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March 2016 exams

ACCA Paper

F8

Audit and Assurance

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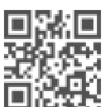

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SYLLABUS

1. Aim

To develop knowledge and understanding of the process of carrying out the assurance engagement and its application in the context of the professional regulatory framework.

2. Objectives

On successful completion of this paper, candidates should be able to:

- Explain the concept of audit and assurance and the functions of audit, corporate governance, including ethics and professional conduct, describing the scope and distinguishing between the functions of internal and external audit.
- Demonstrate how the auditor obtains and accepts audit engagements obtains an understanding of the entity and its environment, assesses the risk of material misstatement (whether arising from fraud or other irregularities) and plans an audit of financial statements.
- Describe and evaluate internal controls, techniques and audit tests, including IT systems to identify and communicate control risks and their potential consequences, making appropriate recommendations.
- Identify and describe the work and evidence obtained by the auditor and others required to meet the objectives of audit engagements and the application of the International Standards on Auditing
- Explain how consideration of subsequent events and the going concern principle can inform the conclusions from audit work and are reflected in different types of audit report, written representations and the final review and report

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3. Approach to examining the syllabus

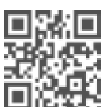
The syllabus is assessed by a three-hour paper- based examination, consisting of a mix of multiple choice and written questions. The bulk of the written questions will be discursive and scenario-based, but some questions involving simple computational elements will be set from time to time.The questions will cover all areas of the syllabus.

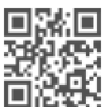
Part A Multiple choice questions (20%)

4 x 1 mark questions and 8 x 2 mark questions

Part B Written questions (80%)

4 x 10 mark questions and 2 x 20 mark questions.





Chapter 1

WHAT IS ASSURANCE?

1. Audit and assurance

It is often not possible to check things for yourself, whether quality, accuracy, performance or existence.

You might not have the skills or the time, or you might be in the wrong location. Therefore you must rely on someone else to give you assurance. This means you have to decide:

- What standards should be applied?
- What represents 'good', 'acceptable' or 'unacceptable?
- How much checking should be done? All checking and assurance has an associated cost

Audit is one form of assurance.

An audit is defined as: the independent examination of and expression of opinion on the financial statements of an entity by a duly appointed auditor in pursuit of that appointment.

The important words here are 'independent' and 'opinion'.

Independence is essential and underlies the value of auditing.

Opinion really means that one auditor could look at a set of financial statements and disagree with the opinion of another auditor.

Judgment is essential to all auditing, there are no certainties and there are no certifications of correctness or accuracy.

2. Elements of an assurance engagement

The following are the five elements of an assurance engagement:

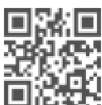
(1) A three party relationship involving a practitioner, a responsible party, and intended users.

(2) Appropriate subject matter.

(3) Suitable criteria.

(4) Sufficient appropriate evidence.

(5) A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.



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2.1 Three party relationship

A three party relationship involving a practitioner, a responsible party, and intended users:

- Practitioner: for example an auditor. The practitioner is responsible for determining the nature, timing and extent of procedures and is required to pursue anything that leads the practitioner to question whether a material modification should be made to the subject matter information.
- A responsible party: the person responsible for the information and assertions.
- The intended users are the person(s) for whom the practitioner prepares the assurance report. The responsible party can be one of the intended users.

2.2 Appropriate subject matter

The subject matter can take many forms, such as:

- Financial performance
- Non-financial performance, for example the key indicators of efficiency and effectiveness.
- Physical characteristics, for example, the capacity of a facility.
- Systems and processes, for example, an entity's internal control or IT system.
- Behaviour, for example, corporate governance, compliance with regulation.

2.3 An appropriate subject matter is:

- Identifiable, and capable of consistent evaluation or measurement against the identified criteria; and
- Such that the information about it can be subjected to procedures for gathering sufficient appropriate evidence.

2.4 Criteria

Criteria are the benchmarks used to evaluate or measure the subject matter.

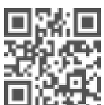
For example:

- When reporting on financial statements, The International Financial Reporting Standards.
- When reporting on internal control, the criteria may be an established internal control framework.
- When reporting on compliance, the criteria may be the applicable law, regulation or contract.

Without the frame of reference provided by suitable criteria, any conclusion is open to individual interpretation and misunderstanding.

Suitable criteria exhibit the following characteristics:

- Relevance: relevant criteria contribute to conclusions that assist decision-making by the intended users.
- Completeness: criteria are sufficiently complete when they include all relevant factors that could affect the conclusions.



- Reliability: reliable criteria allow reasonably consistent evaluation of the subject matter.
- Neutrality: neutral criteria so that conclusions that are free from bias.
- Understandability: conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

The evaluation or measurement of a subject matter on the basis of the practitioner's own expectations, judgments and individual experience would not constitute suitable criteria.

Criteria need to be available to the intended users to allow them to understand how the subject matter has been evaluated or measured.

2.5 Evidence

The practitioner plans and performs an assurance engagement with an attitude of professional scepticism to obtain sufficient appropriate evidence about whether the subject matter information is free of material misstatement. An attitude of professional scepticism means the practitioner questions the validity of evidence and is alert to evidence that brings into question the reliability of documents or representations.

Scepticism means that you don't know. It does not mean that the practitioner assumes everyone is dishonest or that figures have been deliberately misrepresented. Nor does it mean that you believe all figures are statements are correct. It means you are aware that we can all be subject to optimism (perhaps too much), human error, giving quick answers because we are short of time, misunderstanding. It also recognises that sometimes people are deliberately misleading or dishonest.

Scepticism means that evidence is required to test statements or assumptions. You could almost summarise the process of assurance in the phrase 'collect evidence that supports everything that is being claimed'.

Sufficiency is the measure of the quantity of evidence. Appropriateness is the measure of the quality of evidence - its relevance and its reliability.

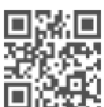
The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained, eg documentary evidence is better then