent person before data entered is allowed posting for further processing. FPL can use check digits to ensure that data is being entered into the correct account.

iii. Control over the Processing of Information

The information is processed by the system in an automated manner without any control over the posting and processing of data. There is a risk that the information processed is inaccurate or posted to the wrong heads.

Related Control:

There should be a control to review and check the information processed through the system by independent personnel who are not involved in data entry. There could be one-time testing of the system over processing of the information if data entry is accurate. FPL can also use checksum and batch totals to check that all the data has been accurately processed.

iv. Financial Statements Compilation

Financial statements are extracted manually on excel spreadsheets from general ledgers and trial balance produced by the accounting system. The process is subject to the risk of manual errors and lack of competence.

Related Control:

The Company should either generate financial statements through the automated accounting system or have an independent review of the financial statements compiled by the chief accountant.

v. Inventory valuation

Inventory valuation sheets are provided by the warehouse in-charge at the month's end to be incorporated in the financials, whereas the valuation should have been done by the FPL's finance department. There is a risk that the valuation provided is incomplete or accurate and also prone to risk of fraud.

Related Control:

Inventory count should be carried out by the warehouse manager supervised by the accounts and/or audit team of the quantities provided by the warehouse in-charge. The valuation of the physically verified quantities should then be entered into the accounting system.

vi. Raw material consumed

Raw materials consumed are calculated on the basis of month-end inventory valuation. This creates the risk of pilferage, uncontrolled wastage, and delayed information for reporting purposes.

Related Control:

There should be regular and timely recording of materials issuance and consumption of the inventory ledgers. The closing balance of the ledger will be reconciled with the physical inventory count sheets to identify any gaps or shortages.

► Practice Question 12:

Titan Products Limited (TPL) operates in a highly decentralized manner, with each of its three plants having significant autonomy over procurement processes. TPL's procurement strategy emphasizes rapid sourcing to minimize production delays, especially for high-demand components critical to their manufacturing process. However, this autonomy has led to several challenges:

- i. Several plants have entered into binding purchase agreements with vendors without proper authorization or approval, often exceeding their delegated financial authority. In some cases, these unauthorized commitments were discovered only after the goods had been delivered and invoices received, leaving the company with significant unapproved financial obligations.
- ii. There have been increasing instances of collusion between plant procurement officers and certain vendors, leading to inflated prices and kickbacks. The decentralized nature of the procurement process has made it difficult to detect such fraudulent activities.
- iii. Due to the lack of standardized vendor evaluation criteria across plants, some vendors have been awarded contracts based on personal relationships rather than objective performance metrics. This has resulted in poor supplier performance, frequent delays, and inconsistent pricing, with some plants paying significantly more for the same goods and services than others.

Required:

Discuss three controls for each challenge faced by TPL.

► *Solution 12:*

i. Internal Controls for Purchase Order Authorization and Vendor Selection

- TPL should implement a strict delegation of authority policy, clearly defining financial limits for each level of procurement staff.
- All POs should require documented pre-approval before commitments are made to vendors.
- Even in a decentralized environment, implement a centralized purchase requisition system in which all POs are initiated and tracked.
- A comprehensive procurement manual should be developed, outlining the policies and procedures for vendor selection, purchase order creation and compliance.
- Regular training programs should be arranged for procurement staff on company policies, ethical procurement practices, and local regulatory requirements. Compliance with these policies should be regularly monitored.

ii. Detecting and Preventing Vendor Collusion and Procurement Fraud

- Regular audits of vendor contracts, pricing, and performance across all plants should be conducted, focusing on detecting patterns of favouritism, inflated pricing, and substandard goods.
- Historical data should be analysed to monitor procurement transactions. Red flags could be raised on repeated transactions with the same vendor just below the approval threshold or significant price variations for similar products.
- The procurement process should be segregated into distinct roles, such as requisitioning, approval, purchasing, and payment.
- For all significant purchases, a competitive bidding process with a minimum number of qualified vendors should be mandated to ensure fairness and cost-effectiveness.
- A confidential whistle-blower mechanism should be established, allowing employees to report suspected fraud or unethical behaviour.

iii. Standardizing Vendor Management Practices

- A centralized vendor database accessible to all plants should be created and maintained. Any deviation from this should require special approval and documentation.
- A standardized vendor pre-qualification process across all plants should be developed and enforced.
- Standardized metrics for evaluating vendor performance, including delivery times, quality, pricing consistency, and service reliability should be developed.
- Regular performance reviews should be conducted, and poor-performing vendors should be removed from the approved list.
- Procurement officers should be required to sign annual conflict-of-interest declarations, disclosing any relationships with vendors.
- Mandatory rotation of procurement staff should be introduced to prevent close relationships from compromising the integrity of vendor selection.

7 OTHER ISSUES WITH TESTS OF CONTROLS

7.1 Tests of controls in smaller entities

Control systems in smaller entities are often less sophisticated than those in larger organisations. This is largely due to a lack of resources. In particular, a proper segregation of duties is often very difficult in small entities. It is also likely in small entities that there will be extensive involvement in control activity by senior management or the entity's owner.

In the case of smaller entities, the auditor will look for the existence of 'minimum business controls'. The minimum business controls should be identified, recorded and tested, as in any other type of control system.

The auditor is unlikely to be able to use the controls existing in a small entity as a basis for using a systems-based approach to the audit; therefore, a large amount of substantive testing is likely to be adopted. However, the auditor may be able to rely on the controls which are in place as a means of gaining assurance on certain aspects of the audit, for example on the completeness of the accounting records.

7.2 Exam technique: generating controls and tests of control

Most of this chapter has presented lists of risks, control objectives, internal controls and tests of control, for different aspects of business and accounting operations. You do not have to learn all these lists, because each accounting system and each business is different. Their control objectives and appropriate controls also differ.

What you may need to be able to do in the exam is to apply general principles to any particular system or business described in an exam question.

The approach that we recommend is the approach that has been explained and illustrated in this chapter. However, it is extremely important that you should understand this approach so that you can apply it in the exam. It is worth summarising again!

- Consider the things that could go wrong with the system. This should give you the **risks**.
- Consider what the controls will need to achieve in order to mitigate those risks. This should give you the **control objectives**.
- Think of **controls** which would help to **prevent** or **detect** the problem. You may be able to base these on some of the examples given in this chapter. Alternatively, you may find it helpful to use the list of control activities from ISA 315 (revised 2019) and their sub-types (performance reviews (including management controls), application controls (including authorisation, arithmetic and accounting controls), general IT controls, physical controls and segregation of duties).
- Design audit procedures to **test** the operation of the control. In doing this, you may find it helpful to think of the key audit testing procedures: inspection, observation, enquiry, confirmation, re-calculation and re-performance and to consider the use of test data.

► Example:

Your audit client operates a chain of fast-food restaurants. Six types of standard meals are available and are heated when customers place their orders. The meals are ordered weekly by the restaurant managers from the distribution centre at head office. At the end of each week, unused meals from the previous week are sent back to the distribution centre for disposal.

Required

List the controls which your client should have in operation to prevent losses to the entity as a result of the above system.

► *Answer*

- Managers should be required to produce a monthly reconciliation of meals bought, meals sold and meals returned to head office.
- Meals sold per this reconciliation should be agreed to the monthly sales figure (a difference could indicate theft).
- Where returns are above a pre-determined level, management at head office should investigate to identify over-ordering or a downturn in demand.
- Where returns are very low, management at head office should investigate to ensure that customers have not been turned away due to a lack of inventory.
- Strict physical controls should operate to ensure that inventory is not damaged in transit (e.g. refrigerated lorries) or once at the branch (e.g. sufficient, properly working refrigerators).
- Authorisation limits should be set for the number of meals any branch can order (based on budgets and past usage).
- Head office should carry out surprise inventory counts at branches.

As an alternative, the examiner might require you to identify the risks to which a business might be exposed as a result of poor internal controls. These risks are the same as the control objectives not being met (for example, for sales, the risk that not all goods despatched are invoiced). However, you could also be asked to set out the **consequences of those risks** and suggest **controls** which would address them.

► *Example:*

An entity selling goods on credit terms is exposed to the risk of invoicing errors.

Required

Set out the possible consequences of the above risk and suggest suitable internal controls which could be implemented to address the above risk.

► *Answer***Possible consequences**

- Sales and receivables will be misstated.
- Customer goodwill may be lost if they are charged too high a price (especially if this happens repeatedly).
- The time taken to correct the errors will result in delays in the payment of invoices by customers and could lead to cash flow problems. (If customers have been undercharged the difference may never be recovered.)
- If process charged or quantities entered are too low goods could be despatched to customers who would have been over their credit limits if the correct price had been charged. Again, this may result in the non-recovery of debts.

Internal controls to address

- Invoice checked for accuracy with respect to despatch note details, price list and any discounts agreed with that customer (or generally available for bulk purchases) and casts checked.
- Or, in an IT system, invoice produced automatically with strong physical controls over master files and good general IT controls).
- Data entry edit controls (e.g. field and range checks) if invoices are raised individually but then put onto an IT system.
- Independent authorisation of amendments to customer details and price lists.
- Amendments to standing data printed out and reviewed.

► *Example:*

Using the list of internal controls in the example immediately above, set out the audit procedures you could use to test the operation of each of those controls.

► *Answer*

- Select a sample of sales invoices, check costs and agree to details per despatch note, master price list and bulk/customer specific discounts.
- Input a sample of dummy despatch notes and ensure invoice generated by the system is accurate.
- Input a sample of dummy sales invoices, with prices/amounts outside the pre-set parameters and with incomplete files to ensure these are rejected by the system.
- Review amendment forms for customer details or prices and ensure properly authorised.
- Review print outs of standing data amendments for evidence of review.

8 COMPUTER-ASSISTED AUDIT TECHNIQUES (CAATS)

Where systems are IT based, specialised techniques of obtaining audit evidence may be required. These are known as **computer-assisted audit techniques** (CAATs).

CAATs can be defined as any technique that enables the auditor to use IT systems as a source of generating audit evidence. They involve the use of computer techniques by the auditor to obtain audit evidence.

- CAATs are often necessary in the audit of IT systems because these systems may not provide an adequate audit trail.
- In addition, processing is 'invisible' because it is electronic. Therefore, the auditor needs to 'get inside the computer' to check the completeness and accuracy of the processing. CAATs allow the auditor to achieve this.

Two commonly-used types of CAATs are:

- test data (most relevant in test of controls); and
- audit software (more relevant to substantive testing)

8.1 Test data

The use of test data involves the auditor processing a sample of data through the IT system and comparing the results obtained from the processing with pre-determined results.

A potential problem with using test data is that it will only give audit evidence at the time that test data is processed. Procedures may therefore be written into the client entity's computer information systems that will generate data for audit purposes **every time the process is run**. One way of achieving this without corrupting the client's data files with the test data is to establish an extra 'dummy' department, to which the test data results are allocated. Only the auditor should have access to the data stored in this dummy department.

► Example:

Looking back to the system described in the previous chapter in relation to Dolally, set out four examples of how test data could be used to test that system. You need not restrict the controls you are testing to those in your previous answer.

► Answer

1. Input a dummy order where you are aware that the goods are out of stock and ensure that the order does not lead to a despatch note being produced). (The system above did not specify how this situation would be dealt with. There would probably be some sort of pending orders file, checked against inventory levels daily).
2. Input a dummy order where you know that the goods are in stock and ensure that a despatch note is produced. View the despatch note on screen and trace it through to the copy in the distribution centre.
3. Input dummy despatch notes without subsequently flagging them up for invoicing and ensure they appear on the exception report.
4. Flag up dummy despatch notes and check invoices are raised.

8.2 Audit Software

Audit software is used by auditors and accountants to streamline the audit process, ensure compliance, manage risks, and generate reports efficiently. These tools help automate various aspects of auditing, such as data analytics, risk assessment, workpaper management, and report generation

► Example: using audit software to test the receivables balance

Audit software may be used in several ways to help with testing the receivables balance, where the client operates a computerised sales and receivables accounting system.

Software can be used to total the balances on the accounts in the receivables ledger, for comparison with the balance on the receivables control account.

Software can also be used to check the balance on each account in the receivables ledger with the credit limit for that customer, to check that credit limits have not been exceeded.

There may also be a computerised reasonableness check on the balances in each customer account in the receivables ledger. This check looks for unusually high or low balances in individual accounts, given the total volume and value of transactions in the account.

- Software can be used to prepare an aged receivables list, if these are not already produced by the client as a matter of operational routine. The audit software can interrogate the trade receivables file, and produce a list and analysis in date order of unpaid invoices. This listing can be used by the auditor to make an assessment of the receivables that may be irrecoverable.
- Software can be used to select the sample of receivables ledger balances for substantive testing in the audit.
- Software can also be used to calculate ratios (analytical procedures): for example an analysis of 'average days to pay' and changes in this ratio over time may help the auditor with an assessment of likely irrecoverable debts and possibly also the going concern assumption for the client.

► **Example:**

You have been put in charge of the audit of inventory at Kitchen Magic, a wholesaler of kitchen goods. Kitchen Magic keeps a permanent record of inventory on its IT system and carries out a rolling programme of inventory counts to check that the record on the system is reflected by actual goods held. The year-end inventory will be listed for you, showing for each product: date of last purchase, date of last sale, cost, selling price, quantity and year-end valuation. This schedule will be available on the last day of the year.

Required

List the tests which could be performed by audit software which will assist you in your audit of inventory. You will need to use your knowledge of IAS 2 *Inventories* from Paper CAF5.

► **Answer**

- Cast the year-end inventory schedule.
- List out all items over a pre-set amount (at least the materiality threshold) (for subsequent physical verification).
- For each item on the schedule multiply the lower of cost and selling price $\times$ quantity and list out any items where this figure does not agree to the year-end valuation.
- Compare prices to those on the current sales price master file.
- List out any items where the date of the last purchase was more than, say, one month ago (as this may indicate that the product is obsolete/damaged/no longer in vogue and may need to be written down).
- List out any items where the date of the last sale was more than, say, one month ago (as, again, this may indicate that the product is obsolete/no longer in vogue and may need to be written down).
- List out any items which do not appear on the post year-end sales listing for the first, say, month of the year (again, may indicate that a provision is needed).

Tutorial note:

If these tests were being carried out manually then only a sample would be checked. Due to the speed of computer software it is feasible to check all items.

Embedded audit facilities

Embedded audit facilities may also be called 'resident audit software' or an 'integrated audit module'. It is audit software that is built into the client's IT system, either temporarily or permanently.

The purpose of embedded audit facilities is to allow the audit to carry out tests at the time that transactions are being processed, in 'real time'.

This can be very useful for the audit of online systems where:

- data is continually processed and master files are being continually updated, and/or
- it is difficult, if not impossible, for the system to provide a satisfactory audit trail for following transactions through the system.

An embedded audit facility may also print out details of the transactions it has monitored, or copy them to a computer file, so that the auditor can study the transactions.

Problems with using audit software

Audit software may need to be written so that it is compatible with the client entity's IT system, and can therefore be expensive to use, particularly in the following circumstances.

- When it is being used for the first time for a client, so that the audit firm has set-up costs.
- The client entity changes its accounting system, so that new audit software is needed.
- There may be problems with producing suitable audit software when the client has an old purpose-written IT accounting system for which there is incomplete system documentation.

The auditor should also be aware of the possibility that if he uses copies of the client's files for carrying out tests with audit software that the client may provide a file that is not actually a copy of the current 'live' files. When using copies of client files, the auditor should insist on being present to observe the copying of the files, to make sure that they are 'genuine'.

8.3 Disadvantages of CAATs

CAATs give the auditor the ability to audit the processing of transactions in an IT system. However, there are some disadvantages of using CAATs. They can be expensive, and the use of CAATs should be evaluated on a cost benefit basis.

The costs related to the use of CAATs may include:

- purchasing or developing the programs
- keeping programs up-to-date for changes in hardware and software

training audit staff in the use of computer systems to run the CAATs. CAATs are of no value unless auditors are properly trained in how to use them.

8.4 Auditing around the computer

An alternative to using audit software to carry out checks within the client's IT system, an auditor may choose to audit 'around the computer'. With auditing around the computer, the client's internal software is not audited. Instead, inputs to the system are checked and agreed with the outputs from the system. The auditor looks at input to the system, and compares the actual output with the output that should be expected.

Auditing around the computer has greater audit risk than auditing of the client's internal software, because:

- If the actual files or programs are not tested, there will be no audit evidence that the programs are functioning properly, as documented.
- Where the auditor finds discrepancies between the input to the system and the output from the system, there is no way of finding out how the discrepancy has occurred. This in turn increases the risk that the auditor will be unable to write an unqualified audit report.

► Example:

Continuing with the example above concerning the audit of year-end inventory at Kitchen Goods.

Required

Describe a test using each of the above procedures (with the exception of analytical procedures).

► *Answer*

Inspection:

Trace items from the year-end inventory schedule to the actual goods.

Observation:

Observe counting of inventory during the year to gain evidence as to the accuracy of the inventory records.

Inquiry:

Inquire of management as to the need for a year-end inventory provision.

Confirmation:

Write to third parties who the client says hold goods included in the entity's year-end inventory to confirm the existence and condition of that inventory.

Recalculation:

Use audit software to cast the year-end inventory schedule.

Re-performance:

Use audit software to re-perform the aging of the year-end inventory schedule.

► *Example:*

Testing trade receivables balances for overstatement/existence

A starting point for testing will be the entity's list of receivables balances (the list of customers owing money as at the end of the reporting period). The auditor wants to check that these receivables do in fact exist. One way of doing this is to write directly to customers on the list asking them to confirm the amount that they owe the entity.

Alternatively, if the auditor is checking documentation within the client entity, he can take a sample of receivables from the list of balances, and trace their existence back through the accounting records, from receivables ledger to sales day book (receivables day book) to invoice.

Testing trade payables balances for understatement/completeness

To test payables for completeness, there is no point in taking as a starting point the entity's list of payables balances – because this may not be complete, and the auditor is testing for completeness.

Instead, the auditor may write to regular suppliers who might possibly be year-end payables, based on the total amount of purchases from the supplier during the year. If the supplier is not on the list of trade payables, or is listed as a payable for only a small amount, the auditor can ask the supplier to confirm this fact. This is often referred to as testing the '**reciprocal population**'.

Alternatively, if the auditor is checking documentation within the client entity, he may take, as a starting point, a sample of documents indicating that goods have been purchased or received – such as a sample of goods received notes – and then trace the purchase through the system from purchase invoice to purchases day book to payables ledger.

9 DATA ANALYTICS AND AUTOMATED TOOLS IN AUDIT

By strategically applying Data Analytics, from data extraction and cleaning to advanced analytics and continuous monitoring, auditors can more quickly and confidently identify areas of heightened risk, understand the design and operating effectiveness of mitigating controls, and drive timely corrective actions in collaboration with management.

Auditing in today's business environment (characterized by large data volumes, automated processes, and advanced IT systems) requires a systematic approach to identifying audit risks. By combining modern data analytics tools with traditional audit techniques, auditors can pinpoint areas where misstatements or control breakdowns are most likely to occur.

Modern organizations rely heavily on Information and Communications Technology (ICT) systems to record, process, and store financial transactions. This dependence introduces complex, system-based risks, such as unauthorized access, data manipulation, or automated processing errors. ISA 315 (Revised) directs auditors to evaluate how IT systems and controls fit into the entity's overall risk environment.

Using ICT and data analytics enables the auditor to:

- Expand Coverage by testing entire populations instead of just samples.
- Enhance Risk Identification through advanced anomaly detection and real-time monitoring.
- Streamline Testing by automating repetitive tasks, which improves both efficiency and consistency.
- Strengthen Insights by pinpointing root causes of risk and more accurately evaluating whether mitigating controls are operating effectively.

9.1. Planning the Audit and Scoping for ICT Usage

Identify Key Risk Areas

- Pinpoint core processes (e.g., sales, procurement, payroll, etc.) and the related financial statement assertions that are high-risk.
- Determine the nature and complexity of the organization's IT systems, such as ERP platforms, databases, and cloud environments.

Define Objectives for Data Analytics

- Align data analytics tests with known high-risk transactions (e.g., revenue recognition, journal entries).
- Decide which audit procedures can be automated or supplemented with data analytics to detect anomalies, outliers, and unusual patterns quickly.

► Practice Question 13:

During audit planning, what two objectives should the auditor set when deciding how to use data analytics?

► Solution 13:

- Align analytic tests with high-risk transactions (e.g., revenue, journals).
- Decide which procedures can be automated or supplemented with analytics to spot anomalies or unusual patterns quickly

9.2. Data Gathering and Preparation

Extracting Data

- Pull data from relevant systems such as the organization's general ledger, sub-ledgers, or operational systems.
- Validate completeness and accuracy by reconciling extracted data with source systems (e.g., checking record counts).

Data Cleaning and Transformation

- Convert extracted data into a common format suitable for analytics tools (Excel, CSV, etc.).
- Address missing fields, duplicated entries, or inconsistent data types before running advanced analytics.

► **Practice Question 14:**

List three key tasks in the *data-cleaning and transformation* phase before running advanced analytics.

► **Solution 14:**

1. Convert extracted data to a common format (CSV, Excel, etc.).
2. Address missing fields or duplicates.
3. Resolve inconsistent data types to ensure reliable processing

9.3. Applying Data Analytics

Type	Techniques	Description
Descriptive Analytics	Trend Analysis	Use data visualization or basic statistical techniques to identify spikes, dips, or irregular transactions over time (e.g., daily or monthly).
	Summary Statistics	Compute averages, medians, and variances by account or cost centre to detect unusual fluctuations.
Diagnostic Analytics	Ratio Analysis	Compare operational ratios (e.g., inventory turnover, receivables days) against historical norms or industry benchmarks for red flags.
	Outlier Detection	Employ filters or algorithms (e.g., z-scores) to identify transactions significantly outside expected ranges.
Predictive and Advanced Analytics	Regression/Forecasting	Develop models to predict expected values (e.g., expected sales for each month based on historical data). Flag variances beyond a threshold for further investigation.
	Machine Learning	Use anomaly detection algorithms (e.g., clustering or classification models) to spot hidden patterns or suspicious transactions.

► **Practice Question 15:**

Give two examples of *descriptive analytics* techniques and state their purpose.

► **Solution 15:**

- Trend analysis – reviews spikes, dips, or irregular transactions over time.
- Summary statistics – averages, medians, variances by account/cost-centre to flag unusual fluctuations

9.4. Identifying Audit Risks

- Analyse user access, timing, and amounts to spot unusual patterns, manual overrides, or postings outside normal business hours.
- Track transactions that don't match typical customer payment patterns, or show inconsistent invoice-to-payment times.
- Check if the same users have conflicting roles that allow them to create and approve transactions.
- Assess how data travels between systems (e.g., from sales systems to the general ledger) for potential errors or manipulation.

9.5. Identifying and Evaluating Mitigating Controls

Automated Controls Within Systems

- **System-Configured Controls:** Confirm that configured controls such as three-way matching (Purchase Order, Receiving Report, Invoice) are active and functioning properly.
- **Application Access Controls:** Verify that user accounts and permission settings align with job responsibilities, preventing unauthorized access.

Manual Controls Supported by ICT

- **Approval Workflows:** Evaluate electronic approval chains to ensure they require the correct sign-offs.
- **Exception Reports:** Look at system-generated reports that highlight anomalies or exceptions, and test whether management reviews and follows up on them.

Continuous Auditing/Continuous Monitoring

- **Real-Time Dashboards:** Where available, leverage dashboard analytics to monitor key metrics and identify variances or control breakdowns quickly.
- **Alerts and Notifications:** Confirm that triggers or alerts (e.g., for large transactions, unusual account combinations) are set up and that they reach responsible parties in a timely manner.

► Practice Question 16:

When evaluating mitigating controls, name two automated controls within systems that the auditor should confirm.

► Solution 16:

- Three-way matching (PO × GRN × Invoice).
- Application access controls ensuring user permissions align with roles.

9.6 Benefits of data analytics

The increased access and manipulation of data and the consistency of application of data analytics tools should increase audit quality and efficiency through:

- Increased business understanding through a more thorough analysis of a client's data and the use of visual output such as dashboard displays rather than text or numerical information allows.
- This increase in understanding, aids the identification of risks associated with a client, enabling testing to be better directed at those areas.
- Freeing up auditor time from analysing routine data so that more time can be spent on areas of risk.
- Increased consistency across group audits where all auditors are using the same technology and process.
- increased efficiency through the use of computer programmes to perform very fast processing of large volumes of data and provide analysis to auditors on which to base their conclusion, saving time within the audit and allowing better focus on judgemental and risk areas (often 100% testing is also possible).
- Data can be more easily manipulated by auditor as part of audit testing, for example performing sensitivity analysis on management assumptions.
- Increased fraud detection through the ability to interrogate all data and to test segregation of duties.
- Information obtained through data analytics can be shared with the client, adding value to the audit and providing a real benefit to management in that they are provided with that useful information.

► *Practice Question 17:*

Explain four ways data analytics can *increase audit quality and efficiency*.

► *Solution 17:*

Any four of:

- sharper risk identification;
- 100 % population testing;
- time saved on routine crunching;
- fraud-pattern detection;
- consistent group-wide testing;
- dashboards that enhance business understanding;
- value-adding insights for management

9.7 Challenges of data analytics

At present there is a lack of consistency or a widely accepted standard across firms and even within a firm. Other issues which can arise with the introduction of data analytics as an audit tool include:

- Data privacy and confidentiality.
- Client may be reluctant to allow the audit firm sufficient access to their systems to perform data analytics.
- Completeness and integrity of the extracted client data may not be guaranteed.
- Compatibility issues with client systems may render standard tests ineffective.
- Audit staff may not be competent to understand the exact nature of the data and output to draw appropriate conclusions.
- Practice management issues arise relating to data storage and accessibility for the duration of the required retention period for audit evidence.
- An expectation gap among stakeholders who think that because the auditor is testing 100% of transactions in a specific area, the client's data must be 100% correct.

► *Practice Question 18:*

List seven examples of significant challenges firms face when adopting data analytics and why each matters.

► *Solution 18:*

Examples:

- data privacy limits access;
- client reluctance to grant system access;
- integrity/completeness of extracts uncertain;
- system-compatibility issues;
- staff skill gaps;
- data-retention concerns;
- expectation-gap if stakeholders equate analytics with absolute assurance

9.8. Documentation

- Record the procedures, scripts, or tools used, along with outcomes and identified exceptions.
- Document how exceptions were investigated and resolved or escalated.

► Practice Question 19:

Outline the documentation requirements for analytics procedures and explain how exceptions should be handled.

► Solution 19:

- Record tools/scripts used, outcomes, and exceptions.
- Investigate, resolve, or escalate each exception. This creates a clear audit trail and demonstrates how anomalies were addressed in line with ISA guidance

9.10 Practical Examples in E-Commerce

Below are concise examples illustrating how ICT and data analytics address specific risks in e-commerce:

- Revenue Recognition: Running daily sales data through machine learning to identify transactions recorded prematurely or posted just before the period-end.
- Fraudulent Returns: Analysing returns data to spot customers with unusually high return rates or refunds processed outside normal business hours.
- Inventory Management: Matching real-time inventory counts against online sales records to detect inconsistencies or potential misstatements in stock levels.
- Unauthorized Transactions: Scanning order logs for suspicious IP addresses or duplicate credit card use across multiple accounts, signalling possible fraud.
- Cybersecurity Controls: Reviewing system logs to determine if known security patches are applied promptly, thus reducing the risk of data manipulation.

► Example: Audit of XYZ E-Commerce Store Using ICT and Data Analytics

Background of the Audit

XYZ E-Commerce Store is a mid-sized online retailer dealing in electronics, apparel, and home appliances. The company has a high volume of transactions processed daily through its website and mobile application. The audit engagement focuses on assessing risks related to **revenue recognition, payment processing, inventory management, and cybersecurity**.

Audit Objective: Identify risks related to fraudulent transactions, revenue leakage, and compliance issues.

Risk Assessment and Identification Using Data Analytics

Tool	Purpose	Findings	Risk Identified
Power BI	Data Visualization & Dashboarding	Sales trends, revenue spikes, high-risk transactions	Unusual spikes in sales before quarter-end
SQL Queries	Detecting Anomalies in Transactions	120 transactions with high order values	Possible fraudulent transactions or money laundering
Python with Pandas & NumPy	Analysing Customer Behaviour	New accounts making multiple high-value purchases	Potential fraudulent accounts using stolen credit cards
Tableau	Detecting Inventory Discrepancies	High sales with low stock updates, supplier delays	Inventory shrinkage and poor supplier controls

Tool	Purpose	Findings	Risk Identified
ACL	Revenue Recognition Testing	Orders marked as 'delivered' with no shipment tracking	Premature revenue recognition
Selenium	Automated Testing of Payment Gateway Controls	Simulated failed transactions, checked data encryption	System did not issue refunds automatically
RPA (UiPath)	Automated Risk-Based Sampling for Order Review	Extracted high-risk transactions, flagged failed payments	Control weaknesses in payment reconciliation
Splunk	Cybersecurity Event Monitoring	Detected multiple failed login attempts	Brute-force attack attempts on customer accounts
Excel Macros	Duplicate Payment Testing	15 cases of duplicate payments	Control Weakness Identified
IDEA (CaseWare)	Fraud Detection in Vendor Payments	One vendor received 50% of payments for 20% of inventory	Possible vendor favouritism or kickback scheme

10 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Understand the key transaction cycles and associated controls for:
 - Sales
 - Purchases & expenses
 - Payroll
 - Bank and cash
 - Inventory
 - Non-current assets
 - Discuss controls in smaller entities
 - Plan tests of controls
 - Understand Data Analytics and its uses by Auditor
 - Describe computer assisted audit techniques

INTRODUCTION TO SUBSTANTIVE PROCEDURES

IN THIS CHAPTER:

1. The role of substantive procedures
2. Analytical procedures: ISA 520
3. Chapter review

1 THE ROLE OF SUBSTANTIVE PROCEDURES

1.1 Exam technique: devising tests of detail

The following chapters describe a variety of substantive procedures that an auditor might carry out. In your exam, you might be asked to suggest what substantive procedures ought to be carried out in a particular situation. Each accounting system and business is different, and substantive procedures that might be appropriate in one situation would be inappropriate in another. What you need to be able to do in the examination is apply general principles of substantive testing to the particular system or business described in the question.

One possible approach to devising tests of detail is as follows (analytical procedures are considered later in this chapter):

- **What am I being asked to test?** Start by asking what it is that you should be trying to test, and obtain evidence about. Usually you will be asked to test for any misstatement, but sometimes you might be asked to test only for:
 - overstatement (occurrence of transactions or existence of assets or liabilities) or
 - understatement (completeness), or
 - one particular aspect of an item (for example, the valuation of an asset).

To decide what you are testing for, think about the financial statement assertions. Which of these do you want to test?

- **How does the system operate and what documents exist?** You should think about the specific system described in the examination question, and write down some ideas at this stage.
- **What special tests are used for this area?** There may be some audit tests that are particularly relevant to the system described in the question. Certain statement of financial position items have specific tests, such as a year-end inventory count for inventory (that the auditor can attend) or 'direct confirmation' as a method of verifying receivables' balances.
- **What tests can I think of?** To devise tests of detail, you should think about what method or methods are appropriate for gathering the evidence you are looking for. For example, in an IT system, the auditor will need to consider the use of audit software (see below).

2 ANALYTICAL PROCEDURES: ISA 520

2.1 Using analytical procedures

Analytical procedures were referred to earlier as one of the procedures for generating audit evidence.

Analytical procedures must be used:

- **at the audit planning stage**, in order to identify and assess the risk of material misstatement.
- **when Forming an Overall Conclusion**

The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

The results of such analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances, ISA 315 (revised 2019) requires the auditor to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly.

Analytical procedures may also be used **as a substantive procedure** during the audit, in the audit work on the income statement and statement of financial position (to look for possible material misstatements during the audit rather than later, in the end-of-audit review).

ISA 520 *Analytical procedures* is concerned with the second two stages – using analytical procedures in the overall review and as substantive procedures.

2.2 The nature of analytical procedures

“Analytical procedures” are defined by ISA 520 as “evaluations of financial information through analysis of plausible relationships among both financial and non-financial data”. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount

Comparisons

The essential feature of analytical procedures in auditing is ‘comparison’. The auditor will calculate key relationships between figures (non-financial figures as well as financial figures) and then make comparisons.

Comparison with	Explanation
Prior accounting periods	To establish patterns and trends, and to look for unusual fluctuations in amounts in the current financial year that seem inconsistent with what has happened previously.
Expected results	Actual results can be compared with the budgeted results or with forecasts, or with results that the auditor was expecting.
Industry average results	Comparable information may be obtained for other entities in the industry or about individual entities in the same industry. Information may be obtainable for the industry as a whole from an industry body or a financial information service. Information about individual companies in the same industry may be obtainable as published financial statements.
Comparable parts of the same entity	The auditor may be able to compare the results of different branches or divisions within the same entity, where there are similar branches or divisions within the entity.

Analytical procedures and the exam

An exam question may ask you to carry out analytical procedures for an entity described in a small case study. The purpose of such a question will be to test your ability to:

- identify unusual features in the draft financial statements of a client entity
- suggest what might be done to investigate the unusual figures more closely
- provide possible explanations for the unusual figures in the financial statements.

Examples of unusual items in the financial statements that analytical procedures would reveal are:

- a substantial increase in sales revenue but a substantial decrease in the cost of sales
- a significant change in the gross profit margin
- a significant change in administrative expenses
- a significant change in selling and distribution expenditure
- a significant change in interest costs or investment income
- a significant change in the net profit margin

► *Example:*

Here are just a few more of the ratios that an auditor might use. Other common ratios are set out at the end of this section.

Payroll costs

Ratios can be used to assess whether the total recorded amount for payroll costs appears to be reasonable:

- One way of doing this is to look at the total payroll costs each month, and in each month of previous years. Changes in the total payroll cost should be reasonable, allowing for increases in wages and salaries, and for changes in the composition of the work force, and for leavers and starters in the period. Monthly payroll costs should be consistent with each other and reasonable.
- Another way of assessing payroll costs would be to measure the average monthly or annual pay per employee, and compare this with other months or previous years. Any unexpected changes should be investigated.

Other expenses

Another simple ratio that can be useful for an auditor is the ratio of expenses to annual revenue. Unusual changes in any ratio, such as the ratio of cost of sales to sales (and so gross profit to sales) should be investigated. Similarly, ratios of distribution costs, selling costs and administration costs to revenue can also be measured and compared.

Working capital ratios

Working capital ratios, such as days' sales outstanding and the average inventory turnover period, can be used to assess whether the total balance for trade receivables or inventory is reasonable (or whether the figures for sales income and purchases appear reasonable).

2.3 Analytical procedures in substantive testing

Several factors should determine the extent to which the auditor can use analytical procedures as a form of substantive audit evidence. ISA 520 **requires** the auditor to:

- determine the suitability of particular substantive analytical procedures for given assertions taking account of the assessed risks of material misstatement and tests of details, if any, for the assertions; how effective they will be in detecting particular type of material misstatements.
- develop an expectation of recorded amounts or ratios and evaluate whether that expectation is sufficiently precise to identify a misstatement. How effectively this can be done depends on factors such as:
 - the accuracy with which amounts can be predicted;
 - the extent to which information can be disaggregated (e.g. sales split out by product line); and
 - the availability of information.

- evaluate the reliability of the data from which the expectation has been developed. If data is unreliable then it will be of little use. The auditor should consider such factors as:
 - the source of the information;
 - comparability of the information available (broad industry data may not be suitable for an entity with more specialised products);
 - the nature and relevance of the information available (budgets may not be suitable if they have been prepared as goals rather than expectations); and
 - controls over the preparation of the data.
- determine what level of difference from expected amounts is acceptable without further investigation (i.e. link to materiality).

2.4 Investigation of fluctuations and relationships

If the auditor finds:

- fluctuations or relationships which are inconsistent with other information, or
- unacceptable levels of differences from expected amounts

then ISA 520 **requires** him to:

- make enquiries of management and verify management's responses, and
- perform other audit procedures as necessary.

The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

► Example:

You are currently planning the audit of Numero for the year ended 31 December 20X4. You are aware that revenue was budgeted to fall by 20% from last year. The following information has been made available to you:

Revenue Rs. 4,000,000 (20X3: Rs. 5,000,000)

Cost of sales Rs. 3,000,000 (20X3: Rs. 3,000,000)

Expenses Rs. 200,000 (20X3: Rs. 500,000)

Trade receivables Rs. 600,000 (Year 1: Rs. 300,000)

Required

Explain which of the above amounts you believe might need further investigation and why.

► Answer

Cost of sales has remained constant and yet revenue has fallen by the anticipated 20%. Cost of sales would generally be expected to move in line with revenue. (*Tutorial note: An alternative comment would be that the gross profit percentage has fallen from 40% to 25%.*)

Expenses have decreased by 60%. This could be due to the fall in revenue or it could indicate a misallocation between cost of sales and expenses.

Trade receivables days have increased from 22 days to 55 days. This may indicate a change in credit terms (to attract new/large customers in the light of falling sales) or that not all debts are recoverable and that a write-down is needed.

2.5 Common ratios

Profitability ratios

$$\text{ROCE} = \frac{\text{Profit before interest and taxation}}{\text{Share capital and reserves} + \text{Long-term debt capital}} \times 100\%$$

$$\text{Profit/sales ratio} = \frac{\text{Profit}}{\text{Sales}} \times 100\%$$

This could be calculated as a **net profit ratio** or a **gross profit ratio** (commonly referred to as the gross profit percentage).

$$\text{Asset turnover ratio} = \frac{\text{Sales}}{\text{Share capital and reserves} + \text{Long-term debt capital}}$$

Working capital efficiency ratios

$$\text{Average days to collect} = \frac{\text{Trade receivables}}{\text{Sales}} \times 365 \text{ days}$$

$$\text{Inventory turnover} = \frac{\text{Inventory}}{\text{Cost of sales}} \times 365 \text{ days}$$

$$\text{Average time to pay} = \frac{\text{Trade payables}}{\text{Cost of purchases}} \times 365 \text{ days}$$

Liquidity ratios

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$\text{Quick ratio} = \frac{\text{Current assets excluding inventory}}{\text{Current liabilities}}$$

Debt ratios

$$\text{Gearing} = \frac{\text{Long-term debt}}{\text{Share capital and reserves}} \times 100\%$$

$$\text{Interest cover} = \frac{\text{Profit before interest and tax}}{\text{Interest charges in the year}}$$

Investor ratios

$$\text{Earnings per share} = \frac{\text{Profits attributable to ordinary shareholders}}{\text{No. of shares}}$$

$$\text{P/E ratio} = \frac{\text{Current market price per share}}{\text{Earnings per share}}$$

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Current market price per share}} \times 100\%$$

$$\text{Dividend cover} = \frac{\text{Earnings per share}}{\text{Dividend per share}} \quad \text{or} \quad \frac{\text{Profit before dividends}}{\text{Dividends}}$$

► *Practice Question 01:*

Identify the matters that need to be considered by the auditor at the time of designing and performing substantive analytical procedures.

Tutorial Notes:

When designing substantive analytical procedures, consider:

Suitability for detecting misstatements.

Precision of expected amounts to identify material misstatements.

Reliability of data sources used to develop expectations.

Acceptable differences before further investigation.

► *Solution 01:*

When designing and performing substantive analytical procedures the auditor should:

- determine the suitability of particular substantive analytical procedures for given assertions – i.e. how effective they will be in detecting a particular type of material misstatement.
- develop an expectation of recorded amounts or ratios and evaluate whether that expectation is sufficiently precise to identify a misstatement.
- evaluate the reliability of the data from which the expectation has been developed.
- determine what level of difference from expected amounts is acceptable without further investigation.

► *Practice Question 02:*

State the factors which determine the extent to which an auditor may use Analytical procedures as a form of substantive audit evidence.

Tutorial Notes:

The extent to which analytical procedures can be used depends on:

Appropriateness for given assertions.

Reliability of underlying data used for comparison.

Precision of expected recorded amounts to detect misstatements.

► *Solution 02:*

The factors which determine the extent to which analytical procedures may be used as a form of substantive procedures are as follows:

- suitability of particular substantive analytical procedures for given assertions;
- reliability of data from which the auditor's expectation of recorded amounts or ratios is developed;
- whether the expectation as regards the recorded amounts is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

► *Practice Question 03:*

You are the audit manager in a firm of chartered accountants. Your audit client Zakir Textile Mills Limited (ZTML) has emailed you its draft financial statements for the year ended 31 December 2018 along with certain explanations. The information provided by ZTML is summarized below:

i. Extracts from statement of financial position

	2018	2017
	-----Rs. in '000-----	
Equity and Liabilities		
Equity and reserves	29,287	22,000
Long-term loan	8,000	12,000
provision against litigation	1,100	1,000
Trade and other payables	6,400	6,500
	44,787	41,500
Assets		
Property, plant and equipment	25,100	22,818
Loans to employees	1,000	800
Trade debtors	8,500	8,000
Inventory	7,600	f,000
Cash and bank balances	2,587	2,882
	44,787	41,500

ii. Extracts from statement of profit or loss

	2018	2017
	-----Rs. in '000-----	
Sales	84,000	73,000
Cost of sales	60,400	54,750
Gross profit	23,600	18,250
Expenses	12,850	10,950
Net profit before taxation	10,750	7,300
Taxation	3,463	2,555
Net profit	7,287	4,745

- iii. At the start of the year, ZTML had increased the sale price of its products by 13%.
- iv. The entire long term loan was obtained in 2017. The principal is payable in three annual instalments along with the amount of interest.
- v. Increase in property, plant and equipment represents additions made during the year, net of depreciation. There were no disposals during the year.
- vi. ZTML has a policy of giving interest free loan to its employees. The loan entitlement was reduced during the year from 8 times the gross salary to 5 times of gross salary.

Required:

Using analytical procedures, identify unexplained fluctuations and inconsistencies in the above scenario. State the key audit procedures which you would perform to address the issues identified by you. (Maximum of three key audit procedures are required for each issue)

Tutorial Notes:

When performing analytical procedures, compare financial data with business trends and policies:

- Provision for litigation: Verify legal confirmations and review expenses.
- Trade payables: Check whether payables decreased despite increased costs.
- Employee loans: Investigate why loans increased despite reduced entitlements.
- Trade debtors: Analyse debtor growth vs. sales increase.
- Cost of sales: Compare with sales growth and verify material usage.
- Expenses & Taxation: Investigate unusual changes.

► **Solution 03:**

i. Provision against litigation

Even though the change in provision against litigation is not significant but due to the high inherent risk, further steps need to be taken as follows:

- Circulate confirmation to legal advisors of the company.
- Scrutinize payments of legal expenses to ensure that all legal cases have been identified by the client.
- Review the minutes of the board meetings.
- Obtain expert advice, if considered necessary.
- Verify the basis for recording of provision.

ii. Trade payables

Despite the increase in cost of sales, trade payables have decreased. Consequently the following procedures may be performed:

- Circulate balance confirmation requests to trade creditors.
- Compare the current list of trade payables with prior year's working papers to identify any omissions.
- Ensure that all regular suppliers are included in the list of trade creditors.
- Scrutinize subsequent payments and ensure that appropriate accruals were made against those payments.

iii. Loans to employees

Despite the reduction of entitlement of loan, it has increased from previous year. Considering this inconsistency, following procedures may be performed:

- Discuss the increase in loan amount with management.
- Check payment of amount of loan given to employees during the year with payment voucher having acknowledgment of employees.
- Obtain confirmation of loan balances from employees.
- Verify approval of new loan given to employees.
- Ensure that recoveries are being made as per policy and are recorded.

iv. Trade debtors

Sales has increased by 15% but debtors have only increased by 6%. Considering this inconsistency following procedures may be performed:

- Discuss the reason for change with the management.
- Circulate confirmation requests to debtors.
- Trace a sample of shipping documents to sales invoice and into the sales and receivable ledgers.

v. Cost of sales

Despite 15% increase in sales, cost of sales has increased by only 10%. Considering this fluctuation, following steps may be performed:

- Perform cut-off test for purchases.
- Check that the correct quantity of material, labour and overheads has been used.
- Perform analytical calculations over the cost of inventory consumed and other major costs.
- Verify the major costs with bills, invoices and other related documents.

vi. Expenses

Even though the finance cost would also have reduced due to reduction in loan, expenses have increased by 17%. Considering this fluctuation, following steps may be performed:

- Ask the client for the detailed breakup of the expenses
- Enquire from management for any inconsistencies in the break-up of expenses obtained.

vii. Taxation

Tax rate was exactly 35% of the profit before taxation in last year which have reduced to 32%. Considering this fluctuation, following steps may be performed.

- Obtain and review the tax working prepared by the management
- Check the enacted tax rates.

► Practice Question 04:

You are manager responsible for the audit of Pine Limited (PL) for the year ended 31 August 2020. PL has large contracts with many government entities. During the year, the government has significantly reduced its spending which has also affected its contract volumes with PL. Devaluation of the local currency has also resulted in increased costs of the materials purchased from overseas suppliers.

During the planning work review, your team has provided you the following ratios:

	2020	2019
Gross profit margin	32%	28%
Accounts payable to cost of sales ratio	0.20	0.28
Trade days receivable	90	75

Required:

- Explain the fluctuations and inconsistencies in the given ratios.
- State any four key audit procedures which you would perform to address each issue identified in (i) above.

Tutorial Notes:

Key unexplained trends included:

- Gross profit margin increased despite rising material costs.
- Payables-to-cost ratio declined despite exchange rate fluctuations.
- Trade receivables increased, suggesting collection issues.
- Audit procedures should include:
 - Reviewing material costing and cut-off testing.
 - Checking supplier payments and foreign currency adjustments.
 - Analysing aging reports and collection follow-ups.

► **Solution 04:**

The increase in the gross profit margin is inconsistent with the increase in the cost of materials due to devaluation of local currency and decrease in volume of sales with the government. Considering this inconsistency, following steps may be performed:

- Review the explanations obtained by the audit team for the increase in the gross profit margin even after decrease in government contracts and increase in import prices.
- Perform cut-off test for purchases and sales.
- Check that the costing of material, labour and overheads have been correctly applied.
- Perform analytical calculations over the cost of inventory consumed and other major costs.

The accounts payable to cost of sales ratio has decreased significantly (29%), despite weakening of the local currency. Consequently, the following procedures may be performed:

- Ensure that foreign trade payables are translated at the closing foreign currency exchange rates.
- Circulate balance confirmation requests to trade creditors.
- Compare the current list of trade payables with prior year's working papers to identify any omissions.
- Ensure that all regular suppliers are included in the list of trade creditors.

Trade day receivable has increased significantly (20%), which indicates that PL is facing problems in collecting trade debts. There is a possibility that provision for doubtful debt may not be correctly recorded. Considering this, following procedures may be performed:

- Obtain aging of the receivable balances.
- Obtain confirmation from major customers.
- Review the subsequent collection of trade receivables.
- Assess the adequacy of provision against overdue balances.

► **Practice Question 05:**

You are the audit manager in a firm of chartered accountants. Your audit client Dairy (Private) Limited (DPL) has emailed you its draft financial statements for the year ended 30 June 2021 along with related notes. The information provided by DPL is summarized below:

Draft statement of financial position as at 30 June 2021

	2021	2020
	----- Rs. in '000 -----	
Equity and reserves	35,922	26,000
Long-term loan	6,000	12,000
Trade and other payables	7,800	6,500
Equity and Liabilities	49,722	44,500
Property, plant and equipment	22,630	26,818
Prepayments	1,500	-
Trade debtors	12,000	8,000
Inventory	13,000	7,000
Cash and bank balances	592	2,682
Assets	49,722	44,500

Draft income statement for the year ended 30 June 2021

	2021	2020
	----- Rs. in '000 -----	
Sales	110,000	73,000
Cost of sales	(83,050)	(54,750)
Gross profit	26,950	18,250
Admin and marketing expenses	(12,100)	(10,950)
Finance cost	(675)	(1,530)
Net profit before taxation	14,175	5,770
Taxation @ 30%	(4,253)	(1,731)
Net profit	9,922	4,039

Notes:

- During the year, sales price of DPL products were increased by 20%, to offset the corresponding increase in cost of production.
- On 30 June 2019, DPL had obtained a loan of Rs. 20 million, which is payable in 10 equal quarterly instalments at the end of every quarter. The loan carries fixed mark-up rate of 9%.
- Decrease in property, plant and equipment represents disposals made during the year, net of depreciation.
- Prepayment represents advance rental payment of warehouse, obtained for 6 months on 16 June 2021 at a monthly rent of Rs. 250,000.

Required:

Using analytical procedures, identify any four unexplained fluctuations and inconsistencies in the above situation. State the key audit procedures which you would perform to address the issues identified by you.

Tutorial Notes:

Key unexplained fluctuations included:

- Loan repayment delays: Check bank correspondence and reclassification.
- Trade payables reduction: Verify balances and supplier confirmations.
- Incorrect prepayment recording: Adjust warehouse rent allocation.
- Higher inventory turnover: Assess for obsolete stock provisions.

► **Solution 05:****Long-term loan**

It seems that DPL has failed to make the quarterly instalment of its long-term loan or has made delayed payment. This may represent default on part of DPL. Furthermore, no accrual of finance cost for the last quarter has been made.

Audit procedures

- Obtain the loan agreement and look for any penal provision.
- Obtain correspondence with the bank to assess the possibility of any penalty or action taken against DD.
- Critically analyse the confirmation received from the bank.
- Ask the management to record any penalty amount or loan re-classification.

Trade payables

Creditor days have decreased from 43 days to 34 days. This may represent that creditor balances might be understated. Consequently, the following procedures may be performed:

Audit procedures

- Circulate balance confirmation requests to trade creditors.
- Compare the current list of trade payables with prior year's working papers to identify any omissions.
- Ensure that all regular suppliers are included in the list of trade creditors.
- Scrutinize subsequent payments and ensure that appropriate accruals were made against those payments.

Prepayments

Since the warehouse was obtained on 16-June-21, an expense amounting to Rs. 125,000 should be transferred to profit and loss and prepayment should be reduced to Rs. 1,375,000 in the statement of financial position.

Audit procedures

- Obtain the rent agreement of the warehouse to verify the monthly rent.
- Verify and trace the payment made for the rent.
- Ask the management to record the expense amounting to Rs. 125,000.

Inventory

The inventory turnover days have increased from 47 to 57 days. Due to this increase there might be some obsolete inventory which requires provisioning.

Audit procedures

- Verify from the stock count sheet whether any obsolete or old inventory was identified
- Obtain the inventory aging analysis.
- Obtain the management working of net realizable value and assess its accuracy.

► Practice Question 06:

Your audit team performed verification of the payroll cost for the year ended 30 June 2022, by projecting the June 2021 payroll cost in line with increase in revenue from last year to current year.

Required:

Comment on the suitability of analytical procedure as substantive procedure performed by your audit team. Also suggest any changes to be made in the analytical procedure.

Tutorial Notes:

Using revenue trends to project payroll costs is incorrect since:

- Payroll includes fixed costs, not tied directly to revenue.
- Changes in new hires, salary increments, and deductions affect payroll.
- Proper analytical procedures should adjust for:
- Employee turnover, salary increments, and deductions.
- Verification of major differences with management.

► *Solution 06:***Payroll cost:**

Completeness and accuracy of the payroll cost can be determined by performing analytical procedures. However, projecting the payroll cost of June 2021 on the basis of revenue is not correct, as certain payroll costs are fixed and do not move in line with the revenue.

Changes to be incorporated in the analytical procedures:

Payroll cost of June 2021 would be projected to the payroll cost of year ended June 2022 by taking the effect of the following:

- The effect of those employees who have joined and left during the year
- The effect of increments
- The effect of any deductions made in the salary
- Discuss any significant differences/inconsistencies with the management

► *Practice Question 07:*

The audit junior was assigned the task of verifying rent expense for a chain of retail stores based on the following data:

	2023	2022
Rent expense – stores	Rs. 21,990,120	Rs. 19,875,890

Certain facts about the rent of stores are as under:

- There is an annual rent increase of 10%.
- The number of new stores opened during the year is 2.
- The number of stores closed during the year is 10.

The audit junior prepared a working detailing substantive analytical procedures in the following manner:

	Rupees
Rent expense for 2022	19,875,890
Add: 10% annual increase as per agreement	1,987,589
Expected rent expense for 2023	21,863,479
Actual rent expense for 2023	21,990,120
Difference – Immaterial	126,641

Required:

Analyse the working prepared by the audit junior and identify deficiency(ies) in above procedure, if any.

Tutorial Notes:

The audit junior incorrectly assumed a flat 10% increase in rent, ignoring:

Store closures reducing rent expense.

New store openings increasing cost.

The expected rent should have decreased, requiring further investigation.

► *Solution 07:*

In the given scenario, the audit junior has relied on a substantive analytical procedure to verify the rental expense. Specifically, the audit junior applied the annual rental increase to the previous year and developed an expectation for the expense that would be recorded during 2023. Coincidentally, this approach resulted in figures that were closer to the actual expenses for the year.

Upon careful analysis, it becomes evident that the audit junior failed to account for certain factors, such as premises vacated due to branch closure throughout the year and premises acquired on a rental basis for newly opened branches. Analytically, it appears that rental expense for 2023 should have been decreased, considering that number of branches closed is higher than number of new branches opened. Therefore, keeping in view this rationale, the procedure developed by the audit junior falls short of providing sufficient reliability.

3 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Describe the nature of substantive procedures
- Explain the financial statement assertions
- Understand different methods of obtaining substantive evidence
- Understand when and why analytical procedures are used
- Use common ratios

SUBSTANTIVE PROCEDURES: NON-CURRENT ASSETS

IN THIS CHAPTER:

1. Tangible non-current assets
2. Intangible non-current assets
3. Chapter review

1 TANGIBLE NON-CURRENT ASSETS

1.1 Tangible non-current assets: the information subject to audit

- Before looking at substantive tests for tangible non-current assets, it is useful to remind yourself of the information about these assets that is presented in the financial statements.

The figures in the statement of financial position itself are supplemented by a note to the accounts, which may be presented as follows:

	Land and buildings	Plant, equipment, fixtures and fittings and motor vehicles	Total
	Rs.	Rs.	Rs.
Cost			
At 31 December Year 1	X	X	X
Additions	X	X	X
Acquisitions through business combinations	X	X	X
Disposals	(X)	(X)	(X)
At 31 December Year 2	X	X	X
Accumulated depreciation and impairment losses			
At 31 December Year 1	X	X	X
Depreciation charge for the year	X	X	X
Disposals	(X)	(X)	(X)
Impairment losses	X	X	X
Reversal of impairment losses	(X)	(X)	(X)
At 31 December Year 2	X	X	X
Net carrying amount			
At 31 December Year 1	X	X	X
At 31 December Year 2	X	X	X

When tangible non-current assets are included in the statement of financial position at a valuation, a note should disclose:

- the basis used to revalue the assets
- the date when the assets were revalued
- whether an independent valuer was involved in the revaluation, and
- the carrying amount of each class of assets that would have been reported if the assets had been reported using the cost method (and so if the assets had been valued at cost minus accumulated depreciation)
- the revaluation surplus, and any movements in this surplus during the financial period.

In addition, a note should disclose the basis used for the depreciation of each class of assets.

When assets are disposed of, the gain or loss on disposal is the difference between the proceeds from the disposal and the carrying amount of the asset at the date of disposal.

When non-current assets are a significant item in the statement of financial position of a company, the disclosures relating to them are therefore both extensive and of some significance in terms of obtaining audit evidence.

1.2 Principal risks of misstatement

The principal risks of tangible non-current asset balances in the financial statements being misstated relate to the following assertions:

- **Completeness assertion.** There is a risk that assets owned by the reporting entity have not been included in the financial statements.
- **Existence assertion.** There is a risk that assets reported in the financial statements do not actually exist (for example, they may have been sold or scrapped).
- **Accuracy, valuation and allocation assertion.** There is a risk that the assets have been incorrectly recorded in financial statements at inappropriate amounts and any resulting valuation or allocation adjustments have been inappropriately recorded and related disclosures have been inappropriately measured and described.
- **Rights and obligations assertion.** There is a risk that the reporting entity does not actually own assets that are included in the financial statements.
- **Classification assertion.** There is a risk that assets have been recorded in the improper accounts.
- **Presentation assertion.** There is also a risk that the assets have not been correctly presented and disclosed in the financial statements.

The auditor can use substantive testing to obtain evidence that the various assertions relating to tangible non-current assets are valid.

1.3 Substantive procedures for tangible non-current assets

The substantive procedures used by an auditor for tangible non-current assets will therefore be designed to obtain sufficient appropriate evidence about the above assertions. The tests will therefore be directed to:

- completeness (no understatement)
- existence (no overstatement)
- accuracy, valuation and allocation
- rights and obligations,
- classification, and
- presentation

Possible substantive procedures to obtain this evidence are listed below.

Completeness

- Obtain or prepare a schedule of tangible non-current assets, showing cost or valuation, depreciation and carrying amount.
- Reconcile this list with the corresponding opening balances (see the notes below on substantive tests for additions and disposals).
- Select a sample of assets that physically exist (and whose existence has been verified, possibly by means of inspection by the auditor) and trace these assets to the asset register.
- Obtain or prepare a reconciliation of ledger balances for tangible non-current assets with the asset register and investigate any differences.

Existence

- Select a sample of assets from the non-current asset register and physically inspect them. During the inspection, note whether the asset is in use and the condition that it is in. For an asset register held on an IT system, audit software could be used to assist in the selection of a sample.

Accuracy, Valuation and allocation

At cost

- **Land and buildings:** Confirm the figures for cost with the purchase contract for the asset and the invoices for associated costs (such as professional fees). Check that the purchase expenditure is analysed reasonably between land, buildings and equipment.
- **Equipment and vehicles:** Check the cost in the financial statements against the purchase invoices for the assets.
- Review the allocation of total expenditure on non-current assets between capital and revenue amounts.

At valuation

- Obtain the revaluation report
- Match the balance appearing in revaluation report with the Financial statement / GL
- Ensure that all the assets for similar class are revalued
- Evaluate the competence, capabilities and objectivity of management expert
- Obtain an understanding of the work of that expert
- Evaluate the adequacy of the expert work by ensuring that:
 - Finding and conclusion are relevant and reasonable
 - Assumptions are reasonable
 - Source of data is complete and accurate
 - Considering the need to use the auditor expert

Depreciation and impairment

- Review depreciation rates for reasonableness in the light of the nature of the asset, its estimated useful life and residual value.
- Ensure that consistent depreciation methods are in use.
- Review gains or losses on sale disposal (and the accumulated depreciation and impairment at the time of disposal).
- Check the depreciation calculations for accuracy, using the entity's stated policy. Again, in an IT system, audit software could be used to check these calculations.
- Ensure that fully-depreciated assets are not subject to further depreciation.
- Perform substantive analytical procedures to verify the total charge for depreciation (for example, by taking the ratio of depreciation to total asset value, and comparing this with the ratio in previous years).
- Obtaining an understanding of management process related to identifying, estimating and recording impairment for fixed assets to determine whether it is consistent with the requirement of IAS 36.
- Obtain management's calculation to write down fixed asset to their recoverable value and check that whether management methods and assumptions (discount rate, future cash flow etc. are reasonable
- Test the operating effectiveness of control over recording of impairment
- Recalculate the impairment working

Rights and obligations (ownership)

- **Land and buildings:** Verify legal title to the assets by inspecting appropriate documents (such as legal documents of ownership, or lease agreements).
- **Vehicles:** Examine vehicle registration documents or similar documentation giving evidence of title.
- **Other assets:** Examine invoices or other documents transferring title.
- Ensure that documents are in the name of the entity (the client company).
- Review legal documents, bank documents and other documents for evidence of any loans that are secured by charges on assets.

Classification

- Ensure that the non-current assets have been classified in the appropriate account.

Presentation

- Review the disclosures in the financial statements and ensure they are correct and clear.
- Ensure the schedule of tangible non-current assets agrees to the figures in the financial statements.

1.4 Substantive procedures – additions and disposals

In the interests of audit efficiency, auditors will pay particular attention to substantive testing of additions and disposals of tangible non-current assets. These transactions, together with the depreciation charge for the year, will normally account for most of the changes between the valuations in the opening and closing statements of financial position. Typical substantive procedures in these areas are listed below.

Additions

- Obtain/prepare a schedule of additions for the period.
- Check the authorisation of the expenditure to purchase these additions.
- Confirm that the total additions reconcile with the movement between the opening and closing balances in the note to the financial statements.
- Inspect a purchase invoice or other document as evidence of the cost of any addition, and confirm that these documents are in the company name.
- Verify the existence of the acquired non-current assets, by means of physical inspection where appropriate.
- Check that the entries in the accounting records are correct, confirming the allocation of total expenditure between capital and revenue expenditure.

Disposals

- Obtain/prepare a schedule of disposals for the period.
- Check the authorisation of the disposals.
- Verify that the cost and related accumulated depreciation have been removed from the accounting records.
- Verify the calculation of the figure for the gain or loss on disposal, and verify that this figure has been correctly recorded in the ledger.
- Discuss with management (including non-financial management) the possibility of unrecorded disposals of assets.

As always, the precise nature of substantive procedures performed by the auditor must reflect the circumstances involved. This is mirrored in the exam by the particular scenarios set. For example, an entity may construct its own non-current assets rather than buy them from an outside supplier. In this event, the substantive procedures will focus on confirming that internal costs (materials, labour, other direct expenses and overheads) have been properly accounted for as capital expenditure.

► *Example:*

During the year ended 30 June Year 6, Constructico acquired freehold land at a cost of Rs.50m and built a distribution centre on it, using a mixture of sub-contract and own labour. The distribution centre cost a total of Rs.20m to construct. The construction was completed by the end of April.

Required

Set out the audit objectives in respect of the above and the substantive procedures you would carry out to achieve those objectives.

► *Answer***The land and the distribution centre exist at 30 June Year 6**

- Visit site and confirm that the distribution centre has been built and is in use.

Constructico owns the land and the distribution centre at 30 June Year 6

- Inspect the land registry certificate or write to third party for confirmation (e.g. bank or solicitor).
- Inspect correspondence confirming that local planning permission was granted and ensure any conditions were met.

Expenditure capitalised in respect of the distribution centre is complete

- Discuss with management their policy for capitalising expenditure incurred in building the distribution centre.
- If a formal system is in place for the identification and capitalisation of construction expenses, test that system.
- Review a sample of invoices not capitalised during the period and ensure treatment was correct.

The land and the distribution centre are appropriately valued at cost

- Inspect completion statement for purchase of land.
- Obtain an analysis of costs of building the distribution centre. Inspect:
 - purchase invoices for a sample of raw material and sub-contract costs
 - time records for a sample of internal labour costs
 - evidence in respect of any overheads capitalised.
- Recalculate the depreciation charge for the year, taking into account that the distribution centre was not completed until the end of April.

The land and the distribution centre are appropriately presented and disclosed in the financial statements

- Review the disclosures in the financial statements and ensure they are correct and clear.
- Ensure the schedule of costs agrees to the figures in the financial statements.

► *Practice Question 01:*

Briefly state test of details for verifying the valuation assertion of tangible non-current assets where the company follows revaluation policy for valuation of such assets.

Tutorial Notes:

When verifying the valuation assertion of non-current assets under revaluation, ensure that:

The cost recorded in financial statements matches purchase invoices or contracts.

The allocation between land, buildings, and equipment is reasonable.

The valuer's report supports the financial statement figures.

Valuations are regularly updated and applied to all assets in the same class.

► *Solution 01:*

Test of details for verification of valuation assertion of tangible non-current assets:

- Check the cost in the financial statements against the purchase invoices/contracts for the assets.
- Check that the purchase expenditure is analysed reasonably between land, buildings and equipment.
- Review the allocation of total expenditure on non-current assets between capital and revenue amounts.
- Verify amounts in the financial statements with the valuer's report.
- Obtain an understanding of the work of the expert through considering the reasonableness of valuations / assumptions used in valuations.
- Evaluating the competence, capabilities and objectivity of the expert.
- Check that valuations are regularly updated.
- Check that all the assets of the similar class are revalued.

► *Practice Question 02:*

You are the audit senior on the audit of Ormara (Pvt.) Limited (OPL). During the planning phase of the audit, you have identified that OPL has adopted the revaluation model for buildings for the first time. The valuation was carried out by an independent well established external valuer.

Required:

Identify and assess the risks of material misstatement at assertion level and briefly state the key audit procedures to mitigate these risks.

(Procedures for assessing the competence and objectivity of the expert are not required)

Tutorial Notes:

When an entity adopts the revaluation model for the first time, key risks include:

Incorrect valuation and misstatement of revaluation surplus.

Inaccurate financial statement presentation of revalued amounts.

Audit procedures should include:

Verifying the revalued amounts with the valuer's report.

Ensuring depreciation is calculated on revalued amounts.

Checking completeness of disclosures in the financial statements.

► *Solution 02:*

Adoption of revaluation model for building indicates the risk of in-correct valuation and presentation of buildings and surplus on revaluation.

Audit procedures to mitigate the above risk are as follows:

- Verify amounts in the financial statements with the valuer's report.
- Consider the reasonableness of the valuation and the assumptions used for valuation.
- Check that the rise in value on revaluation have been appropriately recorded in the financial statements and depreciation has been calculated on the revalued amount(s).
- Consider involving auditor's own expert.
- Check that revaluation has been appropriately disclosed in the financial statements.
- Ensure that all class of buildings has been revalued.

► *Practice Question 03:*

You are the audit manager in a firm of chartered accountants. While reviewing the audit working papers of a client you came across the following audit program on property, plant and equipment:

S. No.	Audit procedures	Related assertion
(i)	Verify reconciliation of ledger balances with the fixed asset register.	Completeness
(ii)	Obtain schedule of fixed assets showing opening balances, additions, disposals, depreciation and closing balances.	Accuracy
(iii)	Verify the cost of additions to fixed assets and capital work in progress with the related invoices.	Accuracy
(iv)	Physically inspect the additions made during the year.	Existence & Ownership
(v)	On sample basis select assets and check the depreciation calculation.	Accuracy

Required:

Critically review the audit program and suggest changes or additional audit procedures as may be necessary. Assume that the assets are carried at cost, no disposal was made during the year and no impairment testing is required.

Tutorial Notes:

The audit program missed key procedures and required the following improvements:

- Accuracy assertion: In addition to verifying invoices, check the date the asset became available for use and classify expenditures correctly.
- Ownership assertion: Physical inspection alone is not enough - verify title documents and bank confirmations for charges on assets.
- Depreciation testing:
 - Perform analytical procedures on overall depreciation.
 - Ensure depreciation methods are consistent and that fully depreciated assets are excluded.
- Presentation assertion: Verify proper classification and disclosure of non-current assets.

► *Solution 03:*

- No comments.
- Obtaining the asset schedule showing opening balances, addition, disposal, depreciation and closing balance addresses the assertion of completeness only but not accuracy.
- Apart from verifying the cost of the asset through purchase invoices, the following steps would also be required:
 - Verify the date from which asset was available for use from purchase invoices or the completion certificate of capital work in progress, to ensure that depreciation is recorded from the correct date.
 - Check the allocation of total expenditure between capital and revenue expenditure in case of additions.
 - Check that purchases are duly authorised.
- Physical inspection of assets may not address the assertion of ownership.

Additional procedures

- For addressing the assertion of ownership, check the title documents of the assets especially the assets purchased on sample basis.
 - Check bank confirmation for any charge on assets, if any.
 - Check register of charges maintained by the client, if any.
 - Physically verify the existing assets from register to floor and vice versa.
- v. This step would not be enough. Following procedures would also be required.
- Perform analytical procedures on the overall depreciation.
 - Review the depreciation rates for reasonableness in the light of the nature of assets, its estimated useful life and residual value.
 - Ensure that consistent depreciation methods are in use.
 - Ensure that fully depreciated assets are not subject to depreciation.
 - Obtain approval for additions made during the year.

The audit program has no procedure related to presentation assertion. Auditor should review the disclosure in the financial statements and ensure that they are correct and clear.

Ensure that non-current assets have been classified in appropriate account.

2 INTANGIBLE NON-CURRENT ASSETS

2.1 Substantive procedures for intangible assets

The risks of misstatement and substantive procedures relating to intangible assets such as goodwill and brands should be similar to those set out above in respect of tangible assets. The emphasis of the substantive procedures will be on:

- existence and
- valuation.

Remember that the only intangible assets that can be recognised in the statement of financial position are:

- purchased goodwill
- intangibles having a readily ascertainable market value, and
- development costs, subject to the conditions set out in IAS 38.

There should therefore be adequate audit evidence available to enable a conclusion to be reached on these assets.

The main substantive procedures are listed below.

2.2 Tests of detail for purchased goodwill

The tests listed below relate mainly to the valuation of purchased goodwill:

Inspect the purchase agreement to check the:

- Amount of consideration
- Number of shares acquired
- Acquisition date
- Inspect the bank statement to ensure that amount has been transferred
- Inspect the CDC statement to ensure that shares exist and are in the name of the Company
- Obtain valuation report from the management and match the amount
- Evaluate the competency, capability and objectivity/independence of the Management expert

Evaluate the adequacy of the expert work:

- Relevance and reasonableness of the expert finding
- Relevance and reasonableness of the assumption and methodology used
- The relevance, completeness and accuracy of source data
- May consider to use the auditor expert
- Ensure that carrying amount and fair value of remaining asset are approximately same by inquiring with the management or engaging expert
- Ensure that fair value of NCI is calculated correctly and accurately by using appropriate rate
- Understand the management process for recording impairment of goodwill if any
- Test operating effectiveness of controls over recording of impairment
- Ensure that assumption used by the management are reasonable such as discount rate and future cash flow
- Perform subsequent event procedures such as inspection of subsequent interim Financial statement and compare the projected result with the actual result
- Obtain written representation from management that assumptions are reasonable

2.3 Tests of detail for other intangibles (excluding development costs)

The tests for other intangible assets, other than development costs, are similar to those that may be applied to tangible non-current assets.

- The auditor should confirm the existence, the cost and the client entity's legal rights to the acquired assets, by looking at the purchase documentation.
- Check the amortisation calculations for accuracy, using the entity's stated policy.
- Consider the possibility that the assets are suffering impairment. This matter may have to be discussed with the directors of the client company.
- Ensure that any impairment has been correctly dealt with in the ledger.

2.4 Tests of detail for development costs

Audit tests might include the following:

- discuss the development project with management, other relevant senior personnel and other key stakeholders to assess the feasibility of the project and product:
 - review projections and forecasts for using resources and generating future economic benefits.
 - assess production and marketing plans and whether a market (or use) actually exists.
 - consider funding requirements to completion.
 - whether the entity will actually be able to use or sell the asset.
 - discuss management's intention to complete the asset and either use or sell it.
- inspect development contracts and records supporting and safeguarding patents.
- test controls around the documentation and safekeeping of scientists notes, discoveries and conclusions.
- test a sample of development costs for appropriate capitalisation.
- obtain written representation from management as to their commitment to complete the project and either use or sell the asset(s).

► Practice Question 04:

Yameen is an audit junior in a firm of chartered accountants. He was recently assigned to an audit client, Tech Innovations Limited (TIL), a company specializing in software development and technology solutions. TIL has significant intangible assets, primarily consisting of internally developed software and acquired patents. Yameen performed the following audit procedures at the assertion level:

Assertion verified	Audit procedures performed
Completeness	• Traced the amounts specified in the list of intangible assets to the figures included in the trial balance. • Inspected software licenses and patents held by TIL.
Accuracy and valuation	• Checked the calculations in the amortization schedule provided by TIL. • Verified that the amortization rates applied to internally developed software and acquired patents are in line with TIL's accounting policy.
Rights and obligations	• Verified the recorded amounts in the ledgers by cross-referencing them with the intangible asset register. • Reviewed contractual agreements related to TIL's intangible assets.
Existence	• Obtained the intangible asset register and traced the recorded amounts to acquisition documents.

Assertion verified	Audit procedures performed
	Obtained management representation that all intangible assets are disclosed to the auditor and that TIL holds valid licenses for them.
Presentation and disclosure	- Confirmed that any revaluations or impairment losses are adequately disclosed in accordance with IAS 38 and IFRS. - Reviewed acquisition agreements to identify terms and conditions such as amortization periods, and legal rights.

Required: Identify and explain the procedures that may lack relevance to the above-mentioned assertions. Also, recommend any two additional procedures to be performed for each assertion.

► *Solution 04:*

Assertion	Irrelevant procedures	Additional procedures
Completeness	Conducted an inspection of software licenses and patents held by TIL. Explanation: Inspecting software licenses and patents is more relevant to the existence assertion rather than completeness. The completeness assertion ensures that all assets that should be recorded are indeed recorded. However, the inspection does not address whether all assets have been included in the list	Perform a reconciliation of the subsidiary ledger for intangible assets with the general ledger to ensure all items are accounted for. Compare the list of intangible assets with prior periods to ensure that no significant assets have been omitted or incorrectly excluded.
Accuracy and valuation	No procedure lacks relevance.	Test the mathematical accuracy of amortization calculations and re-perform the amortization schedule for selected assets. Assess the impairment indicators for intangible assets and, if necessary, perform an impairment test to ensure that the assets are not carried at amounts exceeding their recoverable amounts. Review the assumptions and methodologies used by management for valuing internally developed software and to ensure they are reasonable and in accordance with relevant accounting standards.
Rights and obligations	Checked the recorded amounts in the ledgers, cross-referencing them with the intangible asset register. Explanation: Checking the recorded amounts in the ledger and cross-referencing them with the intangible asset register primarily addresses the completeness assertion rather than the rights and obligations assertion.	Verify legal documentation to confirm ownership rights of the internally developed software and acquired patents. Check for any liens or restrictions on the intangible assets that might affect their valuation or usage. Confirm the existence of any licensing agreements or royalty arrangements that may affect TIL's rights to the intangible assets.
Existence	Obtained management representation that all intangible assets are disclosed to the auditor and TIL has valid licenses for them.	Physically inspect or verify through third-party confirmations the existence of significant intangible assets, such as software licenses and patents.

Assertion	Irrelevant procedures	Additional procedures
	Explanation: Management representation alone does not provide sufficient audit evidence for the existence of intangible assets. It should be corroborated with other substantive audit procedures.	Verify the existence of intangible assets by checking the documentation of acquisition or internal development records. Inspect the physical or electronic documentation related to the internally developed software projects, including development logs and project plans.
Presentation and disclosure	Reviewed acquisition agreements, identifying terms and conditions such as amortization periods and legal rights. Explanation: While reviewing acquisition agreements is important, it primarily addresses rights and obligations rather than presentation and disclosure.	Checked requirements of IFRS and Companies Act and corroborated with the disclosures made in the financial statements Verify that disclosures related to intangible assets are comprehensive and include details on the nature, useful lives, and amortization methods used. Check that the financial statements include disclosures about any significant estimates and judgments related to the valuation and amortization of intangible assets, as required by IAS 1.

3 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Explain the principle risks of misstatement for non-current assets
- Describe the key substantive procedures for auditing both tangible and intangible non-current assets

SUBSTANTIVE PROCEDURES: CURRENT ASSETS

IN THIS CHAPTER:

1. Introduction to substantive procedures for inventory
2. Valuation of inventory
3. Inventory quantity: the physical inventory count and ISA 501
4. Substantive procedures: trade receivables and prepayments
5. Substantive procedures: bank and cash balances
6. Chapter review

1 INTRODUCTION TO SUBSTANTIVE PROCEDURES FOR INVENTORY

1.1 The importance of closing inventory for audit testing

For many businesses (although service organisations are often an exception) inventory is one of the areas needing most attention from the auditor. The reasons for the importance of closing inventory for the auditor include the following:

- Inventory is often a material item in the financial statements.
- Inventory may be a high risk area, involving a high degree of judgement in areas such as valuation. For example, judgement may be needed to estimate the stage of completion of work in progress.
- Inventory may suffer from deterioration, loss or theft that may not be recognised in the client company's financial statements.
- Inventory may be highly technical in nature. Where inventory is complex, the auditor may need to consider whether to rely on the work of an expert.
- Establishing a closing inventory figure may be a lengthy and complex process for the client, with a high risk of error.
- Closing inventory is often not part of the double entry system, so directional testing (tests on other areas and other balances) may not reveal misstatements in inventory.

Audit work on inventory is often given to more experienced members of the audit team. The work will typically be subject to a process of rigorous review and quality management. In addition, analytical procedures are widely used to obtain evidence to supplement the detailed substantive testing on inventory in the audit.

1.2 Principal risks of misstatement

The principal risks of inventory being misstated are due to the following:

- Not all inventory that is owned by the reporting entity being included in the financial statements (the **completeness** assertion).
- Inventory in the financial statements not actually existing (the **existence** assertion).
- Inventory being recorded at inappropriate amounts (which could be due to incorrect recording of costs, or failing to value at net realisable value, if lower, or miscalculation or relevant overheads not being added in the cost) (the **accuracy, valuation and allocation** assertion).
- Inventory being included in the financial statements which actually belongs to third parties (the **rights and obligations** assertion).
- Inventory being incorrectly disclosed in the financial statements (the classification and **presentation** assertion).

1.3 Substantive procedures for inventory

The figure for inventory in the financial statements reflects:

- the **quantity** of inventory on hand at the end of the reporting period, and
- the **value** of each item of that inventory.

Substantive procedures for inventory will therefore focus largely on the **existence** and **valuation** assertions and these are covered in the following sections. However, by carrying out test counts in both directions (see section on the physical inventory count below) the **completeness** assertion will also be covered.

In order to satisfy the **rights and obligations** assertion the auditor will need to check, when he attends the year-end physical inventory count (see below), that inventory belonging to third parties is separated and not included in the count.

To satisfy the **classification and presentation** assertion the auditor will need to ensure that:

- the schedule of year-end inventory (on which he bases his substantive procedures below) agrees to the financial statements
- inventory is correctly presented and classified (e.g. between raw materials, work in progress and finished goods) in the financial statements.

2 VALUATION OF INVENTORY

2.1 IAS 2: Inventories

IAS 2 requires that inventory should be valued at the lower of cost or net realisable value, on an item-by-item basis:

- **Cost** includes the costs of purchase and all other costs incurred in bringing inventories to their present location and condition. In the case of work-in-progress and manufactured finished goods, this includes an amount for production overheads. (The absorption rate for production overheads should be based on normal levels of activity). Cost can be estimated by using a number of methods (such as first-in-first-out or average cost). The method chosen should provide a close approximation to the actual cost of the inventory.
- **Net realisable value** (NRV) is the estimated selling price of the inventory in the ordinary course of business, minus (1) any estimated costs to complete the items (and make them available for sale) and (2) the estimated costs of making the sale.

2.2 Substantive procedures

Substantive procedures on inventory should be designed to allow for the nature of the inventory and the nature of the situation that the auditor is facing.

- If the entity is a retailing organisation, the only major component of the cost of inventory is likely to be the purchase cost of the goods for resale.
- If the entity is involved in manufacturing or processing, the cost of inventory will include an amount for direct labour and production overhead, in addition to the cost of the raw materials and components.

Substantive procedures for the valuation of inventory items are suggested below. In the exam, which procedures are the most appropriate will depend on the particular scenario given.

Cost of raw materials or the cost of goods purchased for resale

For raw materials and goods held for resale, the cost of inventory will be the actual purchase cost of the items (plus any costs of delivery that the entity may have had to pay). The auditor should carry out the following tests for valuation:

- Confirm the approach adopted by the client company to estimate the cost of materials or goods used/sold (for example first-in-first-out, or weighted average cost).
- Check the figures for the cost of inventory by comparing them with prices in purchase invoices

Cost of manufactured goods and work in progress

For work-in-progress and items of finished (manufactured) goods, the auditor needs to check each of the elements in the cost: direct materials, direct labour and production overheads. He should therefore carry out the following tests:

- Obtain schedules showing the make-up of the cost figures for each item of work-in-progress and finished goods.
- Check the accuracy of the calculations.
- Materials
 - Perform the same substantive tests as for raw materials, shown above.
 - Check that the correct **quantity** of materials has been used in the valuation.
- Labour
 - Check pay rates for direct labour cost against payroll/personnel records for the employees who produced the work-in-progress or finished goods items.
 - Check the hours worked (and used to calculate labour costs in the inventory) with the time records for the employees concerned.

- Production overheads
 - Confirm that only production overheads (as opposed to selling and administration overheads) are included in the valuation.
 - Confirm that overhead absorption rates are based on **normal levels of output**.
- Work in progress: in addition to the above tests, the auditor may also need to check the stage of completion of the work in progress, in respect of both materials and conversion costs (labour and overheads).

2.3 Cost or net realisable value?

In his substantive testing of inventory, the auditor should also look at the procedures of the client entity for deciding whether each item of inventory should be valued at cost or at net realisable value (NRV). Considering that estimation of NRV will require judgement, the auditor should apply ISA 540(revised) Auditing accounting estimates and related disclosures (out of the scope of syllabus).

3 INVENTORY QUANTITY: THE PHYSICAL INVENTORY COUNT AND ISA 501

3.1 Physical inventory counts: purpose and responsibilities

Many organisations rely on a physical inventory count at the end of their financial year in order to arrive at a figure for inventory in their financial statements. Even if an entity maintains ‘sophisticated’ inventory records, with continuous accounting records for inventory, the accuracy of these records should be checked by means of regular physical counts of inventory.

There are several reasons for physical counts of inventory:

- Physical counts may be fairly easy to arrange, particularly where most items of inventory are held in a limited number of physical locations.
- Physical counts provide evidence of the actual existence of the inventory. This evidence is important to the client company (for preparing the financial statements) as well as for the auditor (for checking the reliability of those statements).
- Physical counts can be used by the entity to check the accuracy of its inventory records, where it maintains continuous inventory records.
- Where the entity does not have continuous inventory records, a physical count of inventory is probably the only way of establishing the quantity of inventory at the year-end.
- Discrepancies between the physical count of inventory and the entity’s inventory records may indicate weaknesses in physical controls over inventory, and losses due to theft or for losses from other causes.
- A physical count of inventory can also be used to check the physical condition of inventory, and whether there has been any deterioration in condition.

It is important to appreciate the relative responsibilities of management and auditors with respect to inventory counts.

- It is the responsibility of management to arrange for physical counts to be made and to establish appropriate procedures for counting, to ensure that a complete and accurate count is taken. (It is the responsibility of the company’s directors to ensure that the valuation of inventory in the financial statements is reliable.)
- It is the responsibility of the auditor to gather evidence from which he can reach a conclusion on the figure for inventory in the financial statements. Observation and other audit procedures performed by the auditor at the inventory count will provide some of this audit evidence.

The auditor’s attendance at the physical inventory count is covered by ISA 501 *Audit evidence – Additional considerations for specific items*. The **requirements** of ISA 501 in respect of inventory state that if inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding the **existence** and **condition** of inventory by **attendance at physical inventory counting** unless impracticable. The purpose of such attendance is given as being to:

- Evaluate management’s instructions and procedures for recording and controlling the results of the count.
- Observe the performance of management’s count procedures.
- Inspect the inventory.
- Perform tests counts.
- Perform audit procedures over the final inventory records to determine whether they accurately reflect the results of the count.

3.2 Audit work after the count: follow up

The final audit work on inventory may take place several weeks after the inventory count itself. In the intervening period the client should have calculated a final inventory figure for the financial statements.

One of the main objectives of the audit work on inventory quantity at this stage is to ensure that the inventory quantities that existed at the count date are properly reflected in the final inventory figure in the financial statements (the **completeness** and **classification & presentation** assertions). (Note: At this stage, the auditor should also carry out his checks on the valuation of inventory items, as described earlier.)

The audit work involved in verifying inventory **quantities** will include the following:

- Obtaining the final inventory sheets that were prepared by the client's staff during their inventory count.
- Check the numerical sequence of the sheets and the auditor's record of the last sheet number, to confirm that no sheets are missing.
- Check the numerical sequence of tag numbers listed on the sheets and the auditor's record of the final tag number, to confirm that no inventory items are missing from the sheets.
- Check the arithmetical accuracy of the calculations on the sheets.
- Confirm that inventory records have been amended as appropriate. For some inventory items, there is likely to be a difference between the physical count numbers and the quantity of stock shown in the client's inventory records (where a continuous recording system is used). In these situations, the client's inventory records will be incorrect. The auditor should therefore check that the inventory records were amended.
- Confirm that inventory belonging to the client, but held by third parties, is included on the inventory sheets.
- Confirm that inventory belonging to third parties, but on the client's premises at the date of the count, is not included on the inventory sheets.
- Check that cut-off is correct. This is done by reference to the cut-off information recorded at the time of the count.

Having done all this work, the auditor should be able to reach a final conclusion on the quantity of inventory held at the end of the reporting period.

► *Example:*

You are the senior in charge of the audit of inventory at Spares R Us. Inventory is comprised of large quantities of spare parts for the car industry. Spares R Us operates a perpetual inventory recording system, backed up by a rolling programme of physical counts throughout the year. There is no year-end physical inventory count and the amount for inventory in the year-end financial statements is based on the computer records.

Required

Briefly summarise the audit procedures that you would undertake to obtain evidence on the amount for inventory in the year-end financial statements.

► *Answer*

- Carry out spot checks during the year.
- Conduct sample counts at the year end, compare to perpetual records and investigate any differences.
- Review the results of the rolling counts and ensure any differences from book to actual are investigated and adjusted for.
- Check a sample of cost prices to purchase invoices.
- Assess obsolesce.
- Consider the use of audit software on the year-end inventory file.

3.3 Possible control weaknesses in an inventory count

Control weaknesses in the client's inventory counting procedures may be observed by the auditor. These might include:

- Failure to pre-number the count sheets. All count sheets should be pre-numbered, so that they can all be accounted for at the end of the count and none are 'lost' (and none are counted twice).
- Including on the count sheet for each inventory item the quantity of the inventory as recorded in the entity's inventory records. The counters should not be told what quantity of inventory to 'expect' for each item, because this may influence them to expect in advance how much inventory to 'look for'.
- Entering the quantities counted on the count sheets in pencil. Entries in pencil can be erased and altered later, fraudulently, without leaving trace of the alteration.
- Stores staff is commonly used to do the counting. However, if all the counters are from the stores staff, there is a risk that they may collaborate to hide errors or missing inventory. The client should therefore use some other non-stores staff to assist in the count, such as some employees from the accounts department.
- Inventory may not be marked when it is counted. This gives rise to a risk that items of inventory will be counted twice, and possibly that some items will not be counted at all.
- Count sheets may not be signed by the individual counter who prepared them. If there is no signature on the count sheet, it may be difficult to refer queries back to the counter if a problem arises.
- Lack of precise instructions to the counting team. The counting team must be given precise and specific instructions about how to perform the count. If the counting team is left to decide itself how the count should be conducted, this will increase the risk of mistakes in counting – such as missing out some items and double counting others.

► **Practice Question 01:**

Your audit team members have attended the physical inventory count of Sutlaj Limited. Their observations are as follows:

- i. Stock count was supervised by the warehouse in-charge who reports to the production manager.
- ii. In view of the various ongoing projects, temporary staff had to be hired to conduct the stock count.
- iii. Pre-numbered count sheets were used by the staff which contained columns for inventory ledger balances, physical balances and excess/shortages.
- iv. The staff was instructed to ensure that no item of inventory was counted twice and for this purpose they were asked to remain in constant contact with other staff.
- v. On completion, all the count sheets were signed by the store in-charge and the head of the administration department

Required:

Identify the weaknesses in the inventory count procedures and state the implications on the physical count.

Tutorial Notes:

When conducting inventory counts, ensure the independence of counters, clear counting instructions, and proper tagging of counted items. Weaknesses such as lack of segregation of duties, use of temporary staff, and reliance on expected inventory balances can lead to errors in physical counts. Avoid unnecessary discussions on third-party stocks and obsolete inventory unless specifically mentioned in the scenario.

► *Solution 01:*

Weakness	Implications
The warehouse in charge is supervising the inventory count procedure.	The warehouse in charge is himself responsible for the inventory, therefore he lacks independence
Temporary staff involved in the physical inventory count.	Temporary staff may not be aware of the nature of inventory, and may not have any interest in detecting or reporting discrepancies.
Lack of precise instructions to the counting team.	The staff has been instructed to remain in constant contact with each other to avoid double counting. This depicts lack of precise instructions and it increases the risks of mistakes in counting like missing out items or double counting.
Inventory is not tagged when it is counted	This gives rise to a risk that items of inventory will be counted twice, and possibility that some items may not be counted at all.
Count sheets not signed by staff carrying out the count.	In this case, it becomes difficult to identify the staff who has carried out the count, therefore any discrepancy found cannot be investigated properly.
Count sheets stated the quantity of items expected to be found in warehouse.	Count teams will focus on finding the number of items mentioned on the count sheets. This could more likely result in undercounting inventory.

► *Practice Question 02:*

You are the audit senior on the audit engagement of Farhan Foods Limited and assigned to attend the inventory count.

Required:

- State what matters you would consider while observing the inventory count.
- State the procedures to be performed during the final audit in relation to the cut-off assertions for sales and purchases.

Tutorial Notes:

During inventory count observation, verify whether procedures align with management's instructions, assess the condition of inventory, and confirm the identification of third-party stock. At cut-off testing, trace receiving and delivery documents to invoices and ledgers to ensure transactions are recorded in the correct period. Avoid irrelevant verification steps like ledger agreement and NRV checks, which are not part of cut-off procedures.

► *Solution 02:***a) During the count, the auditor should consider:**

- whether or not the count is being conducted in accordance with the written instructions of the client's management
- the condition of the inventory, in order to identify items where NRV might be below cost (and in particular, inventory that seems to have deteriorated in condition)
- whether or not inventory not owned by the client entity is properly identified and labelled (for example, inventory owned by customers but held on the entity's premises)
- whether or not, during the count, production of new inventory and the movement of inventory are controlled and properly documented, in accordance with management's instructions for the count
- At the end of the count, whether or not all inventory items have been counted and tagged accordingly.

b) Cut-off at final audit:

The audit team should take last few receiving and delivering notes on either side of the year-end and trace these to invoices and ledgers and inventory record to ensure that sales and purchases have been included in the correct periods and related receivables and payables are booked accordingly.

► *Practice Question 03:*

During the audit of Shahbaz Chemicals Limited (SCL) for the year ended 31 December 2016, the audit team had noticed that sales of SCL has declined due to various reasons and SCL is facing difficulties in selling the existing stock of inventory at current price levels.

Required:

Explain the steps which the auditor should perform to ensure that carrying value of inventories is based on lower of cost and net realisable value.

Tutorial Notes:

To verify that inventory valuation follows lower of cost or NRV, auditors should:

Review price reductions and sales trends to identify potential losses.

Analyse slow-moving stock records and customer returns.

Compare recent selling prices with book values for potential write-downs.

Avoid focusing solely on NRV calculation methods; instead, address specific indicators of valuation issues mentioned in the scenario.

► *Solution 03:*

Shahbaz Chemicals Limited

The following steps shall be performed by the audit team:

- Review and test the procedures in place for comparing NRV with cost for each item of inventory.
- Review the information gathered during the physical inventory count (e.g. deterioration of inventory) which may suggest that NRV may be lower than cost.
- Review the records relating to goods returned by customers or allowances granted to customers.
- Review inventory records and order books for evidence of slow-moving items and compare their expected NRV with cost.
- Select major items of inventory from the list of stock and compare NRV with cost.
- Review prices at which goods have been sold after the reporting period, for evidence that NRV is higher than cost.

► *Practice Question 04:*

Your firm is the auditor of Shahzad Limited (SL), a wholesaler of consumable products, for the year ended 30 June 2021. SL maintains up to date computerized inventory records. The following matters have been observed during the inventory count:

- i. The inventory count took place on 1 July 2021 under the supervision of the warehouse manager and his staff, who are responsible for maintaining the inventory. No movement of inventory took place on that day.
- ii. Four counting teams were formed. Each team comprised of two persons. The floor area was allocated by the teams among themselves.
- iii. Each team was instructed by the warehouse manager to remember which inventory had been counted.
- iv. Pre-numbered count sheets were provided to the staff involved in the inventory count.

To facilitate inventory count, inventory belonging to third parties and the inventory ledger balances were mentioned on the pre-numbered count sheets.

- v. All the cut-off documents were provided to the audit team on the very next day after the inventory count.

Required:

Identify any four weaknesses in the inventory count procedures and state their implications on the physical count.

Tutorial Notes:

Effective inventory count procedures require segregation of duties, marking of counted items, and independent counts rather than relying on pre-filled records. The absence of cut-off testing can lead to incorrect period-end stock valuation. Ensure third-party inventory is excluded from count totals to avoid misstatements.

► *Solution 04:*

Weakness	Implication
The warehouse manager is supervising the inventory count procedure.	Since there is a lack of segregation of duties, the Warehouse Manager may influence the inventory count process.
No system of marking on counted items.	This may lead to double counting or omission completely and possibility that some items may not be counted at all.
Perpetual inventory records and third party inventory records are available on count sheets.	The person responsible for counting may try to match the numbers provided instead of carrying out an independent count. The third party inventory may be made part of the inventory. Confirm that inventory belonging to third parties, but on the client's premises at the date of the count, is not included in the inventory.
Cut-off documents not obtained during the inventory count.	There is a possibility of recording back dated entries, therefore the cut-off documents should have been obtained on the date of the inventory count date.

► *Practice Question 05:*

Your firm is the auditor of Chemicals Limited (CL). Following matters have been observed while planning the inventory count for the year ending 30 September 2022:

- One of the chemicals having radioactive properties has been procured for a government agency. Considering its hazardous nature, it is stored in a special container which can only be opened in the presence of agency's officials. The container was last opened in the presence of agency's official on 30 June 2022.
- CL's plant has been running on maximum capacity. Therefore, in order to timely deliver an export order to Colombia, CL has decided to procure the chemicals from Malaysia and directly ship the chemicals from Malaysia to Colombia. The chemicals are currently lying at a warehouse in Malaysia and will be shipped to Colombia in the first week of October 2022.
- The production process cannot be stopped during the inventory count. Your team may not observe the inventory count which will be in process on 30 September 2022.

Required:

State the audit procedures to verify the inventory quantities in each of the above situations.

Tutorial Notes:

For inventory verification in complex scenarios:

Hazardous materials: Obtain reports from government agencies or involve an expert.

Goods stored abroad: Seek direct confirmations from third-party warehouses or conduct virtual counts if physical visits are impractical.

Work-in-progress: Use batch records to verify production stages.

Do not miss the importance of involving experts and performing alternative verification procedures for inaccessible inventory.

► *Solution 05:*

Inventory count procedures:

Chemical stored in container

- Obtain the report prepared by agency's officials and verify the quantities as at 30 June.
- Obtain the documentation and verify related to purchase and issuances from 1 July to 30 September and reconcile the movement of inventory from 30 June to 30 September.
- Ask the management to request the agency's official to be present at the inventory count on 30 September.
- Consider involving an expert to verify the quantities within the container.

Inventory held abroad

- Send direct confirmation to third party in Malaysia to confirm condition and quantity of raw materials held.
- Consider visiting to Malaysia for attending the stock count.
- Arrange another auditor to attend the physical count in Malaysia, if practicable.
- Inspect documentation regarding inventory held by third parties (e.g. warehouse receipts), order received from Columbia (e.g. purchase order received) and the subsequent shipment made to the customer.
- Consider performing observing the an online inventory count.

Work in process

- Check the stage of completion of the work in progress, in respect of both materials and conversion costs.
- Check the batch/production records and verify the finished goods subsequently produced and reconcile it with raw material issued.

► *Practice Question 06:*

Your firm is the statutory auditor of Naltar Dairy Limited (NDL) for the year ended 31 December 2022. NDL manufactures and sells various dairy products including ice-cream.

The audit team is currently planning to perform the test of controls in respect of the ice-cream division's inventory. Following information has been provided by the management:

- Upon receipt of inventory at the warehouse, a process is performed to ensure its accurate verification by counting, matching it with purchase orders, performing quality inspection, entering it into the inventory system and proper storing it in a designated area of the warehouse.
- On a weekly basis, the warehouse manager, Fahad Baqer, randomly selects a warehouse area for inventory counting. By rotating the designated areas, each area is counted at least once every quarter. This count is carried out in a manner that prevent the warehouse staff from knowing the expected quantity of items in each area. Furthermore, the inventory is also inspected for damages and expiry dates to ensure product quality.
- Fahad conducts a comparative analysis between the inventory count and quantity of items in the inventory system. If any differences arise, he delegates the same counting task to a separate team for rechecking. Once it is established that the count is correct, adjustments are recorded after the approval of Fahad himself and the finance manager.

NDL has provided the audit team with year-end inventory records, showing for each product: the date of the last purchase, date of the last sale, cost, selling price, quantity and year-end valuation.

Required:

List any five substantive tests that the audit team can perform on the above information.

Tutorial Notes:

For inventory valuation testing, verify:

- Aging of stock to identify obsolete items.
- Recent purchase and selling prices for cost-to-NRV comparisons.
- Post-year-end sales activity to check inventory realizability.
- Avoid generic inventory audit procedures and instead tailor tests to the data provided in the question..

► **Solution 06:**

List out all items over a pre-set amount (at least the materiality threshold) (for subsequent physical verification).

- For each item on the schedule, multiply the lower of cost and selling price quantity, and list any items where this figure does not agree with the year-end valuation.
- Compare prices to those on the current sales price master file.
- List any items where the date of the last purchase was more than, say, one month ago (as this may indicate that the product is obsolete/damaged/no longer in vogue and may need to be written down).
- List any items where the date of the last sale was more than, say, one month ago (as, again, this may indicate that the product is obsolete/no longer in vogue and may need to be written down).
- List any items which do not appear on the post year-end sales listing for the, say, first month of the year (again, may indicate that a provision is needed).
- Obtain the purchases made at 31 December 2022 and perform cut-off.

► **Practice Question 07:**

- a) The essential feature of analytical procedures in auditing is 'comparison'. Discuss any four types of comparisons, which could be made by the auditor.
- b) State any six audit procedures for verifying work in progress in inventory.

► **Solution 07:****Part (a)**

- i. Prior accounting periods: To establish patterns and trends, and to look for unusual fluctuations in amounts in the current financial year that seem inconsistent with what has happened previously.
- ii. Expected results: Actual results can be compared with budgeted results, forecasts, or with results that the auditor is expecting.
- iii. Industry average results: Comparable information may be obtained for other entities in the industry or individual entities in the same industry. Information may be obtainable for the industry as a whole from an industrial body or a financial information service. Information about individual companies in the same industry may be obtainable as published financial statements.
- iv. Comparable parts of the same entity: The auditor may be able to compare the results of different branches or divisions within the same entity, where there are similar branches or divisions within the entity.
- v. Comparison with Non-Financial Information: The auditor compares financial data with relevant non-financial data to assess consistency. For example, comparing the number of units sold (non-financial) with the revenue recognised (financial) to ensure the sales figures align with actual revenue.
- vi. Comparison within the Financial Statements: The auditor compares relationships within the financial statements, such as between related accounts. For instance, comparing the relationship between sales and accounts receivable, or between gross profit and sales, to ensure these relationships remain consistent over time. Significant changes in these relationships might indicate potential misstatements or changes in business operations that require further examination.

Part (b)

- i. Obtain schedules showing the make-up of the cost figures for each item of work-in-progress.
- ii. Check that the correct quantity of materials has been used in the valuation.
- iii. Check pay rates for direct labour costs against payroll/personnel records for the employees who produced the work-in-progress or finished goods items.
- iv. Check the hours worked (and used to calculate labour costs in the inventory) against the time records for the employees concerned.
- v. Confirm that only production overheads (as opposed to selling and administration overheads) are included in the valuation.
- vi. Confirm that overhead absorption rates are based on normal levels of output.
- vii. Check the stage of completion of the work in progress, in respect of both materials and conversion costs (labour and overheads).
- viii. Conduct a physical inspection of the work in progress to verify its existence and condition. This also includes reconciling physical counts with the recorded WIP amounts.
- ix. Examine production reports, job sheets, or work orders to ensure that the WIP is properly recorded and corresponds to the stage of completion.

4 SUBSTANTIVE PROCEDURES: TRADE RECEIVABLES AND PREPAYMENTS

4.1 Confirmation of receivables balances

The balance for trade receivables is usually a material amount in a company's statement of financial position. A significant amount of audit work on trade receivables is therefore likely to be needed to check the reliability of this amount.

The **principal risks of misstatement** of the trade receivables balance are due to:

- receivables being irrecoverable (the **valuation** assertion)
- receivables being contested by customers (the **existence** and **rights and obligations** assertions)
- cut-off between goods outwards and receivables recording being incorrect (the **cut-off** assertion – an **income statement** assertion that has a knock-on effect to the audit of trade receivables (see below)).

Because assets are typically tested for overstatement, the **completeness** assertion is less relevant.

An important audit technique for trade receivables is **direct confirmation of balances** with customers. This is sometimes known as '**circularisation**'.

Direct confirmation involves asking customers to provide written confirmation, direct to the auditors, of their account balance with the client entity. Written confirmation by customers can normally be taken as high-quality audit evidence because it is a strong source of written, external audit evidence.

However, the reliability of this evidence depends on two factors that are not entirely within the auditor's control:

- A large proportion of the customers who are asked to provide written confirmation should do so. Customers are not obliged to provide confirmation, and some time and effort may be required to get some customers to provide the information required.
- Some customers may provide written confirmation without properly checking the details.

As discussed above, the auditor will be concerned to check that the balance for trade receivables is not overstated. The confirmation process is therefore based on the company's own list of receivables ledger balances (customer account balances). This is the main accounting record used in this part of the audit.

A direct confirmation of receivables is intended to check the following assertions:

- **Existence** assertion. That the receivables do in fact exist, and there is no over-statement of receivables in the financial statements.
- **Rights and obligations** assertion. That the client entity has the legal right to the amounts receivable.
- **Accuracy, valuation and allocation** assertion. That the receivables are stated at their appropriate amount.

4.2 ISA 505: External confirmations

The confirmation process is covered by ISA 505 *External confirmations*. In line with the generalisations about the reliability of audit evidence in ISA 500, audit evidence in the form of external confirmations received directly by the auditor are likely to be **more reliable** than evidence generated within the client entity.

It is therefore likely that, where it is reasonable to expect customers to respond to requests for confirmation of their balance, direct confirmation of balances **will be a part of the substantive testing process** for trade receivables.

The requirements of ISA 505

The **auditor should maintain control over external confirmation requests**, including:

- deciding on the information to be confirmed/requested;
- selecting the “confirming party” (e.g. the financial director/controller at the entity contacted);
- designing the confirmation requests (including an instruction for responses to be sent **directly to the auditor**); and
- Follow up confirmation request

Although the letter to customers is sent out by the auditor, it must contain authorisation from the client’s management for the customer to provide the required information direct to the auditor. (An example of the form that this letter might take is shown later.)

Various requirements are set out in relation to the **results of the external confirmation procedures**:

- If there are doubts about the reliability of any response the auditor should obtain further evidence to resolve those doubts. Factors identified that may give rise doubt over the reliability of confirmation request such as:
 - Was received by the auditor indirectly
 - Appeared not to come from originally intended confirming party
 - Responses received electronically because proof of origin and authority of the respondent is difficult to establish.
- Obtain further audit evidence to resolve those doubts such as:
 - request management for direct confirmation
 - contacting the CP – when CP responds by electronic email
 - encryption and other information transmission technology
 - If received from third party – perform procedure such as – response is from proper source, respondent is authorized, integrity over transmission has not compromised
- If a response is determined not to be reliable, the auditor should consider the implications of this on risk assessment and other audit procedures.
- For any non-response, the auditor should perform alternative audit procedures (though for a non-response to a vital positive confirmation request (see below) the auditor will need to consider the implications for his audit report).
- The auditor should investigate all exceptions to determine whether they indicate misstatements. They could indicate fraud or a breakdown in internal control or might just be due to timing differences and therefore not indicative of misstatements.
- The auditor should evaluate the results as a whole to decide whether they provide relevant and reliable audit evidence or whether further evidence is needed.

Management's refusal to allow the auditor to send a confirmation request

If **management refuse to allow the auditor to send a confirmation request** the auditor should:

- inquire as to management's reasons for the refusal, and seek audit evidence as to the validity and reasonableness of those reasons;
- evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- perform alternative audit procedures designed to obtain relevant and reliable audit evidence. (Possible alternative audit procedures are considered in a later section).

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with ISA 260. The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with ISA 705 given such a limitation on scope (see chapter 15).

4.4 Positive or negative confirmation?

The confirmation will be either positive or negative. The auditor should decide which type of confirmation to obtain.

Positive confirmation

A **positive confirmation request** asks the customer to reply to the auditor **whether or not he agrees with the balance** on his account that is in the client company's accounting records (receivables ledger) as at the date selected for the confirmation. Positive confirmation can be obtained in either of two ways:

- **Method 1.** By providing the customer with details of the balance on his account, and asking him to indicate his agreement that this information is correct, or to indicate that it is wrong.
- **Method 2.** By asking the respondent to provide details of his balance at the selected date, but not providing any details of the balance in the client company's receivables ledger.

This should provide reliable audit evidence. However, there is a risk with Method 1 that a customer may reply to a confirmation request without checking that the information is correct. This risk can be reduced by using Method 2. However, with Method 2 there may be a lower response rate from customers, because they are being asked to do more work to provide the confirmation.

Negative confirmation

A **negative confirmation request** asks the customer to reply to the auditor **only where he disagrees** with the balance recorded by the company. If no reply is received, there is no explicit audit evidence in respect of the customer's balance. The absence of a reply could mean that the customer agrees with the balance, but is not required to provide written evidence. On the other hand, the absence of a reply could mean that the customer has not carried out any check of the balance at all.

The use of negative confirmation requests therefore provides audit evidence that is **less reliable** than evidence obtained with positive confirmation requests.

ISA 505 only permits the sole use of negative confirmation **where all of the following conditions are met:**

- The risk of material misstatement has been assessed as low and controls have been tested.
- The population is comprised of a large number of small account balances or transactions.
- A very low exception rate is expected.
- The auditor is not aware of circumstances which would case the respondent to ignore his request for confirmation.

► *Example: request for a confirmation of balance (positive confirmation)*

A sample letter to a customer asking for confirmation of the outstanding balance, using the positive confirmation method, is shown below.

Note that it appears to be written by the management of the client company. In practice, this provides authorisation for the customer to provide the required information direct to the auditor. As discussed above, the letter will also be sent out to customers by the auditor (to make sure that the letters are actually sent to the customers in the selected sample). Replies should go directly to the auditor.

A COMPANY

25 South Street

Any town

Customer's name and address

Date

Dear

In accordance with the request of our auditors, Arthur Dailey and Co we ask that you kindly confirm to them directly your indebtedness to us at (*insert date*) which, according to our records, amounted to Rs..... as shown by the enclosed statement.

If the above amount is in agreement with your records, please sign in the space provided below and return this letter **direct to our auditors** in the enclosed stamped addressed envelope.

If the amount is not in agreement with your records, please notify our auditors **directly** of the amount shown by your records, and if possible detail on the reverse of this letter full particulars of the difference.

Yours faithfully,

A COMPANY

Confirmation No

The amount shown above is/is not* in agreement with our records as at

Account No **Signature**

Date

Title or position

* the position according to our records is attached

4.5 Sample selection and performing the confirmation exercise

The auditor will normally select a sample of customers who will be asked to provide a confirmation of the balance on their account with the client company. The audit procedures for selecting the sample and for the confirmation process are as follows:

- Obtain or prepare an aged listing of receivables ledger balances at the chosen date.
- If the list is prepared by the client, check the completeness and accuracy of the list of balances and the total of the balances in the list. This can be done by checking the list against (1) the total balance for trade receivables in the receivables control account in the main ledger and (2) a sample of customers' account balances in the receivables ledger.

- A suitable sampling method should be chosen. As with all sampling, the sample selection process should as far as possible ensure that the sample is representative of the 'population' of receivables.
- If the 'population' of receivables ledger balances is not homogeneous, stratified sampling might be used. (Stratified sampling was explained in an earlier chapter.)
- In selecting the sample, certain types of account should be considered for inclusion:
 - Overdue accounts
 - Credit balances or 'negative balances' (accounts where the client entity owes money to its customer, having issued credit notes to the customer)
 - Accounts on which round sum payments are received (for example, where the customer makes payments of Rs.5,000, or Rs.10,000 or Rs.30,000, instead of paying specific invoices)
 - Nil balances. (A check on nil balances provides a check on the completeness of trade receivables.)
 - Any individual balances that are considered 'material'.

In an IT system, with many year-end receivables balances audit software can be used to help select the main sample (for by selecting every 500th Rupee for sampling or selecting all balances over a certain amount, as well as nil and credit balances).

- Having selected items for circularisation, details should be extracted from the receivables ledger, and letters to the customer should be prepared.
- In the case of an external audit, the confirmation requests are issued **by the auditor**, not by the client, and replies are sent directly to the auditor. However, the request will need to contain **management's authorisation** to the customer to disclose the necessary information. Should the client refuse to give permission for a confirmation letter to be sent to a particular customer, the auditor should look for a reason for the refusal. As that customer has been included in the sample selection, the auditor will need to carry out alternative audit work (see below) to verify that customer balance.
- The letters should be sent out by post.
- With positive confirmation requests, if the auditor does not receive a reply from a customer within a reasonable period of time, follow-up procedures should be initiated. For example, second request and third request letters could be sent, or the client could be asked to contact the customer and ask for a reply.

4.6 Audit procedures following the receipt of replies (with positive confirmation requests)

On receipt of the replies from customers, the auditor should check that the letters are signed by a responsible official. The replies are filed in the receivables section of the current audit file. The current audit file should classify the customers in the sample as follows:

- **Balance agreed.** The customer has replied and agrees with the balance in the client entity's accounting records (or has provided a balance that corresponds with the entity's accounting records – depending on whether Method 1 or Method 2 of positive confirmation is used). No further audit work is required.
- **Balance not agreed.** The customer has replied but does not agree with the balance in the client entity's accounting records. The auditor should ask the client to review the replies and try to reconcile the balance in their records with the balance confirmed by the customer. The auditor should then check the reconciliation, looking for evidence of errors in the client company's figures which may represent misstatements of their accounts receivable balances. However, many of the reconciling items will often be '**timing differences**' – invoices, credit notes or cash may be recorded in the accounts of one party (the customer or the client entity), but not yet recorded by the other. Provided that the auditor is confident that the difference in the balances is due to timing differences, they should not be seen as evidence of errors in receivables balances.

- **No reply received.** No reply has been received from the customer. The auditor cannot ignore these customer accounts. They have been chosen as part of a representative sample and the auditor needs to reach a conclusion on the accuracy of the balances on **all** the accounts included in the sample for the confirmation process.

Further checking where no reply is received

Where no reply has been received, the auditor should therefore perform **alternative procedures** in order to obtain evidence to confirm the customer's balance.

- If the customer has subsequently paid all of the amount due at the confirmation date, this is strong evidence of the validity of the receivable.
- If no payment (or only part-payment) has been received, all the relevant documentation supporting the amount still due should be examined. For each invoice outstanding at the confirmation date, the auditor should examine:
 - a signed customer purchase order
 - signed delivery documentation (the customer's signature on the delivery note)
 - a sales invoice addressed to the customer.

4.7 Preparing a summary and reaching a conclusion

On completion of the confirmation exercise, the auditor should produce a **summary** of the responses. This should clearly indicate the amounts of the balances subject to confirmation for which the auditor has not been able to establish supporting evidence. These amounts indicate misstatement of receivables balances. In particular, they may indicate the existence of irrecoverable receivables.

As always with a sampling exercise, the auditor should draw a **conclusion** on the likely level of misstatement in the total population of receivables balances based on the result of the sample, and whether this is material.

Such a summary might be prepared as follows:

	Value of balances	% of total
	Rs.	
Replies received and agreed	465,600	80.3
Replies received and reconciled	56,400	9.7
Non-replies agreed using alternative procedures	43,200	7.5
Balances still unresolved	14,300	2.5
	579,500	100

Total value of receivables = Rs.1,248,900.

Extrapolation of potential error = Rs.1,248,900 × 2.5% = Rs.31,222 – Transferred to the cumulative errors schedule

Note: The cumulative errors schedule is a list of items where the auditor's view of the amount of the item differs from the amount in the client company's accounting records/draft financial statements. The auditor builds up this schedule as the audit progresses, and will use it when reaching his final audit opinion.

4.8 Other audit procedures for receivables

In addition to the confirmation process, the auditor should consider the following additional audit procedures in respect of trade receivables:

Irrecoverable receivables

The auditor needs to be satisfied that the amount of irrecoverable receivables written off and any allowance made for receivables are reliable. These will affect the amount included in the statement of financial position for trade receivables. The following substantive procedures should therefore be performed:

- Review the company's procedures for identifying irrecoverable and doubtful receivables.
- Review aged listings of receivables balances ('aged receivables lists'). Irrecoverable receivables and allowances for doubtful receivables should only relate to overdue accounts. The auditor should enquire as to whether the overdue receivables are collectable.
- Review any correspondence of the client company with customers, lawyers and collection agencies that deal with unpaid or disputed debts.
- Review the assumption used for calculation of any allowances against doubtful receivables.
- Check the subsequent clearance.

Classification and Presentation

To satisfy the **classification and presentation** assertion the auditor will need to ensure that:

- the list of receivables ledger balances (on which he bases his substantive procedures below) agrees to the financial statements.
- receivables are correctly classified and presented in the financial statements.

► Example:

The following is a summary of the year-end receivables balances at Mike's Manufacturing and the equivalent figures for the previous year. Performance materiality has been set at Rs.50,000.

Customer	20X5	20X4
	Rs.	Rs.
Jones	25,000	24,000
Smith	60,000	30,000
Brown	20,000	20,000
White	10,000	11,000
Crane	205,000	189,000
Other customers (all balances under Rs.10,000)	166,000	74,000
	486,000	348,000

Brown went into liquidation during the year.

Required

Set out which of the above balances, as a minimum, the auditor should select for testing and explain why.

► *Answer*

- Smith should be selected as this balance is above performance materiality. Also, the balance has doubled since the previous year.
- Brown should probably be selected. Although it is below performance materiality it would seem likely that the receivable is irrecoverable.
- Crane should be selected as individually material.
- Although the “other customers” balances all fall well within the performance materiality threshold, they are material in total, and so a sample of these should be verified. This would particularly be the case if the auditor was not expecting sales to smaller customers to have increased during the year. There could be a deliberate attempt to overstate a number of small balances (or invent fictitious customers and balances) in a deliberate attempt to boost assets and avoid audit detection.

► *Practice Question 08:*

State the conditions under which it may be appropriate to send negative confirmations.

► *Solution 08:***Conditions required to be met for sending external confirmations:**

It may be appropriate to send negative confirmation request if all of the following conditions are met:

- The risk of material misstatement is low and controls have been tested.
- The population comprises of large number of small account balances or transactions.
- A very low exception rate is expected.
- There is no specific reason which would cause the respondent to ignore the confirmation request.

► *Practice Question 09:*

The audit of Sehat Pharmaceuticals Limited (SPL) is in progress. Based on the previous experience with the client and the initial tests of control, the auditor has assessed a low risk of material misstatement in the area of debtors.

The debtors circularization summary depicts the following information:

Customers segment	No. of customers	Balance	Confirmations	Amount covered	Nature	Conf received
		Rs. In 000				
Distributors	12	75,200	8	70,500	Positive	7
Wholesalers	105	52,500	30	12,500	Positive	28
Hospitals & clinics	250	31,200	75	20,300	Negative	4
Retailers	130	12,500	50	7,000	Negative	12

Analysis of confirmations received is as follows:

- 3 out of 7 confirmations received from distributors did not agree with the amount outstanding in SPL's ledger.
- One of the distributors, Saleem Distributors (Private) Limited (SDPL) has gone into winding up. The balance receivable from SDPL is outstanding since last one year.
- Replies received from the hospitals did not agree with the balance outstanding in SPL's records. However, the differences were reconciled by the audit staff.
- All the 12 confirmations received from the retailers showed disagreement with the records of SPL. However, only 2 could be reconciled.

Required:

- a) Evaluate the decision regarding sending of negative confirmations.
- b) Determine the course of action the auditor should consider in case of balances agreed, balances not agreed and replies not received.
- c) State the procedures that need to be performed in case of amount due from SDPL.

Tutorial Notes:

Hospitals & Clinics: Negative confirmation was appropriate due to small balances and low exception rates.

Retailers: High exception rates indicate potential material misstatements, requiring additional verification.

If confirmation replies do not match, auditors must review reconciliations and investigate discrepancies.

Do not fail to differentiate between valid reconciling differences and actual misstatements.

► **Solution 09:**

a)

i. Hospitals and clinics:

The decision to send negative confirmation was appropriate as all the conditions for sending negative confirmation i.e. Large number of small account balances, low risk of material misstatement, low exception rate as only four customers have disagreed with the balances due and that have been also reconciled and there was no knowledge of circumstances that would cause recipient to disregard the confirmation request.

ii. Retailers:

Results of confirmations depict high risk of material misstatement and high exception rate. However, since the decision to send negative confirmation was taken on the basis of initial assessment, the decision under the circumstances seems correct.

b)

Balance agreed:

No further audit work is required.

Balance not agreed:

- The client should be asked to review the replies and reconcile the balances in its records with the balances confirmed by the customer.
- The reconciliation prepared by the client should be checked.
 - The reconciling items depicting errors in the client's records should be investigated and corrected.
 - The client should be asked to resolve the difference in case the reconciling items depicting errors on part of the customers.

No reply received:

In these cases, alternative procedures should be performed (e.g. subsequent payments and checking of invoices/ dispatch notes in order to obtain evidence to confirm the customer's balances.

- c) From the winding up event it appears that the amount receivable from SDPL is irrecoverable. Therefore, the auditor needs to ensure that the amount of irrecoverable receivables are written off or is duly provided for.

The following substantive procedures should also be performed:

- Review any correspondence of the SPL with the liquidator/management of SDPL (if any), relating to recovery of the amount due.
- Review the calculation of amount of provision/write off and basis thereof.

► *Practice Question 10:*

State the conditions under which an auditor may send negative confirmations (4 marks)

► *Solution 10:*

A negative confirmation can be used, where any of the following condition is met:

- The risk of material misstatement has been assessed as low and controls have been tested.
- The population is comprised of large number of small account balances.
- A very low exception rate is expected.
- The auditor is not aware of the circumstances which would cause the respondent to ignore the request for confirmation.

► *Practice Question 11:*

You are the Audit In-charge of Rehan Limited for the year ended 31 December 2015. While reviewing the working papers and discussion with audit team, you have noted the following:

- i. The audit team did not send balance confirmation requests for amounts below Rs. 100,000 because according to the client, lots of efforts were required to follow up the customers and the balances were also not material.
- ii. One of the conclusions drawn as per the working papers is “there are no unrecorded liabilities, as confirmations have been received from all selected parties and no differences were noted. Hence, no further test is required.”

Required:

- a) Discuss with reasons whether you agree with approach adopted/conclusion drawn by audit team.
- b) Provide brief guidance to the audit team in respect of each of the above situations.

Tutorial Notes:

Refusing to send confirmations for balances below Rs. 100,000 is incorrect unless the total is immaterial.

Confirmations only verify recorded amounts; they do not detect unrecorded liabilities, requiring additional audit procedures.

Do not frequently agree with incorrect audit approaches without questioning their validity.

► *Solution 11:*

a)

- i. The approach of not sending confirmation requests to balances below Rs. 100,000 is not correct unless the total of such balances is clearly immaterial.
- ii. The conclusion documented by the team is not correct as the confirmation received from creditors only confirms the recorded amount and is not relevant for the purpose of testing of unrecorded liabilities.

b)

- i. The audit team is required to discuss the matter with client's management and ask them to send confirmation as per the normal sampling procedure of the audit firm.
In case the management does not agree, the audit team should evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures;
- ii. Following information should be tested by the audit team to draw conclusion related to unrecorded liabilities:
 - subsequent disbursements
 - unmatched receiving reports (Inventory Cutoff)

► *Practice Question 12:*

Discuss the auditor's course of action if management refuses to allow auditor to send confirmation request. (Impact on audit report is not required)

Tutorial Notes:

If management refuses to allow confirmation requests, the auditor should:

Investigate reasons for refusal and assess risk implications.

Apply alternative procedures like subsequent receipts testing.

Report concerns to those charged with governance if the refusal is unreasonable.

► *Solution 12:*

If management refuse to allow the auditor to send a confirmation request the auditor should:

- inquire as to management's reasons for the refusal, and seek audit evidence as to the validity and reasonableness of those reasons;
- evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

The auditor shall communicate with those charged with governance if:

- the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable; or
- the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures,

► *Practice Question 13:*

You are currently in the planning phase of the audit of Fresh Dairies Limited (FDL) for the year ended 31 December 2016. The information available to you in respect of the company's debtors includes the following:

Customer category	Number of customers	Balance outstanding (Rs. in '000)	Percentage of customers who confirmed the balance last year
Distributors	20	30,500	90%
Wholesalers	2,250	12,750	70%
Restaurants	12	20,400	83%
Individual customers	5,700	9,800	20%
		73,450	

FDL is a low risk client and therefore you are assessing whether to send negative confirmation requests.

Required:

In respect of each of the above categories of customers, discuss the appropriateness of sending negative confirmation requests.

Tutorial Notes:

All conditions for negative confirmations must be met before they are used. Simply having low misstatement risk and small balances is insufficient. Do not failed to recognise that all four conditions must be present simultaneously.

► *Solution 13:*

For sending negative confirmation, all of the following conditions are required to be met:

- i. The risk of material misstatement has been assessed as low and controls have been tested.
- ii. The population is comprised of large number of small account balances or transaction.
- iii. A very low exception rate is expected.
- iv. The auditor is not aware of circumstances which would cause the respondent to ignore his request for confirmation.

Based on the above, my comment on appropriateness of sending confirmation requests for each category of customers are as follows:

Customer category	Comments
Distributors	The condition of large number of small account balances is missing, therefore positive confirmation will be sent.
Wholesalers	All the conditions of sending negative confirmation exists, therefore negative confirmation can be used.
Restaurants	The condition of large number of small account balances is missing, therefore positive confirmation will be sent.
Individual customers	It is evident from past experience that confirmation request is usually ignored, therefore positive confirmation will be used.

► *Practice Question 14:*

You are the audit manager in a firm of chartered accountants. Following is the extract of the email received from the job-in-charge responsible for the audit of your client Concordia Limited (CL) for the year ending 31 March 2018:

"I am considering to circulate negative confirmations on 1 April 2018 for debtor balances outstanding as on 31 March 2018 as firstly, the reporting deadlines at CL are very stringent, secondly, the population comprises of a large number of small balances and thirdly, risk of material misstatement has been assessed as low.

I have also been offered by CL's CFO that one of their staff would get all the confirmations signed from the debtors and deliver them to our firm's office. This could help us in meeting the reporting deadline."

Required:

Comment on the suggestions of the job-in-charge. Assuming that the suggestion by job in charge is not considered appropriate, suggest an alternative approach keeping in view the time limitations.

Tutorial Notes:

Distributors and Restaurants: Large balances require positive confirmations.

Wholesalers: Small balances with low misstatement risk can use negative confirmations.

Individual customers: Past response history suggests negative confirmations would be ignored, making them inappropriate.

Do not incorrectly assume negative confirmations could be used solely based on low risk and small balances, ignoring exception rates and likelihood of response.

► *Solution 14:*

We cannot choose to circulate negative confirmation merely on the fact that risk of material misstatement has been assessed as low and majority of the balances comprise of large number of small balances. Before using the negative confirmation as the substantive procedures, we also need to ascertain that:

- exception rate is expected to be low; and
- there is no apparent reason to suspect that the customers would disregard the confirmation request.

Furthermore, we cannot consider the offer of CFO because we should maintain control over external confirmation requests which include sending the requests ourselves with an instruction for responses to be sent directly to us.

Ideally, confirmation of balances should take place after the reporting period, and should be based on customers' account balances as at the reporting period. However, to reduce the time pressure at the final audit stage, the confirmation process can also be based on balances at an interim date before the end of the financial year (normally no more than three months before the end of the reporting period). However, while doing so, we should consider the fact that we will need to check the changes in the debtor balances between the confirmation date and the end of the reporting period.

► *Practice Question 15:*

Briefly discuss the steps an auditor would need to take if management refuses to allow him to send confirmation request to a debtor.

Tutorial Notes:

If management refuses confirmation requests, auditors must:

Investigate the reasons for refusal.

Evaluate the risk of fraud or misstatement.

Use alternative procedures (e.g., subsequent payments, invoice testing).

Communicate concerns to governance if refusal is unreasonable.

► *Solution 15:*

If management refuse to allow the auditor to send a confirmation request the auditor should:

- inquire about the reasons for refusal and seek audit evidence as to the validity and reasonableness;
- evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
- perform alternative audit procedures such as, subsequent receipts and inspection of documents, designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance

Failure to obtain sufficient appropriate audit evidence indicates scope limitation and the auditor shall assess the implications of such limitation on the auditor's opinion.

► **Practice Question 16:**

You are the audit manager in a firm of chartered accountants. During the audit of a client for the year ended 31 December 2018, the audit team has prepared the following schedule to summarize the responses from the debtors:

S. No.	Debtor	Debtor account balance	Balance confirmed by the debtor	Management explanation
(i)	AB	Rs. 500,000	Rs. 500,000	No explanation.
(ii)	CD	Rs. 800,000	Rs. 700,000	Consignment of Rs. 100,000 was shipped on 31 December 2018 and received by customer on 01 January 2019.
(iii)	KL	Rs. 600,000	Rs. 250,000	Consignment of Rs. 600,000 was shipped on 27 December 2018 but goods amounting to Rs. 350,000 were returned due to quality issues, subsequent to year end.
(iv)	YZ	Rs. 400,000	No reply received	No explanation.

Required:

Describe the steps (if any) which the audit team may perform in respect of each of the above debtors.

Tutorial Notes:

For unconfirmed debtor balances:

Verify supporting documents (e.g., invoices, delivery notes).

Investigate timing differences in shipments.

Assess post-year-end collections for recoverability.

Do not spent too much time explaining differences instead of suggesting audit steps to resolve them.

► **Solution 16:**

a)

- i. No further audit work is required.
- ii. This is a timing difference. We need to obtain goods delivery note and customer acknowledgement to ascertain the date of delivery and date of acceptance of goods.
- iii. This is an adjusting event. We should perform the following steps:
 - Check the return of goods with the relevant goods receipt document.
 - Ask the client to reduce the sales and receivables and incorporate corresponding effects in cost of sales and inventory.
- iv. Follow-up procedures should be initiated. For example, second request and third request letters could be sent, or the client could be asked to contact the customer for a reply.

Subsequent receipt of the amount should be checked.

If no payment (or only part-payment) has been received, the outstanding sales invoices should be checked with:

- Purchase order issued by the customer.
- Delivery note duly acknowledged by the customer.

► *Practice Question 17:*

You are the job-in-charge on the audit of Ostrich Limited (OL), a food processing company, for the year ended 30 June 2019. For sending debtor balance confirmations, OL has provided you the following schedule for the year ended 30 June 2019:

Debtors	No. of customers	Balance as at 30 June 2019 Rs. in '000
Chain Stores		
Store – A	1	5,150
Store – B	1	3,398
Store – C	1	4,236
Supermarkets	30	7,104
Restaurants	500	6,364
Credit balances	3	(1,000)
Total		25,252

There are no overdue and nil balances as on 30 June 2019. The risk of material misstatement has been assessed as low and controls have been tested.

Required:

Discuss the audit strategy that you would follow for selecting the debtors for balance confirmation.

Tutorial Notes:

Chain Stores: Confirm all due to large balances.

Supermarkets and Restaurants: Use stratified sampling.

Credit balances: Should be separately selected for confirmations.

Do not ignore the need for stratification and selecting confirmations based on relative balances.

► *Solution 17:*

We will have to check the completeness and accuracy of the list prepared by the client.

Stratified sampling could be used for selecting customer balances for circularizing the confirmation.

If the chain stores are selected, 51% (or 49% in absolute terms) of the population can be covered without excessive time and cost being involved. Therefore, all the three chain stores could be selected for confirmation.

Debtors from superstores and restaurants should be chosen on the basis of any appropriate sample selection method adopted by the team.

Since balances of chain stores and super stores consist of large balances, positive confirmation should be circulated.

Since the population of restaurant comprises of large number of small account balances, the risk of material misstatement has been assessed as low and control have been tested, negative confirmation can be used if the following two conditions are also met:

- A very low exception rate is expected; and
- The auditor is not aware of circumstances which would cause the respondent to ignore the request for confirmation.
- Credit account balances should also be separately selected for circulating the confirmation.

► *Practice Question 18:*

You are the audit manager in a firm of chartered accountants. During the audit of a client for the year ended 31 December 2019, the audit team has prepared the following schedule to summarize the responses from three debtors:

Debtor	Balance at year-end	Balance confirmed by the debtor	Comment
A	Rs. 500,000	Rs. 500,000	Confirmation was received through client.
B	Rs. 800,000	Rs. 800,000	Confirmation was received after many follow-ups with the client. However, the audit team have come to know that the confirming party had not received the confirmation request.
C	Rs. 500,000	Rs. 150,000	Consignment of Rs. 500,000 was shipped on 27 December 2019 but goods of Rs. 350,000 were returned subsequent to year-end.

Evaluate the evidence obtained and describe the steps (if any) which the audit team may perform in respect of the above debtors.

Tutorial Notes:

- Debtor A: Confirmation received via client, requiring direct verification.
- Debtor B: Confirmation received after delays, indicating possible fraud risk.
- Debtor C: Sales returns require adjusting entries and fraud risk assessment.
- Do not fail to recognise the risk of manipulation when confirmations are not received directly by the auditor.

► *Solution 18:***Debtor A****Evaluation**

Even though the balance confirmed is the same, it raises doubt for the reliability of the response because the confirmation was not received directly from the confirming party.

Steps to perform

- Auditor should modify or add procedures to resolve doubts over the reliability of information to be used as audit evidence.
- Auditor should contact the confirming party and request them to respond directly to the auditor.

Debtor B**Evaluation**

It appears that the confirmation did not come from the originally intended confirming party. It carries risk of interception, alteration or fraud.

Steps to perform

- Auditor should resend the confirmation again to the debtor.
- Auditor should revise the risk of material misstatement at the assertion level and modify planned audit procedures accordingly.
- If it is ascertained that fraud exist, it is important that the matter is brought to the appropriate level of management and those charged with governance.
- If the auditor has doubts about the integrity of the management or those charged with governance, than the auditor should consider to obtain legal advice for appropriate course of action.

Debtor C

Evaluation

Sales return subsequent to the year-end can be an adjusting event which needs to be adjusted in the financial statements.

Steps to perform

- Check the return of goods with the relevant goods receipt document.
- Inquire from the management the reasons for the return of good and assess whether it is an adjusting event.
- If it is established that it is an adjusting event than ask the client to reduce the sales and receivables and incorporate corresponding effects in cost of sales and inventory.
- Consider the fraud risk that whether the sales were made for overstating the sales for the year end.

Additional steps (overall)

Since there are doubts over the reliability of the confirmation response, the auditor should also perform the following alternate audit procedures to gather audit evidence:

- Subsequent receipt of the amount should be checked.
- If no payment has been received, the outstanding sales invoices should be checked with purchase order issued by the customer and delivery note duly acknowledged by the customer.

► Practice Question 19:

You are the audit manager responsible for the audit of NKL Limited for the year ended 28 February 2021. The audit team has prepared the following summary of debtors' balances for your review:

Summary of debtors' balances and their confirmed amounts as at 31 January 2021

Assertions verified: Completeness, Cut-off and Rights and Obligations

S. No.	Debtor(s)	Balances (Rs.)		Comments
		as per books	confirmed by debtor(s)	
(i)	Alpha	800,000	800,000	-
(ii)	Beta	900,000	900,000	Confirmation was returned by the courier on the grounds of invalid address. Confirmation was resent by the client through its rider. The reply was received directly by the auditor.
(iii)	Gamma	700,000	No reply received	Gamma has gone into liquidation.
(iv)	Small distributors	600,000	Not applicable	These represent various small distributors whose balances were below Rs. 30,000. Due to immaterial balances, they weren't selected for sending confirmation.

Required:

Assess the appropriateness of the work performed by the audit team. Also suggest the additional procedures (if any) which the audit team may perform.

Tutorial Notes:

- Verify changes in receivable balances between the confirmation date and year-end.
- Focus on existence, accuracy, and valuation assertions rather than completeness.

► *Solution 19:***Interim balances:**

Since the interim balances were used for sending confirmation, the auditor will need to check the changes in the receivable balances between the confirmation date and the end of reporting period. This check will consist mainly of checking entries in the receivable control account with the transactions entered in the book of prime entry during the same period.

Assertions addressed:

Cut-off, rights and obligation assertion has been correctly identified the audit team.

However, the receivable balances are generally tested for overstatement, the completeness assertion is therefore less relevant. Assertion related to existence is more relevant as this exercise confirms that the receivables do in fact exist, and there is no overstatement of receivables in the financial statements. Accuracy and valuation assertion is also verified during the confirmation exercise which has not been addressed by the audit team.

Debtors' wise assessment of work:**i. Alpha:**

No further procedure required.

ii. Beta:

The auditor should maintain control over the external confirmation requests, including the process of sending the requests himself. The confirmation being sent directly was returned by the courier on the grounds of invalid address and that resending by the client may indicate doubts on the reliability of the response. The auditor should also consider performing alternate audit procedures to verify the receivable balance such as subsequent clearance, review the supporting documentation such as signed PO, delivery documentation and sales invoice.

iii. Gamma:

From the winding up event it appears that the amount receivable is irrecoverable. Therefore, the auditor needs to ensure that the amount of irrecoverable receivables is written off or is duly provided for.

- Review any correspondence with the liquidator/debtor, relating to recovery of the amount due.
- Review the calculation of amount of provision/write off and basis thereof.

iv. Small Distributors:

Audit team's decision to ignore small balance is not correct. The team may consider sending negative balance confirmation. If the team ensure that there is low risk of material misstatement, low exception rate is expected and there is no reason to disregard the confirmation request.

► *Practice Question 20:***T Milk Limited**

Customer's name and address: DB Limited, 46-Safoora Palace, Mall Road, Quetta. **Date:** 7 September 2021

Dear Mr. Salman

In accordance with the request of our auditor, Abid Ali & Co, Chartered Accountants, we ask that you kindly confirm your indebtedness to us which, according to our records, amounted to Rs. 45.6 million as shown by the enclosed statement.

If the above amount is in agreement with your records, please sign in the space provided below.

If the amount is not in agreement with your records, please notify us of the amount shown by your records.

Yours faithfully,

-Signature-

T Milk Limited

Confirmation No. A-172

The amount shown above is/is not in agreement with our records.

Account No

Signature

Date

Title or position

Required:

Identify the shortcomings in the above draft of balance confirmation request and suggest the necessary changes.

Tutorial Notes:

Do not neglect to identify:

- The year-end date at which the balance needs to be confirmed was not mentioned.
- An addressed and stamped envelope is always attached with the confirmation request.
- Balance reconciliation in case of difference has not been asked.

► **Solution 20:**

Shortcomings		Required changes
(i)	The client has been asked to confirm the balance and notify any difference to the audit client's management.	Instead of using the word 'us' we should use 'our auditors directly'. It should be specifically mentioned somewhere in the confirmation that it needs to be mailed directly to the auditor.
(ii)	The year-end date at which the balance need to be confirmed is not mentioned.	The year-end date needs to be inserted just before or after the places where the account balance has been mentioned and the place where client confirms his balance.
(iii)	An addressed and stamped envelope is always attached with the confirmation request.	This also needs to be mentioned in the balance confirmation request.
(iv)	Balance reconciliation in case of difference has not been asked.	The debtor should be asked that in case he does not agree with the mentioned balance, he should provide the detail and full particulars of the difference.

► **Practice Question 21:**

The auditor will normally select a sample of debtors who will be asked to provide confirmation of their balances. State any six audit procedures for sending the confirmation.

Tutorial Notes:

When sending debtor confirmations, auditors should:

Obtain an aged receivables listing to assess overdue balances.

Verify the accuracy and completeness of the list before sending confirmations.

Use stratified sampling if debtor balances vary significantly.

Do not miss these steps, which are crucial for an effective audit response.

► **Solution 21:**

- i. Evaluate whether to:
 - use interim or final balances for circulating confirmation;
 - sent positive confirmation or negative confirmation.
- ii. Obtain an aged listing of receivables ledger balances at the chosen date.
- iii. If the list is prepared by the client, check the completeness and accuracy of the list of balances and the total of the balances in the list.
- iv. If the population of receivables ledger balances is not homogeneous, stratified sampling might be used.
- v. A suitable sampling method should be chosen. As with all sampling, the sample selection process should as far as possible ensure that the sample is representative of the population of receivables.
- vi. In selecting the sample, certain types of account should be considered for inclusion, such as overdue accounts, credit balance and nil balance.

► **Practice Question 22:**

During the audit of CCN Limited for the year ended 30 June 2023, the audit team circularized direct confirmations to trade debtors. The details are as follows:

Trade debtor's name	Year-end balance	Balance confirmed	Confirmation received date	Comments
	----- Rupees -----			
AAB	12,336,990	10,556,990	28 July 2023	None
BBC	50,997,000	-	Not received	None
CCD	20,234,565	20,234,565	20 July 2023	Received through email
DDE	1,678,000	1,678,000	Not received	Confirmed over phone on 15 July 2023

Required:

Analyse each of the above debtors' responses and recommend further course of action to be adopted by the auditor.

Tutorial Notes:

For AAB, mention whether the misstatement is indicative of fraud or deficiency in internal control. The examinees also did not mention that the auditor would ask the management to rectify it.

In the case of CCD, mention that since the balance had been confirmed, nothing needed to be done, which was not correct.

► **Solution 22:**

The response to the confirmation sent to three receivable balances is analysed as under:

Confirmation from AAB**Analysis:**

The response shows a difference of Rs. 1,780,000 which is an exception. It may or may not be a misstatement.

It is possible that this exception does not represent a misstatement. For example, the auditor may conclude that differences in responses to confirmation requests are due to timing, measurement, or clerical errors in the external confirmation procedures.

Exceptions noted in responses to confirmation requests may indicate misstatements or potential misstatements in the financial statements. When a misstatement is identified, the auditor is required to evaluate whether such misstatement is indicative of fraud. Exceptions also may indicate a deficiency, or deficiencies, in the entity's internal control over financial reporting.

Further course of action:

The auditor should request the management to prepare a reconciliation of the difference.

If it is a misstatement, then the auditor will ask the management to rectify it.

Confirmation from BBC

Analysis:

Since the response to confirmation is not received, the auditor should consider to apply the alternative procedures.

Further course of action:

The auditor should apply the following alternate procedures:

- Send the confirmation request again when a reply to a previous request has not been received within a reasonable time.
- If confirmation is still not received, examine subsequent cash receipts, shipping documentation, and sales near the period's end.

Confirmation from CCD

Analysis:

Since the debtor has confirmed the same amount as circulated through email, the auditor should perform additional steps to ensure its reliability.

Further course of action:

- Telephone the confirming party to determine whether the confirming party did send the response.
- Ensure that the response is from the proper source, the respondent is authorized, and integrity over transmission has not been compromised.

Confirmation from DDE

Analysis:

An oral response to a confirmation request does not meet the definition of an external confirmation because it is not a direct written response to the auditor.

Further course of action:

- Request the confirming party to respond in writing directly to the auditor.
- If no such response is received in writing, the auditor should seek other audit evidence to support the information received orally.

► **Practice Question 23:**

The auditor normally selects a sample of debtors who are asked to provide confirmation of their balances. State any six audit procedures for selecting the sample and the confirmation process.

Tutorial Notes:

Mention audit procedures for verification of debtors, which were not related to the confirmation of balances.

► *Solution 23:*

- i. Obtain an aged listing of receivables ledger balances at the chosen date.
- ii. If the list is prepared by the client, check the completeness and accuracy of the list of balances and the total of the balances in the list.
- iii. If the population of receivables ledger balances is not homogeneous, consider using stratified sampling.
- iv. A suitable sampling method should be chosen. The sample selection process should as far as possible ensure that the sample is representative of the population of receivables.
- v. In selecting the sample, certain types of account should be considered for inclusion, such as overdue accounts, credit balance and nil balance.
- vi. For selected items for circularization, details should be extracted from the receivables ledger, and letters to the customer should be prepared.
- vii. Obtain management's authorization to the confirming parties to respond to the auditor.
- viii. Ensure that the letters should be sent by post directly by the auditor.

5 SUBSTANTIVE PROCEDURES: BANK AND CASH BALANCES

5.1 Features of the audit of bank and cash balances

For the purpose of this chapter, bank balances are amounts held in a bank account, and cash balances are bank notes and coins (although coins are likely to be immaterial).

Assets held as bank balances and cash can be at risk of loss. There may be fraudulent activity, or the misappropriation of money by employees or others, particularly when many individuals have authority for dealing with receipts and payments.

However, bank balances and cash are also easily checked and verified. Bank balances can be confirmed directly in writing by the banks (third parties) and cash can be physically counted.

Bank balances and cash are also usually subject to rigorous internal controls, to prevent loss and theft. In many countries, it is regular practice for business entities to receive regular bank statements from their bank. A feature of internal control for bank balances is the reconciliation of the balance shown in a bank statement with the balance recorded in the entity's own accounting records (cash book).

The audit work on **cash** balances will be determined largely by materiality (how much cash does the entity hold and is it a material amount?) and the effectiveness of the client's internal controls for cash.

5.2 Bank balances: confirmation of balances

Checking the accuracy of bank balances can be done effectively by means of **direct confirmation** to the auditor by the banks at which the entity's bank accounts are held. This is similar to written confirmation of balances from customers, in order to check trade receivables.

The bank confirmation letter

The auditor must decide, taking a risk-based approach, which banks to contact for confirmation. Typically, all banks that hold accounts for the client entity are contacted. However, the auditor may choose to omit some banks for reasons of immateriality.

The auditor can use either of two possible approaches to the confirmation of bank balances:

- **Method 1.** The auditor lists information about the bank balances from the client's accounting records and asks each bank to confirm that the balances are correct. (Note: Banks may operate several different accounts for the same customer.)
- **Method 2.** The auditor requests confirmation of the relevant bank balance(s) without providing any details to the bank. This method provides stronger audit evidence but it may be more time-consuming for the bank to provide the required confirmation.

The two methods are similar to the two methods of positive confirmation of balances from customers for trade receivables.

In the case of the external audit, permission must be given to the bank by the client to release information to the auditor. The letter should be written in a standard form that is acceptable to banks and should include the client entity's authorisation to the bank to release the information to the auditor. (The client entity may give standing authority to the bank to release the information to the auditor each year: if so, the letter should refer to this standing authority.) The letter should be sent by the auditor to the bank.

The reply should be sent by the bank direct to the auditor. (This is also the same as for the confirmation of balances from customers for trade receivables.)

Typical areas covered by the confirmation letter include the following:

- Confirmation of balances on all bank accounts at the end of the reporting period.
- Details of any unpaid bank charges.
- Details of any liens (charges) over assets of the client entity.
- Details of any assets of the client entity held by the bank as security for lending.
- Details of any other client bank accounts that are known to the bank but not listed in the request to the bank for confirmation of balances.

5.3 Audit work on receipt of the banks' replies

The main audit work will focus on the confirmation letters from the bank (or the confirmation letter from the client's bank, if there is just one bank) and the client company's bank reconciliation statement. A statement should be provided by the bank for the end of the reporting period.

- Obtain or prepare a bank reconciliation statement for each bank account.
- If the reconciliation is prepared by the company, check it for arithmetical accuracy.
- Check the bank balance confirmed in the bank's confirmation letter against the balance used in the bank reconciliation statement.
- Relate other information contained in the confirmation letter to other areas of the audit (for example, accrued bank charges must be provided for in the financial statements).
- Check items appearing in the bank reconciliation statement against any available supporting evidence (for example, unpresented cheques in the bank reconciliation statement should be shown as having been presented in a subsequent bank statement).
- Review the cash book and bank statements for unusual items, including unusual delays between cash book and bank statement entries. Investigate the reasons for any unusual item.
- Review the confirmation letter from the bank for any other information to be disclosed in the financial statements (for example, charges on assets and security for loans).

5.4 Cash balances: physical count

The audit work performed on cash balances (as opposed to bank balances) will be largely dictated by materiality considerations. In this context, materiality should be considered not only in terms of the statement of financial position amount, but also in terms of the value of total transactions passing through the cash account during the period.

In addition, the auditor needs to appreciate that certain businesses hold cash in a large number of locations (for example, in a company that operates a chain of hotels or supermarkets). In total, these balances may be material, whereas the amount of cash held in any single location may be insignificant.

The main audit work involved in verifying cash balances is a **physical count**.

Audit procedures include the following:

- The auditor should count cash at all locations simultaneously and in the presence of a company official. (Simultaneous counting is necessary, to prevent the client from moving cash that has been counted at one location to another location ready for the next count.)
- After the count the auditor should obtain a signed receipt for the amount of cash returned to the official, after the count.
- The auditor should check the cash balance obtained from the count against the client's cash records and cash balance in the draft financial statements.
- Where appropriate, the auditor should also investigate the treatment of any money advances to employees (for example, against wages or salary).

6 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Explain the principle risks of misstatement for current assets
- Describe the key substantive procedures for auditing:
 - Inventory
 - Trade receivables
 - Bank and cash

SUBSTANTIVE PROCEDURES: OTHER AREAS

IN THIS CHAPTER:

1. Substantive procedures: trade payables
2. Substantive procedures: accruals, provisions and contingencies
3. Substantive procedures: non-current liabilities
4. The audit of equity
5. Key income statement figures
6. Chapter review

1 SUBSTANTIVE PROCEDURES: TRADE PAYABLES

1.1 Principal risks of misstatement in the audit of liabilities

As discussed in previous chapters, **directional testing** is an approach to audit testing that an auditor may use to improve the efficiency of an audit. With directional testing, liabilities, income and equity are usually tested for **understatement** only. This is testing the financial statement assertion of **completeness**. The reason for this approach is that an auditor will consider it much more likely that an entity will understate its liabilities (in order to present a better financial position) than overstate its liabilities.

Because auditing liabilities involves testing for completeness, auditing liabilities is often more difficult than auditing assets (where the emphasis of audit testing is on overstatement/existence). The auditor is looking for something that is not recorded, rather than verifying something that has been recorded. This influences the audit approach and the type of audit work performed.

The **principal risks of misstatement** in respect of liabilities are therefore due to the following:

- Not all liabilities of the reporting entity being included in the financial statements. This is considered to be the main risk.
- Non-existent liabilities being included in the financial statements (the **existence** and **rights and obligations** assertions).
- Liabilities not being properly disclosed in the financial statements (the **classification and presentation** assertion).

1.2 The general approach to the substantive testing of trade payables

Trade payables are a material item in the statement of financial position of many entities. Therefore, this area is likely to receive a significant level of audit attention.

1.3 Substantive procedures for trade payables

The following substantive procedures can be used to gather audit evidence on trade payables:

- Obtain or prepare a listing of balances on supplier accounts in the payables ledger (a listing of trade payables) and match the balance with the GL
- Select sample from trade payable listing (selection of nil balances and low balances) is important), send confirmation
- In selecting the sample of balances for testing, the auditor should consider the following points:
 - It is **not** important to select large balances, as the main audit emphasis is on completeness and understatement (not existence and overstatement).
 - For the same reason, it **is** important to select a number of accounts showing nil balances and debit balances. (When there is a debit balance, the supplier owes the client entity, presumably because goods have been returned and a credit note has been issued by the supplier, or because an invoice was over-paid or paid twice.)
 - Include major suppliers in the sample. Identification of major suppliers should be based on the auditor's knowledge of the business. This knowledge may be derived from information gained at the inventory count or from audit work on the purchases system.

As with trade receivables, for an IT-based system, audit software can be used to assist in sample selection.

- If there is a difference between the balance in the payables listing and the balance shown in the supplier's statement, the auditor should ask the client company to prepare a reconciliation to explain the difference. The auditor should then check these reconciling items with the relevant supporting documentation.

In order to gain additional assurance about the **completeness** of trade payables balances, the auditor should also carry out the following procedures:

- Review the list of account balances for any suppliers who are not in the listing of trade payables, but who would be expected to be in the listing. These would include regular suppliers of frequently-purchased items.
- Compare the list of trade payables balances with the listing that was prepared for the previous year's audit (at the same date in the previous year). Look for explanations as to why any major balances do not appear on the current year's listing when a major balance for the same supplier is in the listing in the previous year.
- Apply other analytical procedures and obtain explanations for any significant differences identified with this method of testing. For example, the auditor might compare the ratio of trade payables to purchases in the year, and compare this with the same ratio in previous years. He might expect the ratio to remain fairly stable between one year and the next.
- Perform test of unrecorded liability

1.4 Purchases cut-off

Purchases cut-off was explained in an earlier chapter. It is concerned with making sure that purchases transactions just before or after the year end are allocated to the correct financial year, so that purchases (for the income statement/statement of comprehensive income) and inventory and trade payables (for the statement of financial position) are correctly recorded.

- Work performed on cut-off (and recorded at the physical inventory count) will provide evidence as to the accuracy of purchases cut-off.
- This work is based on preparing a list of the goods received notes that were prepared by the client entity immediately before and after the end of the reporting period. The auditor should confirm that goods included in closing inventory have also been recorded as a liability (trade payable) and that purchased goods not recorded in closing inventory have not generated such a liability.

► Practice Question 01:

While reviewing the list of 'trade and other payables' at BAC Limited, you have noticed that one of the trade creditors is not in the list. State any two audit procedures to be performed in relation to the completeness assertions for trade payables.

► Solution 01:

- Review the list to identify major suppliers i.e. regular suppliers of frequently purchased items who are not in the listing of trade payables.
- Compare the list of trade payables with the listing of the previous year's audit. Look for explanations as to why any major supplier is not appearing on the current year's listing.
- Apply other analytical procedures and obtain explanations for any significant differences identified while carrying out the above tests.

► Practice Question 02:

On the audit of Qalander Limited, your team has performed the following audit procedures for collecting the audit evidence with respect to understatement of payables against raw materials:

- i. Verified the amounts recorded in supplier ledgers through underlying supporting documents.
- ii. Sent direct confirmations to selected suppliers from the list of suppliers appearing in the payable subsidiary ledgers.
- iii. Reviewed the list of subsequent material disbursements to suppliers from bank ledgers.
- iv. Reviewed unpaid invoices and ensured that they are properly recorded.

Required:

Comment on above audit procedures performed by your audit team in the context of testing the understatement of payables. Also suggest further procedures, if any, that are required to be performed with respect to the understatement of trade payables.

► **Solution 02:**

- i. Tracing of payable amounts recorded in supplier ledgers may not be relevant as it is directed towards evidence about overstatement of recorded payables.

Suggestion:

- Obtain the list of goods received near to year end and check whether payable has been recorded or not.
 - Trace supplier statement received from the creditor to the supplier's ledger.
- ii. Sending direct confirmation to suppliers which are already recorded in books of account may not be a relevant audit procedure for understatement in payables.

Suggestion:

Select accounts for direct confirmation, showing nil balances and debit balances.

- iii. Tracing material subsequent disbursement from bank ledger is not a reliable audit procedure as amounts are being traced through bank ledgers which is an internally generated document.

Suggestion:

Trace material subsequent disbursement from third party provided bank statements.

- iv. Obtaining and reviewing unpaid invoices is a relevant audit procedure for understatement and may be a reliable audit evidence.

Further procedures to be performed

- Review the list of account balances for any supplier who are not in the listing of trade payable, but who would be expected to be in the listing, such as suppliers of frequently purchased items.
- Compare the list of trade payables balances with the listing that was prepared for the previous year's audit. Look for explanations as to why any major balances do not appear.
- Compare the ratio of trade payables days with the previous year and investigate the variance.

2 SUBSTANTIVE PROCEDURES: ACCRUALS, PROVISIONS AND CONTINGENCIES

2.1 Difficulties of obtaining evidence in this area

The audit of accruals, provisions and contingencies can also be difficult areas for the auditor. Accruals are usually estimated amounts and will be subject to audit techniques which are similar to those applied to prepayments. Provisions and contingencies can be highly subjective areas where a considerable amount of judgement may be called for. Evidence may be needed from outside experts such as legal advisors.

2.2 Accruals

Accruals balances are difficult to audit as the figures reported are often based on estimates. However, the amounts involved may not be material, in which case the auditor will not devote a significant amount of time and resources to this area.

As with all liabilities, the emphasis will be on **completeness**. The nature of the items involved means that analytical procedures and the auditor's knowledge of the business are useful in reaching a conclusion on this area.

Substantive procedures include the following:

- Obtain or prepare a listing of accruals as at the end of the reporting period.
- If the list is prepared by the client company, check the calculations and additions for arithmetical accuracy. Check the amounts in the listing against the balances in the relevant main ledger expense accounts and ensure that the amounts are the same.
- Where invoices have been received, or payments made, after the year end, confirm that the amount accrued appears reasonable in relation to this evidence. For example, suppose that a company makes an accrual for two months of electricity charges, and receives an invoice for three months' supply of electricity one month after the year-end. If the accrual for electricity is, say, Rs. 60,000 (Rs. 30,000 per month), the auditor should expect the total invoice to be for about Rs. 90,000.
- Compare the list of accruals with the list that was prepared at the same date in the previous financial year, and enquire about items not listed in the current year that were in the list in the previous year.
- Review the list of accruals for completeness, based on the auditor's knowledge of the business.
- Relate items on the list of accruals to other audit areas, such as the bank confirmation letter (which might provide details of unpaid/accrued bank charges).

Accrued wages and salaries may be more material than other items and may require a higher level of audit attention:

- Consider what items should be accrued for at the end of the reporting period, such as unpaid wages, overtime, holiday pay, bonuses.
- Check the amounts for accrued wages and salaries by comparing them with personnel records and payroll records (records of time worked, records of wage rates and salaries, details of dates for the payment of wages and salaries, and so on) and to payments made after the year end.
- Confirm that any additional costs (such as employer's payroll taxes) have been accounted for.
- Perform analytical procedures on accrued wages and salaries. For example, the auditor might measure the ratio of accrued payroll expenses to total payroll costs for the year, and compare this with the similar ratio in previous years. Significant differences should be investigated.

2.3 Provisions and contingencies: substantive procedures

The auditor needs to be satisfied that the client has correctly distinguished between provisions (included in the financial statements), contingent liabilities (not included in the financial statements but disclosed in a note) and items that should not even be disclosed.

Similarly, it may be necessary to assess whether an item is an actual asset (included in the financial statements), a contingent asset (not included in the financial statements but disclosed in a note) or not likely to happen and so not disclosed.

The auditor must also be satisfied about the measurement/valuation of the items in the financial statements or disclosed by way of a note.

Provisions

Substantive procedures to provide evidence on provisions such as warranty other than legal should normally include the following:

- Obtain a listing of provisions that the client has included in the (draft) financial statements.
- Obtain an understanding of management process to record provision and ensure that it is consistent with the requirement of IAS 37
- For each item in the listing, confirm that the accounting provisions of IAS 37 have been complied with. Does the item meet the definition of provision?
- Review the changes in the provision for the period during the financial period.
- Review the measurement of the closing balance for each provision and discuss these with management if appropriate. Consider whether it might be appropriate to take expert advice on the existence or measurement of a provision.
- Review the list for possible omissions, based on the auditor's knowledge of the business and the industry in which it operates.
- Compare provisions for the current financial year with provisions in previous years, and investigate any major differences or omissions.
- Ensure that assumptions are reasonable.
- Perform subsequent event procedures.

Contingencies

The audit approach to gathering evidence on contingencies may be as follows:

- Ascertain the approach taken by the client's management to identifying contingencies.
- Review the minutes of board meetings (where such matters are likely to be discussed).
- Review relevant sections of the business press and trade journals for areas in which possible industry-wide contingencies may arise.
- Review the client's correspondence with lawyers and invoices for legal services. These may help the auditor to identify contingencies that the client has not disclosed in the notes to the draft financial statements, or that provide additional information for the auditor about contingencies that have been disclosed.
- Consider direct confirmation from lawyers of matters handled on behalf of the entity under audit. Any letter should be sent by management with an instruction for the reply to be sent directly to the auditor. It is more likely that lawyers will respond if the letter lists specific areas where contingencies may exist, together with an assessment by management of the possible outcome. The lawyers should then be asked to comment on the information in the letter.
- Consider whether expert advice may be required from outside sources other than lawyers.

► *Practice Question 03:*

List any five substantive procedures for the verification of each of the following:

- i. Accrued expenses
- ii. Contingencies

Tutorial Notes:

Do not mention important steps like subsequent payment and analytical review etc.

In case of contingencies, the do not mis important points like lawyers' confirmation and compliance with IFRSs. Do not stress on checking the information made available by the client but did not mention steps to ensure completeness.

► *Solution 03:*

The audit approach to gathering evidence on contingencies and commitments is as follows:

Accrued expenses:

- Obtain or prepare a listing of accrued expenses as at the end of the reporting period. Check the calculations and additions for arithmetical accuracy.
- Check the amounts in the listing against the balances in the relevant main ledger expense accounts and ensure that the amounts are the same.
- Verify the invoices received or payments made after the year end and ensure that the amount accrued appears reasonable in relation to this evidence.
- Compare the list of accrued expenses with the list that was prepared at the same date in the previous financial year, and enquire about items not listed in the current year that were in the list in the previous year.
- Review the list of accruals for completeness, based on the auditor's knowledge of the business.
- Relate items on the list of accruals to other audit areas, such as the bank confirmation letter (which might provide details of unpaid/accrued bank charges).
- Perform analytical procedures on accrued expenses. For example, the auditor might measure the ratio of accrued payroll expenses to total payroll costs for the year, and compare this with the similar ratio in previous years. Significant differences should be investigated.

Contingencies:

- Ascertain the approach taken by the client's management for identifying contingencies.
- Review the minutes of board meetings (where such matters are likely to be discussed).
- Review relevant material related to the industry as a whole such as financial statements of major companies in the industry to identify possible industrywide contingencies.
- Review the client's correspondence with lawyers.
- Review the invoices for legal services to identify undisclosed contingencies and additional information about contingencies
- Consider direct confirmation from the company's lawyers and legal advisors.
- Consider whether expert advice may be required from outside sources other than lawyers.
- Ensure that provisions have been made in case relevant condition as specified in IFRS are met.

► *Practice Question 04:*

State five key substantive audit procedures for verification of Provisions

Tutorial Notes:

Five substantive procedures for verification of Provisions

Specify all of the procedures correctly. Do not miss the procedures for identifying unrecorded liabilities

► *Solution 04:*

Key substantive procedures for verification of provisions include the following:

- i. Ensure that all provisions have been recognised in accordance with the IAS 37.
- ii. Review the measurement of the closing balance for each provision and discuss these with management if appropriate. Consider whether it might be appropriate to take expert advice on the existence or measurement of a provision.
- iii. Review the board approval related to provisions booked in the financial statements.
- iv. Review the list of provisions for possible omissions, based on the auditor's knowledge of the business and the industry in which it operates.
- v. Relate the testing of provisions to other areas of the audit work, such as correspondence with lawyers/minutes of Board of director's meeting (which might reveal more information about matters to which the provisions relate).
- vi. Compare provisions for the current financial year with provisions in previous years, and investigate any major differences or omissions.
- vii. Review the subsequent events to ensure completeness of provisions

3 SUBSTANTIVE PROCEDURES: NON-CURRENT LIABILITIES

3.1 Aspects of reporting non-current liabilities

Non-current liabilities are liabilities repayable after more than one year from the end of the reporting period. They may include:

- debentures
- loan stock
- loan notes
- bank loans
- finance lease obligations.

It may be that loans are repayable at regular intervals throughout the term of the loan, in which case a part of the overall balance owing may be a current liability (repayable within the next 12 months) with the remaining part being a non-current liability. This is an important point for the auditor to consider, in terms of ensuring the proper disclosure of information in the financial statements (and the classification of liabilities as non-current or current).

The agreements under which these non-current liabilities are taken out may impose conditions on the company which, if broken, may give the lender the right to impose penalties or possibly withdraw the finance. This is another significant consideration for the auditor.

3.2 Substantive procedures for non-current liabilities

Substantive procedures in respect of non-current liabilities may be as follows:

- Obtain or prepare a listing of long-term borrowings/non-current liabilities. The listing should include, for each item, details of the lender and the movement on the borrowing in the financial period. (Opening balance plus interest charges minus payments on the loan equals closing balance.)
- If the list is obtained from the client entity, check it for accuracy.
- Agree the opening balances on the listing with the amount for non-current liabilities in last year's statement of financial position.
- Check that any new borrowings during the year have been authorised in accordance with the correct company procedures.
- Agree the details of each loan with the loan agreement/documentation.
- Check whether any restrictions contained in the lending agreements have been complied with. For example, check that the client entity has not been in breach of any covenant in a borrowing agreement.
- Confirm loan repayments in the listing with payments recorded in the cash book, entries in bank statements and also with any correspondence or receipts or statements from lenders.
- Check the interest calculations and confirm that the correct accounting entries for interest have been made, recognising any opening and closing accruals for interest expenses.
- Obtain direct confirmation from lenders of amounts outstanding.
- Confirm that any relevant statutory requirements have been complied with (such as whether charges on assets have been properly registered, if there is a legal obligation to register charges).
- Confirm the correct allocation of the total amounts outstanding between current liabilities (repayable within 12 months) and non-current.
- Review cash book entries for unusual cash receipts that may represent new loans taken out during the period. Where unusual cash book entries are found, obtain an explanation.

► *Practice Question 05:*

Yasin is an audit junior in a firm of chartered accountants. He has recently been assigned to an audit client where he was allocated the area of bank borrowings. Yasin performed the following audit procedures at the assertion level:

Assertion verified	Audit procedures performed
Completeness	- Obtained a list of the schedule of bank borrowings from the client. - Traced the amounts specified in the schedule of borrowings with the figures included in the trail balance. - Conducted an inspection of assets provided as security.
Accuracy and valuation	- Checked the accuracy of calculations in the schedule provided by the client. - Reviewed loan agreements concerning new facilities received.
Rights and obligations	- Obtained schedule of bank charges from the client. - Checked the recorded amounts (both received and repaid) in the ledgers, cross-referencing them with bank statements.
Existence	- Obtained bank borrowing ledgers and traced the recorded amounts received and repaid with bank statements. - Obtained management representation.
Presentation and disclosure	- Inquired from the management about relevant disclosures. - Reviewed loan agreements, identifying terms and conditions such as interest rates, repayment terms, and securities/ mortgages/liens.

Required:

Identify the procedures that lack relevance to the above-mentioned assertions. Also, recommend any two additional procedures to be performed for each assertion.

Tutorial Notes:

When auditing bank borrowings, ensure that:

- Completeness: Confirm loans with direct bank confirmations, not just client-prepared schedules.
- Accuracy & Valuation: Check loan schedules against bank statements and loan agreements, and review interest calculations.
- Rights & Obligations: Verify obligations in loan agreements and lender confirmations, not just bank charges.
- Existence: Confirm borrowings through bank statements and interest payments, not just management representations.
- Presentation & Disclosure: Cross-check disclosures with IFRS & Companies Act and verify register of liens and mortgages.

► *Solution 05:*

Assertion	Audit Procedure not relevant	Additional Audit Procedures to be performed
Completeness	Conducted inspection of assets provided as security	- Obtain complete loan agreements / facility letters / schedule of markup recorded from the client and trace the facilities availed and recorded in books of accounts. - Obtain a list of addresses of the lenders and circularize direct confirmations to identify outstanding balances and facilities provided.
Accuracy and valuation	Reviewed loan agreements concerning new facilities received.	- Obtain a schedule of borrowings showing the opening balance, amounts received, paid, and outstanding balance, and trace the amounts from loan agreements, bank statements, and books of account. - Review direct confirmation received from lenders and compare outstanding balance confirmed by the lender. - Check calculations for any interest/markup amortized in the principal amount as per terms. - Check the fair value of liabilities outstanding as at the year-end and calculate amortization of interest cost, if any.
Rights and Obligations	Obtained schedule of bank charges from the client	- Review loan agreements to identify obligations. - Review response received from lenders of direct confirmation indicating outstanding liability.
Existence	Obtained management representation	- Review loan agreements and amounts received from lenders in bank statements. - Review interest/markup recorded in books and corroborate with the corresponding borrowing. - Review the outstanding balances confirmed by the lenders.
Presentation and Disclosure	Inquired from the management about relevant disclosures	- Checked requirements of IFRS and Companies Act and corroborated with the disclosures of terms and conditions made in the financial statements. - Obtain the register of mortgages/liens and relevant statutory filings to corroborate with the completeness of disclosures.

4 THE AUDIT OF EQUITY

4.1 Introduction

To some extent, the nature of the specific audit work performed on equity in the statement of financial position will be dictated by the requirements of local company law. The procedures described here cover general audit principles which are likely to be relevant in most countries.

The amount of audit work performed on this area is usually not significant. If the auditor is confident that assets and liabilities are correctly stated, the total of equity (capital and reserves = assets minus liabilities) must also be correct.

4.2 Substantive procedures: share capital

The auditor will usually carry out the following substantive procedures on share capital:

- Where local law requires that companies should have an authorised share capital, the auditor should check that the total authorised capital in the draft financial statements is consistent with the company's constitution.
- The auditor should check the nominal value of shares issued during the year, by reading the supporting documentation, and should ensure terms of issue were properly complied with.
- If new shares were issued during the year, check that cash received for them has been properly recorded in the main ledger.
- Check that the amount reported as issued share capital agrees with the amount recorded in the register of members/shareholders, if the company has such a register. (In some countries there is a legal requirement to maintain a register of members.)

4.3 Substantive procedures: reserves

The auditor will usually carry out the following substantive procedures on reserves:

- Obtain an analysis of movements on all reserves during the period.
- Check the accuracy of these movements by checking supporting documentation.
- Ensure that any specific legal requirements relating to reserves have been complied with. (For example, check that the entity has not breached legal restrictions on use of the share premium account.)
- Confirm that dividends have been deducted only from those reserves that are legally distributable (usually the accumulated profits reserve/retained earnings).
- Check the authorisation for the amount of dividends paid.
- Check the dividend calculations and check that the total dividends paid are consistent with the amount of issued share capital at the relevant date.

4.4 The audit of statutory books

Most countries require companies to maintain certain 'books' or records containing defined information, in addition to their normal accounting records. The nature of these '**statutory books**' varies from country to country, but they may include the following:

- Minutes of board meetings and minutes of general meetings of the company.
- Register of members/shareholders.
- Register of directors and their interests in the shares and loan capital of the company.
- Register of charges on the company's assets.
- Copies of directors' service contracts and details of directors' remuneration packages. (Audit work on this area can be included in payroll testing procedures. The auditor should confirm that national company law disclosure requirements are complied with.)

The auditor should confirm that the required statutory records are maintained by the client company and are up-to-date.

► *Practice Question 06:*

State four substantive procedures for verification of share premium account appearing in the statement of financial position.

Tutorial Notes:

Do not be limited to tracing of opening balance only. Further, try to relate market price with share premium. Mention about verification of list of shareholders which was totally irrelevant.

► *Solution 06:*

Audit procedures for verification of share premium account:

- Obtain an analysis of movements in share premium account during the period.
- Check the accuracy of these movements by checking supporting documentation.
- Ensure that any specific legal requirements relating to share premium have been complied with. (For example, check that the entity has not breached legal restrictions on use of the share premium account.)
- Check authorization in respect of all movements during the year.

5 KEY INCOME STATEMENT FIGURES

5.1 Introduction

Tests of controls on key income statement figures were covered in a previous chapter. Whatever the results of those tests, some degree of substantive procedures will need to be performed. For some clients, with strong internal controls, this could be limited to analytical procedures. These and other possible substantive procedures are considered below.

5.2 Sales

Occurrence	Select a sample of recorded transactions from Sales Journal, and vouch for complete audit trail i.e. from recording Journal to initiative document e.g. G.L. Sales Invoice, Delivery Note, Customer Order.
Completeness	Select a sample of Shipping Documents, and vouch for complete audit trail i.e. from Shipping documents to Sales Invoice, recording in GL to obtain evidence that all goods dispatched have been accounted for.
Accuracy	Recalculate amount of bill for a sample of sales invoices by using quantity from Dispatch Note, Rate from authorized rate list, and also check mathematical accuracy of invoices.
Classification & Presentation	Examine a sample of sales invoices and inspect JV for proper classification into revenue accounts.
Cut off	Perform Cut off Test i.e. Select a sample of sales invoice just before and after year end and compare dates of shipment with the dates they were recorded in the sales journal.

5.3 Cost of Sales

Occurrence	- Verify supporting documents (e.g., GRNs, invoices, delivery notes) for a sample of cost of sales transactions to confirm goods were actually sold. - Perform cut-off testing to ensure cost of sales near year-end relate to valid sales in the correct period
Completeness	- Review post-year-end inventory dispatches and related sales invoices to identify any unrecorded cost of sales. - Perform analytical procedures, such as comparing gross profit margins to prior periods or budgets, to identify potential understatement.
Accuracy	- Recalculate cost of sales using: (Opening Inventory + Purchases – Closing Inventory) and compare to the ledger. - Agree unit costs used in the costing system to supplier invoices or standard cost records.
Classification & Presentation	- Review general ledger postings to confirm that only relevant items are included in the cost of sales accounts. - Inspect journal entries affecting COS for appropriate descriptions and categorization.
Cut off	- Check dispatch dates and invoice dates for sales around year-end to ensure proper period recognition. - Examine GRNs and receiving reports to verify correct inclusion/ exclusion in period-end COS

5.4 Payroll costs

Analytical procedures are often carried out on payroll costs as there is a strong relationship between rates of pay and numbers of employees (for gross pay) and between gross pay and deductions (such as employer's national insurance and pension deductions).

An example of analytical procedures for payroll costs is as follows. For a department where employees all receive fixed salaries, compare salary costs in the current year with salary costs in the preceding year. Unless there has been a significant change in staff numbers, the two totals should be similar, except for any inflationary increase in salaries during the year and any bonuses, new hiring and resignation. Another check would be to compare total salary payments for the same department between one month and the next. Except for a month in which a salary increase is applied, total salary costs for the department should be constant from one month to the next.

Other substantive procedures to verify payroll costs might include selecting a sample of payroll records and checking that:

- the employee exists (by reference to personnel records)
- gross pay has been correctly calculated (by reference to personnel records for salaries or time worked multiplied by documented rates of pay)
- deductions have been correctly calculated (by re-performance on a sample of payroll payments).

5.5 Interest Expense

Occurrence	• Trace interest expense entries to loan agreements and bank statements. • Inspect payment vouchers and verify authorization.
Completeness	• Review loan agreements for any unrecorded obligations and accrued interest. • Examine interest accrual calculations at year-end.
Accuracy	• Recalculate interest expense based on loan terms and outstanding balances. • Match recorded amounts with bank confirmations.
Cut-off	• Inspect payment and accruals near year-end to ensure correct period recognition. • Check bank statements for late payments.
Classification	• Verify expense is recorded under finance cost and not operating expenses. • Review general ledger account mapping.

5.6 Interest Income

Occurrence	• Trace interest income to investment agreements or bank deposit confirmations. • Inspect received bank advices or credit notes.
Completeness	• Review investment schedules for completeness. • Examine post-year-end receipts for interest income not yet recorded.
Accuracy	• Recalculate accrued interest using applicable rates and principal amounts. • Agree recorded income to investment terms.
Cut-off	• Review timing of interest receipts to ensure proper cut-off. • Examine accruals to confirm they relate to the reporting period.
Classification	• Ensure income is classified under finance income. • Review GL postings to detect misclassified interest income.

5.6 Operating, Selling & Administrative Expenses

Occurrence	Select a sample of transactions from expense account and perform following procedures: • Check supporting documents • Check mathematical accuracy • Check acknowledgement of receipt of goods/services. • Check approval and authorisation (e.g. Invoices) • Check tax deduction • Check evidence of payment (e.g. copy of cheque, receiving signature, and/or payment from bank statement) • Check supporting duly stamped "Processed" or "Paid". • Ensure that the expense relates to the year and business
Completeness	• Review the period end accrual of expenses. • Search for unrecorded liabilities.
Accuracy	• Recalculate invoices and ensure preparation of vouchers is accurate on the basis of invoices. • Test that calculation of expenses is based on reasonable rates based on market rates.
Cut off	• From selected sample of transactions, check date of acknowledgement of receipt of goods/services.
Classification & Presentation	• Check allocation of payment between expense and prepayments • Scan accounts in G.L. for unusual transactions e.g. credit items in expense accounts, Larger amounts in Repair and Maintenance Account etc.

► **Practice Question 07:**

You have received a copy of the year-end bank reconciliation statement, from your audit client Harison Limited (HL).

Details of which are reproduced below:

	Rupees
Balance as per bank statement as at 31 December 2021	10,500,000
Add:	
i. Incorrect interest charged by the bank (Note-I)	240,000
ii. Charges reversed by bank on 10 January 2022 (Note-II)	100,000
Less:	
iii. Cash directly deposited in bank by the customer to avail 5% discount	(220,000)
iv. Cheques issued to customers not yet presented	(800,000)
v. Cheques signed but not yet handed over to suppliers	(250,000)
Balance as per ledger	9,570,000

Notes to bank reconciliation statement:

- i. Interest on bank overdraft amounting to Rs. 750,000 was recorded in the bank statement. However, review of the Accounts Officer indicated an error and HL recorded the correct amount of Rs. 510,000 in the bank ledger.
- ii. This represents Letter of Credit charges which were charged twice by the bank for import of raw material in December 2021.

Required:

- a) State the audit procedures that should be performed on the above bank reconciliation statement.
- b) Briefly discuss whether the client's year-end bank reconciliation provides evidence about receipts and payments cut-off.

Tutorial Notes:

Following procedures should be emphasized:

- Obtain and verify the interest working prepared by the management.
- Check that it has subsequently been adjusted by the bank.
- Check from bank statement that excess charges have been reversed.
- Ask the client to record cash receipt in cash book and adjust the receivable balance.

► Solution 07:

- a)
 - Verify the balance from bank statement/confirmation letter.
 - Trace the ledger balance to the trial balance.
 - Obtain and verify the interest working prepared by the management.
 - Check whether the amount was also subsequently adjusted by the bank.
 - Check from the bank statement that the excess charges have been reversed.
 - Cash directly deposited in the bank is not a reconciling item. Ask the client to record cash receipt in cash book.
 - Ask the client to adjust the receivable balances and also record discount expense.
 - Verify subsequent clearance of these cheques.
 - Ask the client to reverse the payment relating to suppliers.
- b) Yes, we can check to see when money was received and paid around the year end and compare it to when the receipts and payments occurred.

► Practice Question 08:

State any three substantive audit procedures to verify rent expense.

► Solution 08:

Substantive procedures:

- i. Obtain the rent agreement and verify the rent rates.
- ii. Verify that the new rent agreements have been properly approved.
- iii. Verify the rent payments through bank statements.
- iv. Recalculate prepaid rent to ensure that the correct amount is charged in the current period.

► *Practice Question 09:*

You are the auditor of Glory Cosmetics Limited (GCL), a leading cosmetic company, for the year ended 30 June 2024. GCL is known for its various high-quality cosmetic products.

During the year, GCL discovered that some of its products had traces of banned substance; however, GCL has not been able to quantify the actual presence of such substances. No complaints have yet been received by GCL in this respect.

In a bid to remove banned substances from its products, in January 2024, GCL signed a contract with Organic Materials Limited (OML), a company specializing in the production of organic raw materials for the cosmetic industry. GCL started procuring new organic raw materials for all of its products from OML. The contract specifies that OML will deliver the raw material continuously over the next two years. According to the terms, OML bills GCL on the 15th of each month for the raw materials delivered during the preceding month. GCL is given a credit period of 60 days to settle each invoice.

Required:

- i. Evaluate the impact of the presence of the banned substance and the payment terms with the new supplier on the audit of GCL. s
- ii. Suggest relevant audit procedures for your evaluation. Solution 09:

Part (a) Evaluation

Provision and contingency: Since GCL has discovered the presence of a banned substance, it may result in fines and penalties, for which a provision might be needed to be recognised in the financial statements as of 30 June 2024 or a contingent liability needs to be disclosed if the quantification of the banned substance remains uncertain.

Accrual and payables: OML will issue invoices to GCL on the 15th of each month for raw materials delivered in the prior month. Since billing occurs after the month-end and payment is due 60 days later, as of June 30, 2024, there will be raw material delivered in June that has not yet been billed. The auditor needs to ensure that GCL accurately records the liability for the raw material received but not yet billed.

Inventory: OML needs to write down any inventory which contain the banned substance to its net realizable value.

Sales return: OML may also need to do a stock recall for its already sold products and recognise a provision for sales return.

Part (b) Audit Procedures**Provision and contingency**

- i. Understand management's assessment of the potential obligation related to legal compliance with the presence of a banned substance and their plans to address it.
- ii. Obtain and review the management's report to determine the presence of the banned substance and the estimated costs of compliance.
- iii. Review management's calculations and assumptions for any provision recognised.
- iv. Verify the completeness and accuracy of related disclosures in the financial statements, ensuring that they provide sufficient detail about the nature and extent of the potential obligation.
- v. Determine whether any subsequent events provide additional information that would require adjustments or further disclosures.
- vi. Review any correspondence with regulatory authorities to confirm that the financial statements appropriately reflect the situation.
- vii. Review minutes of meeting of management and those charged with governance minutes for any discussion held on this issue.
- viii. Circulate confirmation to legal advisors of GCL to identify whether any litigation exists against GCL related to the use of the banned substance.

Accrual and payables

- i. Obtain and review the contract between GCL and OML and ensure the contract terms, including delivery schedules, billing arrangements, and payment terms, are accurately accounted for in the books of accounts.
- ii. Obtain and review the invoices issued after year end to verify the accruals recorded by the management.
- iii. Circulate confirmation to OML to verify the raw material supplied until 30 June 2024.

Inventory and sales return

- i. Obtain management reports to identify the products which are in OML's inventory at year-end and sold during the year.
- ii. Review and verify the reasonableness of the management's calculations for any provisions made to cover the cost of the recall and product cost.
- iii. Verify physical inventory counts to ensure that recalled stock is accurately segregated and recorded as damaged or defective.
- iv. Obtain third-party confirmations from distributors involved in the recall to verify the validity of the returns, claims, and adjustments.

6 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Explain the principal risks of misstatement for the areas listed below:
- Describe the key substantive procedures for auditing:
 - Trade payables
 - Accruals, provisions and contingencies
 - Non-current liabilities
 - Equity
 - Key income statement figures

RELATED PARTY TRANSACTIONS

IN THIS CHAPTER:

1. Related parties: ISA 550
2. Chapter review

1 RELATED PARTIES: ISA 550

1.1 BACKGROUND

Enron Scandal

Enron used special purpose entities-limited partnerships or companies, created to fulfil a temporary or specific purpose, to fund or manage risks associated with specific assets. The company elected to disclose minimal details on its use of "special purpose entities".

These **related parties** companies were created by a sponsor and had used hundreds of related parties to **hide its debt**.

Why the International Auditing and Assurance Standards Board require the auditor to obtain sufficient appropriate audit evidence regarding related parties?

As per ISA 700 Auditor express the following opinion:

"In our opinion the accompanying financial statements presents fairly in all material respect in accordance with IFRS".

WHAT IS THE RELEVANT IFRS FOR RELATED PARTY?

IAS 24: RELATED PARTY DISCLOSURES:

"The objective of this Standard is to ensure that an entity's financial statements contain the **disclosures** necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the **existence of related parties** and by transactions and outstanding balances, including commitments, with such parties."

As management is required to disclose all the transaction with related parties, therefore, ISA 550 deals with the auditor's responsibilities relating to:

- Related party relationships and transactions in an audit of financial statements.
- Specifically, it expands on how **ISA 315 (Revised 2019), ISA 330 and ISA 240** are to be applied in relation to risks of material misstatement associated with related party relationships and transactions.

Why is there a High Risk of Material Misstatement in Related Party?

Auditor shall always give special consideration to related party relationship and transactions irrespective of materiality because normally transaction with related party is qualitatively material.

There is always a high risk of material misstatement in a related party relationship and transaction due to the following reasons:

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Inherent Limitation of Related Party- Management may be unaware of existence of all related party relationship and transaction and it represent greater opportunity for fraud.

Important Note: When Enron entered into fraudulent financial reporting through its related parties and subsequently becomes bankrupt, serious criticism was made on the auditor of the company that why auditor was unable to identify those related party relationship and transactions.

DEFINITIONS:

Arm's length transaction - A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

Related party - A party that is either:

- i. a related party as defined in the applicable financial reporting framework; or
- ii. where the applicable financial reporting framework establishes minimal or no related party requirements:
 - a) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
 - b) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
 - c) Another entity that is under common control with the reporting entity through having:
 - i. Common controlling ownership;
 - ii. Owners who are close family members; or
 - iii. Common key management.

OBJECTIVE of ISA 550 – RELATED PARTIES**1st objective:**

To obtain an understanding of related party relationships and transactions to identify fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud.

2nd objective:

To obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework (See IAS 24 objective).

1st Objective:**Objective 1: To obtain an understanding of related party relationship and transactions****Objective 1.1 Who is responsible to prepare financial statements in accordance with IFRS?**

Management.

Yes, if management is responsible then to obtain an understanding of the related party relationship and transactions, auditor shall make **inquiries with the management** such as:

- The identity of the entity's related parties, including changes from the prior period;
- The nature of the relationships between the entity and these related parties; and
- Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

As management is also responsible for design and implementation of internal control, therefore, auditor shall also inquire with the management to **obtain understanding of the controls** that management has established to:

- Identify, account for and disclose related party relationships and transactions in accordance with the AFRF;
- Authorize and approve significant transactions and arrangements with related parties; and
- Authorize and approve significant transactions and arrangements outside the normal course of business.

Important Note: If the Controls are not present or ineffective then auditor will not be able to obtain sufficient appropriate audit evidence, therefore, modify the opinion in accordance with ISA 705.

Objective 1.2 Sharing Related Party Information

Once the auditor has obtained the understanding of related party relationship and transaction, auditor shall discuss and share such information with the engagement team such as:

- the nature and extent of the entity's relationships and transactions with related parties.
- emphasis of maintaining professional skepticism.
- circumstances or conditions of the entity that may indicate the existence of related party relationship or transaction that management has not identified or disclosed to the auditor.
- the records or documents that may indicate the existence of related party relationship or transaction.

Additionally, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud such as how special purpose entity used to facilitate earnings management and misappropriation of asset.

To sum it up, the first objective is that the auditor has obtained the understanding of the related party relationship and transactions by making inquiry with the management and considering the control in order to identify and assess the risk of material misstatement as per ISA 315 (revised 2019) and ISA 240.

Objective 2.2

After performing the above-mentioned procedures, auditor may come across certain risks or come across certain situations. The risks and situations, along with, relevant responses of the auditor and audit procedures have been tabulated below separately:

Risk	Response
Related party transaction may not be properly account for and disclosed.	Procedures to ensure that related party transaction has been appropriately accounted for and disclosed: • Confirming or discussing specific aspects of the transactions with intermediaries such as banks, law firms, guarantors or agents. • Confirming the purposes, specific terms or amounts of the transactions with the related parties. • Where applicable, reading the financial statements or other relevant financial information, if available, of the related parties for evidence of the accounting of the transactions in the related parties' accounting records.
As per ISA 315 (revised 2019): Significant related party transaction outside the normal course of business shall be treated as significant risk. Example of transaction outside the normal course of business: • Complex equity transactions • The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged. • Sales transactions with unusually large discounts or returns.	For identified significant related party transactions outside the entity's normal course of business, the auditor shall: • Inspect the underlying contracts or agreements, if any, and evaluate whether: - The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets; - The terms of the transactions are consistent with management's explanations; and - The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

Risk	Response
• Transactions with circular arrangements, for example, sales with a commitment to repurchase. • Transactions under contracts whose terms are changed before expiry.	• Obtain audit evidence that the transactions have been appropriately authorized and approved. In evaluating the business rationale of a significant related party transaction outside the entity's normal course of business, the auditor may consider the following: • Whether the transaction: - is overly complex (for example, it may involve multiple related parties within a consolidated group). - has unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms. - lacks an apparent logical business reason for its occurrence. • Involves previously unidentified related parties. - is processed in an unusual manner. • Whether management has discussed the nature of, and accounting for, such a transaction with those charged with governance. • Whether management is placing more emphasis on a particular accounting treatment rather than giving due regard to the underlying economics of the transaction. If management's explanations are materially inconsistent with the terms of the related party transaction, the auditor is required, in accordance with ISA 500 to consider the reliability of management's explanations and representations on other significant matters.
There is a significant risk due to fraud.	Inquiries with management, those charged with governance, related parties, inspection of significant contract.
Transaction with the Related party may not have been identified or disclosed by the management.	During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions <u>that management has not previously identified or disclosed to the auditor.</u> • Bank and legal confirmations obtained as part of the auditor's procedures. • Minutes of meetings of shareholders and of those charged with governance. • Third-party confirmations obtained by the auditor (in addition to bank and legal confirmations). • Entity income tax returns. • Information supplied by the entity to regulatory authorities. • Shareholder registers to identify the entity's principal shareholders. • Statements of conflicts of interest from management and those charged with governance. • Records of the entity's investments and those of its pension plans.

Risk	Response
	• Contracts and agreements with key management or those charged with governance. • Significant contracts and agreements not in the entity's ordinary course of business. • Specific invoices and correspondence from the entity's professional advisors. • Significant contracts re-negotiated by the entity during the period. • Reports of the internal audit function.

Situations	Audit Procedures
SITUATION 01: Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.	If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall: • Promptly communicate the relevant information to the other members of the engagement team; • Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and • Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions; • Perform appropriate substantive audit procedures on newly identified related party to reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and • If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit as per ISA. TIPS for Students: Procedures mentioned above are those procedures that auditor has already performed in objective 01 (obtaining an understanding of the related party relationship and transactions)
SITUATION 02 Identify Significant transaction outside the entity's normal course of business	If the auditor identifies significant transaction outside the entity's normal course of business, the auditor shall inquire of management about: • the nature of these transactions (understanding the business rationale of the transactions and terms and conditions under which these have been entered into; and • whether related parties could be involved.

To sum up the 2nd Objective, auditor needs to perform certain procedures to address the risk identified in objective 01.

Evaluation of the accounting for and disclosure of identified related party relationship and transactions

After performing procedures auditor shall evaluate in forming an opinion in accordance with ISA 700:

- Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
- Whether the effects of the related party relationships and transactions:
 - Prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or
 - Cause the financial statements to be misleading (for compliance frameworks).
- Disclosures of related party transactions may not be understandable if:
 - The business rationale and the effects of the transactions on the financial statements are unclear or misstated; or
 - Key terms, conditions, or other important elements of the transactions necessary for understanding them are not appropriately disclosed.

Important Note: While evaluating, always remember that, related party transactions are qualitatively material.

Written Representation

As already explained in ISA 580 that auditor needs to obtain specific representation on related party to obtain Sufficient appropriate audit evidence.

- They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and
- They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.
- Circumstances in which it may be appropriate to obtain written representations from those charged with governance include:
 - When they have approved specific related party transactions that materially affect the financial statements or involve management.
 - When they have made specific oral representations to the auditor on details of certain related party transactions.
 - When they have financial or other interests in the related parties or the related party transactions.

Assertions that Related Party Transactions were conducted on terms equivalent to those prevailing in an arm's length transaction

If management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion:

- Comparing the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties.
- Engaging an external expert to determine a market value and to confirm market terms and conditions for the transaction.
- Comparing the terms of the transaction to known market terms for broadly similar transactions on an open market.

- Considering the appropriateness of management's process for supporting the assertion.
- Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- Evaluating the reasonableness of any significant assumptions on which the assertion is based.

LINKING OF ISA 550 WITH OTHER STANDARDS

ISA	Description
ISA 240	Management may have an opportunity to commit <i>fraudulent financial reporting</i> due to the existence of significant related party transactions, not in the ordinary course of business.
ISA 315 (revised 2019)	Whether the risk involves significant transactions with related parties, auditor shall consider it as a <i>significant risk</i> .
ISA 705	If the Controls are not present or ineffective then auditor will not be able to obtain sufficient appropriate audit evidence, therefore, modify the opinion in accordance with ISA 705. If related party transactions are not appropriately accounted for or disclosed in accordance with IAS 24, auditor shall modify the opinion in accordance with ISA 705.

► Practice Question 01:

Give any three audit procedures to ensure completeness of list of related parties provided by the management.

Tutorial Notes:

Verify the listed related parties rather than procedure for ensuring the completeness of the related information.

► Solution 01:

Audit procedures to ensure completeness of related parties

The procedures to ensure completeness of related parties will generally include:

- review of prior year working papers
- review of company's procedures for identification of related parties
- review shareholder's records

► Practice Question 02:

You are the audit manager on the audit of a listed company, Kamil Limited (KL). Prior to completion of audit, you came across a prospectus issued by Neelum Limited (NL) according to which a director of KL is the chief executive of NL. However, the name of NL was not included in the list of related parties provided by KL. On being confronted the management has advised that the name was omitted inadvertently as the appointment took place just two months prior to the year end.

Required:

Discuss your course of action in the above situation.

Tutorial Notes:

Give details regarding various substantive procedures to verify related party transactions instead of addressing the situation given in the question i.e. clients failure to disclose Neelum Limited as a related party; and its implications on further audit procedures.

Always read the question carefully and it has been mentioned quite often that display of irrelevant knowledge even if correct, is of no value and is a mere wastage of time.

► *Solution 02:*

In the scenario, a previously undisclosed related party has been identified. I shall:

- communicate the relevant information to the audit team.
- assess as to why the entity's system failed to identify or disclose the related party relationship.
- request management to identify all transactions with NL and disclose them accordingly.
- perform appropriate substantive procedures on the newly identified related parties or significant related party transactions.
- assess the reasonableness of the management's explanation and;
- evaluate the implications on the audit, if the non-disclosure appears intentional.

► *Practice Question 03:*

A schedule of related party transactions provided by the client includes two significant transactions which are outside the normal course of business. State the substantive procedures that an auditor should undertake, in respect of these transactions.

Tutorial Notes:

Read the question carefully. Consequently, mention the routine procedures that are performed to identify and disclose the related party transactions instead of focusing on the fact that the transactions were outside the normal course of business.

► *Solution 03:*

If the auditor discovers significant related party transactions outside the entity's normal course of business he must:

- Inspect the underlying contracts or agreements to evaluate whether:
 - the contracts etc. were entered into in order to engage in fraudulent financial reporting or to hide the misappropriation of assets (a lack of business rationale might indicate this)
 - the terms of the contracts etc. are consistent with management's explanations, and
 - the transactions have been properly accounted for and disclosed.
- obtain evidence that the transactions were properly authorized

► *Practice Question 04:*

- a) Specify the procedures that an auditor should perform to ensure completeness of the list of related parties provided by the directors.
- b) As part of audit procedure you have requested the management of Energy Limited to provide specific representation relating to completeness of related parties and related party transactions.

The management is of the view that since the auditor has carried out a detailed review in which no undisclosed transactions were identified, a written representation is not necessary.

Required:

Evaluate the above situation, comment on the management's stance and suggest the appropriate course of action available to the auditor.

Tutorial Notes:

Do not restrict yourselves to steps for verification of the already identified related party transactions rather than steps to ensure completeness.

► *Solution 04:*

- a) In order to ensure the completeness of list of related parties provided by the client, your audit procedures could include the following:
- Review working papers for previous years, to look for names of known related parties.
 - Review the company's procedures for identifying related parties.
 - Inquire about the relationships between directors and other entities i.e. whether any director is a director, CEO, major shareholder etc. in another company.
 - Review shareholder records for the names of major shareholders.
 - Review minutes of BOD meetings and general meetings of the company.
 - Get confirmation from any other audit firms involved in the audit about related parties.
(e.g. in case of audit of a group of companies, more than one firm of auditors are involved)
- b) According to the International Standard on Auditing (ISAs) the auditor is required to obtain written representations from management and, where appropriate, those charged with governance that:
- they have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and
 - they have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

In view of the above, the auditor should not accept the argument given by the management. If management does not provide one or more of requested written representations, the auditor shall:

- discuss the matter with management or those charged with governance;
- re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
- take appropriate actions, including determining the possible effect on the opinion in the auditor's report

► *Practice Question 05:*

On the audit of Babar Limited (BL) you have noted a transaction whereby a loan payable to the holding company which was overdue for six months was settled by transfer of securities owned by BL.

Required:

Evaluate the above scenario and specify the audit procedures which need to be performed.

► *Solution 05:*

Repayment of loan to the holding company in the form of transfer of securities indicates a significant and unusual related party transaction, which is outside the entity's normal course of business. In this regard following audit procedures may be performed:

- Inspect the underlying contracts or agreements to evaluate whether:
 - the terms of the contracts etc. are consistent with management's explanations.
 - the transactions have been properly accounted for and disclosed.
 - the contracts and agreements were entered to engage in fraudulent financial reporting or to hide the misappropriation of assets (a lack of business rationale might indicate this).
- Obtain evidence that the transactions were properly authorised.
- If management has made a statement in the notes to the financial statements that a related party transaction was made on the same terms as an arm's length transaction, the auditor must obtain evidence to support this statement.

► **Practice Question 06:**

Briefly describe any three risks of material misstatement in case of significant related party transactions.

► **Solution 06:**

- Accounting systems may not be effective at identifying and summarizing related party transactions and balances.
- Related party transactions may not be conducted on normal market terms.
- Related parties may operate through complex structures and therefore may be used to commit fraud.

► **Practice Question 07:**

Imran is the audit senior responsible for the audit of Pasni Garments Limited (PGL). During the audit he noticed that PGL made significant transactions with related parties.

Required:

- a) State the audit procedures which should be performed to check whether all related parties have been disclosed.
- b) What steps should Imran perform if he identifies any related party transactions which were not identified and disclosed by the management?

(Impact on the audit report is not required)

Tutorial Notes:

- a) Instead of identifying the audit steps to ensure that all related party transactions have been disclosed, do not verify the already identified related party transactions.
- b) Do not consider it as an unintentional error and ignore the possibility of intentional error.

► **Solution 07:**

- a) Imran should perform the following audit procedures to ensure the completeness of identification of related parties.
 - Review working papers for previous years, to look for names of known related parties.
 - Assess the adequacy of the company's procedures for identifying related parties.
 - Review minutes of shareholder meetings and board of directors meeting.
 - Review shareholder records for the names of major shareholders.
 - Review the regulatory returns and the information supplied by the entity to the regulatory authorities.
 - Inspect non-routine and unusual transactions.
 - Inspect significant contracts and agreements not in the ordinary course of business.
 - Review significant contracts renegotiated by the entity during the period.
 - Identify all employee benefit plans and the names of officers and trustees.
 - Review internal audit reports.
- b) If he discovers previously unidentified or undisclosed related parties or (significant) related party transactions he must:
 - i. promptly communicate the relevant information of the related party transaction to other members of the audit team.
 - ii. perform appropriate substantive procedures on the newly identified related parties or significant related party transactions.

- iii. request management to identify all transactions with the newly identified related parties.
- iv. inquire as to why the entity's internal control system failed to identify or disclose these related party relationships or transactions.
- v. reassess the risk of there being unidentified or undisclosed related parties or (significant) related party transactions and respond to the reassessed risk.
- vi. if the non-disclosure by management appears intentional (and therefore indicative of risk of material misstatement due to fraud), evaluate the implications for the audit.

► *Practice Question 08:*

You are the manager responsible for the audit of Zebra Limited (ZL). ZL normally has significant sale and purchase transactions with its related parties.

Guide your audit team regarding the audit procedures and related activities that should be performed for obtaining information relevant to identifying the risks of material misstatements associated with related party relationships and transactions.

Tutorial Notes:

Mention audit procedures and related activities for identifying risks of material misstatement associated with related parties.

► *Solution 08:*

I would suggest the following activities/procedures to my team, in respect of identification of risks of material misstatement related parties:

- The audit team's discussion on risk shall include specific consideration of susceptibility of financial statements to material misstatement due to fraud or error through related parties and their transactions.
- The audit team should inquire of management regarding:
 - the identity of related parties including changes from prior period;
 - the nature of the relationships between the entity and its related parties; and
 - whether any transactions occurred between these related parties during the period and, if so, the type and purpose of the transactions.
 - what controls the entity has to identify, account for and disclose relating to related party relationships and transactions.
- The audit team should obtain an understanding of the controls, if any, that management has established to:
 - identify, account for, and disclose related party relationships and transactions;
 - authorize and approve significant transactions and arrangements with related parties;
 - authorize and approve significant transactions and arrangements outside the normal course of business.
- The audit team should maintain alertness for evidence of related party information when obtaining other audit evidence, in particular, when scrutinizing bank and legal confirmations and minutes of meetings.
- If significant transactions outside the normal course of business are discovered, the audit team should inquire management the nature of the transactions and whether related parties could be involved.
- The audit team should share relevant information obtained about the entity's related parties with other members of the engagement team.

► *Practice Question 09:*

During the audit of Cedar Limited (CL), your audit team observed that CL has sold one of its freehold lands to Maple (Private) Limited (MPL) at a loss of Rs. 10 million. Your team's further investigation of the matter and reading of the minutes of the board of directors' meeting revealed that:

- i. a director of CL holds 20% shareholdings in MPL which makes this entity as CL's related party; and
- ii. MPL would pay 30% of the consideration in cash and the remaining amount over a period of five years.

Required:

Evaluate the above related party transaction and suggest any eight key audit procedures that your team should perform in this respect.

Tutorial Notes:

- Do not fail to evaluate the fact that there was the possibility that the transaction may not be made in the ordinary course of business.
- Do not fail to mention about inquiring the management in respect of reasons for disposal of freehold land.

► *Solution 09:*

Since the related party transaction was not disclosed to the audit team by the client, it creates a risk of not disclosing all related party(ies) and related party transaction(s). Further, the way the transaction is structured (i.e. sold on loss and 70% payment over a period of five years), it seems that it is not in the ordinary course of business.

Key audit procedures to be performed:

- i. Inquire with management the reasons for disposal of freehold land.
- ii. Promptly communicate relevant information of related party transaction to other members of the audit team.
- iii. Request management to identify all transactions with MPL for further evaluation.
- iv. Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures.
- v. Inquire as to why CL's system failed to identify or disclose this related party relationship and transaction.
- vi. Obtain representation from the management that all related parties have been identified & disclosed to auditor.
- vii. Inquire about the influence of director with respect to the said transactions.
- viii. If the non-disclosure by management appears intentional (and therefore indicative of risk of material misstatement due to fraud), evaluate the implications for the audit.

► *Practice Question 10:*

During the audit of Tether Limited (TL), the audit senior noticed that in one of the floors of the office building, a business other than that of TL was being run. On inquiry with TL's management, it was identified that the floor was given to the daughter of a director for six months for running her online business. No rent is being charged as it has been a vacant floor and carries no marginal cost to TL.

Required:

Evaluate the above arrangement and discuss the procedures which should be performed by the audit senior.

Tutorial Notes:

Do not fail to mention the following audit procedures:

- Discuss with management the terms of the arrangement, and whether there is any contract or agreement in place.
- Request management to identify the fair value of the new arrangement.
- Inquire from the management that whether this arrangement has been authorized.
- If the management does not disclose the arrangement in the financial statements, then discuss the non-disclosure with those charged with governance.

► **Solution 10:****Evaluation:**

Transaction with the daughter of a director is a related party transaction not conducted at arm's length. Even though the management decides not to charge any amount from the daughter of the Director, being a related party transaction, this arrangement needs to be disclosed in the financial statements. Not disclosing the related party transaction would be a non-compliance of IAS-24 and the Fourth Schedule of Companies Act 2017 and will be a material misstatement. Furthermore, it was a transaction which was not disclosed to the audit team.

Procedures to be performed by the audit senior:

- i. Communicate the relevant information to the audit team.
- ii. Discuss with management the terms of the arrangement, and whether is there any contract or agreement in place.
- iii. Request management to identify all transaction related to the new arrangement.
- iv. Request management to identify the fair value of the new arrangement.
- v. Reconsider the risk of other unidentified or undisclosed related parties or related party transactions.
- vi. Inquire from the management that whether this arrangement has been authorized.
- vii. Inquire as to why the client's system failed to identify or disclose this related party relationship and transaction.
- viii. If the management does not disclose the arrangement in the financial statements, then discuss the non-disclosure with those charged with governance.
- ix. Consider the risk of fraud and management integrity if the non-disclosure appears intentional and evaluate the implications for the audit.
- x. Obtain management representation that all related parties and the transactions with them have been disclosed to the audit team.

► **Practice Question 11:**

Your firm is the statutory auditor of Bashu Clothing Limited (BCL) for the year ended 31 December 2022. BCL is a manufacturer of active wear. The draft financial statements show profit before taxation of Rs. 300 million.

During the audit, it was observed that there was an outstanding receivable of Rs. 0.3 million from Shigar (Pvt.) Limited (SPL) since June 2022. On inquiry, the management informed your team that this represents a receivable from SPL for management services related to supply chain management and human resource management. Further inquiry revealed that SPL was referred to BCL by one of BCL's director who also holds the same position in SPL. This was because SPL is a newly incorporated business and required assistance in setting up these departments.

Required:

- a) Evaluate the above transaction and discuss the course of action that the audit team should take. (Reporting implications are not required)
- b) State the representation(s) which your firm should obtain from BCL.

Tutorial Notes:

a)

- Do not fail to evaluate the possibility that transactions with related parties may not be under normal market terms or may be outside the normal course of business.
- Do mention the following audit procedures:
 - Inspect the underlying contracts or agreements and evaluate whether the terms of the transactions are consistent with management's explanations.
 - Compare the credit period given to SPL with one or more unrelated parties.
 - Compare the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties.
 - Send confirmation to the newly identified related party to confirm the transactions conducted and the outstanding balance.

b)

Do mention:

- Whether those charged with governance have financial or other interests in the related parties or the related party transactions.
- Whether the transactions have been carried out at arm's length.
- Whether those charged with governance have approved the related party transactions that materially affect the financial statements.
- Whether those charged with governance have made specific oral representations to the auditor regarding the details of the related party transaction.

► **Solution 11:**

a) Evaluation of the transaction:

Since there is common directorship in BL and SPL, both these entities are related parties. Secondly, it also seems that management had not disclosed this related party relationship as the auditor came to know about it after inquiries from the management. Thirdly, this receivable has been outstanding for the last seven months which may indicate that it may not have been conducted under normal market terms. Furthermore, since BCL is a manufacturer of active wear, providing management consultancy may be considered as a transaction outside normal course of business.

Auditor's course of action:

- Inspect the underlying contracts or agreements, if any, and evaluate:
 - whether the terms of the transactions are consistent with management's explanations.
 - the transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.
- Promptly communicate the relevant information to the other members of the engagement team.
- Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation.
- Remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of further related party relationships or transactions that management has not previously identified or disclosed to the auditor.
- Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions.
- Compare the credit period given to SPL with one or more unrelated parties.
- Comparing the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties.

- Obtain audit evidence that the transactions have been appropriately authorized and approved.
 - Send confirmation to the newly identified related party to confirm the transactions conducted and the outstanding balance.
 - Review minutes of meetings of shareholders and of those charged with governance.
 - If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit as per ISA.
- b) Following representation should be obtained:
- Whether BL has disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware;
 - Whether BL has appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework;
 - Whether those charged with governance have financial or other interests in the related parties or the related party transactions;
 - Whether the transactions have been carried out at arm's length;
 - Whether those charged with governance have approved the related party transactions that materially affect the financial statements;
 - Whether those charged with governance have made specific oral representations to the auditor on details of the related party transaction.

► *Practice Question 12:*

While reviewing the working papers prepared by audit team for the audit of Apple Limited, the audit manager has noted that the team solely relied upon written representation in the following cases:

- i. Identification of related party transactions
- ii. Inventories held by third parties

Required:

Discuss the quality of audit evidence obtained by the audit team.

Tutorial Notes:

Focus on mentioning the alternate audit procedures in detail and did not discuss that how solely relying on the written representation would affect the quality of the audit evidence obtained by the audit team.

► *Solution 12:*

Identification of related parties

ISA 550 specifically requires to obtain written representation regarding disclosure of all related parties and their transaction to the auditor and also their disclosure in the financial statements. However, relying solely on management representation for the identification of related party transactions may not provide sufficient audit evidence. While the management representation can provide initial information, it should be corroborated with additional audit procedures such as review of contracts, inquiries with external parties, and analysis of transaction data to ensure completeness and accuracy. Without corroborating evidence, there is a risk of overlooking undisclosed related party transactions and inaccuracies in the information provided by management.

Inventory held by third parties

Again, solely relying on management representation for inventories held by third parties may not be adequate. Audit procedures such as confirmation of inventory held by third parties, physical count, reliance on report of inventory count performed by third party auditor, or inspection of inventory movement documents, could be performed to obtain reliable evidence. Relying solely on management representation could lead to misstatements or errors being overlooked, particularly if there are discrepancies between what management has recorded and the actual inventory.

► *Practice Question 13:*

Suggest any five audit procedures that the auditor could perform to test whether related party transactions were conducted under the terms consistent with those of an arm's length transaction.

Tutorial Notes:

Do not fail to mention the following audit procedures:

- Considering the appropriateness of management's process for supporting the assertion.
- Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- Evaluating the reasonableness of any significant assumptions on which the assertion is based.

► *Solution 13:*

- i. Comparing the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties.
- ii. Engaging an external expert to determine a market value and to confirm market terms and conditions for the transaction.
- iii. Comparing the terms of the transaction to known market terms for broadly similar transactions on an open market.
- iv. Considering the appropriateness of management's process for supporting the assertion.
- v. Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- vi. Evaluating the reasonableness of any significant assumptions on which the assertion is based.

2 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Define the terms related party and related party transactions
- Discuss the impact on the audit of related party relationships and transactions
- Explain the requirements of ISA 550 and relevant audit procedures

RELIANCE ON OTHERS

IN THIS CHAPTER:

1. Using the work of internal auditors: ISA 610 (Revised)
2. Using the work of an auditor's expert: ISA 620
3. Chapter review

1 USING THE WORK OF INTERNAL AUDITORS: ISA 610 (REVISED)

1.1 Concept and role of internal audit

Purpose and functions of internal audit

Internal audit consists of audit, investigation or review work carried out on a voluntary basis by an entity, for its own control purposes. The internal audit work may be carried out by the entity's own full-time internal audit staff, or by an external accountancy firm.

The range of audit and investigation work that may be performed by internal auditors can be listed more specifically as follows:

- Carrying out audits into the adequacy of financial controls in specific areas of the accounting system.
- Carrying out audits into the adequacy of operational controls in specific areas of the operational systems of the entity.
- Auditing the adequacy of controls in the entity's IT systems.
- Reviewing the economy, efficiency and effectiveness of particular operations or activities, these reviews are called value for money (VFM) audits.
- Carrying out checks into compliance with key aspects of legal or regulatory requirements to which the entity is subject. For example, a bank may use internal auditors to check compliance by the bank with regulations for the prevention or detection of money laundering. Similarly, an oil company may use internal auditors to check into compliance with health and safety regulations at its operating sites.
- Examination and review of financial information produced by the entity.
- Special investigations, such as investigations into suspected cases of fraud within the entity.

Comparison of external and internal audit

Internal and external auditors often carry out their work using similar procedures. This is something to bear in mind when answering 'practical' questions on auditing in an examination.

However, there are a number of fundamental differences between the two audit roles. These are summarised in the following table:

	External Audit	Internal Audit
Role and work	To express an opinion on the truth and fairness of the annual financial statements. The external auditor will therefore carry out whatever work he deems necessary to reach that opinion.	To examine systems and controls and assess risks in order to make recommendations to management for improvement. The internal auditor's work programme will therefore to a large extent be dictated by audit committee.
Qualification to act	As per Companies Act, only Chartered Accountant can be appointed as the auditors of the Company except for small paid up capital companies (refer Companies Act section)	No such statutory requirement other than the listed entity
Appointed by	The shareholders. This ensures independence.	Audit Committee - In order to give as much independence as possible, the internal auditor should therefore report to the Audit Committee
Report to	The shareholders.	Audit Committee.

1.2 Introduction to ISA 610 (Revised)

ISA 610 (Revised) *Using the work of internal auditors* deals specifically with the external auditor's responsibilities when choosing to use the work of internal auditors. This includes:

- using the work of the internal audit function in obtaining audit evidence; and
- using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor.

► Definition: Direct assistance

Direct assistance is defined as the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

ISA 610 (Revised) does not apply if the entity does not have an internal audit function and where an internal audit department exists but both their responsibilities and activities are not relevant to the audit or based on the auditors preliminary understanding, does not expect to use the work of the function in obtaining audit evidence. The external auditor may be **prohibited**, or **restricted** by **law or regulation** from using the work of the **internal audit function** or using internal auditors to provide **direct assistance**.

When ISA 610 (Revised) is applied, the **objectives** of the external auditor are:

- to determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent and having made that determination:
 - if using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and
 - if using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work.

1.3 Evaluating internal audit function

To determine whether the internal auditor's work is adequate for his purposes, the external auditor is **required** to **evaluate** the internal audit function and its procedures. A decision can then be taken as to whether the work of the internal auditors can be used as part of the evidence on which the external audit opinion will be based.

The table below summarises the criteria against which the internal audit function will be assessed:

Criterion	Comment
Objectivity	• To whom does it report? Does it have access to those charged with governance? • Is it free of any conflicting responsibilities (e.g. any operational responsibilities)? • Do those charged with governance oversee employment decisions regarding the internal audit function? • Membership of professional bodies and their compliance with professional standards • Restrictions in place in communicating the finding to the external auditor • Do those charged with governance determine the appropriate remuneration policy?
Competence	• Are the internal auditors members of relevant professional bodies? • Do they have adequate technical training and proficiency? • Are there established policies for hiring and training internal auditors? • Do the internal auditors possess the required knowledge of financial reporting?
Systematic and disciplined approach	• Is internal audit work properly planned, supervised, reviewed and documented? • Does the function have appropriate quality management procedures, audit manuals, work programmes and other relevant documents?

If any of the above factors regarding objectivity, competence and systematic and disciplined approach are lacking, ISA 610 (Revised) states that the external auditor shall not use the work of the internal audit function.

1.4 Using the work of internal auditors

Examples of work of the internal audit function that can be used by the external auditor include:

- Testing of the operating effectiveness of controls;
- Substantive procedures involving limited judgment;
- Observations of inventory counts;
- Tracing transactions through the information system relevant to financial reporting;
- Testing of compliance with regulatory requirements;

In addition to the **general** assessment of the internal audit function, ISA 610 also requires the external auditor to **evaluate each specific piece of work** performed by internal audit before it is used as external audit evidence.

As a basis for determining the areas and extent to which work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed and its relevance to the external auditor's overall audit strategy and audit plan.

The external auditor is **required** to evaluate whether:

- the work was properly planned, performed, supervised, reviewed and documented.
- sufficient, appropriate evidence was obtained to enable auditors to draw reasonable conclusions.
- appropriate conclusions were reached, consistent with any reports prepared.
- any exceptions or unusual matters were properly resolved.

Agreeing certain matters in advance should make it more likely that the external auditor will be able to rely on the work of internal audit. It may therefore be useful for the external auditor to agree the following in advance with internal audit:

- the timing of such work
- the nature of the work performed
- the extent of audit coverage
- materiality and performance materiality
- methods of item selection and sample sizes
- documentation of work performed
- review and reporting procedures.

Having evaluated the internal auditor's specific areas of work, the external auditor will then perform further procedures on some (or all) of the specific areas. Procedures may include:

- making inquiries of appropriate individuals within the internal audit function;
- observing procedures performed by internal audit;
- reviewing the internal audit function's work program and working papers;
- re-performing a sample of the internal audit function's procedures to validate conclusions reached by the internal audit function.

The exact nature, timing and extent of testing of specific work of the internal audit function will depend upon:

- the external auditor's judgement of the risk and materiality of each area concerned;
- the preliminary assessment of the internal audit function; and
- the evaluation of specific work of the internal audit function.

Documentation

If the external auditor uses the **work** of the internal audit function, the external auditor shall include in the audit documentation:

- The evaluation of:
 - i. Organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors.
 - ii. The level of competence of the function.
 - iii. Application of systematic and disciplined approach, including quality management.
- The nature and extent of the work used and the basis for that decision.
- The audit procedures performed by the external auditor to evaluate the adequacy of the work used.

1.5 Direct assistance

Considering the use of internal auditors to provide direct assistance

If the external auditor plans to use internal auditors to provide direct assistance on the audit (and is not prohibited from doing so by law or regulation) they must evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance including association with the division or department in the entity to which the work relates.

This evaluation must include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity.

External auditor shall not plan to use internal auditors to provide direct assistance if:

- there are significant threats to the objectivity of the internal auditor; or
- the internal auditor lacks sufficient competence to perform the proposed work.
- prohibited by laws and regulations.

When determining the nature and extent of direct assistance work to be assigned to internal audit, the external auditor shall consider:

- the amount of judgement involved;
- the assessed risk of material misstatement;
- the external auditor's evaluation of the existence of threats to the objectivity and level of competence of the internal auditors who will be providing such assistance;
- whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

ISA 610 (Revised) precludes the use of internal audit to perform direct assistance procedures that are as follows:

- Discussion of fraud risks. However, the external auditors may make inquiries of internal auditors about fraud risks in the organization in accordance with ISA 315 (revised 2019).
- Determination of unannounced audit procedures as addressed in ISA 240.
- Amount of judgement involved and risk of material misstatement.
- Since, in accordance with ISA 505, the external auditor is required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, it would not be appropriate to assign these responsibilities to internal auditors.

However, internal auditors may assist in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.

Communication with those charged with governance

ISA 610 (Revised) requires the external auditor to communicate the planned use of internal audit in providing direct assistance to those charged with governance.

Using internal auditors to provide direct assistance

Prior to using internal auditors to provide direct assistance, the external auditor shall:

- Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and
- Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with *ISA 220 (revised) Quality Management for an Audit of Financial Statements*.

In so doing:

- The nature, timing and extent of direction, supervision, and review shall recognise that the internal auditors are not independent of the entity and be responsive to the outcome of the evaluation of the amount of judgement involved, the assessed risk of material misstatement and the evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors providing direct assistance; and
- The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.

The direction, supervision and review by the external auditor of the work performed by the internal auditors must be sufficient in order for the external auditor to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

In directing, supervising and reviewing the work performed by internal auditors, the external auditor shall remain alert for indications that the external auditor's evaluations of the existence and significance of threats to the objectivity and level of competence of the internal auditors providing direct assistance are no longer appropriate.

Documentation

The external auditor is **required to document**:

- The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;
- The basis for the decision regarding the nature and extent of the work performed by the internal auditors;
- Who reviewed the work performed and the date and extent of that review in accordance with ISA 230;
- The written agreements obtained from an authorized representative of the entity and the internal auditors; and
- The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

► Practice Question 01:

Your firm is the auditor of Cell Phones (Private) Limited (CPPL), which operates a chain of mobile phone retail outlets. About 25% of shareholding in CPPL is owned by Anwar and his wife. Anwar is the Chief Executive of CPPL and also looks after the finance and operations of the company. There are five other directors and each of them holds 15% shares in CPPL.

The Internal Audit Function comprises of three senior officers who are graduates. Their duties include checking of accounting records, physical stock taking, preparation of bank reconciliations, reviewing payments and verification of fixed and current assets.

During the planning phase, Anwar stressed the need for early completion of audit, in order to be able to submit the audited financial statements for seeking a long term finance. He was of the view that internal audit working papers would be of enormous help in performing and early completion of the audit.

Required:

State whether it would be advisable to use the internal audit working papers in the above situation and give three distinct reasons to support your decision.

Tutorial Notes:

Assess Independence and Conflicting Responsibilities: When evaluating the use of internal audit working papers, highlight the issue of independence. The internal audit team may have conflicting responsibilities or may not be sufficiently independent to provide unbiased evidence.

Personnel Qualifications: While the qualifications of internal audit personnel are important, independence and conflicting roles are critical reasons why relying on internal audit working papers may not be appropriate.

► **Solution 01:**

It is not advisable to use the work of internal audit for external audit purposes due to following reasons:

- **Status of the internal audit function within the entity**

Administratively all the internal audit staff are under the influence of Anwar and hence their independence is impaired.

- **Conflicting responsibilities:**

The internal audit staff's responsibilities for preparing bank reconciliation statement are in conflict with its responsibility as a member of the internal audit function

- **Qualifications of internal audit staff:**

All the internal audit personnel are graduates and do not have required competence about various aspects of the internal audit function.

► **Practice Question 02:**

Identify the factors that are considered in determining the independence of internal auditors.

► **Solution 02:**

Following factors are considered in determining the independence of internal auditors:

- To whom does the internal auditor reports to.
- Who decides the scope of internal audit work.
- Frequency of rotation of internal audit staff.
- Appointing authority of chief internal auditor.
- Conflict of interest i.e. they should not be responsible for designing internal controls.

► **Practice Question 03:**

Briefly explain how an external auditor would evaluate the adequacy of the work performed by the internal audit function.

► **Solution 03:**

In order to evaluate the adequacy of internal audit function, the external auditor should assess whether:

- i. The work was properly planned, performed, supervised, reviewed and documented;
- ii. Sufficient, appropriate evidence was obtained to enable internal auditors to draw reasonable conclusions;
- iii. Appropriate conclusions were reached, consistent with any reports prepared;
- iv. Any exceptions or unusual matters were properly resolved.

► *Practice Question 04:*

Faheem is the audit manager on audit of Blue Bell Limited (BBL) for the year ending 31 March 2018, which is in the planning stage. BBL has a well-established internal audit function which reports directly to the audit committee. The staff of the internal audit department have adequate level of competence and are members of professional accounting bodies.

Considering the above, Faheem intends to engage internal auditors to perform audit procedures for certain audit areas.

Required:

On behalf of the engagement partner, provide appropriate guidance to Faheem to assist him in selecting the areas where direct assistance of internal auditors can be utilized.

► *Solution 04:*

Before selecting the areas where direct assistance of internal auditors can be used. Faheem should consider the following matters:

- The internal auditor should not be involved in making significant amount of judgement in:
 - planning and performing audit procedures; and
 - evaluating the audit evidence gathered.
- The audit areas assigned to internal auditors should not relate to areas where risk of material misstatement is assessed as high.
- Evaluate the existence of threats to objectivity and level of competence of the internal audit staff who will be providing direct assistance
- The areas assigned should not relate to work in which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with the governance by internal audit function.
- The areas assigned should not relate to the decisions you make in accordance with ISA regarding the internal audit function and the use of its work or direct assistance.
- It should be ensured that despite using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, the external auditor would still be sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

► *Practice Question 05:*

State the matters to be documented by the external auditor if he uses the internal auditor for providing direct assistance on the audit.

► *Solution 05:*

If the external auditor uses internal auditors to provide direct assistance on the audit, the external auditor shall include the following in the audit documentation:

- The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;
- The basis for the decision regarding the nature and extent of the work performed by the internal auditors;
- Who reviewed the work performed and the date and extent of that review in accordance with ISA 230;
- The written agreements obtained from an authorized representative of the entity and the internal auditors; and
- The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

► *Practice Question 06:*

Malta Limited (ML) has been facing problems in running an effective internal audit department. The directors of ML have shared with you a brief structure, functioning, roles and responsibilities of the current internal audit department, which are as follows:

The internal audit department is headed by Hina Akram, a Chartered Accountant. She works in close coordination with CFO and CEO. She prepares audit plan for each quarter by herself. All the internal audit findings are first discussed at length with both the CFO and the CEO and are then presented to the audit committee.

Hina's internal audit team comprises of three members, Usman, Kashif and Amna. Usman is responsible for the audit of treasury and payments, Kashif is responsible for the audit of procurement, payables and production and Amna is responsible for the audit of revenues, receivables and assets, for the last three years. Hina believes that the continued involvement of her team in the same areas has helped them to develop expertise in their assigned areas. This also helps her and her team to design internal controls for the above-mentioned areas in an effective manner.

Required:

Identify the deficiencies relating to independence of internal audit department and recommend measures which should be taken to protect the independence.

► *Solution 06:*

Reporting lines:

Hina works in close coordination with CFO and CEO and also discusses all of the findings with them. Therefore, it seems that the internal audit department is also reporting to CFO and CEO which would impair its independence. Hina should be directly reporting to the audit committee rather than going through CEO and CFO.

Deciding the scope of internal audit work:

The scope of work carried out by the internal auditors is solely decided by Hina without the consultation of the audit committee. The scope of internal audit work should be decided by the audit committee or the chief internal auditor herself with the approval of the audit committee.

Rotation of internal audit staff:

Internal auditor staff has been auditing the same processes for the last three years. They would have become too familiar with the operations that they audit or the management responsible for them. To reduce the familiarity threat, internal auditors should be rotated regularly.

Designing internal controls:

The internal audit department is also involved in designing the internal controls. However, they should not be responsible for the design of internal controls within the entity. If they did, they would be required to audit their own work, which creates self-review threat. Senior management in accounting and finance or line management should have responsibility for the design and implementation of internal controls, taking advice where appropriate from the external auditors when control weaknesses are identified during the external audit.

► *Practice Question 07:*

State any four factors which the external auditor may need to consider while assessing the competence of the internal audit function.

► *Solution 07:*

- i. Are the internal auditors members of relevant professional bodies?
- ii. Do they have adequate technical training and proficiency?
- iii. Are there established policies for hiring and training internal auditors?
- iv. Do the internal auditors possess the required knowledge of financial reporting?

► *Practice Question 08:*

Briefly discuss how the objectivity of the internal audit function can be evaluated.

Tutorial Notes:

Do not omit the following points when evaluating the objectivity of the internal audit function:

- Whether there are any restrictions in place regarding the communication of findings to the external auditor.
- Whether the internal audit function team is a member of professional bodies.

► *Solution 08:*

The objectivity of the internal audit function can be evaluated by inquiring the following:

- To whom does it report? Does it have access to those charged with governance?
- Is it free of any conflicting responsibilities (e.g. any operational responsibilities)?
- Do those charged with governance oversee employment decisions regarding the internal audit function?
- Does the internal audit function team have a membership of professional bodies? Does it comply with the professional standards of any professional body?
- Do those charged with governance determine the appropriate remuneration policy?
- Are there any restrictions in place in communicating the finding to the external auditor?

2 USING THE WORK OF AN AUDITOR'S EXPERT: ISA 620

2.1 Introduction

The term 'expert' is used here in the sense of an individual or an organisation that possesses skills, knowledge and experience **in fields other than accounting or auditing**.

The auditor may use the work of an expert to provide knowledge relevant to the audit, which the audit firm itself does not possess. ISA 620 *Using the work of an auditor's expert* gives a number of examples where experts may be used by an auditor. These include:

- legal opinions
- The valuation of complex financial instruments, land and buildings, plant and machinery, jewellery, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
- The estimation of oil and gas reserves.
- The interpretation of contracts, laws and regulations.
- The analysis of complex or unusual tax compliance issues

Note that the ISA covers the work of **the auditor's** expert, the expert is employed by the auditor, not by the entity. The situation where management use the work of an expert is covered by ISA 500.

The **objective** of ISA 620 is to allow the auditor to:

- decide whether to use the work of an expert, and
- assess whether that work is adequate.

2.2 Assessing the need for an expert

There is a cost attached to the use of an expert by the auditors. The expert will charge a fee for the professional service he provides. The use of an expert should therefore be evaluated on a cost/benefit basis.

When deciding whether he needs to use an expert to assist him in obtaining sufficient appropriate evidence, the auditor should consider such factors as:

- the nature, significance and complexity of the matter
- the risk of material misstatement
- the availability of alternative sources of audit evidence such as whether management expert is used

2.3 Assessing the work of an expert

ISA 620 **requires** the auditor to apply the procedures set out below when using the work of an expert. The auditor should:

- assess the competence, capabilities and objectivity of the expert in one or more of the following ways:
 - Personal experience with previous work of that expert.
 - Discussions with that expert.
 - Discussions with other auditors or others who are familiar with that expert's work.
 - Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
 - Published papers or books written by that expert.
- obtain an understanding of the expert's field of expertise, sufficient to allow the auditor to determine the nature, scope and objectives of the expert's work and evaluate the adequacy of that work.

- agree terms of engagement with the expert, including:
 - the nature, scope and objectives of the expert's work
 - the respective responsibilities of the expert and the auditor
 - the form of the expert's report
 - confidentiality requirements
- evaluate the adequacy of the expert's work, including the:
 - relevance and reasonableness of the expert's conclusions and their consistency with other audit evidence
 - reasonableness of significant assumptions and methods used
 - relevance, completeness and accuracy of source data

Generally, the auditor is assessing whether the expert's work constitutes sufficient and appropriate audit evidence.

If the auditor decides that the work of the expert is not adequate he is **required** to:

- agree additional work with the expert, or
- perform other appropriate additional audit procedures.
- If the auditor concludes that the work of the expert is not adequate for the auditor's purposes and the auditor cannot resolve the matter through the additional audit procedures, which may involve further work being performed by both the expert and the auditor, or include employing or engaging another expert, it may be necessary to express a modified opinion in the auditor's report in accordance with ISA 705 because the auditor has not obtained sufficient appropriate audit evidence.

The auditor has sole responsibility for the audit opinion issued and this is not reduced in any way by his use of an expert. Therefore **he should not refer in his report to the use of an expert**, unless that is required by law or regulation. Even then, or if the auditor refers to the expert's work in his report because it is relevant to an understanding of a modified opinion, then he must make it clear that such a reference does not reduce his responsibility for that opinion in any way.

This approach reinforces the point made earlier, that the auditor remains fully responsible for the report produced, even if evidence on which it is based was produced by others. The auditor therefore cannot simply accept work performed by experts. That work must be evaluated in the same way as any other audit evidence is evaluated.

► *Practice Question 09:*

Mineral Limited (ML) has incorporated a liability for gratuity payable to its employees on the basis of actuarial valuation carried out by Professionals Limited (PL). As the audit partner of ML, you are not satisfied with the valuation report prepared by PL, and have decided to appoint Experts Limited (EL) to carry out the valuation exercise again.

Required:

- a) State the matters that you would consider regarding:
 - i. The competence, capabilities and objectivity of EL.
 - ii. Evaluation of the adequacy of EL's work.
- b) Briefly discuss the course of action in case you are not satisfied with the work performed by EL.

Tutorial Notes:

- a) This is a straightforward question. Points related to competence and adequacy of work should not be interchanged in some cases.
- b) In case the auditor was not satisfied with the work performed by the auditors' expert. Do not repeat the same points as were mentioned in response to part (a) of the question.

► *Solution 09:*

a)

- i. Matters that should be considered by the auditor in determining the competence, capabilities and objectivity of EL

The competence, capabilities and objectivity of an expert may be assessed in one or more of the following ways:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with other auditors or others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.

- ii. While evaluating the adequacy of the EL's work, the following would be considered:

- Reasonableness of the EL's conclusions.
- Consistency of such conclusions with other audit evidence.
- Reasonableness of significant assumptions and methods used.
- Relevance, completeness and accuracy of source data.

- b) If the auditor decides that the work of the expert is not adequate, he is required to:

- agree additional work with the expert, or
- perform other appropriate additional audit procedures.
- hire another expert

► *Practice Question 10:*

You are the audit manager in a firm of Chartered Accountants. Your firm is often required to engage an auditor's expert for reporting on matters relating to the audits.

- a) List four key terms of engagement which should be agreed with the expert.
- b) Specify the factors which should be considered in evaluating the adequacy of the work performed by the expert.

Tutorial Notes:

Do not fail to understand that they were required to evaluate the work of the expert rather than the expert themselves. It must be noted that evaluation of the work is carried out after it has been performed as was mentioned in the question, whereas evaluation of the expert is undertaken before appointment

► *Solution 10:*

a)

- i. the nature, scope and objectives of the expert's work
- ii. the respective responsibilities of the expert and the auditor
- iii. the form of the expert's report
- iv. confidentiality requirements

b) The factors that should be considered in evaluating the adequacy of the expert's work, include:

- reasonableness of the expert's conclusions
- consistency of those conclusions with other audit evidence
- reasonableness of significant assumptions and methods used
- Relevance, completeness and accuracy of source data.

► *Practice Question 11:*

Identify four examples of situations which may require the engagement of an auditor's expert.

► *Solution 11:*

Following are the situations which may require the engagement of an auditor's expert:

- legal opinions
- specialist valuation areas, such as property or pension liabilities
- analysis of complex or unusual taxation issues
- specialized inventory counts

► *Practice Question 12:*

An audit junior of your firm has inquired about the following matters relating to an audit:

- i. Is there any need to evaluate the adequacy of expert's work, if the procedures related to competency and independence of the auditor's expert have been performed?
- ii. Can an audit firm include a reference to the expert's work in the audit report so that the audit firm's responsibility may be reduced in the areas in which the audit firm does not have expertise?

Required:

Comment on the above queries raised by audit junior in the light of International Standards on Auditing.

► *Solution 12:*

Auditor remains fully responsible for the report produced, even if evidence on which it is based was produced by others. The auditor has sole responsibility for the audit opinion issued and this is not reduced in any way by his use of an expert.

Therefore, he should not refer in his report to the use of an expert, unless that is required by law or regulation. Even then, or if the auditor refers to the expert's work in his report because it is relevant to an understanding of a modified opinion, then he must make it clear that such a reference does not reduce his responsibility for that opinion in any way.

The auditor therefore cannot simply accept work performed by experts. That work must be evaluated in the same way as any other audit evidence is evaluated.

- reasonableness of the expert's conclusions.
- consistency of those conclusions with other audit evidence.
- reasonableness of significant assumptions and methods used.
- relevance, completeness and accuracy of source data.

► *Practice Question 13:*

You are manager responsible for the audit of Bamboo Limited. Your team has asked for your guidance whether to involve an auditor's expert for:

- i. valuation of provision for doubtful debts. The provision has significantly reduced by Rs. 100 million as compared to previous year.
- ii. fixed asset revaluation. The management has recently revalued its fixed assets. The revaluation surplus has increased by Rs. 80 million.

The draft financial statements show a profit before tax of Rs. 500 million.

Required:

Guide your audit team about involvement of an auditor's expert.

Tutorial Notes:

Do not fail to mention that provision of doubtful debt is an area of accounting and auditing for which an auditor is expected to have expertise.

► *Solution 13:***i. Valuation of provision for doubtful debts**

The auditor may use the work of an expert to provide knowledge relevant to the audit, which the audit firm does not possess. Provision of doubtful debt is an area of accounting and auditing for which an auditor is expected to have expertise and can be verified by various evidences available, such as aging, subsequent receipts, etc. Therefore, the audit team does not require an expert for valuation of provision for doubtful debts.

ii. Fixed asset revaluation

The balance of fixed asset revaluation is material to the financial statements. Furthermore, due to complexity involved it has an inherent risk of material misstatement.

Since the only source of evidence available is valuation report, the auditor should involve an expert due to lack of expertise and availability of audit evidence for verification of revaluation surplus.

► *Practice Question 14:*

How would an auditor assess the competency and capabilities of an auditor's expert?

► *Solution 14:*

We will assess the competence, capabilities and objectivity of the expert in one or more of the following ways:

- i. Personal experience with previous work of that expert.
- ii. Discussions with that expert.
- iii. Discussions with other auditors or others who are familiar with that expert's work.
- iv. Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- v. Published papers or books written by that expert.

► *Practice Question 15:*

Your firm serves as the auditor for Sindh Coal Limited (SCL) for the year ending 31 March 2024. SCL engages in coal mining operations, supplying coal to electricity generation power plants. The coal mined by SCL is stored in piles within a warehouse facility and is weighed only at the time of dispatch to customers. Accurately determining the weight of coal in piles poses a highly complex and technical challenge.

Recognizing the materiality of coal inventory to the financial statements, the audit team has made the decision to engage an auditor's expert. This expert will assist in accurately determining both the quantity and the net realizable value of SCL's coal inventory.

Required:

Discuss the appropriateness of audit team's decision to involve auditor's expert.

Tutorial Notes:

- Discuss the appointment of an expert for the inventory count.
- Do consider that an expert might not be needed for the valuation of the inventory and that the auditor can perform audit procedures for its verification.

► Solution 15:

If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert. The auditor is not an expert to determine the quantity of coal stored in piles. Since the inventory of coal has been categorized as a material area, the use of work of an auditor's expert will be necessary to obtain sufficient appropriate audit evidence on inventory.

However, the determination of the value of the coal stock is an area of accounting and auditing for which an auditor is expected to have expertise and can be verified by various evidences available, such as subsequent sales to power plants, subsequent receipts, verifying market prices etc. However for determining the quality of coal inventory or the quantification of damaged inventory may require the use of auditor expert if it cannot be reasonably determined by the audit team.

3 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Differentiate between internal and external audit
- Explain what is involved when the external auditors seek to place reliance on the work of the internal auditor in accordance with ISA 610 (Revised)
- Discuss how the external auditor uses the work of an auditor's expert in compliance with ISA 620

PROFESSIONAL ETHICS AND CODE OF CONDUCT

IN THIS CHAPTER:

1. Fundamental principles
2. Conceptual Framework Approach
3. Chapter review

1 FUNDAMENTAL PRINCIPLES

1.1 The application of professional ethics

The objectives of the accountancy profession are to work to the highest standards of professionalism, to attain the highest levels of performance and to act in the public interest at all times. The Code of Ethics for Chartered Accountants (revised 2024) provide members with authoritative guidance on minimum acceptable standards of professional conduct.

All chartered accountants are required to comply with the code of ethics. There might be circumstances where laws or regulations preclude an accountant from complying with certain parts of the Code. In such circumstances, those laws and regulations prevail, and the accountant shall comply with all other parts of the Code (R100.7)

A chartered accountant might encounter unusual circumstances in which the accountant believes that the result of applying a specific requirement of the Code would be disproportionate or might not be in the public interest. In those circumstances, the accountant is encouraged to consult with a professional or regulatory body (100.6 A3)

Although these rules apply to all chartered accountants, the examination is primarily concerned with how the rules apply to chartered accountants in practice (e.g. an external auditor or assurance provider).

1.2 The fundamental principles s110.1 A1

A chartered accountant shall comply with the following fundamental principles:

- a) Integrity - to be straightforward and honest in all professional and business relationships.
- b) Objectivity – not to compromise professional or business judgements because of bias, conflict of interest or undue influence of others.
- c) Professional Competence and Due Care –
 - i. Attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and
 - ii. Act diligently and in accordance with applicable technical and professional standards
- d) Confidentiality - to respect the confidentiality of information acquired as a result of professional and business relationships
- e) Professional Behaviour
 - i. Comply with relevant laws and regulations.
 - ii. Behave in a manner consistent with the profession's responsibility to act in the public interest in all professional activities and business relationships; and
 - iii. Avoid any conduct that the chartered accountant knows or should know might discredit the profession

The fundamental principles of ethics establish the standard of behaviour expected of a chartered accountant. The conceptual framework establishes the approach which an accountant is required to apply to assist in complying with those fundamental principles.

A chartered accountant might face a situation in which complying with one fundamental principle conflicts with complying with one or more other fundamental principles. In such a situation, the accountant might consider consulting, on an anonymous basis, if necessary with:

- Others within the firm or the employing organization
- Those charged with governance
- A professional body
- A regulatory body
- Legal counsel

However, such consultation does not relieve the accountant from the responsibility to exercise professional judgement to resolve the conflict or, if necessary, and unless prohibited by law or regulation, disassociate from the matter creating the conflict.

1.3 Integrity [ss111]

A chartered accountant shall comply with the principle of integrity, which requires an accountant to be straightforward and honest in all professional and business relationships.

Integrity implies fair dealing and truthfulness and having the strength of character to act appropriately, even when facing pressure to do otherwise or when doing so might create potential adverse personal or organizational consequences.

A chartered accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information:

- a) Contains a materially false or misleading statement;
- b) Contains statements or information provided recklessly; or
- c) Omits or obscures information required to be included where such omission or obscurity would be misleading.

If a chartered accountant provides a modified report in respect of such a report, return, communication or other information, he is not in breach of the above requirement.

When a chartered accountant becomes aware of having been associated with information described above, the accountant shall take steps to be disassociated from that information.

► Example 01:

You are the audit partner of Metrics Solutions Limited (MSL) a listed entity on Karachi and Lahore stock exchanges. Your team has recently finished the audit field work and you have issued the audit opinion. MSL also issues an unaudited summary annual report to its members. As a good practice, the Company Secretary has provided you with a draft copy of the summary annual report before issuing it to the members. During your reading, you noted that a material information regarding the recent announcement of staff restructuring has been inadvertently omitted from the Chairman's forward.

As per the guidelines of the Code of Ethics, you should act with integrity and inform the Company Secretary about the error. The Chairman's forward and the summary annual report is not subject to the audit but because there is an error known to you it is important that you highlight this error and request it to be fixed before the annual report is issued to the members. If management decides to ignore this error, you should ensure that your name/ or firm's name is not associated with the summary annual report.

► Example 02:

Let's consider the facts in example 01 but assume that the summary annual report is required to be audited. You have not yet released your summary audit opinion on the report. If you become aware of the error, you should communicate to the Company secretary in writing to correct the error and should not release the audit opinion until the error is corrected. If management is unwilling to correct the mistake you should consider modifying your audit report as per ISA 705/706.

Practical considerations

Sometimes accountants may make inadvertent errors or have an honest difference of opinion. These circumstances do not impact the integrity. However, Integrity cannot accommodate deceit or subordination of principles, values and standards. A chartered accountant should test his integrity by asking these two questions:

1. Am I doing the right thing in the given situation that a person with integrity would do?
2. Am I retaining my integrity after making a decision in a particular situation?

1.4 Objectivity [ss112]

A chartered accountant shall comply with the principle of objectivity, which requires an accountant not to compromise professional or business judgment because of bias, conflict of interest or undue influence of others.

A chartered accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity.

► *Example 03:*

Mr. Hashaam is the sole audit partner in the firm "Fellow Chartered Accountants". The firm has been offered to act as the auditors of Zee Limited for the year ending 31 December 2019. Zee Limited previously employed Mr. Hashaam's father who retired from the company two years ago. However, his father is receiving monthly gratuity payments as part of his post-retirement benefits. The monthly payments vary depending on the investment returns made by the gratuity during the month. The gratuity fund's liability and investments are managed by Zee Limited and is required to be consolidated in the group financial statements.

This case brings in question Mr. Hashaam's objectivity to act as the auditor of Zee Limited. The fact that his father is receiving monthly gratuity payments and the amounts vary depending on the investment returns creates conflict of interest for Mr. Hashaam to act the auditor. Fellow Chartered Accountants should reject the offer to act as the auditor of the company.

Practical considerations

A chartered accountant should test his objectivity by asking these two questions:

1. What would be the decision of another equally experienced chartered accountant under the similar circumstances with access to the same information, but without the other relationships or influences that have put my objectivity at risk?
2. After making the decision, have I retained my objectivity?

1.5 Professional Competence and Due Care [ss113]

A chartered accountant shall comply with the principle of professional competence and due care, which requires an accountant to:

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

Serving clients and employing organizations with professional competence requires the exercise of sound judgment in applying professional knowledge and skill when undertaking professional activities.

Maintaining professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. Continuing professional development enables a chartered accountant to develop and maintain the capabilities to perform competently within the professional environment.

Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

In complying with the principle of professional competence and due care, a chartered accountant shall take reasonable steps to ensure that those working in a professional capacity under the accountants have appropriate training and supervision.

► *Example 04:*

Faraz Noman Zaryab Associates (FNZ) is a firm of chartered accountants with offices in Karachi, Lahore and Islamabad. FNZ's main clients are tier1 listed entities in the oil and gas and mining sectors. The release of IFRS 15 has impacted almost all of FNZ's audit clients for recognition and disclosure in the way the revenue is recognised and disclosed. FNZ has not yet devised a strategy to deal with the training and client advisory requirements. They have approached you, as the audit manager responsible for ethics and training, to draft a three key agenda points for the next partners and managers meeting on 21 February 2019 and to discuss the recommendations.

Agenda for the partners/managers meeting

21 February 2019

Attendees: All partners and managers

Subject: IFRS 15 three key considerations

As per your request, I have drafted the three key considerations with regards to training and advisory requirements for IFRS 15:

First: Develop two training sessions to upskill the management group and audit staff on the requirements of IFRS 15. A one-day course for the partners and managers to learn how to review the contracts under the new revenue standard to be able to provide guidance to the wider audit team. We have an obligation to maintain our technical knowledge and continue to upskill ourselves as the new standards are implemented. Ensure that the training is completed before any work is performed.

Second: Ensure that all staff in the firm directly involved in auditing revenue recognition account balances and disclosures attend the two days' extensive training on how to audit revenue accounts under IFRS 15. It is our responsibility to ensure the staff reporting to us are well trained to perform the professional services. We cannot simply rely that the staff will find their own way of learning.

Third: Monthly staff updates and monitoring should be put in place to discuss ongoing issues the auditors see the way IFRS 15 has been implemented by the clients and form a best practice to ensure continuing improvement process. We have an obligation to maintain our knowledge.

Where appropriate, a chartered accountant shall make clients, employers or other users of the accountant's professional services aware of the limitations inherent in the services or activities.

In practical world, it is a common practice in the audit firms to add disclaimers and inherent limitations of providing audit services, such as inherent limitations due to fraud or sample-based approach. The disclaimers are provided in various communications to management or those charged with governance. These communications include, audit engagement letter, management reports on internal control findings and audit close presentations.

Practical considerations

A chartered accountant should test his professional competence by asking these two questions:

1. Am I (as a team) competent and qualified to perform this work?
2. Can I obtain expert advice or assistance to enable me to perform this work Competently?

1.6 Confidentiality [ss114]

A chartered accountant shall comply with the principle of confidentiality, which requires an accountant to respect the confidentiality of information acquired as a result of professional and business relationships.

An accountant shall:

- a) be alert to the possibility of inadvertent disclosure, including in a social environment and particularly to a close business associate or a close or immediate family member.
- b) maintain confidentiality of information within the firm or employing organization.

- c) maintain confidentiality of information disclosed by a prospective client or employing organization.
- d) not disclose confidential information acquired as a result of professional and business relationships.
- e) not use confidential information acquired as a result of professional and business relationships for the personal advantage of the accountant or for the advantage of a third party.
- f) not use or disclose information in respect of which the duty of confidentiality applies even if that information has become publicly available, whether properly or improperly
- g) not use or disclose any confidential information, either acquired or received as a result of professional or business relationship, after the relationship has ended; and
- h) take reasonable steps to ensure that personnel under the accountant's control, and individuals from whom advice and assistance are obtained, respect the accountant's duty of confidentiality.

► *Example 05:*

Two audit associates in your team are on the audit of Confidential Oils Marketing Limited, a listed entity with a market capitalisation of over 10% of total stock exchange. Due to this, the entity's performance results are sensitive to the investors. The audit fieldwork is almost completed, and the audit report is due next week. You become aware of an issue where a key piece of confidential information was breached and leaked from your team before the conclusion of the audit. However, in this situation it was only leaked to the tax partner in your firm who promptly advised you of the breach.

Upon inquiry of the two associates, you become aware that one of the associates was talking about a material restatement with the other associate in a public lift. In this instance the only other person in the lift was the tax partner (who was also on the engagement tax auditing tax calculations). Even though the confidential information was not released to a third party on purpose, this discussion rendered breach of confidentiality for the firm and could have serious consequences. Any confidential information or discussion should be avoided at all costs in public places, home or even outside the engagement team within the firm.

► *Example 06:*

In example 04, let's assume that an advisory partner (another service line in your firm who provide valuation services to non-audit clients) has requested to see the draft annual report of Confidential Oils Marketing Limited before the audit is completed. He has requested this information to be able to write his proposal in order to add some credentials on the size of the company. The proposal he is writing is for another entity's valuation services who also operate in the same business. As per the rules of confidentiality, you should not send the draft annual report to the advisory partner as the information is not yet available to the public. The advisory partner is not part of the engagement team and hence sharing the information would be breach of confidentiality.

Confidentiality serves the public interest because it facilitates the free flow of information from the chartered accountant's client or employing organization to the accountant in the knowledge that the information will not be disclosed to a third party. Nevertheless, the following are circumstances where chartered accountants are or might be required to disclose confidential information or when such disclosure may be appropriate:

- a) Disclosure is required by law, for example:
 - i. Production of documents or other provision of evidence in the course of legal proceedings; or
 - ii. Disclosure to the appropriate public authorities of infringements of the law that come to light;
- b) Disclosure is permitted by law and is authorized by the client or the employer;
- c) There is a professional duty or right to disclose, when not prohibited by law:
 - i. To comply with the quality review of the professional body;
 - ii. To respond to an inquiry or investigation by a professional body or regulatory body;
 - iii. To protect the professional interests of a chartered accountant in legal proceedings; or
 - iv. To comply with technical and professional standards including ethics requirements.

In deciding whether to disclose confidential information, factors to consider, depending on the circumstances, include:

- Whether the interests of any parties, including third parties whose interests might be affected, could be harmed if the client or employer consents to the disclosure of information by the chartered accountant.
- Whether all the relevant information is known and substantiated, to the extent practicable. Factors affecting the decision to disclose include:
 - Unsubstantiated facts.
 - Incomplete information.
 - Unsubstantiated conclusions.
- The proposed type of communication, and to whom it is addressed.
- Whether the parties to whom the communication is addressed are appropriate recipients.
- Any applicable law or regulation (including those governing privacy) in a jurisdiction where disclosure might take place and, if different, the jurisdiction where the confidential information originates.

A chartered accountant shall continue to comply with the principle of confidentiality even after the end of the relationship between the accountant and a client or employing organization. When changing employment or acquiring a new client, the accountant is entitled to use prior experience but shall not use or disclose any confidential information acquired or received as a result of a professional or business relationship.

► *Example 07:*

Your firm has recently completed the audit of Sweet Biscuits Limited's (SBL) financial statements for the year ended 31 December 2018. Two months after issuing the audit report, you have received a notice from the High Court to disclose the information on the manufacturing process costing system notes. The court needs this information as a law suit has just been filed against SBL regarding a flaw in their automated system and manufacturing practices. Can you disclose the confidential information to the court?

In this instance, you should inform SBL that the High Court has requested to disclose the confidential information, and request in writing SBL's permission to disclose the information. If the permission is granted, you should disclose the information to the Court. If the permission is not granted, you should seek legal advice on the matter and notify this fact to the court.

Practical considerations

A chartered accountant should check whether he is disclosing confidential information by asking these two questions:

1. Whether the interest of the party subject to the confidential information could be harmed if the information is disclosed?
2. Whether all the relevant facts are known and substantiated before the information is disclosed?

1.7 Professional Behaviour [ss115]

A chartered accountant shall comply with the principle of professional behaviour, which requires an accountant to

- i. Comply with relevant laws and regulations.
- ii. Behave in a manner consistent with the profession's responsibility to act in the public interest in all professional activities and business relationships; and
- iii. Avoid any conduct that the chartered accountant knows or should know might discredit the profession

A chartered accountant shall not knowingly engage in any business, occupation or activity that impairs or might impair the integrity, objectivity or good reputation of the profession, and as a result would be incompatible with the fundamental principles.

Conduct that might discredit the profession includes conduct that a reasonable and informed third party would likely to conclude adversely affects the good reputation of the profession.

► *Example 08:*

Mr. Khalid is an audit partner in the firm Khalid Associates. Mr. Khalid is preparing to submit a tender to act as the auditor of National Oil Marketing company. In the proposal, Mr. Khalid included three points of differentiation to ensure his chances of success:

- i. His audit services will be far efficient and timely compared to any other chartered accountant firm in the town
- ii. He will beat the audit fee to be quoted by other firms by 10%
- iii. Khalid Associates has always received excellent feedback, which no other firms have achieved

Please discuss whether the above points of differentiation are acceptable to act in the light of the Code of Ethics?

The proposed tender document prepared by Mr. Khalid does not meet the requirements of professional behaviour as per the requirements of the Code of Ethics for Chartered Accountants.

- Mr. Khalid should not compare his services with other members/firms as it denigrates the work of other chartered accountants.
- Mr. Khalid is not allowed to undercut the fee charged by other accountants. In this claim he is guaranteeing to beat the fee proposed by others by 10%. Mr. Khalid should quote a fixed fee representative of hours and staff efforts required to carry out the audit in accordance with the auditing standards.
- Comparing his firm's feedback with other firms is discrediting the profession. There is no harm on adding specific recommendations as long as these do not belittle the work of other chartered accountants.

Practical considerations

A chartered accountant should check whether his actions depicts professional behaviour by asking these two questions:

1. How would I react if I was the client (or other party) and a chartered accountant behaved like this towards me?
2. Have I behaved professionally in any given situation?

► *Practice Question 01:*

- a) Briefly describe the term 'Integrity' in accordance with the Code of Ethics for Chartered Accountants.
- b) Briefly state the difference between 'actual independence' and 'perceived independence'.
- c) The principle of confidentiality imposes an obligation on chartered accountants to refrain from disclosing confidential information. State three key exceptions to the above rule.

► *Solution 01:*

a) **Integrity:**

Members should be straightforward and honest in all professional and business relationships. Integrity implies not just honesty but also fair dealing and truthfulness.

A chartered accountant should not be associated with reports, returns, communications or other information which according to him is materially false or misleading.

b) **Actual Independence:**

Actual independence means that the auditor should not be influenced by anything which results in compromising his professional judgement while expressing an opinion.

Perceived independence: The auditor must be seen to be independent, i.e. the auditor should avoid facts and circumstances due to which a third party may conclude that his integrity, objectivity or professional skepticism had been compromised.

c) The following are circumstances where chartered accountants are or may be required to disclose confidential information:

- Disclosure is permitted by law and is authorized by the client.
- Disclosure is required by law.
- There is a professional duty or right to disclose, when not prohibited by law:

► **Practice Question 02:**

a) You have recently been promoted as a partner in the assurance department of a firm of chartered accountants. Your portfolio of clients includes Shah Motors (Pvt.) Limited (SML), a leading car dealer. Qaiser, a senior manager assurance in your firm, has been auditing SML for the past 7 years. While updating you about SML, Qaiser informed about the following:

- i. On the request of an audit team member, CFO of SML has helped the team member's brother in securing early delivery of a vehicle ordered by him on preferential basis.
- ii. SML has hired a new Head of Marketing. His son Amjad is expected to be included as a junior team member in SML's audit team.

Required:

Discuss the possible threats which may arise, their significance and the safeguards required to mitigate those threats.

b) State the circumstances where a chartered accountant may be required to disclose the information obtained during the audit.

Tutorial Notes:

This question would be answered better after understanding of the 'Conceptual Framework' given in the other unit

Identify only the relevant threats; do not list excessive or irrelevant threats, as this can lead to loss of marks.

Discuss the significance of each identified threat instead of just stating its presence.

Ensure all parts of the question are attempted to avoid unnecessary mark deductions.

Read the question carefully to ensure no sub-part is overlooked.

► **Solution 02:**

a)

i. Familiarity and self-interest threat may arise because of long association of Qaiser on the audit of SML.

The threat is significant but it also needs to be further evaluated by considering whether SML's management team has changed or whether the nature or complexity of SML's accounting and reporting issues has changed.

Following safeguards may be applied:

- Replace Qaiser with any other senior manager having appropriate experience.
- Asking a professional accountant who was not a member of the audit team to review the work.
- Regular independent internal or external quality reviews of the engagement.

- ii. Requesting CFO for expediting the delivery may create self-interest, familiarity, intimidation threat to the independence of the audit team member.

The threats seem to be significant because the preferential treatment was not in the normal course of the business.

The audit team member who has obtained preferential treatment should not be made part of the audit team and in case he is made part of the team, his work should be reviewed by an independent chartered accountant.

It should also be ensured that no such breach of ethics occurs in future and the firm should communicate and strictly implement its policies in this regard. Firm may also consider taking disciplinary action against the individual who had obtained the preferential treatment from SML.

- iii. Family and personal relationship between a member of the audit team and the Head of Marketing of SML may create self-interest, familiarity and / or intimidation threats.

The threat would be significant because of the close relationship. The significance would also depend on Amjad's responsibilities on the audit team.

Following safeguards may be applied:

- Removing Amjad from the audit team
 - Structuring the responsibilities of the audit team so that Amjad does not deal with matters that are within the responsibility of his father.
 - Review of work carried out by Amjad,
- b) A chartered accountant should refrain from disclosing confidential information acquired as a result of professional and business relationships. However, under the following circumstances, a chartered accountant may be required to disclose confidential information:
- Disclosure is required by law.
 - There is a professional duty or right to disclose, when not prohibited by law.
 - Disclosure is permitted by law and is authorized by the client.

► *Practice Question 03:*

In the light of ICAP's Code of Ethics, state the circumstances where a Chartered Accountant is required to disclose confidential information.

► *Solution 03:*

- Disclosure is permitted by law and is authorized by the client or the employer
- Disclosure is required by law
- There is a professional duty or right to disclose

2 CONCEPTUAL FRAMEWORK APPROACH APPLICABLE TO ALL CHARTERED ACCOUNTANTS (S120)

2.1 Introduction

S120.1	The circumstances in which chartered accountants operate might create specific threats to compliance with the fundamental principles. This section sets out requirements and application material, including a conceptual framework, to assist accountants in complying with the fundamental principles and meeting their responsibility to act in the public interest. Such requirements and application material accommodate the wide range of facts and circumstances, including the various professional activities, interests and relationships, that create threats to compliance with the fundamental principles. In addition, they deter accountants from concluding that a situation is permitted solely because that situation is not specifically prohibited by the Code.
S120.2	The conceptual framework specifies an approach for a chartered accountant to: a) Identify threats to compliance with the fundamental principles; b) Evaluate the threats identified; and c) Address the threats by eliminating or reducing them to an acceptable level
R 120.3	The chartered accountants shall apply the conceptual framework to identify, evaluate and address threats to compliance with the fundamental principles.
R 120.5	When applying the conceptual framework, the chartered accountant shall: a) Have an inquiring mind b) Exercise professional judgment; and c) Use the reasonable and informed third party test.

2.2 Threats and Safeguards

Identifying Threats

R 120.6	The chartered accountants shall identify threats to compliance with the fundamental principles.
S120.6 A2	Threats to compliance with the fundamental principles might be created by a broad range of facts and circumstances. It is not possible to define every situation that creates threats. In addition, the nature of engagements and work assignments might differ and, consequently, different types of threats might be created.
S120.6 A3	Threats to compliance with the fundamental principles fall into one or more of the following categories: a) Self-interest threat - the threat that a financial or other interest will inappropriately influence a chartered accountant's judgment or behaviour; b) Self-review threat - the threat that a chartered accountant will not appropriately evaluate the results of a previous judgment made; or an activity performed by the accountant, or by another individual within the accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of performing a current service; c) Advocacy threat - the threat that a chartered accountant will promote a client's or employing organization's position to the point that the accountant's objectivity is compromised;

- d) Familiarity threat - the threat that due to a long or close relationship with a client, or employing organization, a chartered accountant will be too sympathetic to their interests or too accepting of their work; and
- e) Intimidation threat - the threat that a chartered accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the accountant.

S120.6 A3	A circumstance might create more than one threat, and a threat might affect compliance with more than one fundamental principle.

► **Example 09:**

Review the five situations below and comment which threat(s) arises in the circumstances:

1. You are the audit partner on the audit of Pensions Scheme Retirement Fund. The fund has recently changed its investment policy and decided to outsource all its investment and cash to a mutual fund. Your spouse is working as a Chief Investment Officer in the mutual fund.
2. H Processing Plant Limited has been a long standing tax client of your firm. They have outsourced tax preparation and compliance services to your firm. Due to the good relationship they have also requested your firm to act as the auditor for the upcoming financial year. They intend to keep the tax outsourcing with your firm
3. H Processing Plant Limited has been facing a litigation with tax authorities. They have offered your firm to act as a tax representative on their behalf and have offered a material amount in commission if the outcome is in their favour.
4. Mr. Jahanzaib is the audit partner of APM Investment (Private) Limited for the last 10 years.
5. APM Investment (Private) Limited accounts for 40% of the total audit fee of Mr. Jahanzaib.

Threats to the fundamental principles:

1. **Self-interest and familiarity threat** – because the spouse will be responsible to make all investment decisions may impact the judgement of the audit partner. The audit partner may be under threat to not report any control weaknesses in the investments as a result.
2. **Self-review threat** – because your firm prepares the tax calculations you should not be auditing the work prepared by your own firm.
3. **Self-interest and advocacy threat** – the fee is offered on a commission basis make impact your judgement as the focus will be on winning the dispute. Self-interest threat as the fee is material.
4. **Advocacy threat** - as the fee is offered on a commission basis which may impact your judgement as the focus will be on winning the dispute.
5. **Familiarity threat** - due to long standing relationship acting as the audit partner as Mr. Jahanzaib may be too sympathetic to the errors in APM's internal controls or financial statements
6. **Self-interest and intimidation threat** – 40% fee is material to the total fee which renders Mr. Jahanzaib interest in keeping the client. There is also intimidation threat as Mr. Jahanzaib may not want to lose the client and may compromise on his own judgement in case of any issues or weaknesses.

Evaluating Threats

R 120.7	When the chartered accountant identifies a threat to compliance with the fundamental principles, the accountant shall evaluate whether such a threat is at an acceptable level.
120.7 A1	An acceptable level is a level at which a chartered accountant using the reasonable and informed third party test would likely conclude that the accountant complies with the fundamental principles.

Factors relevant in evaluating the level of threats.

S120.8 A1	The consideration of qualitative as well as quantitative factors is relevant in the chartered accountant's evaluation of threats, as is the combined effect of multiple threats, if applicable.

Consideration of new information or changes in facts and circumstances

R120.9	If the chartered accountant becomes aware of new information or changes in facts and circumstances that might impact whether a threat has been eliminated or reduced to an acceptable level, the accountant shall re-evaluate and address that threat accordingly.
R120.9 A1	Remaining alert throughout the professional activity assists the chartered accountant in determining whether new information has emerged or changes in facts and circumstances have occurred that: - Impact the level of a threat; or - Affect the accountant's conclusions about whether safeguards applied continue to be appropriate to address identified threats.
R120.9A2	If new information results in the identification of a new threat, the chartered accountant is required to evaluate and as appropriate, address this threat.

► Example 10:

Your assurance firm is auditor of Happy Goods. The audit manager has just become engaged to the managing director's daughter. The managing director (MD) owns 51% of the shares in Happy Goods.

Required.

List the threats to independence which might arise as a result of the above, explaining clearly why these are threats.

An intimidation threat might arise because the MD could exert influence over the audit manager via any influence he might have over his daughter. Alternatively, as the relationship between the audit manager and his future father-in-law develops, direct intimidation might be possible.

A familiarity threat might arise, again, as the relationship between the audit manager and the MD develops. The audit manager may become less critical of the reporting or operational practices at this client.

A self-interest threat might arise because the MD owns a majority shareholding in Happy Goods and his daughter (who may well inherit the shares at some point in the future) therefore has a vested interest in the performance of the organisation as will her husband (i.e. this threat is probably greater once the marriage has taken place).

Addressing Threats

R120.10	If the chartered accountant determines that the identified threats to compliance with the fundamental principles are not at an acceptable level, the accountant shall address the threats by eliminating them or reducing them to an acceptable level. The accountant shall do so by: - Eliminating the circumstances, including interests or relationships, that are creating the threats; - Applying the safeguards, where available and capable of being applied, to reduce the threats to an acceptable level; or - Declining or ending the specific professional activity

Actions to eliminate threats

R120.10 A1	Depending on the facts and circumstances, a threat might be addressed by eliminating the circumstance creating the threat. However, there are some situations in which threats can only be addressed by declining or ending the specific professional activity. This is because the circumstances that created the threats cannot be eliminated and safeguards are not capable of being applied to reduce the threat to an acceptable level.

Safeguards

R120.10 A2	Safeguards are actions, individually or in combination, that the chartered accountant takes that effectively reduce threats to compliance with the fundamental principles to an acceptable level.

Consideration of significant judgements made and overall conclusions reached

R120.11	The chartered accountant shall form an overall conclusion about whether the actions that the accountant takes, or intends to take, to address the threats created will eliminate those threats or reduce them to an acceptable level. In forming the overall conclusion, the accountant shall: - review any significant judgments made or conclusions reached; and - use the reasonable and informed third party test.

Professional Skepticism

R120.16 A1	Under auditing, review and other assurance standards, including those issued by IAASB, chartered accountants in practice are required to exercise professional skepticism when planning and performing audits, reviews and other assurance engagements. Professional skepticism and fundamental principles are inter-related concepts.

R120.13 A2	In an audit of financial statements, compliance with the fundamental principles, individually and collectively, supports the exercise of professional skepticism, as shown in the following examples:

- Integrity requires the chartered accountant to be straight forward and honest. For example, the accountant complies with the principle of integrity by:
 - Being straightforward and honest when raising concerns about a position taken by a client; and
 - Pursuing inquiries about inconsistent information and seeking further evidence to address concerns about statements that might be materially false or misleading in order to make informed decisions about the appropriate course of action in the circumstances

In doing so, the accountant demonstrates the critical assessment of audit evidence that contributes to the exercise of professional skepticism.

- Objectivity requires the chartered accountant not to compromise professional or business judgement because of bias, conflict of interest or the undue influence of others. For example, the accountant complies with the principle of objectivity by:
 - Recognising circumstances or relationships such as familiarity with the client, that might compromise the accountant's professional or business judgment; and
 - Considering the impact of such circumstances and relationship on the accountant's judgement when evaluating the sufficiency and appropriateness of audit evidence related to a matter material to the client's financial statements.

In doing so, the accountant behaves in a manner that contributes to the exercise of professional skepticism.

- Professional competence and due care require the chartered accountant to have professional knowledge and skill at the level required to ensure the provision of competent professional service and to act diligently in accordance with applicable standards, laws and regulations. For example, the accountant complies with the principle of professional competence and due care by:
 - Applying knowledge that is relevant to a particular client's industry and business activities in order to properly identify risks of material misstatements;
 - Designing and performing appropriate audit procedures; and
 - Applying relevant knowledge when critically assessing whether audit evidence is sufficient and appropriate in the circumstances.

In doing so, the accountant behaves in a manner that contributes to the exercise of professional skepticism.

► **Practice Question 04:**

Discuss the categories of threats that may be involved in each of the following independent situations and advise the partners of the concerned firm with regard to the possible course of action that may be followed in each situation:

- a) Ahmed has recently joined a firm of Chartered Accountants. The firm intends to depute him on the audit of Masoom (Private) Limited (MPL). Prior to joining the firm, Ahmed had been providing accounting and taxation services to MPL for many years, in the capacity of a consultant.
- b) It has been discovered that father of one of the trainees posted on the audit of Chalak Limited (CL), has a financial interest in CL.
- c) Hoshiyar Limited (HL), an audit client of your firm has recently advertised certain vacancies in its accounts department. The said positions have been applied for by number of individuals including two staff members who are posted on the audit of HL.

Tutorial Notes:

a) **Self-Review and Familiarity Threats:**

Correctly identify self-review and familiarity threats, especially when an employee who previously provided accounting and taxation services is now part of the audit team.

Discuss the significance of the threats and evaluate whether the concerned individual should be part of the audit engagement.

Mention relevant safeguards, such as removing the individual from the engagement if the threat is significant.

b) **Self-Interest Threat:**

Correctly identify the self-interest threat when a trainee's father holds a financial interest in the client.

Discuss materiality and significance of the financial interest to evaluate the impact of the threat.

Do not just list safeguards—if the financial interest is material, the only safeguard is to remove the trainee from the audit.

c) **Self-Interest Threat:**

Correctly identify the self-interest threat when a team member knows they might join the client in the future.

Do not misidentify other threats, such as advocacy or intimidation threats, unless they are directly relevant. Only self-interest threat should be considered in this case.

► **Solution 04:**

- a) The previous provision of accounting and taxation services to MPL and long association of Ahmed with MPL will create self-review and familiarity threat.

Significance of threats needs to be evaluated and if threats are other than clearly insignificant, safeguards need to be applied to reduce the threats to an acceptable level.

In case Ahmed is included in the Audit engagement the related safeguards may include:

- involving an additional chartered accountant to review the work done by Ahmed or otherwise advise as necessary.
- independent internal quality reviews.

If the threats are significant, Ahmed should not be part of the assurance engagement team.

- b) In the given situation involvement of such trainees in the audit of CL may result in a self-interest threat.

The materiality and significance of the financial interest, needs to be evaluated. If the financial interest is immaterial then the audit trainee may be allowed to work on that client, otherwise only safeguard available is to withdraw the trainee from this assignment.

- c) A selfinterest threat is created when a member of the assurance team participates in the assurance engagement while knowing, or having reason to believe, that he may join the assurance client in future.

The threat created can be reduced to an acceptable level by the application of the following safeguards:

- Ask the individual to notify the firm when entering serious employment negotiations with the assurance client;
- Remove of the individual from the assurance engagement;
- Perform an independent review of any significant judgments made by that individual while on engagement.

► *Practice Question 05:*

Discuss the categories of threats and related safeguards in each of the following situations:

- a) Your firm is the auditor of Prime Super Markets Limited, a chain of super markets. During a promotional campaign, the management has distributed discount vouchers which have also been given to the audit team members.
- b) You are manager on audit of Abid Textile Mills Limited. Client has requested you to send two staff members on secondment for three months to assist chief financial officer as its two senior accounting team members have resigned recently.
- c) Fine Petroleum Limited (FPL) is the audit client of your firm for five years. During the year, the engagement partner has been changed due to mandatory rotation as per Code of Corporate Governance. However, the firm has decided to retain Atif, the audit manager, who has been involved in the audit of FPL for past five years.

Tutorial Notes:

- a) Self-Interest and Intimidation Threats:

Identify both self-interest and intimidation threats when discussing issues like accepting discount vouchers.

Discuss the significance or insignificance of the amount involved, and how it impacts the overall risk.

Avoid irrelevant safeguards like involving an additional chartered accountant or focusing on quality management and review of work unless they directly address the identified threats.

- b) Self-Review Threat:

Always correctly identify the self-review threat, and clearly state that management responsibilities should not be assumed in the audit process.

Emphasize that auditors must maintain independence by not engaging in management functions.

- c) Safeguards:

When suggesting safeguards, go beyond just rotation of audit personnel. Also mention the use of independent quality management reviews.

Avoid repeating safeguards already provided and instead focus on additional relevant measures that effectively mitigate the identified threats.

► *Solution 05:*

- a) Accepting of discount vouchers may create self interest and intimidation threats.

However, if the value of discount vouchers is not clearly insignificant, the threat to independence cannot be reduced to an acceptable level by the application of any safeguard.

If the value is other than clearly insignificant, the members of the audit team should be instructed not to accept the discount vouchers.

- b) The lending of staff by a firm to an audit client will create a self-review threat. However, the threat may be reduced to an acceptable level if the firm's personnel:
- are not involved in exercising discretionary authority; or
 - do not assume management responsibilities.
 - are not given audit responsibility for any function or activity that they performed or supervised.

The audit client should acknowledge its responsibility for directing and supervising the activities of assigned personnel.

- c) Familiarity and self-interest threats are created by using the same senior personnel on an audit engagement over a long period of time. This applies to the audit manager also.

The significance of the threats shall be evaluated and following safeguards should be applied if necessary to eliminate the threats or reduce them to an acceptable level:

- Rotating the audit manager as well;
- Having a professional accountant who was not a member of the audit team review the work of the audit manager;
- Regular independent internal or external quality reviews of the engagement.

► *Practice Question 06:*

Identify the threats that may be involved and applicable safeguards, if any, in each of the following scenarios:

- a) Your firm is the auditor of Delicious Biscuits Limited (DBL) for the past three years. On previous year's audit, Affan was the audit manager. He has recently joined DBL as GM finance.
- b) ABC leasing company has a lease portfolio of Rs. 500 million. Atif, the Audit Manager on ABC, has obtained a lease finance amounting to Rs. 800,000 from ABC.

Tutorial Notes:

Identify threats accurately; avoid misidentifying threats such as self-interest when it is not applicable.

Suggest only relevant safeguards and avoid mentioning those that do not directly address the identified threats.

When evaluating a lease or similar situation, always assess whether it is under normal conditions or otherwise.

Do not overlook the main issue of the scenario while focusing on threats and safeguards.

► *Solution 06:*

- a) Familiarity or intimidation threats may be created if a member of audit team joins the audit client.

Following are the safeguards:

- i. Modifying the audit plan;
 - ii. Assigning individuals to the audit team who have sufficient experience as compared to the individual who has joined the client;
- b) A loan from an audit client to an audit team member will not create a threat to independence, if the loan is made under normal lending procedures, terms and conditions.

If the loan is not made under normal lending procedures, terms and conditions, a self-interest threat would be created that would be so significant that no safeguard could reduce the threat to an acceptable level. However, as the loan has already been disbursed, the only safeguard available is to remove the manager from the audit team or ask him to settle the lease obligation.

► *Practice Question 07:*

Identify the threats which may be involved and suggest appropriate safeguards, if any, in each of the following scenarios:

- a) The planning phase of the annual audit of ABC (Private) Limited for the year ended 30 June 2016 is in progress. The engagement partner intends to include Kamran as a member of audit team who joined the firm last month. Before joining the firm Kamran was employed in the finance department of ABC.
- b) Nasir is the audit manager on the audit of Diamond Limited (DL) for the year ended 30 June 2016. Nasir has informed that his father owns 10,000 shares in DL.

Tutorial Notes:

Ensure all identified threats are accompanied by the appropriate safeguards.

Do not overlook any relevant safeguard, as missing them may result in lost marks.

Even in well-attempted questions, review answers thoroughly to maximize scoring potential.

► *Solution 07:*

- a) Self-interest, self-review and familiarity threats will be created, as Kamran has served as an employee in ABC.

Safeguards:

- Conducting a review of the work performed by Kamran as a member of the audit team,
- Not including the member in the audit team.

- b) As the father of Nasir is a close family member, having a direct financial interest in DL, a self-interest threat is created.

Safeguards:

- Disposing as soon as practicable, of all the shares by Nasir's father (a close family member)
- Having a professional accountant review the work of Nasir;
- Replacement of Nasir from the Audit team.

► *Practice Question 08:*

Discuss the categories of threats and related safeguards in each of the following situations:

- a) An unlisted audit client which has recently been incorporated has requested your firm to assist the finance department in the preparation of financial statements.
- b) Saleem has recently been promoted as a partner and the audit of TTL has been assigned to him. TTL owns and operates a chain of restaurants. The following matters are under his consideration:
 - i. Asif has been involved in the audit of TTL as audit senior for the last three years. He has recently qualified as chartered accountant and Saleem wants to appoint him as audit manager.
 - ii. TTL's management has requested Saleem to include Rashid, a semi-senior, in the audit team. Rashid is the son of TTL's Marketing Director.
 - iii. The firm has long cordial relationship with the management of TTL. Saleem has noticed that the firm often uses the restaurants run by TTL for conducting its internal functions.

Tutorial Notes:

Identify threats accurately; avoid mislabelling threats such as self-interest or self-review when they are not applicable.

Suggest safeguards that are relevant to the situation; avoid generic statements like "the auditor should not take management decisions" unless applicable.

Recognise the difference between familiarity and self-review threats; do not confuse the two.

Avoid suggesting routine review procedures as special safeguards unless they directly address the threat.

When assessing threats related to benefits, consider whether the benefit is extraordinary before determining its significance.

Do not recommend extreme actions, such as resigning from the audit, if the threat can be mitigated through reasonable safeguards.

► **Solution 08:**

Assisting financial statement audit client in matters such as preparing accounting records or financial statements may create a self-review threat when the financial statements are subsequently audited by the firm.

The related safeguards are as follows:

- Arrange for such services to be performed by an individual who is not a member of audit team.
- If such services are performed by a member of the audit team, use a partner or senior staff member with appropriate expertise who is not a member of the audit team, to review the work performed by such person, during the audit.
 - i. As Asif is associated with the client since last three years it will create a familiarity threat, an appropriate safeguard would be to exclude Asif from the engagement team.
 - ii. Independence of Rashid can be threatened as Rashid is a close family member of marketing director. Although marketing director is not directly related to the preparation of financial statements, however, he could be tempted by management for not identifying errors due to influence of his father. In order to provide safeguard against the threat the firm should not include Rashid in the audit team.
 - iii. Independence of audit firm can be compromised if extra ordinary benefits is obtained for conducting internal functions at restaurants of TTL. As a precaution, the firm should avoid using the restaurants of TTL.

► **Practice Question 09:**

Discuss the threat(s) that may be involved and the related safeguards in each of the following situations:

- a) Anwar, an ex-trainee has recently rejoined your firm. He is interested in acting as the engagement manager on Curtains Limited, where he had been employed during the past two years.
- b) House Limited (HL) owns the building in which the Karachi office of your firm is located. HL owns multiple projects across the city and provides its premises to various concerns on rental basis. HL has requested your firm to become its auditor for the year ending 30 June 2018.
- c) Window Limited (WL), an audit client of your firm has approached the taxation department of your firm to review the income tax return to be filed by WL.

Tutorial Notes:

When suggesting safeguards, consider both scenarios: if the threat is significant and if it is not. Avoid mentioning only one safeguard.

Do not immediately suggest rejecting the audit engagement; first evaluate the significance of the threat and provide reasoning.

Clearly differentiate between threat types, such as self-review vs. familiarity, to ensure accurate identification.

Always justify why a threat is significant or manageable rather than assuming conflict of interest alone is enough to refuse an engagement.

► *Solution 09:*

- a) The association of Anwar with Curtains Limited will create self-review and familiarity threat. If the threats are significant, Anwar should not be part of the assurance engagement team.

In case Anwar is included in the Audit engagement the related safeguards may include:

- Involving an additional chartered accountant to review the work done by Anwar or otherwise advise as necessary.
- Independent internal quality reviews.

- b) In the given situation, the acceptance of audit engagement will result in a business relationship with an audit client which may pose a familiarity threat to objectivity.

However, the significance of the threat in such situation depends upon the following:

- Whether it is in the ordinary course of business;
- Whether the tenancy agreement is on an arm's length basis; and
- The materiality of the contract for either of the party.

From the situation given, it can be determined that this business relationship is in the ordinary course of business on an arm's length basis and not material to either of the parties, hence, the engagement can be accepted.

- c) Income tax return contains information which is directly related to a significant figure in the financial statements. Therefore, the acceptance of review of income tax return would create a self review threat.

In case the engagement is accepted the related safeguards may include the following:

- The review may be performed by professionals who are not members of the audit team;
- If the service is performed by a member of the audit team, a partner or senior staff member with appropriate expertise and is not a member of the audit team, review the tax calculations; or
- The firm does not get involved in management decision making and clarifies this fact in the communication with the client.

► *Practice Question 10:*

- a) Discuss the threats and the related safeguards in each of the following situations:
- i. Saleem is the audit senior at Mango Industries Limited (MIL). MIL's finance manager has requested him to provide the residential addresses of the engagement manager and the engagement partner. The finance manager wants to send them one of MIL's latest product.
 - ii. Akram is the audit senior engaged on the audit of Dragon Limited (DL). He has informed the audit manager that he has been offered a job by DL and that he would be joining DL from 1 April 2018. The audit is expected to be completed on 15 March 2018.
- b) Amjad is the audit senior at Orange Limited (OL), a software house. OL has adopted IFRS 15 'Revenue from Contracts with Customers' for preparation of its financial statements for the year ending 31 March 2018. However, the manager finance of OL is indecisive as regards revenue recognition on certain contracts.

He has asked Amjad to suggest accounting treatment of such contracts in accordance with IFRS 15. Amjad does not have in-depth knowledge of this IFRS and therefore, he has consulted his friend who has recently attended a workshop on IFRS 15.

Required:

- i. Discuss the threats in the above situation.
- ii. What actions the firm should take to ensure that such situation is avoided in future?

Tutorial Notes:

When assessing gifts, always consider their significance before determining whether they should be accepted or not.

Clearly justify why gifts should or should not be accepted rather than making a general statement.

Avoid misidentifying threats; intimidation and advocacy threats should not be mentioned unless applicable.

Identify self-review and confidentiality threats when evaluating a situation involving lack of knowledge or prior involvement in audit work.

When suggesting preventive actions, go beyond CPD activities related to IFRSs; include guidance on professional behaviour, disciplinary measures, and compliance with ethical principles.

► Solution 10:

a)

- i. Accepting of gift may create self-interest and familiarity threats.

If the value of the gift is not clearly insignificant, the threat to independence cannot be reduced to an acceptable level by the application of any safeguard.

Consequently in such situation, the members of the audit team should be instructed not to accept the gift.

- ii. A self-interest threat is created when a member of the audit team participates in the audit engagement while knowing that he / she may join the client sometime in the future.

On receiving such notification, the significance of threat shall be evaluated and following safeguards could be applied:

- Removing the individual from the audit team; or
- A review of any significant judgments made by that individual while on the team.

b)

- i. Following are the threats in the mentioned situation:

- Suggesting the client about accounting treatment would create a self review threat, because that accounting treatment will also be the subject matter of the assurance engagement.
- Even though Amjad's friend has attended the workshop on IFRS-15, it does not necessarily mean that he is competent enough to advise the client regarding the accounting treatment under IFRS-15, as it could involve significant judgment. It would create a threat to professional competence and due care.
- Sharing of information with his friend may create threat to confidentiality.

- ii. Following actions could be taken by the firm to avoid such a situation in future:

- Regularly conduct professional development of its staff for any recent changes or updates in professional pronouncement.
- Circulate documented internal policies and procedures requiring compliance with the fundamental principles.
- Implement an effective disciplinary mechanism to promote compliance with policies and procedure.

► *Practice Question 11:*

You are the audit manager at a client Exim (Private) Limited (EPL). During the finalisation meeting with the client, the CFO of EPL admired the performance of the audit team. He informed that a junior member of the audit team gave valuable suggestions regarding a trading business which EPL is considering to launch in the near future, as he had worked as an intern in a large business house involved in similar business. The CFO also informed that the audit junior has offered to arrange a warehouse on reasonable rent as he works part time in his brother's estate agency.

Required:

Identify the threats in the above scenario and suggest appropriate safeguards.

Tutorial Notes:

Identify the threat of self-review when an audit team member offers business advice to the CFO.

Mention that auditors should not assume management responsibilities, including giving business advice.

Suggest safeguards such as removing the team member from the audit engagement or ensuring management makes independent decisions without auditor influence.

► *Solution 11:*

Offering business advice to the audit client in such an informal manner is a breach of professional behaviour by the audit junior. He also appears to be in breach of the fundamental principle of professional competence and due care, unless he has the required competency to offer such an advice.

Moreover, business relationship between the member of the audit team and the audit client will create self-interest threat and intimidation threat.

Due to above, the following safeguards may be implemented:

- Any work performed by the audit junior to date should be critically reviewed.
- We need to take steps to ensure that the client does not act on any advice that the junior provided.
- We should also assess any gaps in our internal training process; the junior should have received training prior to his audit assignments so that he understood his role as an auditor.

► *Practice Question 12:*

- a) Shayan has recently been hired as the audit manager in a firm of chartered accountants which is the auditor of Python Limited (PL). Shayan previously served as manager finance in PL for three years.

The firm is considering to depute Shayan as the engagement manager for the audit of PL for the year ended 31 August 2019.

Required: Identify the possible threats which may arise and discuss their significance. Also, discuss the safeguards required to mitigate the threats under each of the following assumptions:

- i. Shayan resigned from PL with effect from 30 June 2019
 - ii. Shayan resigned from PL with effect from 30 June 2018
- b) You are the manager on the audit of Dolphin (Private) Limited for the year ending 31 December 2019. The client has requested you to send an audit trainee on secondment for October and November 2019 to assist the chief financial officer, as one of the key staff members of the accounting team has resigned.

Required: Identify the threat(s) in the above scenario and suggest appropriate safeguards.

Tutorial Notes:

When identifying threats, always discuss their significance to provide a complete response.

Do not just list threats—explain their potential impact on independence and objectivity.

Maintain consistency in answering all parts of the question, even if one part is well-attempted.

► *Solution 12:*

- a) Self-interest threat, self-review threat or familiarity threat may be created. Shayan previously being the manager finance was in a position to exert significant influence over the preparation of the PL's accounting records which would now be subject to his own review in the capacity of audit manager. Furthermore, since Shayan has worked for three years in PL, he may be influenced by his ex-subordinates. Considering these facts, the threat appears to be significant.

If Shayan had previously worked in PL until 30 June 2019

Since he resigned during the period covering by the audit, the threat created would be so significant that no safeguard could reduce the threat to an acceptable level. Consequently, Shayan shall not be part of the audit team.

If Shayan had previously worked in PL until 30 June 2018

- Threats would only be created for decisions made or work performed by Shayan in the prior period, while employed at PL and should be evaluated in the current period as part of the current audit engagement.
 - If Shayan is appointed as the engagement manager then the work performed by him as a member of the audit team should be independently reviewed.
- b) The lending of staff by a firm to an audit client will create a self-review threat, However, the threat may be reduced to an acceptable level if:
- they are not involved in exercising discretionary authority; or
 - they do not assume management responsibilities and the audit client should acknowledge its responsibility for directing and supervising the activities of assigned personnel.
 - an additional review of the work performed by the seconded staff may be carried out.
 - they are not given audit responsibility in future for any function or activity that they performed or supervised.
 - are not included in the audit team.

► *Practice Question 13:*

- a) You are a partner in a firm of chartered accountants. You have received a letter from a special investigation committee formed by the government to investigate the affairs of Naqshbandi Limited (NL).

Your client Rahim Limited (RL) is the subsidiary of NL. The investigation committee requires you to submit the details of all the transactions carried out by RL with NL and its related parties. The committee also requires your firm to report the transaction value and the arm's length value of all the transactions.

Required: In the light of Code of Ethics for Chartered Accountants, discuss any three factors that your firm should consider while disclosing client information to the investigation committee.

- b) Your firm has just been appointed as the auditor of Get Fit Gym Limited (GFG) which operates a chain of high end gyms and fitness centres across the country. The managing director of GFG is a close friend of the audit manager and the audit was awarded to your firm through this connection.

In a recent meeting, the managing director of GFG has offered to grant membership to all the staff members of your firm at 50% discount.

Required: Evaluate the threat(s) which may arise in the above situation. Also discuss the safeguards required to mitigate such threat(s).

Tutorial Notes:

Ensure that all relevant information is known and substantiated before determining the appropriate disclosure. When identifying a threat, evaluate its impact instead of just stating its presence.

Mention safeguards such as structuring the audit manager's responsibilities to minimize undue influence over the assurance engagement.

► *Solution 13:*

a)

- Whether the interests of all parties, including third/related parties whose interests may be affected, could be harmed if the client consents to the disclosure of information.
- Whether all the relevant information related to the related parties is known and substantiated, to the extent it is practicable.
- Since the requirement of the committee involves reporting on the arm's length price of the transaction which generally involves unsubstantiated facts or unsubstantiated conclusions, professional judgment shall be used in determining the type of disclosure to be made, if any.

b)

Threat

Close friendship of the audit manager with the managing director would cause a familiarity threat, because the audit manager would be biased towards the managing director and would sympathetic to his interest or too accepting of his work.

Safeguard

- Structure the audit manager's responsibilities to reduce any potential influence over the assurance engagement; or
- Review the assurance work from a chartered accountant; or
- Remove the audit manager from the engagement.

Threats

- Offering of membership at reduced rate could cause a self-interest threat to the audit, because the recipients may not want to lose their benefit, and therefore be biased in their audit work or not seek adjustments where there are material issues in the financial statements.
- An intimidation threat may also arise because the audit client may threaten to make such offers public to degrade the firm's reputation.

Safeguards

Auditors are not allowed to accept such benefits unless their value is trivial and inconsequential. In this case, the value of a reduced membership of a high end gym is unlikely to be trivial and inconsequential to audit staff members and therefore the firm should reject this discounted offer of MD.

► *Practice Question 14:*

Haris Awan has recently been appointed as a partner in HBC Chartered Accountants. Haris has been assigned the audit of Hemlock Limited (HL). HL has been the firm's client for the past 15 years. Haris has asked Babar Raza, manager responsible for the audit of HL for the last seven years, to assist him in the planning phase. Babar has informed him that:

- attitude of HL's Chief Financial Officer (CFO) has been very aggressive towards audit team members, particularly at times when questioned on any of his judgements in relation to accounting matters.
- CFO normally gives us a short deadline for completion of the audit.
- one of the previous audit team members has recently joined HL as Manager Finance and has ensured us his full cooperation towards the timely completion of the audit.

Required:

Discuss the possible threat(s) which may arise in the above situation, their significance and the safeguards required to mitigate those threats.

Tutorial Notes:

- Always discuss the significance of the identified threat to provide a complete response.
- When addressing the aggressive attitude of the CFO, suggest multiple safeguards such as documenting interactions, escalating concerns within the firm, or involving senior audit personnel in discussions.
- Carefully interpret scenarios; if a former audit team member joins the client (not the audit team), recognise the familiarity or self-interest threat and suggest safeguards like modifying the audit team or implementing a cooling-off period.

► **Solution 14:**

Familiarity and self-interest threat may arise because of using Baber on the audit of HL over a long period of time.

The threat is significant but it also needs to be further evaluated by considering whether HL's management team has changed or whether the nature or complexity of HL's accounting and reporting issues has changed. Furthermore, due to the long association of Babar with HL, he may be too sympathetic to their interest or too accepting of their work.

Following safeguards may be applied:

Replace Baber with any other manager having appropriate experience.

- Ask a professional accountant who is not a member of the audit team, to review the work.
- Regular independent internal or external quality reviews of the engagement.

CFO aggressive attitude towards the audit team and setting short deadlines for completion of audit indicates presence of intimidation threat.

The threat is significant as audit firm may be pressurized into accepting CFO's judgements even when these may not be appropriate and due to very strict deadlines firm may not be able to obtain sufficient appropriate audit evidence. This may result in the issuance of an inappropriate audit opinion.

Following safeguards may be applied:

- Independent review of areas requiring judgements.
- Assign highly skilled and competent audit team members.
- Discussing with those charged with governance the attitude of CFO towards the audit team.

Familiarity or intimidation threats are created as the manager finance has been a member of the previous audit team.

Being in the position of manager finance, the individual is responsible for the preparation of financial statements and will be in continuous communication with the audit team. Due to these factors the threat seems significant.

Following safeguards may be applied:

- Assign individuals to the audit team who have sufficient experience in relation to the individual who has joined the client; or
- Have a professional accountant review the work of the former member of the audit team.
- Modify the audit plan.

► **Practice Question 15:**

You are the Ethics and Quality Control Manager in an audit firm namely HMB Chartered Accountants. The audit manager responsible for the audit of Fantom Limited (FL), has started the audit planning for FL and come across the following matters for which he needs your guidance:

- Fizza was planned to be the engagement supervisor for the audit of FL. She has received an employment offer from FL. However, she is considering not to accept FL's employment offer.
- FL is the main sponsor of the ongoing cricketing event. Being the main sponsor, FL has received some entry passes of VIP enclosure of the final match. It has offered three such passes to the audit team members.

- iii. Your firm is under renovation process and about to procure two central air conditioning systems through tendering process. Your firm has received quotations from various vendors including FL. The total expenditures for purchase and installation of two central air conditioning units are expected to be Rs. 50 million.
- iv. FL has offered your firm that the fee for taxation services of this year may be based on a percentage of tax saved.

Required:

Identify the threat(s) which may arise and evaluate their significance. Also recommend the course of action or the mitigating actions which may be taken by your firm.

Tutorial Notes:

- Recognise the importance of formal communication of refusal to the audit manager to eliminate the threat.
- Do not assume that an audit firm cannot enter into any business relationship with a client—understand that it can, provided appropriate safeguards are in place.
- When discussing fees for taxation services, consider negotiating a different basis for determining the fee to avoid self-interest threats.

► **Solution 15:**

- i. A self-interest threat will be created when a member of the audit team may join the audit-client in near future, as her decision making and objectivity may be impaired due to the potential employment with the client. It needs to be ensured that refusal have been formally communicated to the audit manager before planning her in the audit team. When it has been assured that she won't be accepting the offer then no threat would be created and she could be made part of the audit team.

If it can't be ensured that Fizza will not accept the employment offer, then she should not be made part of the audit team.

- ii. Accepting gifts or hospitality from an audit client may create self-interest, and familiarity threats. The audit team's objectivity may be compromised and they would be too accepting the audit clients work if they are treated with gifts of considerable value. Intimidation threat would also arise as the client may threaten the firm of making such offers public.

Even though the tickets would not have any direct cost to the audit client but they are still of significant value to the audit team. Therefore, the audit team should not accept the tickets for the VIP enclosure of the final match.

- iii. The purchase of goods and services from an audit client by the firm does not generally create a threat to independence if the transaction is in the normal course of business and at arm's length. Since the expected transaction is of significant value, a self-interest threat may be created.

Firm should ensure that no undue favours are accepted and that contract is awarded after a proper tendering process.

- iv. Agreeing to accept taxation work on the percentage of the tax saved is essentially accepting a contingent fee. This would create a self-interest threat as there will be pressure to gain the highest tax savings for the client and this could tempt the audit firm to suggest inappropriate tax advice.

The threat created would be so significant that no safeguard could reduce the threat to an acceptable level, therefore the fee must be based on time and experience for the job, not the contingent fee.

A self-review might also be created and therefore the firm should have separate teams for the taxation service and the audit services.

► *Practice Question 16:*

- a) Khursheed Jamal is a Chartered Accountant and has recently established his audit firm in the name of Khursheed & Company, Chartered Accountants. He is trying to expand his clientele and in this process his friend, who is his audit client and the owner of an advertising agency, has offered to provide significant discount for publicity of his new firm.

Required:

In the light of Code of Ethics for Chartered Accountants, discuss whether Khursheed should accept the offer of his friend.

- b) Hussain Tarar is the audit partner responsible for the audit of Petra Travels (Private) Limited (PTL). The chief executive officer (CEO) of the company has informed Hussain that due to liquidity issues amid COVID-19, several employees including some staff members of finance department left the company. CEO has therefore requested Hussain to provide two staff of the audit firm for some time to run the finance department.

Required:

In the light of Code of Ethics for Chartered Accountants, discuss the threats in the above scenario and suggest appropriate safeguards.

Tutorial Notes:

Address all aspects of the question, not just one threat (e.g., publicity and client discounts).

When discussing advertisement threats, mention that using appropriate newspapers or magazines is permissible and explain compliance requirements for such advertisements.

For loaned personnel, suggest safeguards such as:

Ensuring they do not audit functions they previously performed.

Limiting the assistance to a short period.

Preventing the assumption of management responsibilities while ensuring the client directs and supervises their work.

► *Solution 16:*

- a) As per the “Code of Ethics” for Chartered Accountants, the practicing chartered accountants are not allowed to publicize their services in a manner done by other normal businesses.

However, appropriate newspapers or magazines may be used to inform the public of the establishment of a new practice, of changes in the composition of a partnership, or of any alteration in the address and telephone number of a practice. The following should be considered before placing the announcement:

- Such announcements should be limited to a bare statement of facts in an objective manner.
- Consideration should be given to the appropriateness of the area of distribution of the newspaper or magazine and number of insertions.
- The basic principles of legality, decency, clarity, honesty and truthfulness should be followed; and
- Do not project an image, which is inconsistent with that of a professional person bound to high ethical and technical standards.

The purchase of services from an audit client by a firm does not usually create a threat to independence if the transaction is in the normal course of business and at arm’s length. However, the magnitude of the transaction needs to be evaluated to substantiate that whether a self-interest threat may be created. The firm should evaluate that the whether the amount of discount is material to the firm and would it impair the audit team’s objectivity. It also needs to be evaluated that whether such discounts are also offered to other clients.

The firm may accept the discounted offer only if other clients are also given similar sort of offers and the advertisement is in the compliance with the above mentioned principles.

- b) A self-review threat may be created as the firm would be auditing the same financial information which the team had worked on.

An advocacy threat would also be created as the firm's employees might promote the in-correct position adopted by them to the point that their objectivity is impaired.

A familiarity threat would also be created as the seconded employees will become too familiar with the management of the audit client.

The following safeguards may be adopted to address the above threats:

- Conducting an additional review of the work performed by the loaned personnel.
- Not including the loaned personnel as an audit team member.
- Not giving the loaned personnel audit responsibility for any function or activity that the personnel had performed.
- Providing such assistance only for a short period of time.
- Not assuming management responsibilities and the audit client is responsible for directing and supervising the activities of the personnel.

► *Practice Question 17:*

Your firm has been approached by a recently formed IT Company, Data Technology Limited (DTL), for appointment as its statutory auditors. DTL is mainly owned by three foreign companies who are all registered abroad in tax heaven countries. Your firm does not have any experience of auditing an IT company.

Required:

In the light of the Code of Ethics for Chartered Accountants, identify the threats to the fundamental principles and discuss how your firm would evaluate these threats in the context of accepting the client and engagement. Also briefly discuss the safeguards available to your firm to address the threats. (13)

Tutorial Notes:

- Always evaluate the threat when assessing client acceptance, rather than just identifying it.
- When considering engagement acceptance, discuss key factors such as:
- Understanding the client's business nature to assess risks.
- Complexity of operations and whether the firm has the necessary expertise.
- Industry knowledge and subject matter familiarity to ensure competent service.
- Existing quality management policies and procedures to maintain audit standards.

► *Solution 17:*

Self-interest threat to compliance with the principles of integrity or professional behaviour might be created. As there may be questionable issues associated with the client owners because of their registration abroad in tax heaven countries, it might create threat(s) of client's involvement in illegal activities, dishonesty, questionable financial reporting practices or other unethical behaviour.

To further evaluate this threat, we will have to obtain:

- knowledge and understanding of:
- the client;
- who are the eventual owners, management and those charged with governance; and
- business activities.
- the client's commitment to address the questionable issues raised by the firm.

A self-interest threat to compliance with the principle of professional competence and due care is created if the engagement team does not possess, or cannot acquire the competencies to perform the professional services.

Factors that are relevant in evaluating the level of such a threat include the following:

- Understanding of the nature of the DTL's business; what type of IT services does it provide.
- The complexity of DTL's operations.
- The requirements of the engagement.
- The purpose, nature and scope of the work to be performed.
- Knowledge of relevant industries or subject matter.
- Experience with relevant regulatory or reporting requirements.
- The existence of quality management policies and procedures designed to provide reasonable assurance that engagements are accepted only when they can be performed competently.

The threats to professional competence and due care can be reduced by the following safeguards:

- Assigning sufficient engagement personnel with the necessary competencies.
- Agreeing on a realistic time frame for the performance of the engagement.
- Using experts where necessary.

► **Practice Question 18:**

Ahmed has recently joined your firm as an audit manager. The firm intends to depute him on the audit of Monsoon (Private) Limited (MPL). Prior to joining the firm, Ahmed had been providing accounting and taxation consultancy services to MPL for last many years. Ahmed was also assisting MPL in preparation of annual budgets, management accounts and calculation of tax provision based on audited financial statements.

Required:

Identify and explain the threats to the fundamental principles of ICAP code of ethics. Also evaluate the significance of the identified threats.

Tutorial Notes:

- Explain and evaluate the identified threats instead of just stating them.
- Ensure that only relevant safeguards are mentioned—avoid suggesting unnecessary or unrelated measures.
- Focus on why a threat is significant and how it impacts independence or objectivity.

► **Solution 18:**

There is a self-review threat because Ahmed may not appropriately evaluate the work performed by him in the role of accounting and tax consultant.

There is also a familiarity threat due to Ahmed's long association with MPL, and he might be too sympathetic to their interests or too accepting of their work.

Ahmed's objectivity may be compromised because of his bias, conflict of interest or undue influence of the audit client.

Evaluation of significance of threat:

Self-review threat

The consultancy service related to preparation of annual budget and management accounts may not pose a significant threat as the preparation of annual budget is based on expected amount which is not subject to audit. Therefore, there may not be a self-review threat.

It needs to be ascertained whether the preparation of management accounts is based on the historical amounts and whether any adjustments are made to the accounting records on the basis of the management accounts prepared by Ahmed.

However, the calculation of tax provision would be subject to audit which would result in a significant self-review threat.

Familiarity threat

The closeness of Ahmed's relationship with the senior management and frequency of interaction with the management needs to be determined. In any case this is a significant threat.

It also needs to be determined that since how long Ahmed has been providing these services to the audit client.

► *Practice Question 19:*

- a) Your firm is the external auditor of Hoper Limited (HL) for the year ended 28 February 2023. HL has set a strict deadline for the completion of audit. Due to this time limitation, one of the audit team members has prepared the fixed asset schedule himself to ensure prompt completion of the audit for this account and efficient transition to other areas.

Required:

In the light of the Code of Ethics for Chartered Accountants, identify and explain the threats to the fundamental principles.

- b) Chilas Insurance Limited has approached your firm for appointment as a statutory auditor for the year ending 31 December 2023. If your firm accepts this client, it will be the firm's first client in the insurance industry. Apart from the audit partner, there is only one audit supervisor who have the previous experience of handling insurance clients.

Required:

In the light of the Code of Ethics for Chartered Accountants, identify the threats to the fundamental principles and discuss how your firm would evaluate these threats in the context of accepting the engagement. Also briefly discuss the safeguards available to your firm to address the threats.

Tutorial Notes:

Identify and evaluate the threat posed by strict audit deadlines, considering its impact on audit quality and professional skepticism.

Avoid discussing unnecessary safeguards that are not relevant to the identified threat.

When evaluating threats related to engagement acceptance, focus on engagement-specific risks rather than general client acceptance procedures.

Recognise that specialized knowledge is required for auditing an insurance client and highlight any gaps in expertise.

Mention concerns about only one partner having relevant experience, which raises issues regarding mandatory quality management review.

Suggested safeguards should include:

Providing adequate training to ensure staff competency.

Hiring personnel with industry-specific experience to strengthen the audit team.

► *Solution 19:*

- a) There is an intimidation threat to professional competence and professional behaviour. Since the audit team is facing pressure because of tight deadlines, this may lead the audit team to compromise on the audit quality. The audit team may reduce the sample size, increase the materiality level or adopt other ways to meet the deadline.

Preparation of the fixed asset schedule is the responsibility of the management. A self-review threat to objectivity will be created if the audit team member prepares the fixed asset schedule himself. The audit team member will have to review his own schedule which will be part of the financial statements and his professional judgment would be biased due to this fact.

- b) The insurance industry is markedly different from other businesses and requires a specific knowledge base that the audit team must possess. In addition, the financial statements of an insurance company are distinct from those of other companies, making it necessary for the audit team to possess specialized knowledge in this area. Furthermore, insurance transactions and their accounting are inherently complex in nature, necessitating a thorough understanding on the part of the audit team.

Since only two personnel have experience auditing insurance clients, there is a self-interest threat to compliance with the principles of professional competence and due care. Despite this, the firm may accept the client due to financial and reputational interests, and may subsequently be unable to deliver competent services based on professional standards, potentially discrediting the profession.

Given the current situation, it is necessary to assess:

- whether the knowledge possessed by the two experienced personnel can be effectively transferred to other team members to ensure a successful audit.
- that only one partner has relevant experience and consequently, it is unclear who will conduct the mandatory quality management review. It should be noted that the engagement cannot proceed without an effective quality management review.

Given the high level of threat posed by these factors, the firm should not accept this engagement. However, if the firm decides to accept the engagement, the following safeguards should be implemented:

- Providing adequate training to the staff to ensure that only personnel with the necessary competencies are assigned to the engagement.
- Hiring staff members who possess experience and knowledge of the insurance industry.
- Agreeing upon a realistic time frame for the completion of the engagement.
- Using experts where necessary.

► *Practice Question 20:*

Alia recently completed her Chartered Accountancy qualification and training from Rumi Iqbal and Company, Chartered Accountants. During her training, Alia was mainly engaged in audits of fast moving consumer goods (FMCG) companies.

She is currently working with an audit client who approached her for reporting manager position. One of the main reasons for her selection was her audit experience in the FMCG sector. The audit client, who wants to employ her, expects that she will help prepare a comparative analysis of certain financial aspects of the company using the data from the sector that she may have obtained during the course of her audits.

Required:

In light of the Code of Ethics for Chartered Accountants, identify and explain the threats to the fundamental principles.

Tutorial Notes:

- Identify and explain the fundamental principles and threats related to professional behaviour, familiarity, and intimidation, ensuring they are relevant to the scenario.
- Do not just list threats and principles—explain them in the context of the given situation to demonstrate understanding.
- Avoid mentioning unnecessary safeguards that do not directly address the identified threats.

► *Solution 20:*

Alia has been offered a job by the audit client; therefore, there are self-interest, familiarity and intimidation threats to the fundamental principles of objectivity. In order to secure the employment, offer, Alia may overlook audit issues. Furthermore, as a result, she would also gain familiarity with the individuals, responsible for her hiring and the audit team assigned to the audit client may also be familiar with Alia in case she accepts the offer. The audit client may also intimidate her to overlook issues if she is employed by the audit client. Therefore, Alia might compromise her professional judgment due to bias towards the audit client.

The client's expectation that she would share the data of the competitors poses a self-interest threat to the fundamental principles of integrity, confidentiality, and professional behaviour. The ICAP code of ethics prohibits disclosing confidential information acquired as a result of professional relationships outside the firm without proper and specific authorization. Any disclosure of confidential information would discredit the profession and the audit firm. If Alia accepts the client's employment offer she would not be straightforward and honest in her negotiation as she did not inform the client that she could not disclose the information obtained during the audit.

► **Practice Question 21:**

Consider following independent situation:

- a) AA and Company Chartered Accountants, recently received an invitation to audit Polka Limited (PL), a listed company. An examination of PL's shareholding structure revealed that a not-for-profit trust owns 3% of PL's shares. Azhar, a partner at the firm, serves as an independent trustee on this trust's audit committee.

Required:

Analyse above situation in light of the requirements of the ICAP's Code of Ethics for Chartered Accountants and evaluate the significance of the threats.

- b) Usman, serving as the Head of Human Resources at Iqbal and Company Chartered Accountants, recently proposed that the firm may consider accepting an audit engagement for an e-commerce store. This store is operated by Usman's wife, who holds the position of CEO.

Required:

Analyse above situation in light of the requirements of the ICAP's Code of Ethics for Chartered Accountants and evaluate the significance of the threats.

Tutorial Notes:

Discuss the reasons behind the identified threat instead of just stating its existence.

Evaluate the significance of the threat to demonstrate its impact on independence and objectivity.

Avoid suggesting unnecessary safeguards that do not directly address the identified threat.

Carefully interpret the scenario—do not assume that the HR manager is an audit team member if the question does not state so.

► **Solution 21:**

- a) Azhar, serving as an independent trustee on the audit committee of the Trust which owns 3% of PL's shares, faces self-interest threat to his objectivity and professional behaviour. This threat could lead Azhar to overlook audit issues, negatively affecting the trust's shareholding value in the audit client. This threat may result in a compromise of professional ethics because of bias and conflict of interest, undermining his objectivity and discrediting the profession.

Furthermore, it needs to be evaluated whether the 3% shareholding is material to the trust. Considering this shareholding, the trust is unlikely to exert significant influence over the audit client.

Given Azhar's role as an independent trustee who contributes to the good governance and efficient board function without personal benefits from the trust, the threat's significance appears low.

- b) The audit team faces familiarity and intimidation threats to their principles of objectivity and professional behaviour. Usman, as the head of HR, may have a close relationship with the audit team, potentially leading them to over sympathize towards his wife's interests. Therefore, he could intimidate the audit team, given his possible influence over their salaries and other benefits. This situation could compromise the audit team's objectivity due to a bias towards Usman or his undue influence over their employment benefits.

The significance of these threat largely depends on the extent of interaction between the audit team and Usman, the organization structure of the firm, and level of control Usman has over audit team's salary and benefits.

Therefore, considering the above factors, the risk to professional ethics is deemed high.

► *Practice Question 22:*

Consider each of the following independent situations:

Part (a): You are a partner at a well-established audit firm. One of your audit clients, Grid Volt Limited (GVL), recently had its loan restructured by a bank. As part of the restructuring agreement, the bank waived a significant portion of the mark-up on the loan. Under the relevant tax laws, this waiver results in taxable income. GVL's CFO has approached your firm for advice on how to account for this mark-up waiver to avoid its taxability.

Part (b): You are a partner at an audit firm, responsible for auditing the financial statements of Nova Mart Limited (NML), a well-known retail chain. NML has been with your firm for over a decade, and over time, you've developed a close working relationship with NML's senior management, particularly the CFO, who was once your colleague at another firm.

NML is currently under financial strain due to increased competition and changing market conditions. During the audit, your team discovered that NML has been aggressively recognising revenue earlier than appropriate to boost its financial results. The CFO approaches you privately, acknowledging the issue but asks if you can overlook this in the audit report, citing NML's need to show strong financial health to secure additional financing. The CFO also hints that the board of directors have lately been contemplating a change of audit firm.

Required: In light of the Code of Ethics for Chartered Accountants, discuss the threats and the fundamental principles affected by these threats.

► *Solution 22:*

Part (a)

Self-review threat: If the auditor suggests an accounting treatment to avoid taxable income, they would later have to review and audit the same treatment, creating a conflict. The auditor could be in the position of auditing their own work, making it difficult to remain objective when assessing the appropriateness of the treatment they previously recommended.

Advocacy threat: The auditor may advocate for the client's interest by proposing or supporting an accounting treatment that minimizes taxable income, which could bias their judgment. By providing advice on how to account for the markup waiver, the auditor might take on a role that aligns too closely with the client's interests, rather than remaining an impartial evaluator.

Affected Fundamental Principles:

Objectivity: The auditor's ability to evaluate the accounting treatment impartially is compromised, as they could be reviewing decisions or recommendations they initially made.

Integrity: The principle of integrity is compromised if the auditor agrees to manipulate the financial statements to benefit the client financially, as they may be knowingly associated with a false and incorrect representation of the financial statements which may not comply with tax laws.

Professional behaviour: The auditor risks engaging in or endorsing practices that may not fully comply with tax laws or accounting standards.

Part (b)

Intimidation Threat: The CFO's suggestion that the board of directors is considering a change of audit firm if their request is not met introduces a form of coercion. This threat puts pressure on auditors to overlook aggressive revenue recognition to avoid losing a long-standing and significant client. This places undue pressure to act in a way that may compromise professional judgment.

Familiarity Threat: The long-standing relationship and close personal rapport with the CFO, who was once a colleague, can lead to unconscious bias. This familiarity may cause the auditor to be more sympathetic to the CFO's situation and less critical of the company's financial practices. Over time, the close relationship with the CFO might reduce auditor's professional skepticism, making it difficult to maintain the necessary objectivity required to critically evaluate the company's financial statements.

Self-interest Threat: The potential loss of this client could have financial implications for both the firm and the partner's personal standing within it. The desire to retain a client might influence the audit partner's decision-making, leading to prioritizing financial considerations over ethical obligations as an auditor.

Affected Fundamental Principles:

Objectivity: The close relationship with the CFO and the threat of losing a client challenges the auditor's ability to remain impartial, as the pressure to retain the client could lead to biased decision-making that favours the client's interests over accurate financial reporting.

Professional Behaviour: Yielding to the client's pressure to issue a misleading audit report could lead to actions that discredit professional integrity and the audit firm's reputation.

Integrity: The Auditor may be tempted to compromise the truthfulness and accuracy of the audit report to preserve the relationship and the client, which undermines the principle of integrity.

3 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Describe the fundamental principles of Code of Ethics for Chartered Accountants
- Apply the conceptual framework to identify threats to the fundamental principles and suggest appropriate safeguards across a range of common scenarios

AUDIT FINALISATION - REPORTING

IN THIS CHAPTER:

1. Purpose of the audit report
2. Forming an opinion and reporting on financial statements: ISA 700 (Revised)
3. Communicating Key Audit Matters in Audit report: ISA 701
4. Audit reporting and the Companies Act, 2017
5. Modification to audit opinion: ISA 705
6. Emphasis of matter paragraphs and other matter paragraphs: ISA 706
7. Chapter review

1 PURPOSE OF THE AUDIT REPORT

1.1 Introduction

The audit report is the end-product of the external audit process. It is the document in which the auditor expresses his professional judgement on whether the financial statements present a 'true and fair view'.

The contents of the audit report are likely to be regulated by national legislation. In addition, the external auditor is governed by:

- I-SA 700 (Revised) Forming an opinion and reporting on financial statements
- ISA 705 Modifications to the opinion in the independent auditor's report
- ISA 706 Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report

1.2 The expectation gap

The audit report is the only direct means of communication between the auditor and the users of the financial statements (who are mainly, but not exclusively, the shareholders). In recent years, auditing has suffered from an 'expectation gap' as the role of the auditor in law does not match what the users of financial statements expect from an auditor.

The term 'expectation gap' refers to the fact that the public perception of the role and responsibilities of the external auditor is different from his statutory role and responsibilities. The expectations of the public are often set at a level higher than that at which the external auditor actually operates.

Some examples of the misunderstandings inherent in the public's expectations are as follows:

- The public believes that the audit opinion in the audit report amounts to a 'certificate' that the financial statements are correct and can be relied upon for all decision-making purposes, including decisions about takeovers.
- The public also believes that the auditor has a duty to prevent and detect fraud and that this is one reason for an audit.
- The public assumes that, in carrying out his audit work, the auditor tests 100% of the transactions undertaken during the accounting period.

► Practice Question 01:

Explain the term 'expectation gap' in the context of an audit and give three examples of expectation gap.

Tutorial Notes:

Define "expectation gap" as the difference between public expectations of the audit and the auditor's actual responsibilities.

Avoid confusing the gap with differences in audit results or between management and auditors.

Provide examples that focus on misunderstanding of auditor's role, public perception, and the limits of an audit.

► Solution 1:

The term 'expectation gap' refers to the fact that the public perception of the role and responsibilities of the external auditor is different from his statutory role and responsibilities. The expectations of the public are often set at a level higher than that at which the external auditor actually operates.

Some examples of the misunderstandings inherent in the public's expectations are as follows:

- The public believes that the audit opinion in the audit report amounts to a 'certificate' that the financial statements are correct and can be relied upon for all decision-making purposes.
- The public also believes that the auditor has a duty to prevent and detect fraud and that this is one reason for an audit.
- The public assumes that, in carrying out his audit work, the auditor tests 100% of the transactions undertaken during the accounting period.

2 FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS: ISA 700 (REVISED)

2.1 Unmodified audit report

ISA 700 (Revised) **requires** the auditor to give an unmodified opinion when he concludes that the financial statements have been prepared, in all material respects, **in accordance with the applicable financial reporting framework**.

If that framework is a “fair presentation framework” then the report will give an opinion stating whether or not the financial statements “give a true and fair view” or “present fairly” the position and results of the entity.

2.2 Forming the audit opinion

In reaching his audit opinion, the auditor is **required** to evaluate whether:

- he has obtained sufficient appropriate audit evidence as to whether the financial statements are free from material misstatement
- uncorrected misstatements are material, individually or in aggregate
- the financial statements have been prepared in accordance with the requirements of the applicable financial reporting framework:
 - where financial statements are prepared in accordance with a “fair presentation framework”, it will include evaluating whether the financial statements give a true and fair view or present fairly in all material respects; or
 - where financial statements are prepared in accordance with a “compliance framework”, it will include evaluating whether the financial statements are prepared in all material respects);

and, in particular, whether:

- the financial statements adequately refer to or describe the applicable financial reporting framework
- the financial statements adequately disclose the entity’s significant accounting policies
- the significant accounting policies are appropriate and consistent with the applicable financial reporting framework
- accounting estimates are reasonable
- the information in the financial statements is relevant, reliable, comparable and understandable
- the financial statements provide adequate disclosures
- the terminology used in the financial statements is appropriate.

2.3 Core elements of the audit report

The basic elements of an unmodified audit report, as given in ISA 700 (Revised), are as follows:

1. Title
2. Addressee
3. Auditor’s opinion
4. Basis for opinion
5. Going Concern
6. Key Audit Matters
7. Other information

8. Responsibilities for the financial statements
9. Auditor's responsibility for the audit of financial statements
10. Other reporting responsibilities (if any)
11. Name of the Engagement Partner
12. Auditor's signature
13. Auditor's address.
14. Date of the audit report

These elements are designed to achieve the **objectives** of ISA 700 (Revised), which are for the auditor to:

- form an opinion on the financial statements, based on an evaluation of the conclusions drawn from the audit evidence obtained, and
- express that opinion clearly through a written report that also describes the basis for that opinion.

Title

The auditor's report should have a title that clearly indicates that it is the report of an independent auditor. This is to distinguish this type of auditor's report from other reports that might be issued by other auditors (who may not have to abide by the same ethical requirements and requirement for independence as the independent auditor - for example, internal auditors).

Addressee

The report should be appropriately addressed, as required by national law and the circumstances of the engagement. The report is usually addressed to either:

- the shareholders of the entity whose financial statements are being audited, or
- the board of directors of the entity.

Auditor's opinion

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion". The Opinion section of the auditor's report shall also:

- identify the entity whose financial statements have been audited
- state that the financial statements have been audited
- identify the title of each statement that makes up the complete set of financial statements (e.g. statement of comprehensive income, statement of financial position, and so on)
- refer to notes, including the summary of significant accounting policies and other explanatory information
- specify the date or period covered by each statement.

If financial statements are prepared in accordance with a Fair Presentation Framework

An opinion will be expressed on whether the financial statements:

- conform with approved accounting standards as applicable in Pakistan (IFRS) and
- give the information required by the Companies Act, 2017

in the manner so required and respectively give a true and fair view of the state of the Company's affairs.

If financial statements are prepared in accordance with a Compliance Framework

An opinion will be expressed on whether the financial statements are prepared in all material respects in accordance with:

- approved accounting standards as applicable in Pakistan (IFRS) and
- Companies Act, 2017

Where IFRSs are not used as the financial reporting framework, the reference to the financial reporting framework in the wording of the opinion should identify the jurisdiction of the financial reporting framework

Basis for opinion

This section shall be placed immediately after the “opinion” section of the auditor’s report. This section:

- States that the audit was conducted in accordance with International Standards on Auditing;
- Refers to the section of the auditor’s report that describes the auditor’s responsibilities under the ISAs;
- Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor’s other ethical responsibilities in accordance with these requirements.

The statement shall identify the jurisdiction of origin of the relevant ethical requirements or refer to the International Ethics Standards Board for Accountants’ Code of Ethics for Professional Accountants (IESBA Code); and

- States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor’s opinion.

Going Concern

- The auditor shall report in accordance with ISA 570(Revised), where applicable. This section has been explained in a later portion of this chapter.

Key Audit Matters

For audits of listed entities and other prescribed or selected entities, auditor shall communicate “Key Audit Matters” in auditor’s report. This section has been explained in a later portion of this chapter.

Responsibilities for the financial statements

This section of the report should describe the responsibilities of those responsible for the preparation and presentation of the financial statements. It should include an explanation that management is responsible for:

- the preparation of the financial statements in accordance with the applicable financial reporting framework, and
- for such internal controls as deemed necessary to enable the preparation of financial statements which are free from material misstatement.
- assessing the entity’s ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern.

This section shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from the management.

When financial statements are prepared in accordance with a fair presentation framework, the description of responsibilities for the financial statements in the auditor’s report shall refer to the preparation of financial statements that give a true and fair view or the preparation and fair presentation of these financial statements, as appropriate.

Auditor's responsibility

This section of the report shall:

- state that the objectives of the auditor are to:
 - obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and
 - issue an auditor's report that includes the auditor's opinion.
- state that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists; and
- state that misstatements can arise from fraud or error, and either:
 - describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or
 - provide a definition or description of materiality in accordance with the applicable financial reporting framework.

The Auditor's Responsibilities section of the auditor's report shall further:

- state that the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and
- describe an audit by stating that the auditor's responsibilities are:
 - to identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error
 - to obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control
 - to evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management
 - to conclude on the appropriateness of management's use of the going concern basis of accounting
 - to evaluate the overall presentation, structure and content of the financial statements (when the financial statements are prepared in accordance with a fair presentation framework)

(*see illustration at the end of this unit for exact wording suggested by ISA 700 (Revised))

This section of the auditor's report also shall:

- state that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;
- for audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and
- where "Key Audit Matters" are communicated, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters.

The description of the auditor's responsibilities **shall be included**:

- within the body of the auditor's report;
- within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or
- by a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority

Other reporting responsibilities

In some countries, the auditor may have additional reporting responsibilities. For example, he may be required by local legislation to report certain matters if they come to his attention during the course of the audit, or he may be required to report on specific matters such as the adequacy of accounting records.

Such other reporting responsibilities may be addressed in a separate section of the report sub-titled "Report on Other Legal and Regulatory Requirements. In this case the auditor's report would be having two separate sections.

- "Report on Audit of the financial statements" encompassing the auditor's opinion, basis for opinion, key audit matters, management's responsibilities and auditor's responsibilities areas; and
- "Report on other legal and regulatory requirements" covering the specific requirements of that particular area.

Name of the engagement partner

The name of the engagement partner shall be included in the auditor's report for audits of complete sets of general purpose financial statements of **listed entities**

However, if in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security, threat the auditor should not include the name as such and shall also discuss the severity with those charge with governance.

Auditor's signature

The report should be signed:

- in the name of the audit firm, or
- in the personal name of the auditor, or
- both.

The report is usually signed in the name of the firm because the firm assumes responsibility for the audit.

Auditor's address

The report should give a specific location for the auditor. This will usually be the city where the office responsible for the audit is located.

Date of the auditor's report

The report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base his opinion on the financial statements.

This will not be earlier than the date on which the financial statements are signed or approved by the directors/management of the client company.

The date of the report informs the reader that the auditor has considered the effect on the financial statements (and on his audit report) of subsequent events which occurred after the reporting period and up to that date.

► *Example:*

An example of an unmodified audit report, of a **listed entity** prepared in accordance with **fair presentation framework**, is set out below.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements¹**Opinion**

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants (IESBA Code)* together with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701.]

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[Reporting in accordance with the reporting requirements in ISA 720 (Revised)]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs², and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

¹ The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable

² Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

³[As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.⁴
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.]

³ Paragraph 41(b) of this ISA explains that the shaded material can be located in an Appendix to the auditor's report. Paragraph 41(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities.

⁴ This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards. The matters addressed by other law, regulation or national auditing standards (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the ISAs may be combined (i.e., included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the ISAs where such a difference exists.]

The engagement partner on the audit resulting in this independent auditor's report is [name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

► Example:

An example of an unmodified audit report, of an **entity other than listed entity** prepared in accordance with **compliance framework**, is set out below.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements of the Company are prepared, in all material respects, in accordance with XYZ Law of Jurisdiction X.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[Reporting in accordance with the reporting requirements in ISA 720 (Revised)]

Responsibilities of Management and Those Charged with Governance for the Financial Statements⁵

Management is responsible for the preparation of the financial statements in accordance with XYZ Law of Jurisdiction X⁶ and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

⁵ Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

⁶ Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

⁷[As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.]

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

⁷ Paragraph 40(b) of this ISA explains that the shaded material can be located in an Appendix to the auditor's report. Paragraph 40(c) explains that when law, regulation or national auditing standards expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities.

► *Practice Question 02:*

In relation to the audit report on financial statements and the contents thereof (under revised/new ISAs), discuss the appropriateness or otherwise of the following statements:

- a) The description of the auditor's responsibilities for the audit of the financial statements should be included within the body of the auditor's report.
- b) The audit report can only be signed in the personal name of the auditor.

Tutorial Notes:

When discussing the responsibilities of signing the audit report, avoid irrelevant comparisons like single member vs. multi-partner firms.

► *Solution 02:*

- a) The statement is not appropriate. The responsibilities in addition to the main body of the audit report can be included;
 - Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or
 - By a specific reference within the auditor's report to the location of such description on a website of an appropriate authority.
- b) The statement is not appropriate as the audit report can either be signed in the name of the audit firm or the personal name of the auditor or both.

3 COMMUNICATING KEY AUDIT MATTERS IN AN AUDIT REPORT: ISA 701

3.1 Scope of the ISA 701

This International Standard on Auditing (ISA) deals with the auditor's responsibility to communicate key audit matters in the auditor's report. The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed.

► **Definition: Key Audit Matters**

Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

Auditor shall communicate key audit matters in the auditor's report for audits of

- Listed entities
- Entities other than listed entities, if required by law or regulation of any area

Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.

3.2 Determining Key Audit Matters

The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

- Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised 2019).
- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- The effect on the audit of significant events or transactions that occurred during the period.

For example, the auditor may have had extensive discussions with management and those charged with governance at various stages throughout the audit about the effect on the financial statements of significant transactions with related parties or significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

Note: Auditor's procedures regarding the related parties have been discussed in an earlier chapter.

Determining the relative significance of a matter

Other considerations that may be relevant to determining the relative significance of a matter communicated with those charged with governance and whether such a matter is a key audit matter include:

- The importance of the matter to intended users' understanding.
- The complexity or subjectivity involved in management's selection of an appropriate policy compared to other entities within its industry.
- The nature and materiality (quantitatively or qualitatively) of the misstatements due to fraud or error related to the matter, if any.

- The nature and extent of audit effort needed to address the matter, including:
 - The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any.
 - The nature of consultations outside the engagement team regarding the matter.
- The severity of any control deficiencies identified relevant to the matter.

3.3 Communicating Key Audit Matters

The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters,"

The introductory language in this section of the auditor's report shall state that:

- Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements [of the current period]; and
- These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

No key audit matters to communicate

If the auditor determines, depending on the facts and circumstances of the entity and the audit, that there are no key audit matters to communicate, the auditor shall include a statement to this effect in a separate section of the auditor's report under the heading "Key Audit Matters."

Note: The auditor shall not communicate a matter in the Key Audit Matters section of the auditor's report when the auditor would be required to modify the opinion, in respect of that matter, in accordance with ISA 705 (Revised).

► Illustration:

Key Audit Matters

[Except for the matter described in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section,] We have determined that there are no [other] key audit matters to communicate in our report.

3.4 Descriptions of Individual Key Audit Matters

The description of each key audit matter in the Key Audit Matters section of the auditor's report shall

- Include a reference to the related disclosure(s), if any, in the financial statements;
- State that why the matter was considered to be one of most significance in the audit; and
- Specify how the matter was addressed in the audit
 - A brief overview of procedures performed;
 - An indication of the outcome of the auditor's procedures; or
 - Key observations with respect to the matter,

The description may also make reference to the principal considerations that led the auditor, in the circumstances of the audit, to determine the matter to be one of most significance, for example:

3.5 DOCUMENTATION

- The matters that required significant auditor's attention and the rationale for the auditor's determination as to whether or not each of these matters is a key audit matter
- Where applicable, the rationale for the auditor's determination that there are no key audit matters to communicate in the auditor's report
- Where applicable, the rationale for the auditor's determination not to communicate in the auditor's report a matter determined to be a key audit matter

► *Practice Question 03:*

In relation to the audit report on financial statements and the contents thereof (under revised/new ISAs), discuss the appropriateness or otherwise of the following statement:

"Key audit matters are determined from the matters communicated with the management of the entity that required significant auditor's attention in performing the audit. In making that determination, the auditor shall take into account the effects on the audit of significant events or transactions that occurred during the current year and prior period presented"

Tutorial Notes:

The key points to remember are that Key audit matters should be selected from matters reported to those charged with governance and only current-year matters should be covered; issues relating to previous years should not be included in the audit report.

► *Solution 03:*

The statement is not appropriate as the Key Audit Matters are selected from the matters communicated with those charged with governance and in making those assessments matters pertaining current period only are considered as opposed to matters pertaining to prior period.

► *Practice Question 04:*

The management of Sohni Limited has changed its revenue recognition policy. As the audit engagement partner you are satisfied with the accounting and disclosures related to change in accounting policy. Further, the impact of the change is significant.

Required:

Discuss the possible impact on the audit report and specify the procedures (if any) which you would undertake in the above situations.

Tutorial Notes:

Accounting Policy Change: Recognise that a change in accounting policy must be reported as a key audit matter and that the auditor needs to concur with the change.

Focus on the specifics: In addition to agreeing with the change, identify other related issues such as the impact on comparability and consistency.

► *Solution 04:*

Change in accounting policy has to be reported as a key audit matter. For this purpose it is necessary that it should be discussed with those charged with governance. In the key audit matter section, the auditor shall:

- include a reference to the related disclosure(s), if any, in the financial statements
- state why the matter was considered to be one of most significance in the audit;
- specify how the matter was addressed in the audit.

► *Practice Question 05:*

Respond to the following independent situations in the light of International Standards on Auditing:

- a) Risk of overstatement in revenue was considered as significant risk and was also communicated to those charged with governance. Discuss whether it should be included in the key audit matters section.
- b) No such matter arose during the audit which needs to be reported as key audit matter.
Discuss whether the auditor still needs to include key audit matters section in audit report.
- c) A qualified opinion has been expressed. The details of the qualification are also mentioned in the key audit matters section. Is it appropriate to do so?

Tutorial Notes:

- a) Key Audit Matters: Not all significant risks or matters communicated to governance are key audit matters. If there's a misstatement in revenue, it should lead to a qualified opinion, not just be reported as a key audit matter.
- b) No Key Audit Matters: If no key audit matters exist, this fact should be disclosed in the audit report.
- c) Qualified Opinion: A qualified opinion should not be listed as a key audit matter, but the basis for the qualified opinion must be clearly mentioned in the audit report.

► *Solution 05:*

- a) The audit report should include only those matters in the KAM section which required significant auditor attention.

Areas which require significant auditor attention are those which:

- Involve significant audit risks
- Significant judgement on the part of management / auditor.
- Significant transactions and events affecting the audit.

Even though KAMs are extracted from the matters communicated with those charged with governance, however, not all significant risks or matters communicated to those charged with governance are considered as KAMs. The auditor needs to determine whether the risk of overstatement of revenue fulfils the above mentioned criteria and is of most significance to the current year audit, only then it can be included as a key audit matter.

- b) Even if the auditor determines, depending on the facts and circumstances of the entity and the audit, that there are no key audit matters to communicate, the audit report shall include the key audit matter section.
The fact that there are no key audit matters to communicate in the report, should be mentioned under the heading Key Audit Matters.
- c) A matter giving rise to a qualification by their nature is a key audit matter. However, these matters shall not be described in the Key Audit Matters section of the audit report, rather the matter is to be reported in accordance with the requirements of related ISA. However, reference to the basis for qualified opinion is to be included in the Key Audit Matter section.

► *Practice Question 06:*

Discuss the impact on the key audit matter section of the audit report when the auditor expresses an adverse opinion.

Tutorial Notes:

Key audit matters should not imply that the financial statements are more credible in relation to those matters, especially when an adverse opinion is expressed.

Ensure that the inclusion of key audit matters does not create a misleading impression about the overall reliability of the financial statements.

► *Solution 06:*

When the auditor expresses an adverse opinion, communicating key audit matters would still be relevant to enhancing intended users' understanding of the audit, and therefore the requirements to determine key audit matters apply.

However, as an adverse opinion is expressed in circumstances when the auditor has concluded that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements, the auditor may determine that no other matters are key audit matters. The auditor will include a statement that except for the matters described in the basis for adverse opinion section, we have determined that there are no other key audit matters to communicate in our report.

If one or more matters other than the matter(s) giving rise to an adverse opinion are determined to be key audit matters, it is particularly important that the descriptions of such other key audit matters do not imply that the financial statements as a whole are more credible in relation to those matters than would be appropriate in the circumstances, in view of the adverse opinion.

4 AUDIT REPORTING AND THE COMPANIES ACT, 2017

4.1 Reporting requirements under the laws applicable in Pakistan

- *Illustration: Auditors' report to the members – Auditors (Reporting Obligations) Regulations 2018*

INDEPENDENT AUDITOR'S REPORT

[See regulation 3 of Auditors (Reporting Obligations) Regulation 2018]

To the members of (name of Company)

Report on the Audit of the Financial Statements

Opinion

We have audited the annexed financial statements (**or revised financial statements, if applicable**)ⁱ of(the Company), which comprise the statement of financial position as at, and the statement of profit or lossⁱⁱ and other comprehensive income or the income and expenditure statement, the statement of changes in equity, the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of material accounting policy information and other explanatory information, and we state that we have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purposes of the audit.

In our opinion and to the best of our information and according to the explanations given to us, the statement of financial position, statement of profit or loss and other comprehensive income or the income or expenditure statement, the statement of changes in equity and the statement of cash flows together with the notes forming part thereof conform with the accounting and reporting standards as applicable in Pakistan and give the information required by the Companies Act, 2017 (XIX of 2017), in the manner so required and respectively give a true and fair view of the state of the Company's affairs as at and of the profit or loss and other comprehensive income or loss, or the surplus or deficitⁱⁱⁱ, the changes in equity and its cash flows for the year then ended.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs) as applicable in Pakistan. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants* as adopted by the Institute of Chartered Accountants of Pakistan / Institute of Cost and management Accountants (the Code)^{iv} and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Material Uncertainty relating to Going Concern (if applicable)

Emphasis of Matter (if any)

Key Audit Matter(s)^v

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

S. No.	Key audit matters	How the matter was addressed in our audit

Information Other than the Financial Statements and Auditor's Report Thereon

[Reporting in accordance with the reporting requirements in ISA 720 (Revised)]

Responsibilities of Management and Board of Directors for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with the accounting and reporting standards as applicable in Pakistan and the requirements of Companies Act, 2017(XIX of 2017) and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Board of directors are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs as applicable in Pakistan will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs as applicable in Pakistan, we exercise professional judgment and maintain professional skepticism throughout the audit.

We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with the board of directors regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide the board of directors with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with the board of directors, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements ^{vii}

Based on our audit, we further report that in our opinion:

- a) proper books of account have been kept by the Company as required by the Companies Act, 2017 (XIX of 2017);
- b) the statement of financial position, the statement of profit or loss and other comprehensive income or the income and expenditure account, the statement of changes in equity and the statement of cash flows together with the notes thereon have been drawn up in conformity with the Companies Act, 2017 (XIX of 2017) and are in agreement with the books of account and returns;
- c) investments made, expenditure incurred and guarantees extended during the year were for the purpose of the Company's business; and
- d) zakat deductible at source under the Zakat and Ushr Ordinance, 1980 (XVIII of 1980), was deducted by the company and deposited in the Central Zakat Fund established under section 7 of that Ordinance ^{viii}.

Other Matter(s)

Prior Year Financial Statements Audited by Predecessor Auditor^{ix}

The engagement partner on the audit resulting in this independent auditor's report is [name].

[Signature]

[Place/ location]

[Date]

[UDIN: XXXX XXXX XXXX XXXX XXXX]

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- i. Wherever applicable, substitute "income and expenditure statement" and "surplus or deficit" in case of association not for profit.
 - ii. As the case may be, use either profit or loss, similarly either other comprehensive income or loss and surplus (in case of income and expenditure account only).
 - iii. To use the name of the relevant Institute.
 - iv. In the case of a non-listed company the section of key audit matter(s) in the report and the related last two paragraphs in the auditor's responsibilities section may be omitted.
 - v. In case there is no KAM following wording may be used:
We have determined that there are no key audit matters to communicate in our report.
 - vi. With Reference to explanation of Section 249(3) and Section 249(4) of the Companies Act, 2017 (XIX of 2017):
 - Where any of the matters referred in the Auditor's Report is answered in negative or with a qualification the report shall state the reasons for such answers along with the factual position to the best of auditor's information.
 - Where the auditor's report contains a reference to any other report, statement or remarks which they have made on the financial statements examined by them, such statement or remarks shall be annexed to the auditor's report and shall be deemed to be a part of the auditor's report.
 - vii. Where no Zakat is deductible, substitute "no Zakat was deductible at source under the Zakat and Ushr Ordinance, 1980 (XVIII of 1980).
 - viii. The paragraph is not required in cases where the auditor of the Company is same in the previous year.

Additional Notes:

- i. Omit that component of financial statements which is not applicable in case of a particular company.
- ii. Terms “statement of profit or loss and other comprehensive income” or “statement of comprehensive income” can be used interchangeably.

Unique Document Identification Number (UDIN) is a 20-digit auto generated (from designated portal of ICAP) alpha numeric number for placement on auditors’ reports signed by practicing members. The objective of UDIN for auditors’ reports is to enhance the trust of users of audited financial statements in the authenticity of the auditors’ reports that these have been issued by authorized practicing members.

5 MODIFICATION TO AUDIT OPINION: ISA 705

Previous sections of the chapter discussed the unmodified audit opinion under ISA 700 (Revised) and under the Companies Act, 2017. Amongst all the additional paragraphs, it simply states that the financial statements show a true and fair view. There are no 'ifs', 'buts' or 'additional information provided.'

The standard audit report provides a positive opinion with reasonable assurance that the financial statements give a true and fair view of the state of the company's affairs as on specific date and of profit/loss, its cash flows and changes in equity for the year then ended in accordance with the approved accounting standards as applicable in Pakistan.

In order to form an opinion on the financial statements the ISA 700 (Revised) requires that the auditor should conclude as to whether reasonable assurance has been obtained whether the financial statements are free from material misstatement or not. If there is any uncorrected misstatement the auditor should consider and evaluate the effect of such misstatements on financial statements in accordance with ISAs.

5.1 When auditor modify the opinion

The ISA 705 states that the auditor shall modify the opinion in the auditor's report when:

- The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

5.2 Nature of material misstatements

ISA defines a misstatement as a difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

A material misstatement of the financial statements may arise in relation to the following:

- The appropriateness of the selected accounting policies;
- The application of the selected accounting policies; or
- The appropriateness or adequacy of disclosures in the financial statements.

Appropriateness of the selected accounting policies

In relation to the appropriateness of the accounting policies that management has selected, material misstatements of the financial statements may arise when:

- The selected accounting policies are not consistent with the applicable financial reporting framework; or
- The financial statements, including the related notes, do not represent the underlying transactions and events in a manner that achieves fair presentation.

Financial reporting frameworks often contain requirements for the accounting for, and disclosure of, changes in accounting policies. Where the entity has changed its selection of significant accounting policies, a material misstatement of the financial statements may arise when the entity has not complied with these requirements.

Application of the selected accounting policies

In relation to the application of the selected accounting policies, material misstatements of the financial statements may arise:

- When management has not applied the selected accounting policies consistently with the financial reporting framework, including when management has not applied the selected accounting policies consistently between periods or to similar transactions and events (consistency in application); or
- Due to the method of application of the selected accounting policies (such as an unintentional error in application).

Appropriateness or adequacy of disclosures in the financial statements

In relation to the appropriateness or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when:

- The financial statements do not include all of the disclosures required by the applicable financial reporting framework;
- The disclosures in the financial statements are not presented in accordance with the applicable financial reporting framework; or
- The financial statements do not provide the disclosures necessary to achieve fair presentation.

5.3 Nature of an inability to obtain audit evidence

The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

- Circumstances beyond the control of the entity;
- Circumstances relating to the nature or timing of the auditor's work; or
- Limitations imposed by management.

Circumstances beyond the control of the entity

Examples of circumstances beyond the control of the entity include when:

- The entity's accounting records have been destroyed.
- The accounting records of a significant component have been seized indefinitely by governmental authorities.

Circumstances relating to the nature or timing of the auditor's work

Examples of circumstances relating to the nature or timing of the auditor's work include when:

- The timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories.
- The auditor determines that performing substantive procedures alone is not sufficient, but the entity's controls are not effective.

Limitations imposed by management

Examples of an inability to obtain sufficient appropriate audit evidence arising from a limitation on the scope of the audit imposed by management include when:

- Management prevents the auditor from observing the counting of the physical inventory.
- Management prevents the auditor from requesting external confirmation of specific account balances.

An inability to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. If this is not possible, the requirements of modification to audit opinion may apply as appropriate.

5.4 Determining the type of modification to opinion

ISA 705 provides guidance on following modifications to the opinion of the auditor:

- Qualified opinion
- Adverse opinion
- Disclaimer of opinion

Qualified opinion

ISA 705 states that the auditor shall express a qualified opinion when:

- The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

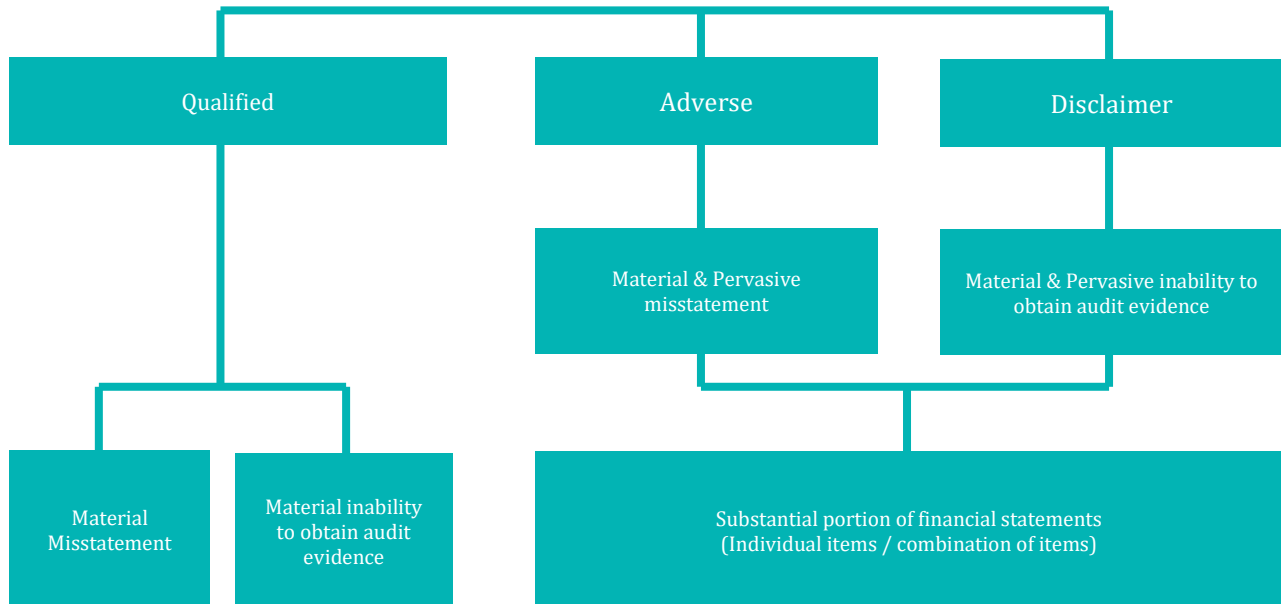
Adverse opinion

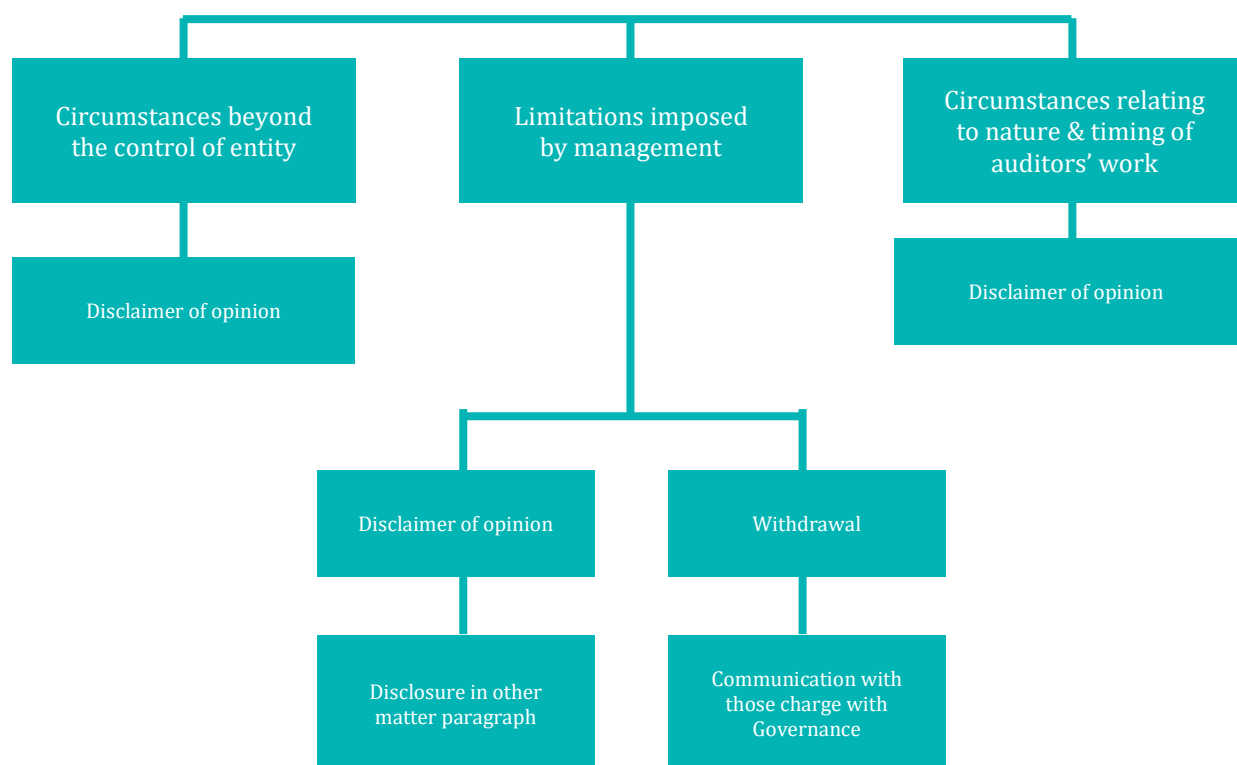
ISA 705 states that the auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Disclaimer of opinion

- ISA 705 states that the auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.
- ISA 705 states that the auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Types of modifications



Materiality and pervasive on types of scope limitation

Following illustrative table is provided by the ISA 705 that shows how the auditor forms judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed:

<i>Nature of Matter Giving Rise to the Modification</i>	<i>Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements</i>	
	<i>Material but Not Pervasive</i>	<i>Material and Pervasive</i>
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

► **Definition: Pervasive**

A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

- Are not confined to specific elements, accounts or items of the financial statements;
- If so confined, represent or could represent a substantial proportion of the financial statements; or
- In relation to disclosures, are fundamental to users' understanding of the financial statements.

5.5 Management-imposed limitation after the auditor has accepted the engagement

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove such limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

- If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
- If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
 - Withdraw from the audit, where practicable and possible under applicable law or regulation
 - If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

But the practicality of withdrawing from the audit may depend on the stage of completion of the engagement at the time that management imposes the scope limitation. If the auditor has substantially completed the audit, the auditor may decide to complete the audit to the extent possible, disclaim an opinion and explain the scope limitation in the Basis for Disclaimer of Opinion paragraph prior to withdrawing.

Moreover, in certain circumstances withdrawal from the audit may not be possible if the auditor is required by law or regulation to continue the audit engagement. This may be the case for an auditor that is appointed to audit the financial statements of public sector entities. It may also be the case in jurisdictions where the auditor is appointed to audit the financial statements covering a specific period, or appointed for a specific period and is prohibited from withdrawing before the completion of the audit of those financial statements or before the end of that period, respectively. The auditor may also consider it necessary to include an Other Matter paragraph in the auditor's report describing why auditor may not be able to withdraw from engagement

If the auditor withdraws as contemplated by ISA 705, before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

Moreover, when the auditor concludes that withdrawal from the audit is necessary because of a scope limitation, there may be a professional, legal or regulatory requirement for the auditor to communicate matters relating to the withdrawal from the engagement to regulators or the entity's owners.

5.6 Form and content of the modified report

Consistency in the auditor's report helps to promote users' understanding and to identify unusual circumstances when they occur. Accordingly, although uniformity in the wording of a modified opinion and in the description of the basis for the modification may not be possible, consistency in both the form and content of the auditor's report is desirable.

Opinion paragraph

When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the opinion paragraph.

Inclusion of this paragraph heading makes it clear to the user that the auditor's opinion is modified and indicates the type of modification.

Qualified opinion

When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state in the opinion paragraph that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph:

- The financial statements present fairly, in all material respects (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; or
- The financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion.

When the auditor expresses a qualified opinion, it would not be appropriate to use phrases such as "with the foregoing explanation" or "subject to" in the opinion paragraph as these are not sufficiently clear or forceful.

Adverse opinion

When the auditor expresses an adverse opinion, the auditor shall state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph:

- The financial statements do not present fairly (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; or
- The financial statements have not been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

Disclaimer of opinion

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall state in the opinion paragraph that:

- The auditor does not express an opinion on the financial statements.
- Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and, accordingly,
- Auditor was engaged to audit the financial statements.

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the opinion section of the auditor's report to state that the auditor was engaged to audit the financial statements. The auditor shall also amend the description of the auditor's responsibility and the description of the scope of the audit accordingly.

Basis for opinion

- When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by ISA 700 (Revised), amend the heading "Basis for Opinion" to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and within this section, include a description of the matter giving rise to the modification.

If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures in the notes to the financial statements), the auditor shall include in the basis for opinion section a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in this section.

An example of the financial effects of material misstatements that the auditor may describe in the basis for modification paragraph in the auditor's report is the quantification of the effects on income tax, income before taxes, net income and equity if inventory is overstated.

If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the basis for opinion section an explanation of how the disclosures are misstated.

If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:

- Discuss the non-disclosure with those charged with governance;
- Describe in the basis for opinion section the nature of the omitted information; and
- Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

Disclosing the omitted information in the basis for modification paragraph would not be practicable if:

- The disclosures have not been prepared by management or the disclosures are otherwise not readily available to the auditor; or
- In the auditor's judgment, the disclosures would be unduly voluminous in relation to the auditor's report.

If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the basis for opinion section the reasons for that inability.

An adverse opinion or a disclaimer of opinion relating to a specific matter described in the basis for opinion section does not justify the omission of a description of other identified matters that would have otherwise required a modification of the auditor's opinion. In such cases, the disclosure of such other matters of which the auditor is aware may be relevant to users of the financial statements.

Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the basis for opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof.

Description of auditor's responsibility when the auditor expresses a qualified or adverse opinion

When the auditor expresses a qualified or adverse opinion, the auditor shall amend the description of the auditor's responsibility to state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

Effect of disclaimer of opinion on "Key Audit Matters"

Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with ISA 701.

5.7 Communication with those charged with governance

When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification.

The ISA 705 further explains that communicating with those charged with governance the circumstances that lead to an expected modification to the auditor's opinion and the proposed wording of the modification enables:

- The auditor to give notice to those charged with governance of the intended modification(s) and the reasons (or circumstances) for the modification(s);
- The auditor to seek the concurrence of those charged with governance regarding the facts of the matter(s) giving rise to the expected modification(s), or to confirm matters of disagreement with management as such; and
- Those charged with governance to have an opportunity, where appropriate, to provide the auditor with further information and explanations in respect of the matter(s) giving rise to the expected modification(s).

5.8 Illustrations of auditors' reports with modifications to the opinion as provided in the appendix to ISA 705

Illustration 1:

An auditor's report containing a qualified opinion due to a material misstatement of the financial statements.

Illustration 2:

An auditor's report containing an adverse opinion due to a material misstatement of the consolidated financial statements.

Illustration 3:

An auditor's report containing a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence regarding a foreign associate.

Illustration 4:

An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements.

Illustration 5:

An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements.

► Illustration 1:

Circumstances include the following:

- Audit of a complete set of financial statements of a listed entity using a fair presentation framework.
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.
- Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements (i.e., a qualified opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).
- Key audit matters have been communicated in accordance with ISA 701.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

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

Basis for Qualified Opinion

The Company's inventories are carried in the statement of financial position at xxx. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from IFRSs. The Company's records indicate that, had management stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Qualified Opinion* section we have determined the matters described below to be the key audit matters to be communicated in our report.

[Description of each key audit matter in accordance with ISA 701.]

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with ISA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with ISA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with ISA 700 (Revised).]

The engagement partner on the audit resulting in this independent auditor's report is [name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

► *Illustration 2:*

Circumstances include the following:

- Audit of a complete set of consolidated financial statements of a listed entity using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., ISA 600 applies).
- The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in ISA 210.
- The consolidated financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the consolidated financial statements. The effects of the misstatement on the consolidated financial statements have not been determined because it was not practicable to do so (i.e., an adverse opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).
- ISA 701 applies; however, the auditor has determined that there are no key audit matters other than the matter described in the Basis for Adverse Opinion section.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Consolidated Financial Statements

Adverse Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the *Basis for Adverse Opinion* section of our report, the accompanying consolidated financial statements do not present fairly (or *do not give a true and fair view of*) the consolidated financial position of the Group as at December 31, 20X1, and (of) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Adverse Opinion

As explained in Note X, the Group has not consolidated subsidiary XYZ Company that the Group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under IFRSs, the Company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

Key Audit Matters

Except for the matter described in the *Basis for Adverse Opinion* section, we have determined that there are no other key audit matters to communicate in our report.

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements

[Reporting in accordance with ISA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

[Reporting in accordance with ISA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with ISA 700 (Revised).]

The engagement partner on the audit resulting in this independent auditor's report is [name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

► Illustration 3:

Circumstances include the following:

- Audit of a complete set of consolidated financial statements of a listed entity using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., ISA 600 applies).
- The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in ISA 210.
- The auditor was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the consolidated financial statements (i.e., a qualified opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).
- Key audit matters have been communicated in accordance with ISA 701.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Consolidated Financial Statements

Qualified Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

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

Basis for Qualified Opinion

The Group's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at xxx on the consolidated statement of financial position as at December 31, 20X1, and ABC's share of XYZ's net income of xxx is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at December 31, 20X1 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Qualified Opinion* section, we have determined the matters described below to be the key audit matters to be communicated in our report.

[Description of each key audit matter in accordance with ISA 701.]

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements

[Reporting in accordance with ISA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

[Reporting in accordance with ISA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with ISA 700 (Revised).]

The engagement partner on the audit resulting in this independent auditor's report is [name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

► *Illustration 4:*

Circumstances include the following:

- Audit of a complete set of consolidated financial statements of an entity other than a listed entity using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., ISA 600 applies).
- The consolidated financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in ISA 210.
- The auditor was unable to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements. That is, the auditor was also unable to obtain audit evidence about the financial information of a joint venture investment that represents over 90% of the entity's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the consolidated financial statements (i.e., a disclaimer of opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- A more limited description of the auditor's responsibilities section is required.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Consolidated Financial Statements

Disclaimer of Opinion

We were engaged to audit the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying consolidated financial statements of the Group. Because of the significance of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

Basis for Disclaimer of Opinion

The Group's investment in its joint venture XYZ Company is carried at xxx on the Group's consolidated statement of financial position, which represents over 90% of the Group's net assets as at December 31, 20X1. We were not allowed access to the management and the auditors of XYZ Company, including XYZ Company's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, and the elements making up the consolidated statement of changes in equity and the consolidated cash flow statement.

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements

[Reporting in accordance with ISA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our responsibility is to conduct an audit of the Group's consolidated financial statements in accordance with International Standards on Auditing and to issue an auditor's report. However, because of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements.

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with ISA 700 (Revised).]

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

► Illustration 5:

Circumstances include the following:

- Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework.
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.
- The auditor was unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements, that is, the auditor was also unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- A more limited description of the auditor's responsibilities section is required.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Disclaimer of Opinion

We were engaged to audit the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the Company. Because of the significance of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We were not appointed as auditors of the Company until after December 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and 20X1, which are stated in the statements of financial position at xxx and xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of xxx as at December 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of comprehensive income, statement of changes in equity and statement of cash flows.

Responsibilities of Management and Those Charged with Governance for the Financial Statements²²

[Reporting in accordance with ISA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Financial Statements

Our responsibility is to conduct an audit of the Company's financial statements in accordance with International Standards on Auditing and to issue an auditor's report. However, because of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements.

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with ISA 700 (Revised).]

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

6 EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS: ISA 706

ISA 706 requires that there may be additional communication in the auditor's report when the auditor considers it is necessary to have these additional communications. ISA 706 describes such type of communication as 'Emphasis of Matter Paragraphs' and 'Other Matter Paragraphs'.

6.1 Emphasis of matter paragraphs

► *Definition: Emphasis of matter paragraphs*

A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

When the auditor considers it is necessary to draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements the emphasis of matter paragraph shall be included in the auditor's report.

The matter highlighted must not be a matter:

- requiring modification of opinion as per ISA 705; or
- determined to be a key audit matter to be communicated in the auditor's report

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- Include it as a separate section in the auditor's report;
- Use any appropriate heading including the term "Emphasis of Matter,";
- Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements; and
- Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion. An Emphasis of Matter paragraph is not a substitute for either:

- The auditor expressing a modified opinion as per ISA 705 (Revised); or
- Disclosures in the financial statements that the applicable financial reporting framework requires management to make.
- Reporting in accordance with ISA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern

Circumstances in which an emphasis of matter paragraph may be necessary

Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements.
- ISA 210- When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation

ISA 560 When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).

significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.

- A major catastrophe that has or continued to have, a significant effect on the entity's financial position.

A widespread use of Emphasis of Matter paragraphs may diminish the effectiveness of the auditor's communication about such matters.

6.2 Other matter paragraphs

► *Definition: Other matter paragraphs*

A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

When the auditor considers it is necessary to draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the other matter paragraph shall be included in the auditor's report as a separate section with the heading of "other matters" or any other appropriate heading.

Auditor is allowed to use "other matter" paragraph where:

- this is not prohibited by law or regulation; and
- the matter has not been determined to be a key audit matter to be communicated in the auditor's report (ISA 701)

The content of an Other Matter paragraph reflects clearly that such other matter is not required to be presented and disclosed in the financial statements. An Other Matter paragraph does not include information that the auditor is prohibited from providing by law, regulation or other professional standards, for example, ethical standards relating to confidentiality of information. An Other Matter paragraph also does not include information that is required to be provided by management.

An Other Matter paragraph does not deal with circumstances where the auditor has other reporting responsibilities that are in addition to the auditor's responsibility under the ISAs, or where the auditor has been asked to perform and report on additional specified procedures, or to express an opinion on specific matters.

Circumstances where auditor may include other matter paragraph in report

- **Relevant to Users' Understanding of the Audit:** In the rare circumstance where the auditor is unable to withdraw from an engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a limitation on the scope of the audit imposed by management is pervasive, the auditor may consider it necessary to include an Other Matter paragraph in the auditor's report to explain why it is not possible for the auditor to withdraw from the engagement.

Also there may be a situation where law or regulation require the auditor to communicate about planning and scoping matters in the auditor's report, or the auditor may consider it necessary to communicate about such matters in an Other Matter paragraph.

- **Relevant to Users' Understanding of the Auditor's Responsibilities or the Auditor's Report:** Law, regulation or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon. Where relevant, one or more sub-headings may be used that describe the content of the Other Matter paragraph.

ISA 560 – Dual Date

Where the auditor has restricted the audit procedure on subsequent events to that amendment, convey in Emphasis of Matter paragraph or Other matter paragraph that auditors' procedure on subsequent events are restricted solely to that amendment ISA 560 When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).

- Other Matter paragraph in the auditor's report, referring to the fact that another set of financial statements has been prepared by the same entity in accordance with another general purpose framework and that the auditor has issued a report on those financial statements.

6.3 Placement of emphasis of matter or other matter paragraph in auditor's report

The placement of an Emphasis of Matter paragraph or Other Matter paragraph depends on the nature of the information to be communicated and the auditor's judgment of the relative significance of such information to intended users.

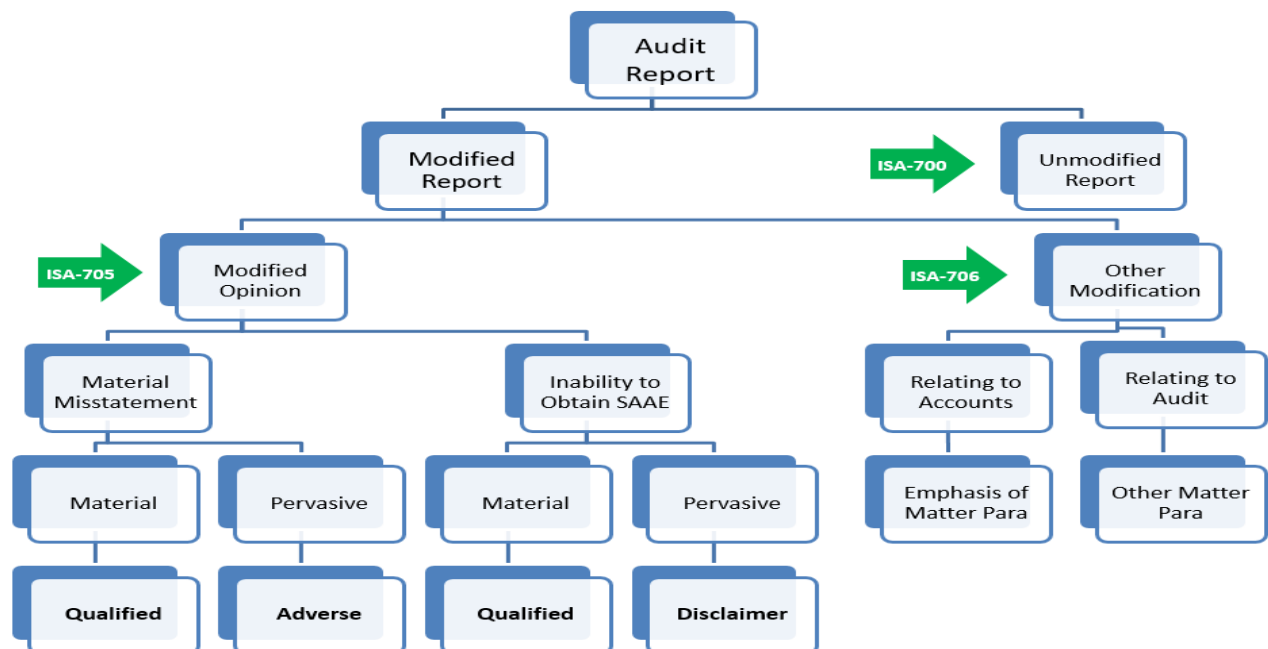
Emphasis of matter paragraph

When the Emphasis of Matter paragraph relates to the applicable financial reporting framework, the auditor may consider it necessary to place the paragraph immediately following the Basis of Opinion section to provide appropriate context to the auditor's opinion.

When a Key Audit Matters section is presented in the auditor's report, an Emphasis of Matter paragraph may be presented either directly before or after the Key Audit Matters section, based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph. The auditor may also add further context to the heading "Emphasis of Matter", such as "Emphasis of Matter – Subsequent Event", to differentiate the Emphasis of Matter paragraph from the individual matters described in the Key Audit Matters section.

Other Matter Paragraphs

When a Key Audit Matters section is presented in the auditor's report and an Other Matter paragraph is also considered necessary, the auditor may add further context to the heading "Other Matter", such as "Other Matter – Scope of the Audit", to differentiate the Other Matter paragraph from the individual matters described in the Key Audit Matters section.



► *Illustration of an Auditor's Report that Includes a Key Audit Matters Section, an Emphasis of Matter Paragraph, and an Other Matter Paragraph*

Circumstances include the following:

- Audit of a complete set of general purpose financial statements prepared by management of the entity in accordance with International Financial Reporting Standards.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).
- Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.
- Key audit matters have been communicated in accordance with ISA 701.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701.]

Other Matter

The financial statements of ABC Company for the year ended December 31, 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

Responsibilities of Management and Those Charged with Governance for the Financial Statements⁴

[Reporting in accordance with ISA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with ISA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with ISA 700 (Revised).]

The engagement partner on the audit resulting in this independent auditor's report is [name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

► Illustration of an Auditor's Report Containing a Qualified Opinion Due to a Departure from the Applicable Financial Reporting Framework and that Includes an Emphasis of Matter Paragraph

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using a fair presentation framework.
- The financial statements are prepared by management of the entity in accordance with IFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in ISA 210.
- A departure from the applicable financial reporting framework resulted in a qualified opinion.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with ISA 570 (Revised).
- Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with ISA 701.

- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

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

Basis for Qualified Opinion

The Company's short-term marketable securities are carried in the statement of financial position at xxx. Management has not marked these securities to market but has instead stated them at cost, which constitutes a departure from IFRSs. The Company's records indicate that had management marked the marketable securities to market, the Company would have recognised an unrealized loss of xxx in the statement of comprehensive income for the year. The carrying amount of the securities in the statement of financial position would have been reduced by the same amount at December 31, 20X1, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Emphasis of Matter – Effects of a Fire

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[Reporting in accordance with ISA 700 (Revised).]

Auditor's Responsibilities for the Audit of the Financial Statements

[Reporting in accordance with ISA 700 (Revised).]

Report on Other Legal and Regulatory Requirements

[Reporting in accordance with ISA 700 (Revised).]

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

► *Practice Question 07:*

Discuss the circumstances in which an auditor may include other matter paragraph in the audit report.

► *Solution 07:*

Following are circumstances in which an auditor may include other matter paragraph in audit report:

- **Relevant to Users' Understanding of the Audit:** In the rare circumstance where the auditor is unable to withdraw from an engagement, the auditor may consider it necessary to include an Other Matter paragraph in the auditor's report to explain why it is not possible for the auditor to withdraw from the engagement.
- **Relevant to Users' Understanding of the Auditor's Responsibilities or the Auditor's Report:** Law, regulation or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon.
- **Reporting on more than one set of financial statements:** An entity may prepare set of financial statements in accordance with more than one framework and engage the auditor to report on both sets of financial statements. If both the frameworks are acceptable, the auditor may include an Other Matter paragraph in the auditor's report
- **Restriction on distribution or use of the auditor's report:** When the financial statements are prepared for a specific purpose, the auditor may consider it necessary to include an Other Matter paragraph, stating that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties.

► *Practice Question 08:*

Briefly discuss the reason(s) for inclusion of 'emphasis of matter paragraph' and 'other matter paragraph' in the audit report. (Examples are not required)

Tutorial Notes:

"Other Matter" Paragraph: Remember, an "Other Matter" paragraph in the auditor's report refers to an issue that is separate from the financial statements or other matters disclosed in the statements.

Avoid confusion by ensuring that the "Other Matter" paragraph does not overlap with information that should be included in the financial statements themselves or within the opinion section of the report.

► *Solution 08:*

An emphasis of matter paragraph is included in the auditor's report to appropriately refer to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

An other matter paragraph included in the auditor's report refers to a matter, other than those presented or disclosed in the financial statements, that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

7 AUDIT REPORTS MIX QUESTIONS (ISA 705,706,570)

► Practice Question 09:

As the engagement partner, you have reviewed the working papers of Nadeem Limited (NL) in which the audit team has highlighted the following matters:

- NL provides six months warranty to its customers and has hired an expert to compute the warranty provision. The management is not willing to provide written representation for the warranty provision because the provision is in accordance with the expert's advice.
- Certain contingent assets have been disclosed in the draft financial statements in which inflow of economic benefits is possible but not probable. The management is of the view that International Financial Reporting Standards does not prohibit making additional disclosures which enhance the users understanding of the financial statements.
- According to the accounting policy for revenue recognition, revenue from sale of goods is recognised on dispatch of goods to customers. However, during the year, NL has entered into various agreements in which the goods are required to be delivered at the premises of the customers.

Required:

Discuss the possible impact on the audit report

Tutorial Notes:

- Provision Based on Assumptions:** If the provision is based on assumptions, management must assume responsibility for these assumptions. If they refuse to provide appropriate representation, the audit report should be modified. Avoid discussing irrelevant details like expert attributes.
- Contingent Assets:** Contingent assets should not be disclosed unless it is probable that they will be realized. If not disclosed properly, the audit report may need a qualified opinion, not just an emphasis of matter.
- Revenue Recognition:** Revenue recognition policies must be consistent with the transfer of risks and rewards. In this case, the accounting policy needs revision, not just qualification of the report. Do not automatically recommend a qualification without understanding the underlying accounting policy.

► Solution 09:

- The argument that the written representation is not necessary because the provision is incorporated on the basis of expert's advice is not correct.

The recognition of provision on basis of expert's advice will not preclude management from assuming responsibility for the warranty provision.

If the management do not provide the written representation, the auditor will require to reevaluate the effect which may have on reliability of representations and audit evidence in general.

The auditor may qualify or disclaim the opinion on the financial statements depending on the materiality and pervasiveness of the matter.

- The argument of management relating to additional disclosures is not valid, as this disclosure will make financial statements misleading, as IAS allows disclosure of only those contingent assets which are probable.

If the amount is material and the management refuses to remove the disclosures from the financial statements, then the auditor may qualify the audit report.

- It is not a change in Accounting policy. However, if the revenue for the customers to whom the goods are to be delivered to their premises, is material to the financial statements, auditor will ask the management to revise the accounting policy for revenue recognition to cover all types of sales contracts.

If the management refuses to revise the policy accordingly and record the sales based on such policy then the audit report will be qualified.

► *Practice Question 10:*

You are the audit partner in a firm of chartered accountants. Some of the audits are in the finalization stage and presently the following matters are under your consideration:

- a) There is a legal dispute between Marvi Limited and one of its customers. In this regard, the legal advisor has confirmed the stance of the management in a meeting with you. However, he has refused to provide a written confirmation thereon.
- b) The management of Laila Limited is not willing to make certain disclosures. The management is of the view that these disclosures will not add any value to the financial statements. Further, the information required to make these disclosures cannot be compiled before the deadline for completion of the audit.

Required:

Discuss the possible impact on the audit report and specify the procedures (if any) which you would undertake in the above situations.

Tutorial Notes:

- a) **Scope Limitation (Lawyer Confirmation):** When a lawyer refuses to provide written confirmation, this results in a scope limitation, potentially leading to a qualified opinion or disclaimer. Ensure the distinction is clear and do not confuse it with management representation.
- b) **Management's Refusal to Disclose:** If management refuses to make necessary disclosures, the auditor may issue a qualified opinion. Ensure that the basis for opinion paragraph clearly explains the nature of the withheld information. Also, inform those charged with governance before deciding on the audit opinion.

► *Solution 10:*

- a) The verbal confirmation from the legal advisor cannot be taken as sufficient appropriate audit evidence and on account of inability to obtain sufficient appropriate audit evidence. The auditor may consider to qualify or disclaim an opinion on the financial statements
- b) If in the opinion of the auditor the non-disclosure of information results in material misstatement in the financial statements, he shall:
 - discuss the non-disclosure with those charged with governance;
 - describe in the 'Basis for opinion section' the nature of the omitted information; and
 - issue a qualified opinion on the basis of inability to obtain sufficient appropriate audit evidence.

► *Practice Question 11:*

You are audit partner of the firm and your manager has highlighted the following matters:

- a) The profit before tax of Tariq Limited (TL) for the year ended 30 June 2017 is Rs. 790 million. TL provides three year warranty to its customers and has made provision of Rs. 80 million in this regard. The management carries out the computation internally. The process is complex and based on various assumptions. Therefore, your firm has appointed an expert after following all the necessary procedures for assessing the competence, capability and objectivity of the expert.
- b) Your firm has been appointed as the auditor of Yaqoob Limited for the audit of the year ended 30 June 2017. The audit team was not able to perform the inventory count at year end because the appointment was made on 15 July 2017.

Required:

Describe the steps that will be performed in each of the above situation and discuss the possible implications of the above on the audit report. (Drafting of opinion not required)

Tutorial Notes:

- a) Expert for Warranty Provision: If the expert's competence and capability have already been assessed, avoid repeating this in your response. Focus on procedures for evaluating the assumptions used by the client and verifying that management has taken responsibility for them. The issue should be reported as a key audit matter in the audit report.
- b) Inventory Count: If the auditor cannot perform the inventory count at year-end, focus on verifying inventory movements and obtaining alternative evidence. Acknowledge that verification may not always be possible. For a first-year audit, ensure that the Other Matter paragraph is included to highlight the lack of opening balances.

► **Solution 11:**

- a) Provision of warranty is 10% of the PBT and therefore it is material to the financial statements. Since the expert has been appointed and matters related to his appointment have already been considered, we may need to perform the following procedures:
 - Evaluate the reasonableness of significant assumptions and methods used
 - Evaluate the relevance, completeness and accuracy of source data
 - Evaluate the reasonableness of the expert's conclusions
 - Carry out analytical procedures to assess the reasonableness of the provision as compared to other relevant items
 - Confirm that the accounting provisions of IAS 37 have been complied with, in making the provision
 - In case there is a difference between the valuation of the auditor's expert and the valuation of the management, discuss the difference with the management.

Reporting implication

In case the difference between the valuation of the auditor's expert and the valuation of the management is material and cannot be resolved, we will have to give a qualified opinion.

However, if we have obtained sufficient appropriate evidence regarding the valuation and presentation of the warranty provision, then we will have to include relevant details under the heading of key audit matters in our audit report, because it is an area of higher assessed risk of material misstatement due to involvement of high degree of uncertainty and significant auditor judgment.

- b) Our firm was not appointed as auditors of the YL until 30 June 2017 and thus did not observe the counting of physical inventories as the end of year 30 June 2017. In this situation, we may perform the following procedures:
 - Conduct physical inventory count after the date of the financial statements.
 - Check whether the changes in inventory between the count date and the date of the financial statements are properly recorded.
 - Investigate the reason for significant differences between the information obtained during the physical count and the inventory records.
 - Assess the reliability of inventory records.

Reporting implication

If the auditor concludes that it would be impracticable or not possible to work back the inventory then this would be a scope limitation and depending upon the material and pervasiveness of the amount of inventory, the auditor should qualify or disclaim his opinion.

Furthermore, the auditor should include other matter paragraph and mention that the prior period financial statements were audited by another auditor.

► *Practice Question 12:*

You are the audit partner at BLC & Company, Chartered Accountants. The following matters are under your consideration:

- i. Artificial Technologies Limited (ATL) has recognised an intangible asset of Rs. 100 million in respect of development costs relating to a software which ATL expects to market in future. The market research conducted by ATL indicates a promising demand for such software. However, the expected cost required to complete the software has increased significantly and ATL requires further Rs. 50 million to complete the project. Since ATL has already utilised its existing credit limit on other projects, it is facing difficulties in raising financing for the above software.

ATL's draft financial statements show profit before tax of Rs. 270 million.

- ii. RL is involved in the manufacturing and supply of beverages throughout Pakistan, through its plant situated in Lahore. During the year, a fire occurred at RL's plant due to which a significant portion of the plant has been destroyed. The management has written off the plant and recorded an insurance claim amounting to Rs. 400 million. The written down value of the plant at the time of fire was Rs. 390 million.

RL is negotiating the purchase of another plant and order is expected to be placed soon after receiving the insurance claim.

RL's draft financial statements show profit before tax of Rs. 300 million.

Required:

Discuss how you would deal with each of the above situations and the possible implications of the above on the audit report. (Drafting of audit opinion is not required)

Tutorial Notes:

- i. Intangible Asset Misstatement: Focus on whether the accounting treatment of the Rs. 100 million as an intangible asset is correct and explain why it may be incorrect (e.g., failure to meet recognition criteria). Materiality of the misstatement should be assessed based on the total value of the intangible (Rs. 100 million), not the additional Rs. 50 million. Conclude whether the misstatement is material or pervasive and discuss the consequences for the audit report.
- ii. Going Concern Issue: Do not jump to conclusions about invalidating the going concern assumption. Assess the situation carefully—consider that the plant is fully insured and the company is profitable, which suggests the going concern assumption may still be valid. Explain how the auditor should evaluate the situation, such as reviewing management's plans and projections. Avoid irrelevant steps like recalculating the purchase price or focusing solely on the insurance claim.

► *Solution 12:*

- i.
 - The intangible asset measured at Rs. 100 million is material as it represents 37% of profit before tax.
 - IAS 38 requires that the entity should be able to demonstrate the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset. As ATL appears to be short of finance, it is questionable whether sufficient funds would be available to complete the development work and take the product to market. Therefore, it appears that the criteria for capitalization of development costs contained in IAS 38 Intangible Assets is not met.
 - Discuss this matter with the management and those charged with governance to assess their plans for arranging the necessary finance. In case the auditor believes that there is a doubt as regards the company's ability to complete the development work, the intangible asset should be derecognised and the auditor should request the management to amend the financial statements.
 - If the management fails to resolve the issue appropriately, the auditor may have to qualify the report as the misstatement is material, but not pervasive.

ii.

- Since the fire has destroyed a significant portion of RL's plant, the auditor should consider RL's ability to continue as a going concern.
- Evaluate financial condition of RL as the cost of new plant is expected to be much higher and insurance claim of Rs. 400 million may not be sufficient to purchase a new plant.
- Discuss with the management and those charged with governance that how they intend to finance the new plant and the operational expenses during the closure of the plant.
- Inspect the insurance policy and the correspondence with insurance company for the verification of the insurance claim.
- Read the minutes of those charged with governance for further details.
- Analyse the latest available interim financial statements, to assess the impact of the accident on RL's financial performance.
- In case the going concern basis is inappropriate but the financial statements have not been adjusted accordingly we will express an adverse opinion.
- In case going concern basis is appropriate but material uncertainty exists and the management has not made appropriate disclosures, we will express a qualified or adverse opinion depending upon the materiality and pervasiveness of the situation.
- If the management has made appropriate disclosures in the financial statements regarding material uncertainty, we will express an unmodified opinion and will draw attention to the disclosure through a separate section under the heading material uncertainty related to going concern.

► **Practice Question 13:**

You are the audit manager responsible for the audit of Hub Mills Limited (HML). At the planning stage, materiality level was determined at Rs. 8 million.

Audit team has completed the audit field work for the year ended 30 June 2018 and has presented the following issues identified during the audit for your review:

- i. Goods worth Rs. 3 million were returned by a customer on 5 July 2018 due to poor quality. Since the goods were returned subsequent to year end, no adjustment has been recorded by the management.
- ii. HML is facing liquidity issues which has resulted in adverse key financial ratios. To address the issue, HML has sold one of its offices to a company managed by a director of HML. The office was sold for Rs. 40 million. Since the management had correctly recorded the disposal, no specific disclosures related to this sale have been made in the financial statements. Directors are confident that these sale proceeds would solve the cash flow problems of HML.
- iii. A customer who owed Rs. 11 million at year-end, was declared bankrupt on 15 August 2018. The management had already provided 50% of the balance in the financial statements.

Revenue for the current year is Rs. 800 million (2017: Rs. 950 million) and loss before tax is Rs. 22 million (2017: Rs. 7.6 million).

Required:

In respect of each of the audit issues identified by your team, mention the impact (if any) which these might have on the audit report along with proper justification.

Tutorial Notes:

Always provide proper justification when discussing the impact of issues on the audit report.

Consider factors like materiality, whether the issue is an adjusting or non-adjusting event, and the nature of the issue (e.g., whether it affects the financial statements or audit evidence).

Simply stating the impact on the audit report is insufficient without explaining why the impact occurs based on these key considerations.

► **Solution 13:**

- i. The return of goods due to quality issues is an adjusting event for which condition existed at the year end. Revenue reported in the financial statements should be reduced by Rs. 3,000,000 by recording sales return. The cost of sales should also be reduced accordingly.

The auditor should also consider that there may be quality issues with other inventory items as well requiring them to be written down to NRV.

In term of the impact on the audit report, the level of misstatement is not material as the materiality has been set at Rs. 8 million, consequently this issue will have no impact on the audit report; unless there are other misstatements and the aggregate of such misstatements is material to the financial statements.

ii.

- HML's liquidity issues, adverse key financial ratios and recurring net loss cast a doubt on HML's ability to continue as a going concern.

We need to satisfy that there is no doubt over the going concern assumption.

If the going concern basis is appropriate but a material uncertainty exists, which is adequately disclosed in the financial statements, then a paragraph related to material uncertainty would have to be included in the audit report. In case adequate disclosures are not given, audit report may express qualified or an adverse opinion.

If the going concern basis is not appropriate an adverse opinion would be given, unless HML agrees to present the financial statements on other than going concern basis.

- Sale of office to a company managed by the director of HML is a related party transaction and needs to be disclosed specifically as a related party transaction.

The disclosure and the magnitude of transaction are both material to the financial statements. If it is not disclosed in the financial statements appropriately, it will be considered as a misstatement on account of application of accounting policy. The opinion will be modified accordingly.

- iii. Declaration of a customer as bankrupt is an adjusting subsequent event and the remaining 50% of the balance also needs to be written off.

The above issue individually is not material to the financial statement, therefore has no impact on audit report. However, if this misstatement is not corrected and aggregate of all uncorrected misstatements is material to the financial statements, the report will be modified accordingly.

► **Practice Question 14:**

You are the audit manager on Beluga Limited (BL) for the year ended 31 August 2019. The following issues have been brought to your notice by your audit team:

- i. BL has pending tax litigation in which tax department has raised demand of Rs. 75 million. The matter has been challenged by BL and the decision in this respect is currently pending with the Appellate Tribunal. BL's tax advisor is confident of positive outcome of this litigation. No provision has been made in this regard; however, it has been disclosed as a contingency in the financial statements.
- ii. On 20 September 2019 one of the warehouses of BL caught fire destroying entire inventory, furniture, fixtures and equipment. The book values of the destroyed assets at the time of fire were Rs. 100 million. BL has lodged a claim with the insurance company.

The draft financial statements for the year ended 31 August 2019 show a profit before taxation of Rs. 500 million and net assets of Rs. 1,400 million.

Required:

- a) State the audit procedures which may be performed in respect of each of the above audit issues identified by your team. Also briefly discuss the implications of these issues on the audit report.
- b) Draft an opinion paragraph to be included in the audit report of BL in accordance with the requirement of International Standards on Auditing, assuming that the matter in (i) above is not dealt with in accordance with the requirements of IFRS. (Basis of opinion paragraph is not required)

Tutorial Notes:

- a) Audit Procedures: Always mention multiple relevant audit procedures. For pending tax litigation, focus on obtaining legal confirmations or reviewing communication from legal counsel, rather than automatically qualifying the audit report. For subsequent events like a fire incident, discuss the reporting implications related to the event, not the going concern unless it is directly related to the situation.
- b) Avoid Selective Study: Ensure a well-rounded understanding of all topics to avoid missing questions or underperforming due to selective study. Always attempt all questions to maximize scoring opportunities.

► **Solution 14:**

- a)
 - i.
 - Review minutes of the board meeting in which such matter were discussed.
 - Review the client's correspondence with the tax advisers and invoices for tax services.
 - Obtain direct confirmation from tax adviser.
 - Obtain and review the correspondence with the tax authorities.
 - Consider whether expert advice may be required from outside sources other than tax advisor.
 - Consider any legal precedent or case law by assessing relevant historical and recent judgments passed by the courts and other authorities in similar situation.
 - Obtain written representation from the management.
 - Evaluate the adequacy of the disclosure in the financial statement.

From the information provided it seem to indicate that the accounting treatment adopted is in line with IAS 37 which requires a contingent liability to be disclosed. Therefore there would be no impact on the audit report of BL.

We may have to include an emphasis of matter paragraph in the audit report highlighting the matter with a reference to the note to the financial statements.

- ii. Since the event occurred after the date of financial statements and the amount of loss is material, the auditor should obtain evidence that whether the incident has been appropriately disclosed in the financial statements as a non-adjusting event.

We will need to verify the financial impact to be disclosed in the financial statements by verifying the write down of stocks, loss of property and equipment, etc.

We will also need to assess the adequacy of the insurance claim and whether it covers all the losses by reviewing the insurance policy and the correspondence with the insurers.

We will have to include an emphasis of matter paragraph in the audit report highlighting the matter with a reference to the note to the financial statements.

In case the management disagrees to disclose the incident then we may consider expressing a qualified opinion.

- b) Qualified Opinion We have audited the financial statements of Beluga Limited (the Company), which comprise the statement of financial position as at 31 August 2019, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of the Company as at 31 August 2019, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

► *Practice Question 15:*

You are the manager responsible for the audit of Crown Limited (CL) for the year ended 31 December 2019. Your audit team has informed you that CL is developing a new product 'Solar giant' which would have three times more power generation capacity than the regular solar panels available in the market. CL had capitalised development costs of Rs. 40 million in 2018 and Rs. 38 million in 2019. Based on technical feasibility carried out by the production department, testing of solar giant is in the right direction and the product would be launched as per plan in June 2020.

However, review of board minutes revealed that CL is facing technical problems that may delay the launch of solar giant till March 2021. The minutes further revealed that CL may require to incur further Rs. 50 million for the development of this project. This would result in increase in selling price that was originally envisaged by CL.

CL's management is of the view that they would overcome these technical problems without incurring any additional cost and would launch the solar giant as per original plan, in June 2020.

The draft financial statements show a profit before tax of Rs. 150 million.

Required:

State the audit procedures which may be performed in respect of above audit issue. Also discuss the implication of this issue, if any, on the audit report.

Tutorial Notes:

- Discuss conflicting views with both management and those charged with governance to resolve discrepancies.
- Inquire about revised marketing plans to determine if a market exists at the proposed price, which supports the project's feasibility.
- Review revised projections, feasibility studies, and forecasts to ensure resources will generate future economic benefits.
- Do not base materiality on the additional Rs. 50 million required; assess materiality based on the total misstatement in the financial statements.
- Avoid vague statements like "qualified opinion if misstatement is material"—clearly state the type of modification based on the nature and pervasiveness of the misstatement.

► *Solution 15:*

The total development cost incurred to date is Rs. 78 million which is 52% of profit before tax and is therefore material.

Your team should first discuss with the management and those charged with governance to evaluate the contradicting views obtained from the board minutes and the management's explanation.

If the view of the board of directors is valid then perform the following audit procedures:

- Consider whether CL would be able to arrange the additional funding requirements for completion of the project.
- Ask management to provide the revised marketing plans to assess that whether a market at such an increased price actually exists.
- Review revised projections, feasibility and forecasts for using resources and generating future economic benefits.
- Obtain written representation from management as to their commitment to complete the project.
- Assess whether CL would be able to produce the solar roof at an increased cost.

If the view of the board of directors is not valid then perform the following audit procedures:

- Obtain and read the documentation of research team's notes and conclusions related to completion of the project and the funding requirements.

Reporting implications:

If the matter is resolved the auditor may consider including it in the key audit matter section of the audit report. However, if it is established that conditions required for recognition of development cost are not met then auditor should request the management and those charge with governance to expense out the development cost. If they disagree, as the matter is not pervasive as it only affects specific items in the financial statements and therefore a qualified opinion should be issued. The audit report should include an explanation of the issue in the basis for qualified opinion paragraph.

► **Practice Question 16:**

You are manager responsible for the audit of Oak (Private) Limited (OPL) for the year ending 30 September 2020. The following issues have been brought to your notice by your audit team:

- i. During planning the year-end inventory count, audit team decided to visit third party premises for inventory valued at Rs. 10 million. Third party has informed that because of restrictions imposed by the government in the wake of COVID-19, it has limited number of staff and consequently may not allow the audit team to visit its premises for inventory count at year-end. However, the audit team may visit its premises on or after 31 October 2020 for inventory count.
- ii. A competitor has alleged that OPL has infringed its patent rights and has taken legal action for damages of Rs. 500 million. OPL's independent legal advisor is of the view that no estimate can be made about the outcome of the case at this point of time. No provision has been made for the possible loss, however OPL intends to fully disclose it in the notes to the financial statements.

The projected profit before tax is Rs. 75 million.

Required:

For each of the above issues:

- a) state the audit procedures which may be performed by your audit team.
- b) discuss with reasons, the implication(s) on the audit report.

Tutorial Notes:

- a) Inventory Count Procedures: If the inventory count is conducted later, assess the reliability of inventory records and determine if alternative procedures can verify the inventory balance.

If it is impracticable to perform the inventory count at a later date, consider procedures like verifying subsequent inventory movements and obtaining third-party confirmations.

Review the minutes of meetings related to litigation to gain insight into ongoing legal matters.

- b) Reporting Implications: Always discuss the reporting implications of the identified issues, such as modifications to the audit opinion.

Avoid vague statements like "qualified opinion if misstatement is material"—be specific about the nature and pervasiveness of the misstatement to determine the appropriate modification.

For legal actions related to patent rights, consider including an Emphasis of Matter paragraph to highlight the matter without modifying the audit opinion..

► **Solution 16:**

a)

Inventory count:

Audit team should consider whether the physical count can be conducted on 31 October 2020. If the inventory count can be carried out, then the following procedures should be performed:

- Conduct physical inventory count after the date of the financial statements.
- Check whether the changes in inventory between the count date and the date of the financial statements are properly recorded.

- Investigate the reason for significant differences identified during the physical count and the inventory records.
- Assess the reliability of inventory records.

Audit team should also consider and discuss with the management and the third party that whether the physical count can be conducted through video link.

If it is impracticable to conduct an inventory count at a later date, then the following procedures should be performed:

- Inquire from the management whether third party will carry out any inventory count on 30 September 2020, and if yes, obtain the inventory count sheets.
- Inquire from the management whether third party regularly provides the inventory levels held at their warehouse, and whether any discrepancies has previously been identified.
- Obtain details of the inventory transferred to the third party warehouse and inspect documents of subsequent sale/transfer out to ascertain the condition and existence of the inventory.
- Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

Litigation:

- Discuss with the OPL's legal advisor(s) in respect of the outcome of the case.
- Obtain the minutes of meeting with regards to discussion on this litigation.
- Review the subsequent correspondence with the competitor, if any.
- Involve auditor's legal expert to assess the outcome of the case.
- Evaluate the adequacy of the disclosure in the financial statements, in particular the disclosure of the uncertainty in estimation and its quantification.
- Obtain written representation from the management regarding the fact that no estimate can be made about the outcome of the case.

b)

Inventory count

- If the auditor is able to attend the inventory count or obtains sufficient appropriate audit evidence without attending the inventory count, an unmodified opinion will be expressed.
- If the auditor is not able to attend the inventory count at the third party warehouse and also could not obtain sufficient appropriate audit evidence through alternate audit procedures, it will be a limitation of scope.

If the auditor attends the inventory count on 31 October 2020 but still could not obtain sufficient appropriate evidence, it will also be a limitation of scope.

The value of the inventory recorded by management is 13.3% of profit before tax and therefore material but not pervasive as it is isolated to one account head of the financial statements.

Therefore, the audit opinion should be modified with a qualified opinion. The auditor needs to include a basis for qualified opinion, explaining the reasons for inability to obtain sufficient appropriate audit evidence.

Litigation

- If the auditor agrees with management's treatment, an unmodified opinion should be issued.
- The claim is 667% of profit before tax and represents a significant uncertainty which would turn

OPL's profit into a loss. Therefore, the audit report should be modified using an Emphasis of Matter paragraph and a brief description should draw the users' attention to the relevant disclosure note.

- If the auditor does not agree with management's treatment based on the opinion of the auditors expert, auditor should modify his opinion accordingly.

► *Practice Question 17:*

You are a partner in a firm of chartered accountants. Following independent matters are under your consideration:

- i. The draft financial statements of Elrond Pakistan Limited (EPL) for the year ended 31 January 2021 include inventory of Rs. 26 million that was purchased on 1 January 2021 for fulfilling a large specialized order of a foreign customer. Due to sudden imposition of import restriction in the foreign country, the customer cancelled the order on 28 January 2021. The draft financial statements show that EPL's profit before tax is Rs. 130 million.
- ii. During the audit of Stellar Limited (SL), the management informed the audit team that its largest customer, Ether Limited (EL) has recently notified that it will not renew its contract with SL, which is due to expire on 30 June 2021. Sales from EL constitutes 70% of the total revenue. The management has further informed that they are in negotiation with EL and are hopeful to retain the customer.

Required:

For each of the above independent matters:

- a) state the audit procedures which may be performed by your audit team.
- b) discuss with reasons, the implication(s) on the audit report.

Tutorial Notes:

a) Audit Procedures:

Elrond Pakistan Limited:

Assess if a contract exists with the foreign customer.

Review the contract to determine whether any recovery can be made.

Determine if the inventory has alternative use to assess potential impairment.

Stellar Limited:

Discuss with management regarding contingency plans for the potential loss of the contract.

Review negotiations with EL about the contract renewal.

Inquire if any new customer has been identified subsequently.

b) Reporting Implications:

Elrond Pakistan Limited:

Do not assume the issue is pervasive without evidence.

Avoid incorrectly linking the situation to going concern.

Clarify the nature of the misstatement and its materiality, not just vague statements like "qualified opinion" or "adverse opinion".

If no adjustment to inventory is made, the auditor must combine it with other misstatements to assess if the combined effect is material.

Stellar Limited:

If management fails to assess the entity as a going concern, the audit report must reflect this risk.

Include a "Material Uncertainty Related to Going Concern" paragraph, not an emphasis of matter paragraph, when going concern is at risk.

► *Solution 17:***i. (a) Audit procedures:**

- Inquire from the management that whether any contract was made with the foreign customer.
- Review the contract to identify as to whether any recovery can be made from the customer for exiting/breaching the contract.
- Inquire from the management that since the inventory was for specific use, could it be put to some other use.
- Inquire from the management that whether they have carried out any exercise to determine the NRV of this inventory.
- Assess the managements working of NRV for accuracy.

(b) Reporting implication:

The value of the inventory recorded by management is 20% of profit before tax and therefore material but not pervasive as its effect restricted to one account head of the financial statements.

If the management records the NRV adjustment then a clean opinion would be issued. However, the auditor may consider including it as a key audit matter.

If the auditor considers that no major adjustment is required in the inventory value and the management has not recorded that adjustment, then the auditor will combine it with other misstatements to assess whether the combined effect is material.

If the auditor considers that major adjustment is required in the inventory value and the management has not recorded that adjustment, then the auditor expressed a qualified opinion. The auditor needs to include a basis for qualified opinion, explaining the reasons for qualifying the opinion.

ii. (a) Audit procedures:

- Discuss with the management that whether they have carried out a going concern assessment.
- Discuss with management that whether there are any contingency plan(s) in place for the loss of this contract.
- Review the negotiations with EL regarding the contract renewal being carried out.
- Inquire the management that whether any new customer has been identified subsequently.
- Review the minutes of board of directors meeting to identify the course of action to be adopted by the management.
- Review the projected cash flow and profit and loss forecast prepared by the management in light of this event.
- Review subsequent financial statements of EL to obtain evidence regarding the going concern assumption.
- Obtain management representation regarding the fact that EL have sufficient resources/support from sponsors to continue as a going concern.

(b) Reporting implication:

If there is uncertainty about the going concern status of the company and management is willing to fully disclose the circumstances, a paragraph headed Material Uncertainty Related to Going Concern should be included, highlighting the issue and drawing users' attention to the note in the financial statements. There should be a specific statement that the opinion is not modified.

If management refuses to disclose the uncertainty, the opinion should be modified due to misstatement/disagreement. The modification should be a qualified opinion if the issue is considered material but not pervasive or an adverse opinion if considered material and pervasive.

If the entity's going concern is not valid and the financial statements are prepared on an inappropriate basis and consequently many items in the financial statements will be materially misstated. This would be pervasive requiring an adverse opinion stating that the financial statements do not give true and fair view.

If the management is unwilling to make or extend its assessment a disclaimer of opinion would be given.

► **Practice Question 18:**

You are the audit partner in a firm of Chartered Accountants. Following independent matters for the year ended 31 December 2021 are presently under your consideration:

- a) Pioneer Electronics Limited (PEL) had implemented a new accounting software in 2021. Due to high pressure from top management, the implementation of the new accounting software was hurried, which has resulted in numerous errors in the inventory, payable and receivable module of the software. PEL's staff is still in the process of identifying and rectifying the software deficiencies. The audit team has been unable to verify these balances through alternate means. Inventory, payable and receivable are appearing as Rs. 200 million, Rs. 150 million and Rs. 100 million respectively in the financial statements.

Profit before tax is Rs. 500 million, whereas the net assets are Rs. 1,850 million.

- b) Your firm has been appointed as auditor in place of retiring auditor for Smart Footwear Limited (SFL), a listed company. SFL owns number of retail outlets across Pakistan and many of them were acquired on rental basis. During the year, SFL has adopted IFRS 16 'Leases'. The audit team has made significant efforts to review the adjusting entries made in the financial statements to reconcile the change in accounting policy of operating leases. The matter was discussed in detail in the audit committee meeting.

Your team has included the details about adjustments and impact on financial statements in the board letter.

Required:

In each of the above independent situations, discuss the reporting implication(s) including the changes that needs to be made in the audit report as illustrated in ISA-700.

Tutorial Notes:

- a) **Audit Opinion:**

Avoid suggesting a qualified or adverse opinion without proper analysis. Consider the facts and materiality before determining the appropriate opinion.

If a disclaimer of opinion is required, clearly mention the necessary changes to the audit report, including the disclaimer paragraph and the removal of the opinion paragraph.

- b) **Key Audit Matter and Other Matter Paragraph:**

When identifying a key audit matter, explain why the matter is significant to the audit and the users of the financial statements.

Include an Other Matter paragraph if previous year's financial statements were audited by a different firm, to ensure transparency and proper disclosure.

► **Solution 18:**

- a) **Reporting implication:**

Multiple accounts balances of the financial statements are affected for which the auditor has not been able to obtain sufficient appropriate audit evidence, which is a scope limitation imposed by the circumstances. Since the undetected misstatements are not confined to single specific element of the financial statements and these also represent a substantial portion of the financial statements, it will have a pervasive effect on the financial statements.

Auditor shall disclaim an opinion as they are unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Changes in the standard audit report:

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall state in the opinion paragraph that:

- the auditor does not express an opinion on the financial statements.
- because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion;
- the auditor shall amend the opinion section of the auditor's report to state that the auditor was engaged to audit the financial statements.
- the auditor shall also amend the description of the auditor's responsibility and the description of the scope of the audit accordingly.
- unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with ISA 701.

b) Reporting implication:

The matter of application of IFRS 16 is significant as Smart Footwear operates through number of rentals outlets. Furthermore, the change in accounting policy and related adjustments have taken considerable time of audit team to verify. The matter was also discussed and brought to the knowledge of those charged with governance in the meeting of the audit committee and through board letter. Considering all these factors, the auditor will add the matter of application of IFRS 16 as key audit matter in the audit report.

Changes in the standard audit report:

Since the financial statements of previous year were audited by another auditor, the other matter paragraph will be added in the report which will mention that the financial statements were audited by another auditor, the type of opinion expressed and the date of that auditor's report.

► Practice Question 19:

You are the audit manager in a firm of chartered accountants. Following independent situations of three listed audit clients are under your consideration:

- a) The client's management has refused to provide written representation about management responsibilities.
- b) Power Generation Limited has used the fuel price as at 30 June 2022 to value its closing fuel inventories. Consequently, the value of fuel inventories has been increased from Rs. 500 million to Rs. 750 million. Profit before tax for the year ended 30 June 2022 is Rs. 2,000 million.
- c) Based on detailed assessment, the management of W Limited (WL) believes that WL may not be a going concern. Consequently, they have prepared WL's financial statements on liquidation basis.

Required:

Briefly evaluate each of the above independent situations and discuss the impact of each matter on the audit report including impact on the key audit matter section, if any.

Tutorial Notes:

- a) Scope Limitation and Management Representation:

Always discuss the necessity of management's representation regarding their responsibilities in the financial statements.

Recognise that a scope limitation leads to a disclaimer of opinion, not an adverse or qualified opinion.

When issuing a disclaimer of opinion, key audit matters should not be included in the audit report.

- b) Inventory Valuation:

When evaluating the upward valuation of inventory, ensure that the valuation is correct before suggesting an unmodified opinion.

Do not include the upward valuation as a key audit matter unless it is truly significant, which is rarely the case for routine inventory adjustments.

c) **Unmodified Opinion:**

Clearly state that an unmodified opinion will be expressed if the situation warrants it.

Do not include routine matters as key audit matters unless they are truly significant to the users of the financial statements.

► **Solution 19:**a) **Brief evaluation of the situation:**

It is necessary for the auditor to obtain written representation that management has fulfilled its responsibilities. It supports the overall control and the managements attitude over the financial reporting process. It also supports the other audit evidence obtained by the auditor.

Managements refusal to provide the written representation is inability to obtain sufficient appropriate audit evidence arising from a limitation on the scope of the audit imposed by the management.

Reporting implication:

Since the limitation of scope is related to preparation of financial statements, the effect is pervasive.

Auditor will therefore disclaim the opinion and mention it in the opinion paragraph that the auditor does not express an opinion on the financial statements.

Since the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the basis for opinion section the reasons for that inability.

Implication on key audit matter:

Since we are disclaiming the opinion, key audit matter section will not be made part of the audit report.

b) **Brief evaluation of the situation:**

Inventory is measured at the lower of cost and net realizable value. Increase of fuel prices in international market will not have any impact on fuel quantities already procured and held by Power Generation Limited. Any upward valuation of fuel inventories would result in misstatement.

Reporting implication:

The effect of upward valuation is Rs. 250 million which is 10% of the profit before tax. Since the effect is confined to a single element of the financial statement, the effect is material but not pervasive.

The misstatement being material, auditor will have to express a qualified opinion. The auditor shall include in the basis for opinion section, a description and quantification of the financial effects of the misstatement.

Implication on key audit matter:

Qualified opinion is by nature a key audit matter. Therefore, a reference to the Basis for Qualified Opinion should be included in the Key Audit Matters section.

c) **Brief evaluation of the situation:**

Since the going concern basis is not appropriate, the management has rightly prepared the financial statements on liquidation basis.

Reporting implication:

The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein about the basis of accounting on which the financial statements are prepared.

However, the auditor will include an Emphasis of Matter paragraph to draw the user's attention to that alternative basis of accounting and the reasons for its use.

Implication on key audit matter:

There will not be any impact on the key audit matter section of the audit report and it would be presented as usual.

► *Practice Question 20:*

Your firm is the external auditor of Passu Limited for the year ended 31 December 2022. The draft financial statements show profit before tax of Rs. 250 million.

During the audit, it was observed that the management has not provided depreciation on one of its production plant for the months of November and December 2022 which has been temporarily shut down due to reduction in demand. The depreciation on the plant for these two months was Rs. 5 million.

Required:

- a) Briefly evaluate the above situation and state any four key audit procedures which may be performed by your audit team.
- b) Discuss the possible impact on the audit report.

Tutorial Notes:

- **Identify Impairment:** Understand that decreased demand and non-operational status of a production plant may indicate impairment of the asset.
- **Audit Procedures:** Include procedures like testing the recoverable amount of the asset and assessing management's impairment review.
- **Reporting Implications:** Discuss how impairment affects the financial statements and whether it leads to a qualified opinion or needs disclosure in the audit report.

► *Solution 20:*

- a) Evaluation:

Depreciation needs to be recorded despite the production unit being shut down for two months. Furthermore, the shut down of the production unit due to a reduction in demand may be an indicator of impairment.

Audit procedures:

- Obtain the management working of depreciation and impairment and verify its accuracy.
- Obtain an understanding of management process related to identifying, estimating and recording impairment for fixed assets.
- Obtain the management working and verify the authenticity of the source data used by the management.
- Assess the reasonableness of the assumptions used by the management for the working of the impairment.
- Obtain the management fair valuation report of the production unit.
- Consider involving the auditor's expert for valuation of the production unit.
- Review the disclosures prepared by the management related to impairment of plant.

- b) Reporting implications:

Although depreciation only amounts to 2% of the profit before tax, and may not be material individually, we would still ask the management or those charged with governance to record the depreciation for the last two months. However, being immaterial, an unqualified opinion would be issued.

Additionally, the misstatements must be aggregated with other misstatements to determine if the total amount of misstatement is material in the aggregate.

It should also be evaluated whether the impairment of the production unit exceeds the materiality threshold. If it does, the audit report would be qualified and a basis of qualified opinion paragraph would be added, which would describe the reasons for the qualification.

► *Practice Question 21:*

You are the auditor of Ghizer Limited for the year ended 31 December 2022. During the audit, you have been informed that the Federal Board of Revenue has seized the accounting records pertaining to revenue and production for further investigation into the alleged charges of tax evasion.

Required:

Evaluate the above situation and discuss the implications on the audit report.

Tutorial Notes:

- **Audit Procedures:** Focus only on relevant audit procedures for the scenario; avoid discussing procedures that are not directly related to the issue at hand.
- **Fraudulent Financial Reporting:** If management is involved in tax evasion, evaluate the impact on financial statements, especially regarding fraudulent financial reporting. Ensure appropriate disclosures and consider the need for reporting a modified opinion if the fraud is material.
- **Contingency and Provision:** Assess whether the contingency requires disclosure in the financial statements or recognition of a provision. This could affect the audit report and should be properly disclosed based on its materiality and likelihood.

► *Solution 21:*

Evaluation:

Revenue and production records generally constitute a significant portion of financial records, unavailability of these records could impede the auditor's the ability to obtain sufficient appropriate audit evidence, and could result in a scope limitation. It is necessary to assess the availability of electronic records, and to consider verifying these records through alternate audit procedures.

Implication of fraudulent financial reporting would also be relevant if the management is involved in tax evasion. In addition, a contingency related to this matter may need to be disclosed in the financial statements, or a provision could be recognised.

Reporting implication:

Since the records of a significant portion of revenue have been seized by FBR in order to probe an allegation of tax evasion, the auditor will consider the scope limitation imposed by circumstances beyond management control on the sufficiency and appropriateness of audit evidence.

Since revenue and production records constitute a significant portion of the accounting records, the auditor's inability to obtain sufficient appropriate audit evidence will have a pervasive effect. Therefore, a disclaimer of opinion will be expressed. We will discuss the reason for disclaiming the opinion in basis of opinion paragraph. However, a qualified opinion will be expressed if inability to obtain sufficient appropriate audit evidence has a material impact.

If we are able to obtain sufficient appropriate audit evidence through alternate audit procedures, we will also evaluate whether management has adequately disclosed the contingency or recorded additional taxes and fines that the entity may face as a result of the probe. If appropriate accounting/disclosures have not been made, we will have to express a qualified opinion.

If it is determined that the evasion was intentional, the auditor should consider its earlier assessment regarding the integrity of the management and consider informing the fact to those charged with governance. The auditor should also consider resigning from the assignment and obtain a legal opinion in this regard and shall determine whether there is a responsibility to report to the regulatory authorities.

► **Practice Question 22:**

Aslam has been assigned the role of audit manager for the audit engagement of Exploration Limited (EL). While reviewing the draft financial statements, Aslam has identified significant increase in the value of specialized assets used in the drilling of wells due to a recent revaluation conducted by EL. The revalued amount of these assets is Rs. 4,000 million. Owing to the significance of the matter, Aslam engaged an independent valuation company “the Valuers” for the valuation of specialized assets. After completing their work, the Valuers submitted their valuation report, according to which the value of these assets should be Rs. 3,500 million.

The draft financial statements show a profit before tax of Rs. 2,500 million.

Required:

- i. State any five key audit procedures which may be performed by the audit team to address the difference in the fair value of the assets.
- ii. Discuss the possible impact on the audit report if the difference is not adjusted.

Tutorial Notes:

- Focus on Fair Value Differences: Ensure that audit procedures specifically address the difference in fair values of assets, rather than just general procedures related to hiring experts or fixed assets.

Audit Procedures for Fair Value:

- Review management’s work for determining the fair value of the specialized asset.
- Compare the source data and assumptions used by both the auditor’s expert and management to assess the asset’s value.
- Assess the relevance and reasonableness of those assumptions and valuation methods in the context of the asset.

Opinion Selection: Avoid discussing both qualified and adverse opinions unless you have fully assessed the misstatement and its impact on the financial statements. Select the appropriate opinion based on the facts and the materiality of the misstatement.

► **Solution 22:**

Audit procedures:

- Review the expert’s documentation and report to obtain an understanding of the work of that expert.
- Review the management’s work for arriving at the fair value of the specialized asset.
- Compare the source data and assumptions used by the auditor expert and the management to assess the value of the assets.
- Obtain the source data used by expert and verify the relevance, completeness, and accuracy of that source data.
- Assess the relevance and reasonableness of those assumptions and methods in the circumstances.
- Assess the relevance and reasonableness of that expert’s findings or conclusions and their consistency with other audit evidence obtained during the audit.

Implications on audit report:

The effect of Rs. 500 million is 20% of the profit before tax of Rs. 2,500 million. Since the effect is confined to a single element of the financial statement, the effect is material but not pervasive.

If the difference remains unadjusted then, the misstatement being material in nature, the auditor will have to express a qualified opinion. The auditor shall include in the basis for opinion section, a description and quantification of the financial effects of the misstatement.

► *Practice Question 23:*

You are the audit manager in a firm of Chartered Accountants. The following independent matters for the year ended 31 December 2023 are presently under your consideration:

- a) Your firm serves as the auditor of Karsaz Limited (KL). During the audit process, the audit team encountered a challenge in conducting the inventory count at one of the warehouses. KL failed to make necessary arrangements for inventory count at this particular location, citing the unavailability of relevant staff on the scheduled inventory count day. The inventory in the financial statements is reported at Rs. 600 million, whereas inventory in that warehouse is recorded at Rs. 150 million.

KL's profit before tax is Rs. 700 million.

- b) Your firm is the auditor of Malir Limited (ML). During the audit process, ML has notified the audit team that its human resource department has also been given the responsibility for managing the human resources of its subsidiary, Valeeka Limited (VL). This decision was made because the operational costs associated with running the human resource department at ML are relatively minimal, considering the scale of ML's business operations. Consequently, ML has not considered this transaction while preparing its financial statements.

Required:

Analyse each of the above independent situations and discuss the related audit reporting implications if the issue could not be resolved. (Audit procedures are not required)

Tutorial Notes:

- a) **Inventory Materiality:** When assessing the materiality of the inventory value, focus only on the inventory at the warehouse where the count was not conducted, rather than the entire inventory. If the misstatement is material, consider the appropriate opinion (qualified or unmodified), not both qualified and adverse opinions. Avoid an incorrect adverse opinion unless the misstatement is both material and pervasive.
- b) **Related Party Transactions:** Related party transactions must be disclosed regardless of materiality. If a related party transaction is not disclosed, it must be addressed, even if the amount is immaterial. Recognise that the failure to disclose related party transactions could have an impact on the audit report. Again, avoid mixing qualified and adverse opinions—carefully assess whether a qualified opinion is necessary based on materiality and impact.

► *Solution 23:*

- a) The inventory not verified by the auditor through stock count is 21.4% of the profit and is therefore material. Audit team needs to obtain evidence either by performing inventory count at an alternate date and verification of existence of inventory through other alternate procedures. If the auditor cannot obtain evidence due to non-performance of the stock count it would be a scope limitation.

Since the effect is confined to a single element of the financial statement, the effect is material but not pervasive. Being material and not pervasive in nature auditor will express a qualified opinion. Auditor will include a basis of qualified opinion paragraph in which the auditor will discuss the matter giving rise to modification and their inability to obtain sufficient appropriate audit evidence.

- b) Any transaction with the subsidiary will be a related party transaction. Even though the management decides not to charge any amount from KL, being a related party transaction, this arrangement needs to be disclosed in the financial statements. Not disclosing the related party transaction would be a non-compliance of IAS-24 and will be a material misstatement.

Being a material misstatement auditor will have to express a qualified opinion. Since it is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:

- Describe in the basis for opinion section the nature of the omitted information; and
- Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

► *Practice Question 24:*

You are the audit manager in a firm of chartered accountants. Following independent matters are under your consideration:

- i. In the draft financial statements of Elrond (Private) Limited (EPL) for the year ended 30 June 2021, capital work in progress of Rs. 100 million related to construction of a new production facility is included in property, plant and equipment. Your team has observed that the last cost incurred on the said facility was on 30 April 2021. However, it was put to use from 1 August 2021 and therefore no depreciation has been charged at the year-end. The useful life of the said facility is assessed to be 10 years. The draft financial statements show that EPL's profit before tax is Rs. 150 million.
- ii. Cafe Elixiar (Private) Limited (CEL) operates a chain of cafes in Pakistan. Before the year-end, a large number of customers complained about food poisoning, possibly as a result of eating at the cafe. Some of the customers have taken legal action against CEL. An out of court settlement with these customers is under process. No information has been provided in this regard in the draft financial statements.

Required:

For each of the above independent matters:

- a) state the audit procedures which may be performed by your audit team.
- b) discuss the implication(s) on the audit report.

► *Solution 24:*

EPL-Audit Procedures:

- i. Inquire from management when the asset was available for use.
- ii. Obtain the engineer's certificate / documentation to assess when the asset was completely built.
- iii. Read the management meeting minutes to find out whether any discussion has been made related to the project completion.
- iv. Obtain management representation regarding when the asset was available for use.
- v. Inspect the purchase invoice of the additions made to this CWIP.
- vi. Review that only capital expenditure has been capitalized and revenue expenses has been recorded in profit and loss.
- vii. Review the useful life for reasonableness by comparing it with other similar assets.

EPL-Reporting Implications:

EPL should start depreciating the asset when it is available for use and not when it is put to use. If it is established that the asset has been completed before year end, the management of EPL should be asked to record depreciation. However, the maximum possible adjustment i.e. Rs. 1.67 million is below the materiality level i.e. Rs. 7.5 million. Therefore there would not be any impact on the audit report and we will express an unqualified opinion. The potential adjustment amount would need to be added to the list of uncorrected misstatements and assess that whether they are material in aggregate. We will also obtain a written representation in this regard that the effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole.

CEL-Audit Procedures:

- i. Review the legal expense account for any further claims or proceedings against the company.
- ii. Send confirmation to the legal advisor to confirm the current status of the litigation and the expected outcome.
- iii. Review communication with the customers for out of court settlement.

- iv. Review the minutes of the board of directors meeting to assess the possible outcome of the case.
- v. Consider the possibility of any legal proceedings and any proceedings that may be instigated by the public health authorities as such authorities might impose significant fines.
- vi. Seek written representation from the management about likely outcome of the case.
- vii. Ensure that proper disclosure in this regard in the financial statements should be made.

CEL-Reporting Implications:

Not giving disclosure of the event is qualitatively material to the financial statements. The financial statements should include the disclosure required by the applicable financial reporting framework. If CEL does not disclose this matter, it would be considered as a material misstatement that relates to the non-disclosure of information required to be disclosed. The auditor shall:

- discuss the non-disclosure with those charged with governance;
- Express a qualified opinion
- describe in the basis for opinion section the nature of the omitted information; and
- unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

For the customers with whom out of court settlement has been agreed a provision needs to be recorded. If the management does not record the provision and if it is material, then the auditor shall express a qualified opinion. The auditor needs to include a basis for qualified opinion, explaining the reasons for qualifying the opinion.

► Practice Question 25:

You are the audit manager at a firm of Chartered Accountants. The following independent matters concerning the listed audit clients for the year ended 30 June 2024 are presently under your consideration:

- a) During the audit of Zero Synthetic Limited (ZSL), it was identified that ZSL has recognised revenue from a major contract before the delivery of the goods. The revenue recognised from this contract amounts to Rs. 175 million. Management justifies the early recognition by stating that it is a non-cancellable contract for which the customer has already made complete advance payment, as the goods were specifically manufactured for them. ZSL had incurred a cost of Rs. 150 million on these goods. The profit before tax of ZSL is Rs. 400 million.
- b) Bio Health Limited (BHL) is engaged in extensive research and development activities. BHL has capitalized a large portion of its research costs, amounting to Rs. 300 million, arguing that initial surveys suggest that these projects will lead to significant future economic benefits. The profit before tax is Rs. 2,900 million.
- c) Tech Geni Limited (TGL), a technology company, conducted an impairment exercise for its intangible assets and patents. TGL's management has estimated the impairment at Rs. 350 million, while your audit team determined it to be Rs. 375 million. The audit team engaged in extensive discussions with management and those charged with governance to understand why the impairment was not recognised at Rs. 375 million. However, management decided to record an impairment of Rs. 350 million in the financial statements, as they believe this to be their best estimate. The profit before tax is Rs. 1,500 million.

Required:

Analyse each of the above independent situations and discuss the related audit reporting implications. (Audit procedures are not required)

► *Solution 25:*

Part (a) Zero Synthetic Limited

Merely recognizing revenue on the grounds that the contract is non-cancellable and the goods are of a specialized nature is not correct. For recognizing revenue, the performance obligation needs to be satisfied. Revenue should be recognised when the goods have been delivered to the customer and the customer has accepted the delivery.

Revenue recognised is 44% of the profit before tax and the net profit effect by this early recognition is Rs. 25 million which is 6% of profit before tax. Since the effects are confined to specific elements of the financial statement, the effect is material but not pervasive. Being material but not pervasive in nature, the auditor will express a qualified opinion. The auditor will include a Basis of Qualified Opinion paragraph in which the auditor will discuss the matter giving rise to the modification. The auditor also needs to quantify the impact of this misstatement on revenue, profit, inventory, and advances.

Part (b) Bio Health Limited

Even though initial surveys suggest that these projects will lead to significant future economic benefits, the research costs must be expensed as incurred because there is insufficient certainty about the future economic benefits at the research stage. The capitalization of these research costs by BHL does not comply with IAS 38. This results in a material misstatement in the financial statements.

The research cost recognised amounts to 10% of the profit before tax. Since the effect is confined to a specific element of the financial statement, the effect is material but not pervasive. Being material but not pervasive in nature, the auditor will express a qualified opinion. The auditor will include a Basis of Qualified Opinion paragraph in which the auditor will discuss the matter giving rise to modification. The auditor also needs to quantify of the impact this misstatement on intangible assets and profit.

Part (c) Tech Geni Limited

The provision recorded by management needs to be based on their best estimate. Furthermore, the difference between the management's and auditor's estimate is only 2% of the profit before tax. Since the difference in estimation is below the materiality level there would be no impact on the audit opinion expressed by the auditor.

Additionally, the misstatements must be aggregated with other misstatements to determine if the total amount of misstatements is material in aggregate.

However, as the impairment involves a higher assessed risk of material misstatement, requires significant management judgment and estimates, and has been discussed with those charged with governance it should be included as a key audit matter in the Key Audit Matters section of the audit report.

8 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Describe what is involved in the final review prior to signing the audit report
- Explain the contents of an unmodified auditor's report both in terms of the requirements of ISA 700 (Revised) and the Companies Act, 2017
- Explain modification in auditor's opinion and report according to circumstances

AUDIT FINALISATION - FINAL EVALUATION

IN THIS CHAPTER:

1. Evaluation of Misstatements Identified during the Audit (ISA 450)
2. Subsequent events: ISA 560
3. Written representations: ISA 580
4. Going concern basis and the audit report: ISA 570
5. Chapter review

1 EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT (ISA 450)

► Definitions:

Misstatement

A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

Uncorrected Misstatement

Misstatements that the auditor has accumulated during audit and that have not been corrected.

► Practice Question 01:

Define a "misstatement" according to ISA 450 and explain what additional adjustments the term includes when the auditor gives an opinion on fair presentation.

► Solution 01:

Misstatement is any difference in amount, classification, presentation or disclosure between what is reported and what the applicable financial reporting framework requires; the definition extends to any adjustments the auditor judges necessary for the financial statements to be presented fairly, in all material respects, or give a true and fair view

1.1 Accumulation of Identified Misstatements

Auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. Auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated.

Type of Misstatements

- Factual misstatements: Misstatements about which there is no doubt.
- Judgmental misstatements: Differences arising from the judgments of management concerning accounting estimates, or selection or application of accounting policies that the auditor considers inappropriate.
- Projected misstatements: Auditor's best estimate of misstatements in populations. (See ISA 530).

► Practice Question 02:

List and briefly describe the three categories of misstatements the auditor accumulates

► Solution 02:

1. Factual – no doubt exists about the error.
2. Judgemental – arise from management's accounting estimates or policy choices the auditor considers inappropriate.
3. Projected – auditor's best estimate of misstatement in a population

1.2 Consideration of Identified Misstatements as the Audit Progresses

Auditor shall determine whether the overall audit strategy and audit plan need to be revised if:

- The nature of identified misstatements and circumstances of their occurrence indicate the existence of other similar misstatements. (e.g. misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity)
- Aggregate of misstatements accumulated during audit approaches materiality.

If management has examined and corrected misstatements that were detected by auditor, the auditor shall perform additional procedures to determine whether misstatements remain.

► *Practice Question 03:*

Give two indicators that require the auditor to consider revising the overall audit strategy or plan while the audit is in progress.

► *Solution 03:*

- The nature of identified misstatements or the circumstances of their occurrence suggest other similar misstatements may exist (e.g., pervasive control failure).
- The aggregate of accumulated misstatements is approaching materiality

1.3 Communication and Correction of Misstatements

Auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation.

Auditor shall request management to correct those misstatements. (Such correction enables management to maintain accurate accounting books and records).

If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall:

- Obtain an understanding of management's reasons for not making the corrections; and
- Take that understanding into account when evaluating whether the financial statements are free from material misstatement.

► *Practice Question 04:*

Describe the auditor's responsibilities for *communicating* and *requesting correction* of misstatements, and explain how management's response can affect the final audit opinion

► *Solution 04:*

The auditor must communicate all accumulated misstatements promptly to an appropriate management level and request their correction. Timely correction helps management keep accurate records. If management refuses, the auditor must understand the reasons and factor them into the overall evaluation of whether the financial statements are materially misstated. Persistent material uncorrected misstatements may lead to a qualified or adverse opinion

► *Practice Question 05:*

If management refuses to correct certain misstatements, what two actions must the auditor take?

► *Solution 05:*

1. Obtain an understanding of management's reasons for not making the corrections.
2. Consider that understanding when evaluating whether the financial statements are free from material misstatement.

1.4 Evaluating the Effect of Uncorrected Misstatements

Prior to evaluating effect of uncorrected misstatements, auditor shall reassess materiality to confirm whether it remains appropriate in the context of the entity's actual financial results.

If reassessment gives rise to a lower amount, then performance materiality and appropriateness of the nature, timing and extent of the further audit procedures shall also be reconsidered.

Auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

- Size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and
- Effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures and the financial statements as a whole.

► **Practice Question 06:**

State two factors the auditor must consider when deciding whether uncorrected misstatements are material, individually or in aggregate

► **Solution 06:**

- Size and nature of the misstatements in relation to specific classes, balances, disclosures and the financial statements as a whole
- Effect of uncorrected prior-period misstatements on current-period information and the financial statements as a whole

► **Practice Question 07:**

Outline the sequence of steps the auditor should perform when the *aggregate of misstatements approaches materiality*, including any required reassessment of materiality and further audit work.

► **Solution 07:**

1. Reassess materiality in light of actual financial results (could lower it).
2. If lowered, re-evaluate performance materiality and nature, timing, extent of procedures.
3. Determine whether additional misstatements are likely and extend testing where necessary.
4. Accumulate remaining errors, revisit the overall strategy, and decide whether the financial statements remain free of material misstatement.

► **Examples of Particular Circumstances (nature of misstatement)**

Circumstances that may affect the evaluation of any misstatement as material, include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate entity's financial position, results of operations or cash flows;
- Affects segment information presented in financial statements;

- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to auditor's understanding of the known previous communications to users, for example, in relation to forecast earnings;
- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management); or
- Is an omission of information not specifically required by applicable financial reporting framework but which, in the judgment of auditor, is important to users' understanding of financial position & performance etc.

► *Practice Question 08:*

Provide three examples of "particular circumstances" that could cause an otherwise small misstatement to be evaluated as material

► *Solution 08:*

Any three of:

- Affects compliance with regulatory requirements.
- Masks a change in earnings or trends.
- Alters ratios used by users.
- Impacts segment information.
- Increases management compensation.
- Relates to parties connected to management, etc

1.5 Communication with those charged with governance

- Auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they may have on the auditor's opinion (unless prohibited by law or regulation).
- Where there is a large number of individual immaterial uncorrected misstatements, auditor may communicate the number and overall monetary effect of uncorrected misstatements.
- Auditor shall identify material uncorrected misstatements individually.
- Auditor shall request that uncorrected misstatements be corrected.

► *Practice Question 09:*

Explain the auditor's obligations to those charged with governance regarding uncorrected misstatements and discuss why this communication is critical to audit quality and stakeholder confidence.

► *Solution 09:*

Auditor must communicate all uncorrected misstatements and their potential effect on the opinion. Material items must be identified individually; numerous immaterial items may be summarised. The auditor also requests correction. This dialogue ensures governance bodies are aware of remaining errors and can act, supporting transparency, accountability, and informed decision-making, which underpins user confidence in the audited financial statements

1.6 Written Representations

Auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole.

A summary of such items shall be included in or attached to the written representation.

They may add to their written representation words such as: “We do not agree that items ... and ... constitute misstatements because [description of reasons].”

Obtaining representation does not, however, relieve the auditor from his responsibilities.

► *Practice Question 10:*

Draft the key points that should appear in the *written representation* about uncorrected misstatements and justify why obtaining this letter does *not* relieve the auditor’s responsibility.

► *Solution 10:*

Representation should state that management (and, where appropriate, those charged with governance) believe the aggregate effect of uncorrected misstatements is immaterial to the financial statements as a whole and should attach a summary of the items (with optional explanatory wording if they disagree with classifications). While the letter documents management’s position, ISA 450 makes clear that the auditor still must independently conclude on the materiality of uncorrected misstatements; the representation does not replace audit evidence nor shift responsibility for the audit opinion

1.7 Documentation

Auditor shall include in the audit documentation:

- Amount below which misstatements would be regarded as clearly trivial;
- All misstatements accumulated during audit and whether they have been corrected; and
- Auditor’s conclusion as to whether uncorrected misstatements are material, individually or in aggregate and the basis for that conclusion.

► *Practice Question 11:*

Identify three specific items the auditor must include in the ISA 450 audit documentation file

► *Solution 11:*

- The clearly trivial threshold.
- All misstatements accumulated and whether corrected.
- The auditor’s conclusion on uncorrected misstatements’ materiality and the basis for that conclusion

2 SUBSEQUENT EVENTS: ISA 560

2.1 IAS 10 and ISA 560

It is not possible to prepare financial statements that present a true and fair view by considering only those events and transactions that take place before the date at which the balance sheet is prepared. Material events that occur after the reporting period should also be considered when preparing the financial statements for the year.

Purpose of IAS 10

IAS 10 Events after the reporting period has two main objectives:

- to specify when an entity should adjust its financial statements for events that occur after the reporting period, but before the financial statements are authorised for issue, and
- to specify the disclosures that should be given about events that have occurred after the reporting period but before the financial statements were authorised for issue.

Events after the reporting period are defined in IAS 10 as ‘those events, favourable and unfavourable that occur between the end of the reporting period and the date when the financial statements are authorised for issue.’

There are two types of events after the reporting period:

- **Adjusting events.** These are events that provide evidence of **conditions that already existed** at the end of the reporting period.
- **Non-adjusting events.** These are events that have occurred due to conditions arising after the reporting period.

The role of the auditor: ISA 560

The work of the external auditor in this area is covered by ISA 560 Subsequent events.

The **objectives** of the auditor, as stated in ISA 560 are as follows:

- The auditor should obtain sufficient, appropriate evidence about whether events occurring between the date of the financial statements and the date of the audit report are appropriately reflected in those financial statements.
- The auditor should also respond appropriately to facts that become known to him after the date of the audit report that, had they been known to him at that date, may have caused him to amend his report.

2.2 Events occurring up to the date of the audit report

Between the end of the reporting period and the date of the audit report, the auditor is required to obtain sufficient appropriate evidence that all events that require adjustment of or disclosure in the financial statements:

- have been identified, and
- are suitably reported in the financial statements.

Normal audit verification work

The auditor may find sufficient evidence of subsequent events in the course of his normal audit verification work. Where this is the case he is not required to perform additional audit procedures.

Such normal audit verification work might include the following:

- The audit of receivables will consider whether receivables at the end of the reporting period are collectable. Cash receipts after the year-end may indicate a significant non-payment, suggesting the need to write off a debt as irrecoverable.

- The audit of inventory includes a review of the net realisable value of inventory. Sales of inventory after the year-end may indicate that some inventory in the balance sheet is over-valued (because subsequent events have shown that its NRV was less than cost).
- A search for unrecorded liabilities may discover the existence of some unrecorded liabilities, from invoices received after the reporting period but relating to the period covered by the financial statements.
- A review of the entity's cash position at the end of the reporting period may find that a cheque from a customer, recorded as part of the bank balances, was dishonoured after the reporting period.

Procedures aimed specifically at identifying subsequent events

The auditor should also actively look for 'subsequent events', up to the time that he prepares the audit report. Taking into account his risk assessment of this area, he should:

- obtain an understanding of management's procedures for identifying subsequent events
- inquire of management as to whether any subsequent events have occurred which might affect the financial statements
- read the entity's latest subsequent financial statements
- read minutes of shareholders' meetings, meetings of the board of directors and senior management meetings held after the date of the financial statements and inquire about matters discussed at any such meetings where minutes are not yet available
- obtain written representations in respect of subsequent events (covered in a later section).

Additional audit procedures or above procedures could not be performed:

- Review or testing of accounting records or transactions occurring between the date of financial statements and the date of auditor's report.
- Where no subsequent interim and minutes are prepared, inspect available books and records including bank statement.
- Read the entity's latest available budgets, cash flow forecast and other related management reports for periods after the date of the financial statements.
- Inquire or extend previous oral or written inquiries of the entity's legal counsel concerning litigation and claims.

2.3 Facts discovered after the date of the audit report

Between the date of the audit report and the issue of the financial statements

The auditor has no obligation to perform any audit procedures after the date of his audit report. However, if he becomes aware of a fact that had it been known to him at the date of his report, may have caused him to amend his report then he is **required** to:

- discuss the matter with management
- determine whether the financial statements need amending, and
- inquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to:

- carry out the necessary audit procedures on the amendment
- extend his review of subsequent events up to the date of the new audit report.

If management do not amend the financial statements for the subsequent event, but the auditor believes that an amendment should be made, the auditor is **required** to take the following action:

- If the audit report has not yet been provided to the entity, modify his opinion as appropriate.
- If the audit report has been provided to the entity:
 - notify management not to issue the financial statements before the necessary amendments have been made
 - if they do so, take appropriate action to prevent reliance on the audit report, after taking legal advice.

Facts discovered after the financial statements have been issued

As above, the auditor has no obligation to perform any audit procedures after the financial statements have been issued. However, if he becomes aware of a fact that had it been known to him at the date of his report, may have caused him to amend his report then he is **required** to:

- discuss the matter with management
- determine whether the financial statements need amending, and
- inquire how management intend to address the matter in the financial statements.

If the financial statements are amended, the auditor is **required** to:

- carry out the necessary audit procedures on the amendment
- review the steps taken by management to inform anyone who received the original financial statements and audit report of the situation
- extend his review of subsequent events up to the date of the new audit report
- issue a new audit report, containing an **emphasis of matter paragraph** or **other matter paragraph**. This should refer to a note in the revised financial statements that explains in more detail the reason for the re-issue of the financial statements.

As usual, in the real exam, you are likely to be asked to **apply** your knowledge to a given scenario.

► Example:

You are the auditor in charge of the audit of Hindsight, which has a 30 June year end. The subsequent events review for the year ended 30 June Year 5 revealed that, on 1 August Year 5, a receiver was appointed at a major customer. At 30 June Year 5 that customer owed Rs 200,000 and goods costing Rs 300,000 made to that customer's specification were held in inventory. Both these amounts are material.

Required

List the matters to which you would direct your attention in respect of the above in relation to the audit for the year ended 30 June Year 5, if the audit report on the financial statements has not yet been written

► Answer

- Check that the directors are willing to adjust the financial statements for this adjusting event after the reporting period.
- Establish whether any cash has been received from this customer since the year end.
- Review any correspondence from the receiver to establish to what extent the outstanding debt will be recovered.
- Consider whether the goods held in inventory are now valued at the lower of cost and NRV, given that these goods were made to the customer's specification. This may depend on whether or not those goods can be sold to a different customer.
- In the light of the above, consider whether any write downs proposed by the directors to receivables and/or inventory are reasonable.
- If they are not, or if the directors refuse to adjust the financial statements, consider the impact on the audit report.

Note

Where law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of financial statements to the effects of the subsequent events, events causing that amendment and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events required in paragraph 11(b)(i) to that amendment. In such cases the auditor shall either:

- a) Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the audit procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements; or
- b) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter paragraph that conveys that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

Dual Dating

Auditor is permitted to apply audit procedures on subsequent events to that amendment where:

- Law, regulation or financial reporting framework does not prohibit management (i.e. allows) from amending the financial statements to the effects of subsequent event; and
- Those responsible for approving financial statements are not prohibited from approving that amendment.

In such cases, the auditor shall either:

- Amend report to include an additional date restricted to that amendment indicating that auditor's procedures are restricted solely to amendment of financial statements; or
- Provide a new or amended report that including an Emphasis of Matter paragraph or Other Matter paragraph highlighting that auditor's procedures are restricted solely to amendment.

Illustration of additional date (Dual Dating)

"August 14, 2021, except as to Note 37.1, which is as of September 06, 2021."

► Practice Question 12:

State the auditor's responsibility with respect to events between the end of the reporting period and the date of the auditor's report.

Tutorial Notes:

Differentiate between auditor's responsibility for subsequent events: Focus on events after the period-end but before the auditor's report, rather than events after the financial statements are published or the audit report is signed.

Clarify the auditor's role: The management is responsible for incorporating subsequent events in the financial statements, while the auditor's responsibility is to obtain sufficient audit evidence to verify proper treatment.

Avoid stating that the auditor ensures all subsequent events are incorporated—instead, highlight that the auditor evaluates management's handling of such events.

► Solution 12:

Auditor's responsibility with respect to events between end of reporting period and date of the auditor's report:

The auditor is required to obtain sufficient appropriate evidence that all subsequent events that require adjustment or disclosure in the financial statements:

- have been identified, and
- are suitably reported in the financial statements.

► *Practice Question 13:*

Your firm is the auditor of Customized Machinery Limited (CML), a listed company, for the year ended 30 June 2015. CML has an asset base of Rs. 3.5 billion and profit before tax of Rs. 350 million. On 10 August 2015, after the issuance of audit report but prior to the issuance of financial statements, you have been informed as under:

- i. CML had been awarded a contract of Rs. 500 million in April 2015 for supply of specialized machinery parts in August 2015 to a foreign customer. CML was expecting a profit of 20% on the contract.

However, the government of the foreign country has placed certain restrictions on import because of which the customer has cancelled the purchase order under force majeure clause.

- ii. The inventory against the above order is lying in the warehouse and requires an expense of Rs. 105 million in order to become usable for other customers.
- iii. According to the management, the cancellation of this order will not affect the operations of the company in any significant manner.

Required:

Discuss how you would deal with the above situation. (7 marks)

Tutorial Notes:

Clearly identify adjusting events: When an event occurs after the audit report is issued but before financial statements are released, assess whether it is adjusting or non-adjusting based on its impact on conditions existing at the reporting date.

Follow a structured approach: Before concluding that the audit report should not be relied upon, first discuss with the client and attempt to reach an agreement on amending the financial statements.

Recommend appropriate amendments: If the event is adjusting, suggest both disclosure and necessary adjustments to the financial statements instead of disclosure alone.

Pay attention to the timeline: If the audit report has already been issued, do not mention procedures applicable before audit report issuance—focus on post-reporting responsibilities.

Outline auditor's steps if the client agrees to revisions: Specify procedures such as issuing a revised audit report, updating audit documentation, and informing users of the changes.

Treat related information consistently: If all details pertain to a single event, do not categorize some aspects as adjusting and others as non-adjusting—analyse the event holistically.

► *Solution 13:*

The imposition of restriction by foreign country is an adjusting event as the inventory prepared for the order cannot be supplied to any other customer, without considerable expense of Rs. 105 million. The revised net realizable value of the inventory would therefore be approximately Rs. 395 million (500-105), as against the cost of Rs. 416.67 million (500÷1.2), resulting in an adjustment of Rs. 21.67 million which is approximately 6.19% of the profit before tax.

As an auditor we have no obligation to perform any audit procedures after the date of the audit report. However, in view of the fact that the above situation has come to our knowledge, we are required to discuss the matter with management and inquire how it intends to address the matter in the financial statements.

If the financial statements are amended, the auditor is required to:

- carry out the necessary audit procedures on the amendment.
- extend his review of subsequent events up to the date of the new audit report.

If management do not amend the financial statements for the event identified, then the auditor should take appropriate action to prevent reliance on the audit report after taking legal advice.

► *Practice Question 14:*

Express Limited is a medium size entity engaged in trading of electronic appliances. After the issuance of financial statements and audit report for the year ended 30 June 2016, a major debtor was declared bankrupt by the Court. No recovery has been made from the debtor after year-end.

Required:

Evaluate the above situation and state the procedures which auditor would need to perform.

Tutorial Notes:

Understand ISA 560 requirements: When facts become known after the financial statements have been issued, refer specifically to the steps outlined in ISA 560 rather than general verification procedures.

Do not suggest verifying past audit evidence: Once financial statements are issued, the auditor's role is not to re-audit, but to assess the impact of newly discovered facts.

Know the correct steps: If the newly discovered facts indicate material misstatement, the auditor should discuss with management, assess the need for reissuance, and determine whether users need to be informed.

Thoroughly study ISA 560: Ensure familiarity with the auditor's post-reporting responsibilities to avoid irrelevant or incorrect responses.

► *Solution 14:***Express Limited**

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, the matter has come to the knowledge of the auditor and bankruptcy of customer is indicative of condition that existed at balance sheet date as no recovery has been made from the debtor after the balance sheet date. Had the bankruptcy been known to the auditor at the date of the auditor's report, it may have caused the auditor to amend the audit report, therefore, he shall:

- discuss the matter with management and, where appropriate, those charged with governance.
- determine whether the financial statements need amendment and, if so inquire how management intends to address the matter in the financial statements.
- carry out the necessary audit procedures on the amendment.
- review the steps taken by management to inform about the situation to anyone who received the original financial statements and audit report.
- extend the review of subsequent events up to the date of the new audit report
- if management does not agree to change the financial statements, the auditor should consider the available alternative to him.

► *Practice Question 15:*

Auditor should actively look for subsequent events up to the date of auditor's report.

State the procedures which an auditor should perform specifically for identification of subsequent events.

Tutorial Notes:

Focus on the specific audit area being tested: Avoid mentioning irrelevant procedures such as subsequent receipts, warranty claims, or sale prices if they do not directly relate to the question. Understand the audit procedure in context: Ensure that your answer aligns with the specific audit objective being assessed rather than listing general procedures.

Clarify the purpose of subsequent event procedures: Use subsequent information only when appropriate, such as for assessing going concern, provisions, or fair value adjustments, but avoid applying it where not relevant.

Read the question carefully: Ensure that your response addresses the specific audit assertion or standard being tested.

► **Solution 15:**

- Obtain an understanding of management's procedures for identifying subsequent events.
- Inquire of management as to whether any subsequent events have occurred which might affect the financial statements.
- Read the entity's latest subsequent financial statements.
- Read minutes of shareholders' meetings, meeting of the board of directors held after the date of the financial statements and inquire about matters discussed at any such meetings where minutes are not available.
- Obtain written representations in respect of subsequent events.

► **Practice Question 16:**

Expert Limited (EL) is an unlisted public company engaged in production of various products. In January 2018, an equipment malfunctioned which caused severe injuries to some of the workers. EL had paid compensation to the workers but a case for violation of safety regulations had also been filed by the regulator. On the basis of legal advice, EL had recorded a provision of Rs. 5 million in its financial statements for the year ended 31 December 2018.

The board of directors approved the financial statements on 01 March 2019 and on the same date your firm expressed an unmodified opinion. EL plans to issue the financial statements on 5 March 2019. On 3 March 2019 the court imposed a penalty of Rs. 15 million on EL. Management of EL informed the auditor accordingly.

Required:

Evaluate the need for amendment in financial statements and state the procedures which the auditor would need to perform in the above situation.

Tutorial Notes:

Specify actions if financial statements are not amended: The auditor must take appropriate steps to prevent reliance on the audit report if management refuses to correct material misstatements.

Consider informing relevant parties: The auditor should communicate with those charged with governance and, if necessary, regulatory authorities about the issue.

Assess the need for withdrawal: If management refuses to take corrective action, the auditor should consider resigning from the engagement to maintain professional integrity.

Follow professional and legal requirements: Ensure that any withdrawal or notification aligns with ISA 560 and ethical guidelines to avoid potential legal repercussions.

► **Solution 16:**

Evaluation of the situation:

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, the matter has come to the knowledge of the auditor before publication of financial statements and imposition of penalty is indicative of condition that existed at balance-sheet date.

Course of action:

Had the actual amount of penalty imposed by the court been known to the auditor at the date of the auditor's report, it may have caused the auditor to ask the management for adjustment in the financial statements. Therefore, the auditor need to perform the following procedures:

- Discuss the matter with management and, where appropriate those charged with governance
- Inquire how management intend to address the matter in the financial statements.
- Instruct management not to issue the financial statements before the necessary amendments have been made

- If the financial statements are amended, the auditor is required to:
 - Carry out the necessary audit procedures on the amendment.
 - Extend his review of subsequent events up to the date of the new audit report.
- If the financial statements are not amended, the auditor is required to
 - Take appropriate action to prevent reliance on the audit report, after taking legal advice.
 - In the longer term, the auditor should also consider resigning from the audit, but this would not be appropriate as an immediate response to the problem.

► **Practice Question 17:**

Consider each of the following independent situations:

- i. Spruce Limited issued its financial statements on 15 September 2020 for the year ended 30 June 2020. On 22 September 2020, your audit team came to know that a major debtor has filed bankruptcy due to destruction of its production facility in a terrorist attack on 20 August 2020.
- ii. During the audit of Larch Limited (LL) for the year ended 30 June 2020, the audit team noticed that the management of LL had worked out the net realizable value (NRV) on the basis of the sales price at year-end. Since NRV was greater than cost, LL recorded the inventory in the draft financial statements at cost. However, after reporting period, LL is facing difficulties in selling the inventory at current price level and therefore considering to revise its prices.

Required:

In each of the above situations, evaluate the need for amendment in the financial statements and suggest the audit procedures, if any, which the auditor would need to perform.

Tutorial Notes:

- Correctly classify adjusting vs. non-adjusting events: A bankruptcy occurring after year-end is a non-adjusting event unless evidence existed before the reporting date that the debtor was already in financial difficulty.
- For NRV assessment, include key audit procedures:
- Review post-reporting period sales prices to verify if NRV is higher than cost.
- Test management's procedures for comparing NRV with cost to ensure compliance with accounting policies.
- Analyse inventory records and order books to identify slow-moving or obsolete stock and compare expected NRV with cost.
- Focus on relevant evidence: Ensure that audit procedures directly support the assessment of NRV rather than providing unrelated information.

► **Solution 17:**

i. **Evaluation:**

The incident occurred after the year-end for which no condition existed before the year-end. Therefore, it is a non-adjusting event for which the financial statements does not need an amendment.

Furthermore, after the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements.

Therefore, no action from the auditor with regards to financial statements for the year ended 30 June 2020 is required. However, auditor shall inquire how the management intends to address the matter in the financial statements. If the management amends the financial statements to disclose the non-adjusting event then the auditor shall extend the audit procedures to the date of new audit report.

ii. Evaluation:

The difficulty in selling the inventory after the year-end at current prices and consideration of revising the price give the evidence about their net realizable value (NRV) at the year-end, which is an adjusting event. Therefore, NRV of the inventory should be calculated on the basis of revised selling price after the yearend and the financial statements should be adjusted accordingly.

Suggested audit procedure:

- Review prices at which goods have been sold after the reporting period, for evidence that NRV is higher than cost.
- Review and test the procedures in place for comparing NRV with cost for each item of inventory.
- Select major items of inventory from the list of stock and compare NRV with cost.
- Review inventory records and order books to identify of slow-moving items and compare their expected NRV with cost.
- Review the information gathered during the physical inventory count (e.g. deterioration of inventory) which may suggest that NRV may be lower than cost.
- Review the records related.

► Practice Question 18:

You are the audit manager in a firm of chartered accountants. Following independent situations are under your consideration:

- i. Mega Motors Limited (MML) offers 3-year warranty for its products. MML assessed its warranty obligation to be Rs. 20 million for the year ended 30 June 2021. The board of directors has approved the financial statements on 6 September 2021. Just before signing the audit report, your audit team came to know about a latent defect in MML's products. This defect was neither earlier discovered nor known to MML.
- ii. Dawn Hotel Limited was severely damaged by flash flood on 31 August 2021. Initial assessment of the incident shows that significant repairs are required and the hotel would not be operational for at least a month. Audit report for the year ended 30 June 2021 has not yet been issued.

Required:

For each of the above situations, evaluate the need for amendment in the financial statements and suggest the auditor's course of action.

Tutorial Notes:

- Go beyond classifying events as adjusting or non-adjusting: After classification, discuss the appropriate course of action, including whether financial statements should be adjusted or disclosed.
- Consider the timing of the event correctly: Carefully determine when the event occurred—whether before or after the issuance of financial statements—to apply the correct audit response.
- Follow ISA 560 guidance: If the event occurs before the audit report date, assess whether adjustments or disclosures are required. If after issuance, determine if actions like informing users or revising financial statements are needed.
- Ensure accuracy in scenario analysis: Misinterpreting the timeline of events can lead to an incorrect conclusion and audit response.

► Solution 18:**Evaluation:**

Even though MML came to know about the defect after the year end, the existence of defect in MML products provide evidence of conditions that already existed at the end of the reporting period. Therefore, it is as an adjusting event. The warranty provision should be reassessed on the basis of the identified defect and the financial statements should be adjusted accordingly.

Course of action:

- i. Inquire with the management about the quantity of effected products which have been sold until the year end.
- ii. Inquire from the management whether they have assessed the revised warranty provision on the basis of this new information.
- iii. Consider involving auditor's expert to re-assess the warranty provision.
- iv. Evaluate the management assumptions for the revised warranty provision.
- v. Assess whether there is any material effect to the warranty provision because of the identified defect.
- vi. Ask the management to revise the financial statements and get it approved by the board of directors.
- vii. Obtain management representation that the warranty provision reflects the management best estimate.
- viii. Ask the management to prepare a working for the net realizable value of the inventory and assess its adequacy.

Evaluation:

The incident occurred after the year-end for which no condition existed before the year-end. Therefore, it is a non-adjusting event for which the financial statements do not need amendment. The incident has a significant impact and it seems material for the users of the financial statements. Therefore, DHL shall disclose nature of the event and an estimate of its financial effect.

Course of action:

- i. Inquire from the management about the time it would take to repair the hotel and make it operational.
- ii. Inquire from the management to assess the amount of revenue lost due to non-functionality of hotel.
- iii. Inquire from the management about the estimated cost of repair.
- iv. Inquire from the management about any amount to be received from the insurance company.
- v. Ask the management to disclose the matter in accordance with the requirements of IFRSs.

► Practice Question 19:

You are the audit manager in a firm of chartered accountants. Following independent situations are under your consideration for the year ended 30 June 2022:

- i. The board of directors of Hacksaw Limited (HL), producer of confectionery products, approved the financial statements on 7 September 2022. Before signing the audit report, it was revealed that retailers are returning one of HL's products to the distributors. On enquiry, it was found out that certain batches of that product were not processed correctly and have caused a very bad taste. HL's closing inventory also contains finished goods from those batches.
- ii. Your audit client, Cola Limited was in negotiation for the acquisition of Orange Limited (OL) since April 2022. On 15 June 2022, it was principally agreed to acquire OL at a price of Rs. 4 billion. However, the agreement was formally signed on 10 July 2022.

Required:

For each of the above situations, evaluate the need for amendment in the financial statements and suggest the auditor's course of action.

Tutorial Notes:

- HL (Inventory Verification): Verify inventory quantity and value by inspecting records, insurance confirmations, post-event sales, and NRV calculations.
- OL (Event Classification): Do not misclassify a non-adjusting event as adjusting; check if it provides evidence of pre-existing conditions at the reporting date.

► **Solution 19:**

i. **Evaluation:**

Even though HL came to know about the issue after the year-end, the existence of defect in HL products provide evidence of conditions that already existed at the end of the reporting period. Therefore, it is as an adjusting event. The provision for sales return and NRV provision should be reassessed on the basis of the identified defect and the financial statements should be adjusted accordingly.

Auditor's course of action:

Sales return:

- Obtain reports to verify the quantity of those batches sold during the year.
 - Obtain production reports to calculate the total production of those batches.
 - Consider whether quantity of such inventory could be verified through inventory count performed at year end.
 - Obtain any subsequent claims made by the distributor for return of inventory.
 - Obtain the managements working for the net realizable value of the inventory and assess its adequacy.
 - Evaluate the management assumptions for the revised provisions.
 - Obtain management representation that the sales return provision and NRV provision reflects the management best estimate.
 - Ask the management to revise the financial statements and get it approved by the board of directors.
- ii. The acquisition of OL occurred after the year-end and therefore, it is a non-adjusting event for which the financial statements do not need amendment. It is a material acquisition and therefore, CL shall disclose the details of the acquisition in the financial statements.

Auditor's course of action:

- Obtain from the management the agreement made for the acquisition.
- Assess the adequacy of the disclosure made in the financial statements.

► **Practice Question 20:**

Your firm is the auditor of MAB Limited (MAB), a company listed on Pakistan Stock Exchange, for the year ended 30 June 2023. MAB had issued its financial statements on 1 September 2023 in which a profit before tax of Rs. 1,700 million was disclosed.

On 10 September 2023 an ongoing litigation at the appellate forum was decided against MAB, resulting in a liability of Rs. 500 million to the taxation authorities. This was previously disclosed as a contingent liability in MAB's financial statement. MAB's legal team is of the view that the liability would amount to Rs. 150 million, and they have decided to file an appeal to a higher judicial forum. Considering the legal team's advice, MAB's management has decided to amend its previously issued financial statements by recognising a provision of Rs. 150 million and disclosing the remaining Rs. 350 million as a contingent liability in its amended financial statements for the year ended 30 June 2023.

Required:

Discuss the implications on the audit report.

Tutorial Notes:

- Focus on reporting implications; avoid unnecessary audit procedures.
- Reissue the audit report and include an Emphasis of Matter paragraph.
- Clarify in the paragraph that auditor's subsequent event procedures were limited to the amendments in financial statements.

► *Solution 20:*

The effect of Rs. 350 million will be 23% of the revised profit before tax of Rs. 1,550 million. Since the effect is confined to a single element of the financial statement, the effect is material but not pervasive.

If the auditor concludes that the provision should have been recorded for Rs. 500 million then, the misstatement being material in nature, the auditor will have to express a qualified opinion. The auditor shall include in the basis for opinion section, a description and quantification of the financial effects of the misstatement.

However, if the auditor agrees with the legal team of the audit client then an unmodified opinion will be expressed.

In either case, since the audit report is being re-issued following changes need to be made irrespective of the audit opinion being expressed:

- Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the audit procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements; or
- Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter paragraph that conveys that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

3 WRITTEN REPRESENTATIONS: ISA 580

3.1 Definition and objectives

► *Definition: Written representation*

A written statement by management provided to confirm certain matters or to support other audit evidence. It does not include financial statements, assertions, or supporting books and records.

The **objectives** of the auditor in this area, per ISA 580, are to:

- obtain written representations from management that it has fulfilled its responsibilities in respect of the financial statements and the audit
- obtain written representations as appropriate to support other audit evidence as required by other ISA's
- respond appropriately to written representations provided by management or if management refuse to provide the written representations requested.

ISA 580 requires appropriate written representations from management (often referred to as “**management representations**”) to be in the form of a **letter of representation**, addressed to the auditor.

These written representations may be an important source of audit evidence.

3.2 Written representations as audit evidence

If the auditor considers that written representations are needed **to support other audit evidence** he is **required** to request such other written representations.

During the course of the audit, management will make many representations to the auditor. Some of these will be unsolicited but some will be given in response to specific enquiries from the auditor. The auditor will have recorded such verbal discussions with management in the audit working papers. However, verbal evidence is not strong audit evidence. In order to improve the quality of this evidence, the auditor will ask for any significant discussions to be confirmed in writing.

Such representations are likely to be needed:

- to support the auditor's understanding of management's intention or judgment (for example, in respect of future plans for the business or a specific matter such as the net realisable value of inventory), or
- in respect of the completeness of a specific item (for example, that all liabilities have been provided for).

However, although such written representations provide necessary audit evidence, **they do not provide sufficient appropriate evidence on their own.**

If a representation by management is contradicted by other audit evidence, the auditor should:

Perform audit procedures to resolve matters

- perform other audit procedures (consider whether his risk assessment remains appropriate and if not revise the risk assessment and determine nature, timing and extent audit procedures) to resolve the matter.

If the matter not resolved the auditor shall reconsider the assessment of the competence, integrity, ethical values of management, the auditor shall determine the effect that this may have on the reliability of representations and audit evidence in general.

- consider whether the risk assessment remains appropriate
- if not revise the risk assessment and determine nature timing and extent of further audit procedures to resolve matter

if Auditor has concerns about the integrity and ethical values of management, auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general. It may cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that audit cannot be conducted.

In such case auditor may consider withdrawing from engagement where withdrawal is possible under applicable law or regulation, unless:

The auditor is also **required by specific other ISAs** to request certain other written representations. These requirements are illustrated in the example letter set out below.

3.3 Written representations about management's responsibilities

The auditor is also **required** by ISA 580 to obtain certain other specific written representations from management. In these representations management acknowledges that:

- it has fulfilled its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- it has provided the auditor with all relevant information and access
- all transactions have been recorded and are reflected in the financial statements.

The auditor shall disclaim an opinion in accordance with ISA 705:

- if management do not provide written representation about management responsibilities; or
- there is sufficient doubt about the integrity of management such that written representation about management responsibility are not reliable.

Again, these points are illustrated in the example letter set out below.

3.4 Form and contents of the letter of representation

The letter of representation is:

- usually drafted by the auditor (since he knows the areas on which he requires written representations)
- addressed to the auditor
- dated as near as practicable (but not after) the date of the audit report.

Written representations may be requested from the entity's chief financial officer and chief executive officer or other equivalent persons in entities that do not use such titles. In some circumstances other parties such as those charge with governance, are also responsible for the preparation of the financial statements.

Can management modify the language of written representation? It is appropriate to do so only in following circumstances:

- **Due to fire** – management said that except for the information destroyed in fire we have provided all the information
- **Except for recording impairment** – we have prepared the financial statements in accordance with the IFRS

Examples

The following example of a letter of representation shows the minimum contents of such a letter. However, remember that the auditor may also need to request management to provide written representations about specific assertions in the financial statements.

► *Example of a letter of representation*

(Entity Letterhead)

(To Auditor)

(Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Ltd for the year ended 31 December 31 20X1 for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or *give a true and fair view*) in accordance with International Financial Reporting Standards.

We confirm that *(to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves)*:

Financial statements

We have fulfilled our responsibilities for the preparation and presentation of the financial statements as set out in the terms of the audit engagement dated.... and, in particular, the financial statements are fairly presented (or *give a true and fair view*) in accordance with International Financial Reporting Standards.

Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. (ISA 540)

Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of International Financial Reporting Standards. (ISA 550)

All events subsequent to the date of the financial statements and for which International Financial Reporting Standards require adjustment or disclosure have been adjusted or disclosed. (ISA 560)

The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (ISA 450)

Information provided

We have provided you with:

- all information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements
- additional information that you have requested from us; and
- unrestricted access to those within the entity.

All transactions have been recorded in the accounting records and are reflected in the financial statements.

We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (ISA 240)

We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:

- management
- employees who have significant roles in internal control; or
- others where the fraud could have a material effect on the financial statements. (ISA 240)

We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (ISA 240)

We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (ISA 550)

3.5 Refusal to provide requested written representations

If management refuses to provide requested written representations the auditor is **required** to:

- discuss the matter with management
- re-evaluate the integrity of management and reconsider the impact on other representations and audit evidence
- take appropriate action, including considering the effect on the audit report.

► *Example:*

The following points have arisen during the audit for the year ended 30 June 20X6 of Compo, a nationwide dealer in used cars.

1. During the year, five of Compo's properties were revalued by an independent surveyor.
2. One property was sold during the year to the marketing director.
3. The directors have refused to make provision against a bad debt.

Required

Explain whether or not each of the above would be referred to in the letter of representation for the year ended 30 June 20X6.

► *Answer*

1. No – other evidence should be available (the independent surveyor's report).
2. Yes – to support the completeness of disclosure of loans and other transactions with directors.
3. No – the impact on the audit report will need to be considered. (And if the directors have refused, and the auditor is sure the debt is bad, the directors are not going to provide evidence to support this view in the letter of representation.)

► *Practice Question 21:*

The management of Pioneer Textile Limited (PTL) has provided you with management representation that they have disclosed to you all known instances of non-compliances with laws and regulations that are relevant to the preparation of the financial statements.

However, during the field work your team identified a payment of penalty of Rs. 2 million to an environmental agency. PTL's management claims that the disclosure of the related non-compliance was inadvertently omitted.

Required:

Discuss the appropriateness of management representation and how would you deal with the above situation.

Tutorial Notes:

Do not immediately conclude opinion modification; first analyse the situation.

Reassess risk in the affected area to determine audit impact.

Evaluate management's integrity, document concerns, and consider further actions.

► *Solution 21:*

The management representation regarding disclosure of non-compliance with law does not remain appropriate, as it contradicts with the audit evidence obtained.

To address the contradiction, we should:

- consider whether his risk assessment of that area is still appropriate.
- consider whether additional audit procedures are needed.
- consider the integrity of management, document those concerns and consider the possible course of action.

► *Practice Question 22:*

State the matters that auditor needs to consider where the written representation provided by the management is inconsistent with other audit evidence.

► *Solution 22:*

If a representation by management is contradicted by other audit evidence, the auditor should:

- consider whether his risk assessment of that area is still appropriate.
- consider whether additional audit procedures are needed.

If the auditor has concerns about the integrity of management, document those concerns and consider withdrawing from the audit.

► *Practice Question 23:*

You are the audit partner of XYZ & Company, Chartered Accountants. The following matters are under your consideration:

- a) Asif Limited has made certain investments and has classified them as long term investments. The management has also provided written representation in this regard. However, before the finalization of financial statements the company disposed of some of the said investments.
- b) Mansoor Limited has entered into significant related party transactions during the year which are approved by the Board of Directors and appropriately disclosed. The management has also agreed to provide a written representation but you have not received it yet.

Required:

Analyse the above situations and explain how you would proceed in the above matters.

Tutorial Notes:

- a) Reassess risk when subsequent events prove management's representation false, rather than discussing adjusting vs. non-adjusting events.
- b) Recognise the importance of written representation; avoid suggesting alternate procedures when the issue concerns management's reliability.

► *Solution 23:*

- a) In this case, the representation provided by the management contradicts with the audit evidence obtained later and therefore we should:
 - consider whether his risk assessment of that area is still appropriate
 - consider whether additional audit procedures are needed
 - assess the impact on auditors assessment of management's integrity, document those concerns and consider withdrawing from the audit.
- b) The written representation from the management must cover:
 - the completeness of the information that has been provided about the identity of related parties and related party relationships and transactions, and
 - the adequacy of accounting for and disclosure of such related party relationships and transactions in the financial statements.

The audit report should not be signed unless the written representation has been received.

If management does not provide the written representation, it will result in limitation of scope and we would take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

► *Practice Question 24:*

You are the audit manager at Afzal Textile Mills Limited (ATML). While reviewing the draft financial statements and the working paper file, the following matters have come to your attention:

- i. There is a significant decline in the number of related parties and related party transactions.
- ii. During the year, ATML has acquired 15% shareholding in Bashir Textiles Limited, a listed company.
- iii. ATML owns six buildings out of which four have been revalued during the current year while the remaining buildings would be revalued next year.

Required:

Discuss whether it would be necessary to obtain management representation in respect of the above matters.

Tutorial Notes:

Obtain representation for related parties, but not as a substitute for audit evidence.

Representation cannot justify incorrect accounting treatment; always rely on appropriate audit procedures.

► *Solution 24:*

- i. This must be included in a representation letter. The written representation must cover the completeness of the information that has been provided about the related parties and related party transactions.
- ii. This may not be included in a representation letter. The auditor should obtain sufficient appropriate audit evidence on this matter such as checking the shareholding in the share register, etc.
- iii. This should not be included in a representation letter. This is a matter of incorrect accounting treatment which the auditor should discuss and resolve with the management.

► *Practice Question 25:*

Briefly state the course of action which should be adopted by a firm if the requested written representations are not provided by the client.

► *Solution 25:*

- Discuss the matter with the management.
- Re-evaluate the integrity of the management.
- Take appropriate action including determining the possible effects on the auditor's report.

► *Practice Question 26:*

You are the audit partner of GMP & Company, Chartered Accountants. The following matters are under your consideration:

- a) The CEO of a client is travelling out of the country on 20 September 2017 and would not be available on the date of signing of report which is 29 September 2017.

However, he has offered to sign all the representations before leaving.

- b) A client has modified the representation letter with regard to the responsibility of management to provide the auditor with all information relevant for the purpose of audit. It has been stated, that "except for the information destroyed in fire, we have provided all the necessary information for the purpose of audit".
- c) The managing director of a client which is a family owned business has sent the following email to the audit manager:

"I believe the financial statements we have provided to you are final. Although adjustments are required to correct some of the balances, but being immaterial, they would not affect the decision making of the owner. We therefore believe that the audit report may now be signed and the required corrections may be included in the representation letter".

Required:

Discuss how you would deal with the above situations.

Tutorial Notes:

- a) **Timing of Representations:** Management representations should be signed as close as possible to the audit report date. The CEO does not have to sign; another authorized representative can do so.
- b) **Incomplete Audit Evidence:** Even if management's stance is reasonable, an unmodified opinion cannot be given without assessing the significance of missing information and the auditor's ability to obtain alternative evidence.
- c) **Stakeholder Consideration:** Financial statements affect all stakeholders, not just the owner. Adjustments should be properly reflected rather than relying on a representation letter alone..

► **Solution 26:**

- a) Offer of CEO cannot be accepted as the letter of representation is to be dated as near as practicable (but not after) the date of audit report, because:
 - written representation is also obtained in respect of subsequent events
 - further matters might also arise during the course of audit for which we may require management representation.

However, the written representations are requested from those responsible for the preparation of financial statements. Therefore, in the absence of the Chief Executive Officer, management representation may be obtained from the Chief Financial Officer and those charged with governance.

- b) If the management modifies our requested wording, we may still be able to conclude that it is a reliable representation.

However, before arriving at any conclusion, we must consider the effects of the information destroyed in the fire on the financial statements and on our ability to obtain the necessary audit evidence and the possible impact on our audit report.

- c) If adjustments are immaterial, representation letter may include the effect of any uncorrected immaterial misstatements. However, the decision regarding materiality of the uncorrected misstatements is to be made by the auditor and not by the client.

Further, materiality depends on the fact that omission or misstatement would influence the economic decision of the user, and the financial statements are relevant not only for the owners but also for other users which may include bankers, government institutions, etc., therefore, the comment of the managing director regarding the effect on decision making is not correct.

If financial statements remain uncorrected and the required correction is material also, its impact on audit report would need to be assessed.

► **Practice Question 27:**

What course of action should the auditor take, if he doubts the reliability of the management representation due to its inconsistency with other audit evidence?

► **Solution 27:**

- Perform other audit procedures to attempt to resolve the matter or finalize your view point.
- Consider the effect of the above on reliability of other representations and the audit evidence.
- Consider whether the risk assessment remains appropriate and if not, revise the risk assessment and determine the nature, timing and extent of further audit procedure. The auditor may also reconsider assessment of the competence, integrity, ethical values or diligence of the management.

- If the auditor has concerns about the integrity of management, he should document those concerns and consider withdrawing from the audit and the impact on the report.

► *Practice Question 28:*

You are the audit manager responsible for the audit of Hub Mills Limited (HML). At the planning stage, materiality level was determined at Rs. 8 million.

Audit team has completed the audit field work for the year ended 30 June 2018 and has presented the following issues identified during the audit for your review:

- i. Goods worth Rs. 3 million were returned by a customer on 5 July 2018 due to poor quality. Since the goods were returned subsequent to year end, no adjustment has been recorded by the management.
- ii. HML is facing liquidity issues which has resulted in adverse key financial ratios. To address the issue, HML has sold one of its offices to a company managed by a director of HML. The office was sold for Rs. 40 million. Since the management had correctly recorded the disposal, no specific disclosures related to this sale have been made in the financial statements. Directors are confident that these sale proceeds would solve the cash flow problems of HML.
- iii. A customer who owed Rs. 11 million at year-end, was declared bankrupt on 15 August 2018. The management had already provided 50% of the balance in the financial statements.

Revenue for the current year is Rs. 800 million (2017: Rs. 950 million) and loss before tax is Rs. 22 million (2017: Rs. 7.6 million).

Required:

What matters would you want to include in the management representation letter, with regard to the above issues.

Tutorial Notes:

Read the requirement carefully to ensure your response is relevant to the specific issues in the question.

Only include matters related to the identified issues—avoid listing unrelated items.

Differentiate between a management letter and a management representation letter; ensure the response aligns with the correct document.

► *Solution 28:*

The directors would need to provide representation as regards the following:

- i. That based on their assessment it is appropriate to prepare accounts on the going concern basis.
- ii. That the assumptions used to assess going concern (future cash flows, earnings etc.) are reasonable.
- iii. Completeness of the information that has been provided about the identity of related parties and related party relationships and transactions.
- iv. Adequacy of accounting and disclosure of such related party relationships and transactions in the financial statements.
- v. All the transaction with the related parties have been carried out at arms length.
- vi. All events subsequent to the date of financial statements and for which IFRS require adjustment or disclosure have been adjusted or disclosed.
- vii. The effects of uncorrected misstatement are immaterial, both individually and in aggregate to the financial statement as a whole along with the list of uncorrected misstatement.

► *Practice Question 29:*

Tariq Limited (TL) is in dispute with one of its suppliers Hamid (Private) Limited (HPL) over a claim of Rs. 10 million; due to quality issues with the product. The management has informed you that negotiations with HPL have concluded and HPL has agreed to pay Rs. 7 million whereas the rest of the amount would be written off. TL's management has provided a written representation to the auditor with respect to the said receivable. However, they want to preclude the auditor from sending a confirmation to HPL.

Required:

Evaluate the appropriateness of written representation as audit evidence and determine the course of action available to the auditor in the above situation.

Tutorial Notes:

- Assess the impact of refusal on the risk of material misstatement and adjust the nature, timing, and extent of audit procedures accordingly.
- Communicate with those charged with governance to address concerns and document the issue properly.

► *Solution 29:*

Written representations are necessary information that the auditor requires in connection with the entity's financial statements. Although written representations provide audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

The fact that the management has provided reliable written representations do not affect the nature or extent of other audit evidence that the auditor should obtain. Hence, considering the scenario, the auditor should take the following steps to obtain the required evidence:

- Inquire management about reasons for refusal to send confirmation.
- Seek audit evidence as to their validity and reasonableness.
- In case a valid reason is not provided by the management, evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud and on the nature, timing and extent of other audit procedures;
- Perform alternative audit procedures to obtain relevant and reliable audit evidence, such as:
 - Obtain the correspondence with the supplier.
 - Check subsequent receipt from the supplier.
- Communicate with those charged with governance, if:
 - The auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable.
 - The auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures.
- The auditor shall determine the implications for the audit and the auditor's opinion in accordance with ISA 705 given such a limitation on scope.

► *Practice Question 30:*

You are the manager of Saba and Company, Chartered Accountants, responsible for the audit of Tiger Limited (TL). While reviewing the draft financial statements and the working paper file, following matters have come to your attention:

- i. No subsequent events were identified.
- ii. During the stock count, certain items were physically present but were not appearing in stock sheets provided by TL. The management informed you that these items were sold but were not dispatched upon customer request.

- iii. TL has a policy for making full provision against receivables when they become overdue for 360 days or more. However, three customers were not fully provided for in accordance with the TL's policy. The management contented that they are rigorously following up with these parties and are confident to recover the outstanding balances very soon.
- iv. There was only one litigation pending against the company which has appropriately been disclosed in the financial statements.

Required:

Discuss whether it would be necessary to obtain management representation in respect of above matters.

Tutorial Notes:

- Subsequent events should still be included in the representation letter, even if none are identified.
- Stock held on behalf of a customer should be included in the representation letter regardless of whether audit evidence is available.

► Solution 30:

- i. This must be included in the representation letter. The written representation must cover that there were no events subsequent to the date of the financial statements and for which IFRSs require adjustment or disclosure.
- ii. This may not be included in the representation letter. The auditor should obtain sufficient appropriate evidence on this matter such as checking the customer correspondence or directly confirming from the customer. However, after obtaining sufficient appropriate audit evidence, the auditor may still ask for management representation that the stock has been held on the instruction of the customer.
- iii. This should not be included in the representation letter. This is a matter of incorrect application of accounting policy, which the auditor should discuss and resolve with the management.
- iv. The auditor must include this matter in the representation letter. The representation would cover that all known actual or possible litigation and claims, whose effects should be considered when preparing the financial statements, have been disclosed to the auditor and accounted for and disclosed in the financial statements.

► Practice Question 31:

Your firm is the auditor of Iota Limited (IL) and audit report is expected to be signed on 10 March 2021.

IL's management has just informed you that due to certain personal reasons, CEO will not be available from 5 March 2021 to 15 March 2021. They have provided you with the following alternate options:

- i. CEO will sign all the representations either on 4 March 2021 or 16 March 2021.
- ii. CEO will call on 10 March 2021 to the engagement partner and will verbally confirm all the representations required by the auditor.

Required:

Comment on the acceptability of each option with reason(s) and suggest the best course of action for obtaining the representations in the above scenario.

Tutorial Notes:

- Representation should be signed as close as possible to the audit report date to account for any new matters.
- Signing after the audit report date (16 March 2021) is not acceptable; it must be obtained before the report is signed.
- Best course of action: Request management to sign the representation letter on the same day or just before the audit report date.

► *Solution 31:*

Representation letter dated 05 March 2021:

Offer of CEO cannot be accepted as the letter of representation is to be dated as near as practicable to the date of audit report because further matters might also arise during the intervening period for which the auditor may require management representation.

Representation letter dated 16 March 2021:

The audit report should not be signed unless the written representation has been received as it supports other audit evidence obtained during the course of audit. If management does not provide the written representation, it will result in limitation of scope, which would impact the audit opinion.

Verbal Representation:

Verbal evidence is not strong audit evidence. Therefore, in order to improve the quality of this evidence, the auditor will need to ask for any significant discussions to be confirmed in writing.

Suggestion:

If it is practicable to do so sign the audit report on 16 March 2021 or management representation may be obtained from the Chief Financial Officer or those charged with governance on the date of signing.

► *Practice Question 32:*

Your audit client has provided you a draft representation letter. The extract from the representation letter is as follows:

No management employee is involved in any fraudulent activity.

All the related party transactions and the identities of those related parties have been disclosed to you. These have also been appropriately accounted for and disclosed in accordance with the requirements of International Financial Reporting Standards.

All the uncorrected misstatements identified are immaterial individually and therefore do not need any adjustments.

Required:

Critically analyse the above representations given by the audit client.

Tutorial Notes:

Critically analyse representations for fraud and related parties, rather than just stating that audit procedures must be performed.

Identify errors within the given representation, instead of listing general audit procedures.

Focus only on the provided extract; do not discuss unrelated elements like date, year-end, or client name unless specifically required.

► *Solution 32:*

Representation from management regarding any knowledge of fraud, which has occurred is required. However, only obtaining the representation regarding management employees narrows the representation. The representation should also include management and other employees. Furthermore, the wording is more directed towards an absolute assurance that no fraud has occurred. Preferably the representation should state that “no frauds...had come to the attention of management” rather than “no frauds...have occurred”.

The auditor is required to obtain a representation from the management regarding the related party relationship and transactions. However, in the above statement, management has only given the representation of those related parties with which transactions have been made. In fact, representation should be obtained for all the related party relationships, irrespective of the fact that whether transaction has been made or not. Similarly, disclosures are also required for all related party relationships.

Materiality of uncorrected misstatement should be evaluated on aggregate basis instead of individually. If aggregate uncorrected adjustments are immaterial, representation letter may include the effect of any uncorrected immaterial misstatements.

4 GOING CONCERN BASIS AND THE AUDIT REPORT: ISA 570

4.1 Going concern basis and the Financial Statements

As discussed in the previous studies, the financial statements of the entity are normally prepared on a going concern basis. In the going concern basis it is assumed that the entity will continue to be in existence for foreseeable future (at least 12 months as per IAS 1).

IAS 1 requires management to make an assessment of the entity's ability to continue as a going concern. If management has some significant concerns about the entity's ability to continue as a going concern due to some material uncertainties, the uncertainties must be disclosed in a note to the financial statements.

If management concludes that the entity is not a going concern, the financial statements should not be prepared on a going concern basis.

4.2 Risk Assessment Procedures and the Related Activities

Auditor shall consider whether events or conditions exist that may cast significant doubt on entity's ability to continue as going concern.

EVALUATING MANAGEMENT ASSESSMENT

- Shall evaluate management assessment to continue as going concern.
- Shall cover the same period as used by management but should not be less than 12 months
- Assumptions on which assessment is based.
- If less than 12 months, request management for future action and whether such plan are feasible.
- Whether all information which auditor is aware are included in assessment.

Period beyond Management Assessment

- Inquire management of its knowledge of events or condition beyond the period of management assessment.
- Remain alert for events or condition beyond management assessment.
- Request management to consider that events or condition if it is significant.
- Other than inquiry auditor does not have responsibility to perform any other procedures on period beyond management assessment.

Examples of such events or conditions

Financial

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

Operating

- Management intentions to liquidate entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labour difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against entity that may result in claims that entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured disasters when they occur.

Auditor shall also determine whether management has already performed a preliminary assessment of continuance as going concern:

- If such assessment has been performed, auditor shall discuss with management and determine whether management has identified such events or conditions and, if so, what are the plans to address those.
- If such assessment has not yet been performed, auditor shall discuss with management basis for the intended use of the going concern basis of accounting, and inquire whether events or conditions exist that may cast significant doubt on going concern.

4.3 Additional Procedures when Events or Conditions are Identified

Auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on going concern through additional audit procedures, including following factors:

- Analysing and discussing the cash flow, profit and other relevant forecasts with the management.
- Analysing and discussing latest available interim financial statements.
- Reading the terms of debentures and loan agreements.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring entity's legal counsel regarding existence of litigation and claims and reasonableness of management's assessments of their outcome and estimate of their financial implications.
- Performing audit procedures regarding subsequent events.
- Confirming existence, terms and adequacy of the borrowing facilities.
- Obtaining and reviewing reports of regulatory actions.

Requesting written representations from management and those charged with governance regarding their plans for the future actions and feasibility of those plans.

4.4 Implications for the Auditor's Report

Scenario	Implication
Going Concern Basis is inappropriate Financial Statements have been appropriately amended to reflect alternate basis of accounting	Unmodified Opinion with "Emphasis of Matter Paragraph" highlighting the alternate basis of accounting used
Going Concern Basis is inappropriate Financial statements are still prepared under the assumption of going concern	Adverse opinion
- Going Concern Basis is appropriate but a material uncertainty exists - Adequate disclosure is made in the financial statements	Unmodified opinion with an Material uncertainty related to going concern referring to the disclosure(s) of material uncertainty.
- Going Concern Basis is appropriate but a Material Uncertainty Exists - Adequate disclosure is not given in the financial statements	Qualified Opinion or Adverse Opinion
Management unwilling to make or extend Its assessment	Qualified or Disclaimer

4.5 Communication with Those Charged with Governance

Auditor shall communicate with those charged with governance about the events or conditions identified that may cast significant doubt on going concern. Such communication shall include:

- Whether events or conditions constitute a material uncertainty
- Whether use of going concern basis is appropriate
- Adequacy of related disclosures in the financial statements
- Implications for the auditor's report.

Significant Delay in the Approval of Financial Statements

If there is significant delay in approval of the financial statements by management or those charged with governance after the date of financial statements, auditor shall inquire the reasons for the delay. If the auditor believes that the delay could be related to events or conditions relating to the going concern assessment, the auditor shall perform necessary additional audit procedures.

► Practice Question 33:

State any five audit procedures that could be performed to obtain sufficient appropriate audit evidence for determining whether or not a material uncertainty exists when events are identified that may cast doubt on the entity's ability to continue as a going concern.

Note: The scenarios for ISA 706 and ISA 570 have been covered under ISA 705/706.

Tutorial Notes:

Focus on Audit Procedures: When assessing going concern, focus on audit procedures to determine whether there is a material uncertainty that could cast doubt on the entity's ability to continue.

Avoid listing examples of events or conditions. Instead, discuss procedures like reviewing management's plans, evaluating financial forecasts, and analysing liquidity and debt obligations. These are crucial to assess the going concern assumption properly.

► **Solution 33:**

- i. Analysing and discussing the cash flow, profit and other relevant forecasts with the management.
- ii. Analysing and discussing latest available interim financial statements.
- iii. Reading the terms of loan agreements.
- iv. Confirming existence, terms and adequacy of the borrowing facilities.
- v. Reading minutes of meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.

► **Practice Question 34:**

You are the audit manager in a firm of Chartered Accountants. Following independent matters for the year ended 31 December 2021 are presently under your consideration:

- a) Quality Foods Limited has been facing liquidity issues and is heavily reliant on a bank overdraft, which was due for renewal on 15 February 2022. Management has informed you that negotiations with the bank are underway and it is expected that bank overdraft limit will be renewed in next few days.
- b) During the year, Delta Limited (DL) has recognised an intangible asset of Rs. 55 million in respect of development costs of a software which DL expects to market in future. The market research conducted by DL indicated a promising demand for such software.

In November 2021, one of DL's competitors successfully launched a similar software with the help of high foreign investment. It has helped them to capture a large market share in a short span of time.

DL's draft financial statements show profit before tax of Rs. 250 million.

Required:

For each of the above independent situations:

- discuss, from an audit perspective, the impact on the financial statements.
- state the audit procedures which may be performed by the audit team.

(Reporting implications are not required)**Tutorial Notes:**

- a) *Going Concern Issue:*

Focus on going concern by reviewing bank correspondence and minutes of board meetings to assess the negotiation status with the bank.

Ensure that management's disclosures related to going concern are reviewed and properly assessed.

Avoid irrelevant audit procedures, such as verifying interest expense or loan amount, unless directly related to going concern.

- b) *Impairment of Intangible Assets:*

If competitor product launch indicates impairment, focus on impairment procedures rather than standard procedures for intangible assets.

Procedures should include evaluating the recoverable amount and testing impairment based on the asset's fair value or value in use.

► *Solution 34:***a) Financial Statement Impact:**

The delay in the renewal and lack of agreement of the overdraft facility raises material uncertainties over going concern. It needs to be determined that in case the facility is not renewed, then would QFL would still be able to continue as a going concern. In case there is only a material uncertainty then these should be adequately disclosed in the financial statements to ensure that the users understand the details of the uncertainties. If it is concluded that QFL is not a going concern then it's financial statements should be prepared as not a going concern.

Audit procedures:

- i. Review the correspondence of the bank with QFL's management.
- ii. Review the board of director meeting minutes to assess the stage and likely outcome of the with the bank.
- iii. Discuss with the management the status of negotiation with the bank.
- iv. Review the disclosures made by the management regarding the material uncertainty / or the preparation of financial statement as not a going concern basis.
- v. Obtain the management's assessment of QFL ability to operate as a going concern.
- vi. Evaluate the reasonableness of the assumptions taken by the QFL's management.

b) Financial Statement Impact:

IAS 38 requires that the entity should be able to demonstrate the ability to sell the intangible asset and generate future economic benefit. As BL's competitor has successfully launched its product and has captured majority of the market share, it appears that the criteria for capitalization of development costs contained in IAS 38 Intangible Assets might not be met. Therefore, BL might have to either derecognise the asset or consider booking an impairment loss.

Audit procedures:

- i. Test a sample of development costs for appropriate capitalisation.
- ii. Discuss the development project with management, to assess the feasibility of the project and product.
- iii. Review revised projections and forecasts for using resources and generating future economic benefits.
- iv. Assess marketing plans and whether a market still actually exists.
- v. Whether the entity will actually be able to use or sell the asset.
- vi. Discuss management's intention to complete the asset and either use or sell it.
- vii. Inspect development contracts and records supporting and safeguarding patents.

► *Practice Question 35:*

Your firm is the auditor of Ninja Foods Limited (NFL) for the year ended 30 June 2022. NFL is a food chain having restaurants located in all major cities of Pakistan. NFL specializes in Pan-Asian cuisine and has Japanese, Thai and Chinese food on its menu.

Following information has been gathered by the audit team:

- i. Some of the ingredients used in the food products offered to customers are imported. On 31 August 2022, the government has banned import of luxury food items which includes most of the imported items used in the NFL's most selling items. NFL currently has stock of these imported items which fulfil its requirement of next one month only.
- ii. 70% of the customers pay in cash while the remaining 30% pay through credit/debit cards. Furthermore, 55% of the customers' visits are on weekend. All cash collection on weekend is deposited in the bank on the very next working day.

- iii. NFL follows a policy in which all the expired stock is to be placed in separate store room, which can then be adequately destroyed. In the internal audit report, it has been highlighted that two of the restaurants were not following this policy.
- iv. During the year ended 30 June 2022, NFL's profits have been reduced by 30% mainly due to rising electricity prices, increase in interest rates on long term loan, decrease in demand of the product due to recession in the economy and increase in raw material prices due to rupee devaluation.

Required:

- a) Assess NFL's ability to continue as a going concern. Also suggest the audit procedures which your team need to perform in order to validate your assessment.

Tutorial Notes:

Assess Going Concern: Before mentioning audit procedures, first assess the entity's ability to continue as a going concern in light of the given scenario.

Key Audit Procedures:

Review management's plans, including identification of substitutes in the market, availability, impact on future purchase prices, changes in customer behaviour, and adjustments in product recipes.

Identify the quantum of materials used in production and their impact on related revenue.

Examine loan agreement terms to ensure no breaches have occurred, which could affect the entity's going concern status.

► **Solution 35:****Going concern assessment:**

- The imported raw materials are used in their most selling items. Considering this, it would be important to identify the quantum of revenue attributed to those items. If it constitutes NFL's major revenue, it may impact the future revenue and profitability of NFL.
- Due to rupee devaluation, raw material costs have risen significantly. However, if NFL is able to find local substitute of these imported products than they might be able to bring down the operational costs.
- NFL's profitability has significantly declined in the current year. It may further decline in the coming year as there is a recession in the economy and NFL may witness low customer turnout.
- It also needs to be determined that how the increase in interest rates and electricity will impact the profitability and whether NFL will be able to fulfil its liabilities.

Audit procedures:

- Discuss the above situation with the management and obtain management plans to address the ban on import of raw materials used by the Company.
- Review the management plans including identification of substitutes in the local market, availability, impact on future purchase price, consumption and change in recipe and customer behaviour.
- Identify the quantum of those materials in the production cycle and related revenue.
- Obtain management forecasts for next twelve months including the impact of above factors.
- Evaluate the assumptions used by the management in preparation of the forecast.
- Review the board minutes to identify the action plan being adopted by the management.
- Obtain and review interim financial statements to assess the effect of the above events.
- Read the terms of loan agreements and determine whether any of them have been breached.
- Confirm the existence, terms and adequacy of the borrowing facilities.
- Obtain written representation from the management that their assumptions are reasonable and that NFL will continue as a going concern.

► *Practice Question 36:*

Your firm serves as the auditor for Appolo Limited (AL) for the year ended 31 December 2023. AL operates within the specialized market of small private jet planes, catering primarily to large corporate clients and high-net-worth individuals through its charter flight services. AL's fleet consists of six Gulfstream-III aircraft models, along with a helicopter.

Some major airports restrict the operation of Gulfstream-III aircraft due to concerns over harmful emissions and noise pollution. This restriction poses operational challenges for AL in accessing certain airports. Adding to the complexity, aviation authorities in Pakistan issued a notification on 30 December 2023, stipulating that these Gulfstream-III aircrafts must be phased out by 30 June 2024.

Required:

Evaluate the impact of notice issued by the aviation authority, on the audit of AL. Also, suggest relevant audit procedures. (Reporting implications are not required)

Tutorial Notes:

Going Concern and Impairment:

- Understand that if the entity can continue as a going concern, the notification from the aviation authority indicating impairment of the aircraft must be addressed separately from the going concern issue.
- Impairment procedures should focus on evaluating the aircraft's recoverable amount based on the impairment conditions, rather than only discussing the going concern.

Audit Procedures for Going Concern:

- Assess whether the entity has sufficient funds or borrowing facilities to purchase new aircraft.
- Review the disclosures in the financial statements regarding material uncertainties related to going concern and ensure that management's plans to mitigate these uncertainties are adequately disclosed.

► *Solution 36:***Evaluation of the scenario:**

Since the aviation authorities has notified to phase out Gulfstream-III aircrafts and AL has only one helicopter for its business, its imperative to ascertain how AL intends to continue its business after 30 June 2024.

There is therefore a material uncertainty regarding the going concern assumption of AL. Consequently, AL's management must assess the going concern of the company and prepare the financial statements accordingly.

If AL can continue as a going concern, the notification issued by the aviation authority indicates impairment of the aircrafts. This necessitates testing for impairment and recognition of any impairment loss in the financial statements.

Audit procedures going concern:

- Discuss and obtain management plans to mitigate these uncertainties if these still persist as at the balance sheet date.
- Assess whether AL has sufficient funds or borrowing facilities to purchase new aircrafts.
- Review the minutes of meeting of the board of directors discussing this issue.
- Review and assess the management assumption regarding the plans and forecast prepared by the management.
- Review that the disclosures made in the financial statements regarding material uncertainties as to going concern assumptions and management plans to mitigate those material uncertainties are adequate.
- Assess how much revenue is generated from the aircraft and helicopter to further assess the going concern assumption.

Audit procedures impairment:

- Obtaining an understanding of management process related to identifying, estimating and recording impairment for fixed assets to determine whether it is consistent with the requirement of IAS 36.
- Obtain and review the cash flow forecast prepared by the management for arriving at the net present value.
- Review and assess adequacy of assumptions like discount rate used by the management in this regard.
- Obtain the fair valuation report prepared by the management expert to determine the sale value of the aircrafts.
- Consider involving auditor's own expert to determine the value of the aircraft.
- Obtain and evaluate the accuracy and completeness of the source data used.

5 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Describe what is involved in performing the subsequent events review in accordance with ISA 560
- Explain what a written representation is and discuss the instances in when they would be used
- Evaluate the going concern assumption of the management in finalizing the audit

REVIEW AND ASSURANCE ENGAGEMENTS

IN THIS CHAPTER:

1. Review engagements (ISRE 2400)
2. Introduction to the Assurance Engagements
3. Assurance Engagements - Other Considerations
4. Sustainability assurance and audit context
5. Sustainability assurance engagements
6. Chapter review

1 REVIEW ENGAGEMENTS (ISRE 2400)

1.1 The distinction between audit and review of financial information

An **audit** is a form of **assurance engagement**. The objective of an audit is to enable the auditor to form an opinion as to whether the financial statements of an entity give a 'true and fair view'.

An audit is designed to provide a high level of assurance to the users of the financial statements.

Review of financial information is done to:

- a) obtain limited assurance, primarily by performing inquiry and analytical procedures in accordance with applicable financial reporting framework; and
- b) report on the financial statements.

1.2 Review engagement

Unless required by law or regulation, the practitioner shall not accept a review engagement if:

- The practitioner is not satisfied that:
 - there is a rational purpose for the engagement
 - a review engagement would be appropriate in the circumstances
- The Practitioner has reason to believe that relevant ethical requirements, including independence will not be satisfied.
- The Practitioner has doubt over management integrity.

Precondition for accepting a Review Engagement

- Whether financial reporting framework is acceptable
- Obtain agreement of management that it acknowledge and understand that it has the responsibility for:
 - the preparation of financial statements in accordance with approved financial reporting framework
 - internal controls
 - providing practitioner with all information

1.3 Engagement and performance

The practitioner shall agree the terms of the engagement with management or those charged with governance that shall include:

- a) The intended use and distribution of the financial statements,
- b) Identification of the applicable financial reporting framework;
- c) The objective and scope of the review engagement;
- d) The responsibilities of the practitioner;
- e) The responsibilities of management.;
- f) A statement that the engagement is not an audit, and that the practitioner will not express an audit opinion on the financial statements; and
- g) Reference to the expected form and content of the report to be issued by the practitioner.

Performing the Engagement

The practitioner shall determine and apply materiality for the financial statements as a whole. The practitioner shall obtain an understanding of the entity and its environment.

In obtaining sufficient appropriate evidence the practitioner shall design and perform inquiry and analytical procedures.

Inquiry

Inquiries of management and others within the entity shall include inquiries relating to:

- a) how management makes significant accounting estimates.
- b) the identification of related parties and related party transactions and their purpose
- c) whether there are significant, unusual or complex transactions, events or matters including significant changes in the entity's business activity or operations, significant adjustments, significant transactions occurring near the end of the reporting period, the existence of any frauds or illegal acts or non-compliance, subsequent events, going concern, material commitments etc.
- d) the existence of any actual, suspected or alleged fraud
- e) whether management has identified or addressed subsequent events
- f) the basis for management assessment for going concern
- g) whether there are events or condition that may cast significant doubt on the entity's ability to continue as a going concern

If the practitioner identifies significant transactions outside the entity's normal course of business, the practitioner shall inquire of management about:

- a) the nature of those transactions;
- b) whether related parties could be involved; and
- c) the business rationale (or lack thereof) of those transactions.

Going concern

A review of financial statements includes consideration of the entity's ability to continue as a going concern. In this consideration, the practitioner shall cover the same period as that used by management.

Use of work performed by others

If the practitioner uses work performed by another practitioner or an expert in the course of performing the review, the practitioner shall take appropriate steps to be satisfied that the work performed is adequate for the practitioner's purposes.

Subsequent Events

If the practitioner becomes aware of subsequent events that require adjustment of, or disclosure in, the financial statements the practitioner shall request management to correct those misstatements.

Written Representations

The practitioner shall request management to provide a written representation that management has fulfilled its responsibilities described in the agreed terms of engagement.

The practitioner shall also request management's written representations that management has disclosed to the practitioner entity's related parties and related party transactions, significant facts relating to any frauds, known non-compliance, all information relevant to going concern assumption, subsequent events, material commitments and material non-monetary transactions

1.4 Forming the Practitioner's conclusion on the Financial Statements

In forming the conclusion on the financial statements, the practitioner shall:

- a) evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework

- b) consider whether in the context of the requirements of the applicable financial reporting framework and the results of procedures performed:
 - i. The terminology used in the financial statements including the title of each financial statement is appropriate;
 - ii. The financial statements adequately disclose the significant accounting policies selected and applied;
 - iii. The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
 - iv. Accounting estimates made by management appear reasonable;
 - v. The information presented in the financial statements appears relevant, reliable, comparable, and understandable; and
 - vi. The financial statements provide adequate disclosures.

Unmodified Conclusion

The practitioner shall express an unmodified conclusion in the practitioner's report on the financial statements as a whole when the practitioner has obtained limited assurance to be able to conclude that nothing has come to the practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework.

Modified Conclusion

The practitioner shall express a modified conclusion in the practitioner's report on the financial statements as a whole when:

- a) The practitioner determines, that the financial statements are materially misstated; or
- b) The practitioner is unable to obtain sufficient appropriate evidence.

When the practitioner modifies the conclusion expressed on the financial statements, the practitioner shall:

- a) use the heading "Qualified Conclusion," "Adverse Conclusion" or "Disclaimer of Conclusion," as appropriate, for the conclusion paragraph in the practitioner's report; and
- b) provide a description of the matter giving rise to the modification.

Financial statements are materially misstated

If the practitioner determines that the financial statements are materially misstated, the practitioner shall express:

- a) A qualified conclusion, when the practitioner concludes that the effects of the matter(s) giving rise to the modification are material, but not pervasive to the financial statements; or
- b) An adverse conclusion, when the effects of the matter(s) giving rise to the modification are both material and pervasive to the financial statements.

In the basis for conclusion paragraph, in relation to material misstatements that give rise to either a qualified conclusion or an adverse conclusion, the practitioner shall describe and quantify the financial effects of the misstatement if the material misstatement relates to specific accounts in the financial statements (including quantitative disclosures), unless impracticable, in which case the practitioner shall also explain:

- i. how disclosures are misstated; or
- ii. the nature of omitted information.

Inability to obtain sufficient appropriate evidence

If the practitioner is unable to form a conclusion on the financial statements due to inability to obtain sufficient appropriate evidence the practitioner shall:

- a) Express a qualified conclusion if the practitioner concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive; or
- b) Disclaim a conclusion if the practitioner concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The practitioner shall disclaim a conclusion on the financial statements, or withdraw from the engagement, if:

- a) The practitioner concludes that there is sufficient doubt about the integrity of management; or
- b) Management does not provide the representations that are the preconditions for accepting an engagement.

The Practitioner's Report

The practitioner's report for the review engagement shall be in writing, and shall contain the following elements:

- a) A title of report
- b) The addressee(s),
- c) An introductory paragraph that:
 - i. identifies the financial statements reviewed, including identification of the title of each of the statements contained;
 - ii. refers to the summary of significant accounting policies and other explanatory information; and
 - iii. states that the financial statements have been reviewed;
- d) A description of the responsibility of management for the preparation of the financial statements.
- e) A description of the practitioner's responsibility to express a conclusion on the financial statements including reference to this ISRE and, where relevant, applicable law or regulation;
- f) A description of a review of financial statements and its limitations, and the following statements:
 - i. a review engagement under this ISRE is a limited assurance engagement;
 - ii. the practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained; and
 - iii. the procedures performed in a review are substantially less than those performed in an audit conducted in accordance with International Standards on Auditing (ISAs), and, accordingly, the practitioner does not express an audit opinion on the financial statements;
- g) A paragraph under the heading "Conclusion" that contains:
 - i. the practitioner conclusion on the financial statements as a whole
 - ii. a reference to the applicable financial reporting framework used to prepare the financial statements,
 - iii. when the practitioner's conclusion on the financial statements is modified:
- h) A paragraph under the appropriate heading that contains the practitioner's modified conclusion
- i) A paragraph, under an appropriate heading, that provides a description of the matter(s) giving rise to the modification
- j) A reference to the practitioner's obligation under this ISRE to comply with relevant ethical requirements
- k) Date of the practitioner's report
- l) Practitioner's signature
- m) Location in the jurisdiction where the practitioner practices

Emphasis of Matter Paragraph

The practitioner may consider it necessary to draw users' attention to a matter presented or disclosed in the financial statements. In such cases, the practitioner shall include an Emphasis of Matter paragraph in the practitioner's report.

► *Illustration*

INDEPENDENT PRACTITIONER'S REVIEW REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have reviewed the accompanying financial statements of ABC Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the International Financial Reporting Standard for Small and Medium-sized Entities, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Practitioner's Responsibility

Our responsibility is to express a conclusion on the accompanying financial statements. We conducted our review in accordance with International Standard on Review Engagements (ISRE) 2400 (Revised), Engagements to Review Historical Financial Statements. ISRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. The Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with ISRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with International Standards on Auditing. Accordingly, we do not express an audit opinion on these financial statements.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that these financial statements do not present fairly, in all material respects, (or do not give a true and fair view of) the financial position of ABC Company as at December 31, 20X1, and (of) its financial performance and cash flows for the year then ended, in accordance with the International Financial Reporting Standard for Small and Medium-sized Entities.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the practitioner's report will vary depending on the nature of the practitioner's other reporting responsibilities.]

[Practitioner's signature]

[Date of the practitioner's report]

[Practitioner's address]

► *Practice Question 01:*

State any three procedures which are generally adopted by the auditor to obtain evidence in review engagement.

► *Solution 01:*

Procedures of review engagement:

The procedures for the review of financial statements will usually include:

- Inquiry
- analytical procedures
- Agree and reconcile Interim Financial Information with the accounting records.

► *Practice Question 02:*

State the key features of review engagement which distinguish it from a statutory audit and identify two types of review engagements. (3 marks)

► *Solution 02:*

The key features of review engagement that distinguish it from statutory audit are as follows:

- Review engagement requires less evidence than an audit
- Opinion in the review engagement is expressed in negative terms

Two types of review engagements:

- Attestation engagement
- Direct reporting engagement

► *Practice Question 03:*

State any eight key procedures which are performed during a review engagement of historical financial statements.

► *Solution 03:*

Procedures for the review of historical financial statements will usually include the following:

- Obtain an understanding of the entity's business and the industry in which it operates.
 - Make inquiries into:
 - the entity's accounting policies, practices and procedures, including the preparation of financial statements
 - material assertions in the financial statements that are subject to the review
 - decisions taken at board meetings and other meetings of the entity that may affect the financial statements
 - the completeness of the accounting records that were used to prepare the financial statements.
- Applying analytical procedures designed to identify unusual relationships between items in the financial statements, and individual items that appear unusual. Analytical procedures would include:
 - comparing the financial statements under review with financial statements for prior periods
 - comparing the financial statements with the anticipated results and financial position of the entity
 - a study of the relationships between elements in the financial statements that should be expected to conform to a predictable pattern (based on the entity's past experience or normal ratios/relationships for the industry as a whole).

- Other procedures that will usually be carried out in a review of financial statements include:
 - discussions with the company's auditors (if the audit firm is not the firm of accountants that is performing the review engagement)
 - obtaining representations from management
 - considering the appropriateness of the accounting policies employed by the entity
 - making inquiries into subsequent events (after the date of the statement of financial position)
 - making a review of the statements as a whole.

► *Practice Question 04:*

Differentiate between review engagement of financial statements and the annual audit.

► *Solution 04:*

Review Engagement	Annual Audit
The procedures performed are substantially less than those performed in an audit and are mostly limited to analytical procedures and inquiries.	The procedures performed in an audit includes test of controls, substantive procedures, analytical procedures and inquiries.
A review does not provide a high level of assurance but provide limited level of assurance.	An audit is designed to provide a high level of assurance to the users of the financial statements.

2 INTRODUCTION TO THE ASSURANCE ENGAGEMENTS

2.1 Definition of assurance

‘Assurance’ means confidence. In an assurance engagement, an ‘assurance firm’ is engaged by one party to give an opinion on a piece of information that has been prepared by another party. The opinion is an expression of **assurance** about the information that has been reviewed. It gives assurance to the party that hired the assurance firm that the information can be relied on.

As per the study text area covered till this point, what we have learned is that, assurance can be provided by:

- **audit:** this may be external audit, internal audit or a combination of the two
- review.

A statutory audit is one form of assurance. Without assurance from the auditors, the shareholders may not accept that the information provided by the financial statements is sufficiently accurate and reliable. The statutory audit provides assurance as to the quality of the information.

The provision of this assurance should add credibility to the information in the financial statements, making the information more reliable and therefore more useful to the user.

However, there are differing levels or degrees of assurance. Some assurances are more reliable than others.

2.2 Levels of assurance

The degree of assurance that can be provided about the reliability of the financial statements of a company will depend on:

- the amount of work performed in carrying out the assurance process, and
- the results of that work.

The resulting assurance falls into one of two categories:

- **Reasonable Assurance** – A **high (but not absolute)** level of assurance provided by the practitioner’s conclusion expressed in a **positive form**. E.g. *“In our opinion the accounts are true and fair”*. The objective of a statutory audit is to provide reasonable assurance.
- **Limited Assurance** – A **moderate** level of assurance provided by the practitioner’s conclusion expressed in a **negative form**. E.g. *“Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view”*. The objective of a review engagement is often to provide limited assurance.

Assurance provided by audit

An **audit** provides a **high, but not absolute**, level of assurance that the audited information is free from any material misstatement. This is often referred to as **reasonable assurance**.

The reason why auditor is not expected to provide absolute assurance is that there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive. The inherent limitations of an audit are discussed later in this chapter.

Assurance provided by review

A **review** in contrast to ‘reasonable’ level of assurance provided by an audit, a **review** into an aspect of the financial statements would provide only a **moderate** level of assurance that the information under review is free of material misstatement. The resulting opinion is usually (although not always) expressed in the form of **negative assurance**.

Negative assurance is an opinion that nothing is obviously wrong: in other words, ‘nothing has come to our attention to suggest that the information is misstated’.

A review does not provide the same amount of assurance as an audit. An external audit provides **positive assurance** that, in the opinion of the auditors, the financial statements **do** present fairly the financial position and performance of the company.

The higher level of assurance provided by an audit will enhance the credibility provided by the assurance process, but the audit work is likely to be:

- more time-consuming than a review, and so
- costlier than a review.

2.3 Elements of an assurance engagement

► *Definition: Assurance engagement*

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

An assurance engagement performed by a practitioner will consist of the following five elements:

- A three party relationship:
 - **Practitioner** – the individual providing professional services that will review the subject matter and provide the assurance. E.g. the audit firm in a statutory audit
 - **Responsible party** – the person(s) responsible for the subject matter. E.g. the Directors are responsible for preparing the financial statements to be audited
 - **Intended users** – the person(s) or class of persons for whom the practitioner prepares the assurance report. E.g. the shareholders in a statutory audit
- **Subject matter:** This is the data such as the financial statements that have been prepared by the responsible party for the practitioner to evaluate. Another example might be a cash flow forecast to be reviewed by the practitioner.
- **Suitable criteria:** This can be thought of as ‘the rules’ against which the subject matter is evaluated in order to reach an opinion. In a statutory audit this would be the applicable reporting framework (e.g. IFRS and company law).
- **Evidence:** Information used by the practitioner in arriving at the conclusion on which their opinion is based. This must be sufficient (enough) and appropriate (relevant).
- **Assurance Report:** The report (normally written) containing the practitioner’s opinion. This is issued to the intended user following the collection of evidence.

► *Practice Question 05:*

Briefly explain with examples, the different levels of assurance that can be provided to an assurance client.

Tutorial Notes:

When asked about “levels of assurance,” focus on reasonable assurance (high level, positive expression) and limited assurance (moderate level, negative expression).

Provide examples for each (e.g., statutory audit vs. review engagement).

Avoid mixing up levels of assurance with types of audit reports (qualified, unqualified, etc.).

For “understanding internal controls,” clarify that the auditor does not express a separate opinion on their effectiveness unless specifically engaged.

► *Solution 05:*

- a) The statement is appropriate to the extent that reasonable assurance is a high level of assurance. However, second statement is not appropriate as reasonable assurance is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement, due to inherent limitations of audit.
- b) The statement is appropriate to the extent that auditor has to obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances. However, the second statement is not appropriate because the auditor is not required to express an opinion on the effectiveness of internal controls in conjunction with the audit of the financial statements.

► *Practice Question 06:*

In response to an audit engagement letter sent to Roof Limited (RL), Mr. Aziz Aslam, the new chief executive of RL has requested your firm to provide absolute assurance in the audit report.

Required:

Draft an appropriate reply mentioning any four reasons why the above request cannot be complied with.

► *Solution 06:*

To CEO, APL.

An auditor cannot obtain absolute assurance because there are inherent limitations in an audit that affect the auditor's ability to detect material misstatements. These limitations arise because of the following:

- i. The use of testing/sampling techniques;
- ii. The limitations that exist in any accounting and internal controls system (for example, the possibility of collusion);
- iii. The fact that most audit evidence is persuasive rather than conclusive; and
- iv. The work undertaken by the auditor to form an opinion is permeated by judgment.

Further, other limitations may affect the persuasiveness of evidence available to draw conclusions on particular financial statement assertions (for example, transactions between related parties).

► *Practice Question 07:*

Briefly explain any four elements of an assurance engagement.

Tutorial Notes:

For an assurance engagement's elements, systematically list the three-party relationship, subject matter, criteria, evidence, and conclusion/report.

► *Solution 07:*

An assurance engagement performed by a practitioner consists of the following elements:

- i. Three party relationships: An assurance engagement is a three party relationship consist of practitioner, responsible party and intended users.
- ii. Subject matter: This is the data such as the financial statements that have been prepared by the responsible party for the practitioner to evaluate.
- iii. Evidence: Information used by the practitioner in arriving at the conclusion on which their opinion is based. This must be sufficient and appropriate.
- iv. Assurance Report: The report containing the practitioner's opinion. This is issued to the intended user(s) following the collection of evidence.

2.4 Objectives of an assurance engagement

The primary objective of an assurance engagement is to **enhance the degree of confidence of the intended users** in the subject matter information. The practitioner achieves this by gathering sufficient appropriate evidence and expressing a written conclusion about the subject matter's conformity with identified criteria.

Beyond this overall purpose, specific assurance engagements may have more tailored objectives. For instance, an assurance engagement could be designed to conclude on the effectiveness of internal controls, compliance with laws or regulations, sustainability metrics, or other subject matters. In each case, however, the common objective is to have a qualified independent practitioner evaluate the subject matter against suitable criteria and provide a conclusion (often in the form of an opinion or report) that lends credibility to the subject matter information.

2.5 Phases of an Assurance Engagement

Assurance engagements, much like audits, typically progress through a series of phases or stages. Each phase has specific activities and objectives, ensuring a systematic approach to achieving the engagement's overall goal. While the exact terminology may vary, we can summarize the phases as follows:

Phase	Description
1. Acceptance and Continuance	Practitioner ensures all preconditions are met (e.g., subject matter, criteria, evidence, independence). If any are missing, the engagement is declined.
2. Planning	An overall strategy and detailed plan are developed, assessing risks and defining materiality to guide resource allocation and procedures.
3. Execution (Evidence Gathering)	Assurance procedures (e.g., inspections, confirmations, analytics) are carried out, with updates to the plan as needed and professional scepticism maintained.
4. Evaluation and Conclusion	Evidence is evaluated against criteria, considering materiality and qualitative factors. Inconsistencies are resolved before forming a conclusion.
5. Reporting	An assurance report is issued, detailing scope, responsibilities, and the conclusion. It clearly distinguishes the engagement from non-assurance ones.

2.6 Types of Assurance Engagements

The IAASB's assurance framework recognises several types or categories of assurance engagements, which can be distinguished by their subject matters, their structure, or the standards under which they are performed. Here we discuss a few ways to classify assurance engagements:

- **Attestation Engagement (Assertion-Based)**

In this type, the responsible party (e.g., management) evaluates the subject matter and provides subject matter information (like financial statements).

The practitioner's role is to assess and attest whether this information is reliable.

An audit is a common example: management prepares the statements, and the auditor expresses an opinion on them. The report refers to the assertion made by the responsible party.

- **Direct Engagement (Direct Reporting)**

Here, the practitioner directly evaluates the subject matter without a prior assertion from management. They both measure and report the outcome (e.g., effectiveness of internal controls). The report includes the subject matter information and the conclusion. This type is often used in non-financial assurance like compliance audits.

► *Practical Examples of Assurance Engagements*

Audit of Financial Statements	Opinion on whether financial statements present a true and fair view under applicable financial reporting framework.
Review of Financial Statements	Limited assurance that nothing has come to the practitioner's attention indicating material misstatement.
Assurance on Accounts Receivable Schedule	Verification of accuracy and completeness of a detailed AR schedule.
Assurance on Pro Forma Financial Information	Evaluating adjustments and presentation in projected or hypothetical financial scenarios.
Internal Control over Financial Reporting	Opinion on effectiveness of controls designed to ensure reliable financial reporting.
Sustainability Report Assurance	Limited or reasonable assurance on reported environmental and social metrics (e.g., GHG emissions).
Compliance with Grant Terms	Verification that a grantee has complied with specific financial and operational terms of a funding agreement.
Assurance on Environmental Compliance	Opinion on adherence to regulatory environmental requirements (e.g., pollution limits).
Risk Management Process Review	Evaluation of the design and effectiveness of enterprise risk management systems.
Operational Efficiency Review	Evaluating whether an organization's operations are efficient and deliver value for money.

2.7 Non-Assurance Engagements:

The IAASB clearly distinguishes assurance engagements from other professional services where no assurance is expressed. While assurance engagements aim to provide a conclusion that enhances the confidence of users (such as audits and reviews), many services provided by accountants fall under non-assurance engagements, which include compilation, valuation, and recruitment services. These services do not meet the criteria for assurance under the IAASB framework and are often classified as advisory, consulting, or related services.

- **Preparing Accounting Records and Financial Statements**

This involves assisting management in compiling financial information such as maintaining ledgers, posting journal entries, or drafting financial statements. Governed by ISRS 4410, this is a related service, not an assurance engagement. The practitioner does not provide a conclusion or opinion on the accuracy of the information. Instead, the client is responsible for the financial information's reliability. The compilation report clearly states that no assurance is provided. However, when the same firm is also the auditor, ethical concerns may arise due to the self-review threat.

- **Valuation Services**

Valuation involves estimating the worth of assets, liabilities, or businesses for example, in mergers, fair value accounting, or asset impairments. While it may appear similar to assurance, valuation is an expert or consulting service, not an assurance engagement, because it does not involve evaluating information against a formal set of criteria for external users. The accountant provides management with a valuation report, not an assurance conclusion. If, however, an accountant were to audit a fair value prepared by someone else, that may constitute an assurance task. Ethical and independence rules still apply if the valuation is done for an audit client.

- **Recruitment Services**

Recruitment services involve helping clients hire staff—for example, screening candidates or assisting in executive hiring. These are clearly consulting services, not assurance engagements, as they do not involve verifying information or issuing a conclusion. The practitioner provides advice, not confidence to third-party users. However, ethical issues arise if such services are provided to audit clients, especially in hiring senior management, as it may create self-interest or familiarity threats.

In conclusion, these non-assurance services differ fundamentally from assurance engagements because they do not include the expression of an independent conclusion intended to instil confidence in users. While professional standards and ethical requirements still apply, such engagements fall outside the scope of IAASB assurance standards. Understanding these distinctions is important for proper application of standards and maintaining independence in practice.

3 ASSURANCE ENGAGEMENTS - OTHER CONSIDERATIONS

3.1 Material Misstatement: Concept and Impact on Assurance

A material misstatement occurs when subject matter information (like financial statements or sustainability reports) deviates from the applicable criteria in a way that could reasonably influence user decisions. Misstatements can arise from errors or fraud and may be quantitative or qualitative.

- **Planning:** Practitioners set materiality thresholds early to determine the focus areas. These thresholds depend on user needs and engagement context.
- **Risk Assessment:** Includes identifying inherent and control risks in high-judgment or error-prone areas (e.g., revenue recognition).
- **Detection and Evaluation:** Practitioners detect misstatements during evidence gathering. If material, they may extend procedures to assess full impact.
- **Correction and Reporting:** Misstatements are discussed with management. If uncorrected and material, they affect the audit opinion leading to qualified or adverse opinions.
- **Communication:** All significant misstatements, corrected or uncorrected, are communicated to management or governance bodies.

3.2 Traditional Assurance Procedures

Traditional assurance procedures include:

- **Inquiry:** Asking informed personnel questions.
- **Inspection:** Examining documents or assets.
- **Observation:** Watching processes being performed.
- **Recalculation:** Verifying arithmetic accuracy.
- **Reperformance:** Repeating the procedures of responsible parties.
- **Analytical Procedures:** Studying trends, ratios and applying mathematical reasoning.
- **External Confirmation:** Getting independent verification from third parties.

3.3 Automated Tools and Techniques (ATT)

Automated Tools and Techniques (ATT) refer to the use of technology to perform assurance procedures traditionally done manually. The IAASB defines ATT broadly, covering everything from data analytics to AI, RPA (Robotic Process Automation), and even drones.

Types and Uses of ATT

ATT can range from basic (e.g., using Excel) to advanced tools like:

- Generalized Audit Software (GAS) for sorting and analyzing entire data sets.
- Data Analytics to detect anomalies and trends across full populations.
- Process Mining and Risk Visualization for identifying control weaknesses or risks.
- Digital Confirmations to streamline third-party evidence gathering.
- RPA and AI to automate repetitive tasks or analyze contracts and transactions.
- Drones for inventory observation in inaccessible locations.

Benefits of ATT

- Full-population testing increases coverage compared to sampling.
- Anomaly detection through pattern recognition can highlight risks.
- Efficiency improves by automating routine procedures.
- Integrated procedures (e.g., a single analytic tool may serve as a risk assessment, analytical, and substantive procedure).
- Handling big/unstructured data that manual methods can't easily process.

Challenges and Considerations

Practitioner must ensure:

- Reliability of the tool (verify code, scripts, or algorithms used)
- Data integrity (ensure complete and unaltered client data).
- Professional interpretation of the outcome
- Proper documentation of the procedures and results from ATT

► Practical Examples of ATT for assurance

Generalized Audit Software (GAS)	Used to extract and analyze client data such as all transactions. Helps in identifying high-risk items or selecting samples efficiently.
Digital Confirmation Platforms	Enables secure, automated confirmations from banks or customers. Improves speed and reliability over manual methods.
Data Analytics for Journal Entry Testing	Analyzes all journal entries to detect unusual patterns (e.g., entries made on weekends or just below approval thresholds).
Drones for Inventory Observation	Captures video or images of inventory in large or remote areas, supplementing or replacing physical count observation.
AI-Powered Document Review	Scans contracts or invoices to flag unusual terms or inconsistencies, aiding in efficient document inspection and risk identification.

3.4 Quality of evidence and its impact on conclusions

In assurance engagements, practitioners rely on sufficient appropriate evidence, which must be both relevant (logically connected to the assertion) and reliable (from trustworthy sources). When evidence is consistent, forming a conclusion is relatively straightforward. However, when contradictory evidence arises, it can complicate professional judgment and decision-making.

Contradictory evidence occurs when one piece of evidence supports a conclusion, while another suggests the opposite. For example, if customer confirmations agree with receivable balances but internal ledgers show discrepancies, the auditor cannot immediately conclude that receivables are fairly stated. Instead, they must investigate the inconsistency.

Such contradictions require the practitioner to:

- Weigh the reliability of each piece (e.g., external vs. internal sources).
- Perform additional procedures to resolve inconsistencies.
- Avoid relying on incomplete or biased evidence, even if voluminous.
- Adjust the risk assessment, strategy, or conclusion if the contradiction cannot be resolved.

If unresolved, contradictory evidence may lead the practitioner to modify the opinion, expand testing, or withhold assurance. For example, if a lawyer's letter discloses litigation that management denies, this indicates a possible misstatement or management bias, requiring deeper inquiry.

Ultimately, conclusions must be well-reasoned and evidence-based. If multiple sources corroborate a finding, confidence increases. If evidence conflicts, the practitioner must either resolve the conflict or reflect the uncertainty in their report, ensuring that users are not misled by an overconfident conclusion. Thus, handling contradictory evidence is a critical test of professional scepticism and judgment in any assurance engagement.

3.5 Connected Information

Connected information refers to data or evidence that links various elements of the subject matter being examined. In assurance engagements, this interconnectedness helps practitioners form a more complete, coherent understanding of the entity's operations, risks, and controls.

When information from different sources (e.g., financial, operational, regulatory) aligns, it enhances the **reliability** and **persuasiveness** of evidence. For example, if sales data, bank deposits, and tax filings all support recorded revenue, the assurance gained is stronger.

Conversely, **inconsistencies** or **gaps** in connected information can signal errors, fraud, or control weaknesses, prompting further investigation. For instance, if payroll records and HR reports do not reconcile, it may suggest fictitious employees or poor controls.

Connected information also aids in **risk assessment**, helping practitioners identify unusual patterns or anomalies across systems. It enables **cross-validation** of evidence and supports more informed **judgments and conclusions**.

Using connected information helps the practitioner see the full picture and understand how different parts of the business relate to each other. This leads to better, more accurate assurance and gives more confidence in the assurance report.

3.6 Sufficiency, Appropriateness, and Documentation

In an assurance engagement, the auditor must obtain and document **sufficient appropriate evidence** to support their conclusion. This means the evidence must be enough in **quantity** (sufficiency) and high in **quality** (appropriateness, which includes relevance and reliability).

To assess whether this has been achieved, the practitioner considers:

- **Coverage:** Have all significant areas, risks, and assertions been addressed through relevant procedures?
- **Reliability:** Has the evidence come from dependable sources (e.g., third parties, direct observation, or recalculation)?
- **Relevance:** Does the evidence directly relate to the specific assertion or subject matter?
- **Consistency:** Does the evidence from various procedures and sources support the same conclusion, or are there contradictions that require further work?

In an assurance engagement, proper **documentation** is much critical. The practitioner must clearly record:

- What procedures were performed
- What evidence was obtained
- How that evidence supports the conclusion

The documentation should be clear and complete so that another experienced assurance practitioner could understand the nature, timing, and extent of the procedures, and how the evidence led to the conclusion. If documentation is lacking or unclear, it may appear that the assurance conclusion is not well supported, even if sufficient appropriate evidence was actually gathered. Therefore, thorough documentation is just as important as obtaining the evidence itself in delivering a credible assurance engagement.

4 SUSTAINABILITY ASSURANCE IN AUDIT CONTEXT

4.1 Requirements of Sustainability Reporting in an Audit Context

Requirements of Sustainability Reporting in an Audit Context

Sustainability reporting discloses an organization's environmental, social, and governance (ESG) performance, using frameworks such as IFRS Sustainability Disclosure Standards (S1 & S2) and Global Reporting Initiative (GRI) Standards. These frameworks ensure transparency, comparability, and completeness, forming the foundation for audit and assurance engagements.

For sustainability information to be assured, certain preconditions must be met:

- Use of recognised reporting frameworks (GRI, IFRS S1/S2, SASB).
- Disclosure of material ESG matters that significantly impact stakeholders.
- Compliance with regulatory requirements (e.g., Code of Corporate Governance).

Auditors assess sustainability information against suitable criteria, ensuring it is verifiable, measurable, and reliable. Like financial audits, sustainability reporting requires proper documentation to support assurance engagements.

► Practice Question 08:

State two *pre-conditions* that must exist before sustainability information can be assured

► Solution 08:

- The entity uses a recognised reporting framework (e.g. GRI, IFRS S1/S2, SASB).
- Material ESG matters that significantly impact stakeholders are disclosed

4.2 Disclosures in Assurance of Sustainability Reporting

Assurance reports must clearly communicate the results of engagements to enhance stakeholder confidence. Key disclosures include:

- Subject matter (specific sustainability metrics or entire reports).
- Criteria/framework used (GRI, IFRS S1/S2).
- Level of assurance (reasonable or limited).
- Scope of work and procedures performed.
- Responsibilities of management and the assurance provider.

Reports must state the standards followed (e.g. ISAE 3000 or ISSA 5000) and declare the practitioner's independence. Any limitations (e.g., exclusions of certain data) must be disclosed to ensure transparency.

► Practice Question 09:

List the *key disclosures* that an assurance report on sustainability information should contain.

► Solution 09:

- Subject matter covered
- Criteria / framework used
- Level of assurance (reasonable or limited)
- Scope & procedures performed
- Responsibilities of management and practitioner

4.3 Ethical Considerations for Assurance of Sustainability Reporting

The International Ethics Standards for Sustainability Assurance (IESSA) introduces the need for ethical consideration in such engagements by following words:

“It is of public interest that sustainability assurance practitioners act ethically in order to maintain public trust and confidence in sustainability information that is subject to assurance. High-quality ethics and independence standards alongside other reporting and assurance standards will help investors, customers, employees and other users of sustainability information to confidently rely on such information in their decision-making (5100.1)”

“Sustainability assurance practitioners are expected to have relevant knowledge, skills and experience to perform sustainability assurance engagements and have appropriate training to ensure their assurance skills are continually up to date with relevant developments (5100.1a)”

The fundamental principles are:

- a) **Integrity** – to be straightforward and honest in all professional and business relationships.
- b) **Objectivity** – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.
- c) **Professional Competence and Due Care – to:**
 - Attain and maintain professional knowledge and skill at the level required to ensure that a sustainability assurance client receives competent professional service, based on current technical and professional standards and relevant legislation; and
 - Act diligently and in accordance with applicable technical and professional standards.
- d) **Confidentiality** – to respect the confidentiality of information acquired as a result of professional and business relationships.
- e) **Professional Behaviour** – to comply with relevant laws and regulations and avoid any conduct that the sustainability assurance practitioner knows or should know might discredit the sustainability assurance profession

High ethical standards (e.g., IESBA Code of Ethics) protect public trust in sustainability reporting.

► **Practice Question 10:**

According to IESSA 5100.1, why must sustainability assurance practitioners “act ethically”?

► **Solution 10:**

To protect the public interest by maintaining public trust and confidence in sustainability information subject to assurance

► **Practice Question 11:**

State the five *fundamental ethical principles* that apply to sustainability assurance practitioners under IESSA.

► **Solution 11:**

1. Integrity
2. Objectivity
3. Professional competence & due care
4. Confidentiality
5. Professional behaviour

► **Practice Question 12:**

Explain the distinction between *reasonable* and *limited* assurance in sustainability engagements.

► *Solution 12:*

- Reasonable assurance – higher confidence; engagement risk reduced to an acceptably low level; conclusion phrased positively (“is free from material misstatement”).
- Limited assurance – moderate confidence; higher engagement risk remains; conclusion phrased negatively (“nothing has come to our attention...”).

4.4 Examples of Sustainability Reporting in an Audit Context

1. Framework-Based Reporting and Assurance

Company A publishes a sustainability report using GRI Standards, covering carbon emissions, energy usage, and workforce data. An external auditor performs limited assurance and verifies data against GRI criteria using ISAE 3000/ISSA 5000. The assurance statement confirms no material misstatements, reinforcing stakeholder trust.

2. Mandatory Sustainability Reporting with Audit Oversight

Company B operates in a jurisdiction requiring integrated financial and sustainability reporting. Auditors review sustainability disclosures for material inconsistencies under ISA 720 (Other Information). Additionally, greenhouse gas emissions are independently verified under ISO 14064 standards, ensuring compliance and strengthening investor confidence.

3. Ethical Independence in Assurance Services

Company C, a tech firm, seeks sustainability assurance after hiring a consultancy to develop its ESG data systems. Its audit firm identifies a self-review threat and assigns a separate assurance team to maintain independence. The assurance report follows IESBA’s Code of Ethics, explicitly confirming independence and ethical compliance.

4. Reasonable Assurance on Key ESG Metrics

Company D requires reasonable assurance on workplace safety and GHG emissions, key ESG metrics for investors and regulators. The assurance provider conducts in-depth testing (inspections, data verification, and recalculations) and issues a positive opinion, demonstrating the rigor and reliability of ESG reporting.

5. Public Accountability in Sustainability Assurance

Company E, a state-owned enterprise, must report national sustainability commitments (e.g., emissions reduction). An independent auditor provides reasonable assurance, addressing the report to management, regulators, and public stakeholders. This ensures full transparency and reinforces public trust.

5 SUSTAINABILITY ASSURANCE ENGAGEMENTS (ISSA 5000)

5.1 Introduction to Sustainability Assurance Engagements

The scope of the assurance engagement may extend to all of the sustainability information to be reported by the entity or only part of that information. For example, some jurisdictions may require the entirety of the sustainability information to be reported in accordance with an established framework to be subject to assurance. However, in certain jurisdictions, law or regulation may require that only climate-related disclosures in an entity's sustainability information be subject to assurance. The reporting requirements of this ISSA require the practitioner to identify or describe the information that is subject to the assurance engagement.

Sustainability assurance engagements independently evaluate ESG disclosures, ensuring transparency, reliability, and accountability. These engagements align sustainability assurance with financial audits, following standards like ISAE 3000 and IAASB's ISSA 5000.

Levels of Assurance

- Limited assurance – Moderate confidence (e.g. no evidence of misstatements found).
- Reasonable assurance – Higher confidence (e.g. ESG information is fairly stated).

IAASB ISSA 5000 provides a global framework for sustainability assurance, ensuring consistent, high-quality engagements across industries.

5.2 Objectives of Sustainability Assurance Engagements

Sustainability information is reported in accordance with the criteria. This ISSA requires the practitioner to evaluate whether the criteria that the practitioner expects to be applied in the preparation of the sustainability information are suitable for the engagement circumstances. In the absence of indications to the contrary, framework criteria that are embodied in law or regulation or are established by authorized or recognised organizations that follow a transparent due process are presumed to be suitable.

The objectives of the practitioner are to:

- obtain either reasonable assurance or limited assurance, as appropriate, about whether the sustainability information is free from material misstatement
- express a conclusion on the sustainability information through a written report that conveys a reasonable assurance or a limited assurance conclusion, as applicable, and describes the basis for the conclusion
- communicate further as required by this ISSA and any other relevant ISSA.

In all cases when reasonable assurance or limited assurance, as applicable, cannot be obtained and a qualified conclusion in the practitioner's assurance report is insufficient in the circumstances for purposes of reporting to the intended users, this ISSA requires the practitioner to disclaim a conclusion or withdraw from the engagement, where withdrawal is possible under applicable law or regulation.

► Practice Question 13:

How does ISSA 5000 direct practitioners to evaluate the suitability of criteria, and what presumption applies to framework criteria embodied in law?

► Solution 13:

Practitioner must assess whether expected criteria are appropriate for the engagement; criteria set in law/regulation or by recognised bodies with transparent due process are presumed suitable unless evidence suggests otherwise.

► Practice Question 14:

State the three practitioner objectives in ISSA 5000 and explain the purpose of each.

► *Solution 14:*

- Obtain reasonable/limited assurance → reduce engagement risk.
- Express a written conclusion → communicate findings clearly.
- Communicate further as required → meet all additional ISSA obligations (e.g., reporting to regulators)

5.3 Elements of Sustainability Assurance Engagements

Element	Description
1. Three-party Relationship	The assurance engagement involves: - Practitioner (e.g., auditor or assurance provider) - Responsible party (usually management of the entity) - Intended users (stakeholders relying on the sustainability information).
2. Appropriate Underlying Subject Matter	The subject matter must be identifiable and capable of consistent evaluation or measurement against the criteria. In sustainability engagements, this typically includes ESG disclosures, carbon emissions, supply chain impacts, etc.
3. Suitable Criteria	The subject matter must be evaluated against established benchmarks (e.g., GRI, SASB, IFRS S1/S2, or laws/regulations). Criteria must be relevant, complete, reliable, neutral, and understandable.
4. Sufficient Appropriate Evidence	The practitioner must obtain enough relevant and reliable evidence to support their conclusion. The level of evidence differs between reasonable and limited assurance engagements.
5. Assurance Report	A written report expressing the conclusion in a clear and unambiguous manner. It must specify the level of assurance and describe the basis of conclusion, scope, and any limitations.

► *Practice Question 15:*

Describe the five elements of a sustainability assurance engagement and show (briefly) how they interrelate.

► *Solution 15:*

1. Three-party relationship → defines roles.
2. Underlying subject matter → what is measured.
3. Suitable criteria → how it's measured.
4. Sufficient appropriate evidence → basis for opinion.
5. Assurance report → communicates conclusion.

► *Practice Question 16:*

ISSA 5000 allows assurance over all or part of sustainability information. Give two factors that influence scope and detail practitioner obligations regarding scope in the report

► *Solution 16:*

Factors: jurisdictional requirements (e.g., only climate data) and stakeholder needs/contract terms.

Practitioner must identify or describe exactly which disclosures were assured in the written report.

► *Practice Question 17:*

When sufficient appropriate evidence cannot be obtained and a qualified conclusion would be inadequate, what actions does ISSA 5000 require?

► *Solution 17:*

The practitioner must disclaim a conclusion or withdraw from the engagement, subject to what applicable law permits

► *Practice Question 18:*

Identify two evidence-gathering techniques appropriate for sustainability metrics and explain how they help achieve engagement objectives

► *Solution 18:*

- Re-performance/calculation of intensity ratios verifies numerical accuracy.
- External confirmation (e.g., from suppliers) corroborates reported data, increasing reliability.

► *Practice Question 19:*

Outline the responsibilities of each party in the three-party relationship and explain why clarity of roles supports accountability

► *Solution 19:*

Responsible party (management) prepares and fairly presents information;

Practitioner obtains evidence and reports;

Intended users rely on the report. Clear delineation prevents expectation gaps and promotes trust.

► *Practice Question 20:*

Define “suitable criteria” under ISSA 5000 and list four qualitative characteristics such criteria must possess

► *Solution 20:*

Criteria are the benchmarks used to measure/evaluate the subject matter; they must be relevant, complete, reliable, neutral and understandable (any four)

5.4 Examples of Sustainability Assurance Engagements and IAASB ISSA 5000

1. Social Compliance Audit in Supply Chains

Company: Clothing Retailer Q

Scenario: Q sources products from global factories and has committed to fair wages, no child labour, and safe working conditions. To ensure credibility, Q hires an assurance provider to validate its supplier compliance claims.

Key Assurance Elements:

- **Subject Matter:** Supplier compliance with Q’s Labor Code of Conduct.
- **Criteria:** Labor standards used in audits
- **Evidence Gathering:** Factory site visits, worker interviews, inspection of internal audit reports.
- **Assurance Level: Limited assurance** (sampling-based assessment).
- **Outcome:** The assurance report confirms compliance levels, reinforcing stakeholder confidence in ethical sourcing and meeting regulatory/import requirements in certain markets.

2. Greenhouse Gas (GHG) Emissions Verification for Carbon Trading

Company: ABC Manufacturing

Scenario: ABC requires independent assurance on its Scope 1 and Scope 2 GHG emissions for regulatory compliance and carbon trading eligibility.

Key Assurance Elements:

- **Subject Matter:** Reported GHG emissions for the year.
- **Criteria:** Greenhouse Gas Protocol, ISO 14064 for emissions measurement.
- **Evidence Gathering:** Verification of energy bills, recalculations of emission factors, third-party certification records.
- **Assurance Level:** Reasonable assurance due to financial and compliance implications.
- **Outcome:** The assurance report confirms emissions accuracy, ensuring credibility for climate reporting and carbon credit transactions.

3. Assurance for Sustainability-Linked Bonds

Company: Green Energy Co.

Scenario: Green Energy Co. issued a sustainability-linked bond, where the interest rate is tied to achieving renewable energy goals. An independent assurance provider is engaged to verify whether the company met its agreed sustainability targets.

Key Assurance Elements:

- **Subject Matter:** Reported renewable energy usage percentage.
- **Criteria:** Industry standards & bond agreement definitions of renewable energy.
- **Evidence Gathering:** Energy purchase records, contract verifications, supplier certifications.
- **Assurance Level:** Reasonable assurance due to financial implications.
- **Outcome:** The assurance statement, addressed to both management and bondholders, confirms whether Green Energy met its target, impacting the interest rate paid on the bond.

4. Community & NGO Assurance on Environmental and Social Impact

Company: ABC Mining

Scenario: Due to community concerns over its environmental and social impact, ABC Mining agrees with NGOs to undergo independent sustainability assurance, ensuring transparency in land restoration and community engagement claims.

Key Assurance Elements:

- **Subject Matter:** Sustainability report sections on land rehabilitation, water quality, and community grievance resolution.
- **Criteria:** Local environmental laws, voluntary sustainability frameworks, and company commitments.
- **Evidence Gathering:** Field inspections, laboratory water quality tests, community feedback analysis.
- **Assurance Level:** Limited assurance, with an NGO-involved review process.
- **Outcome:** The assurance report, made public, builds trust between ABC Mining, NGOs, and local communities, ensuring sustainability claims are independently verified.

5. Multi-Framework Assurance Under ISSA 5000

Company: Global Conglomerate Y

Scenario: Global Y reports sustainability data under multiple frameworks (GRI, TCFD, SASB) to meet diverse stakeholder needs. To ensure global consistency, the company aligns all sustainability assurance engagements with ISSA 5000.

Key Assurance Elements:

- **Subject Matter:** Full sustainability report, covering climate risks, social impact, and governance metrics.
- **Criteria:** GRI, TCFD, and SASB standards.
- **Evidence Gathering:** Governance reviews, site inspections, verification of climate risk disclosures.
- **Assurance Level:** Limited assurance for qualitative disclosures, reasonable assurance for quantitative ESG metrics.
- **Outcome:** The assurance statement references ISSA 5000, ensuring that ESG disclosures meet an internationally recognised assurance standard, increasing investor and regulatory confidence.

6 CHAPTER REVIEW

Before moving on to the next chapter check that you now know how to:

- Distinguish between audit and review engagement
- Explain the requirements of ISRE 2400 Engagements to review financial information
- Differentiate Assurance and Non-Assurance from Review and Audits
- Use different levels and phases of assurance engagements
- Apply assurance tools of sustainability assurance engagements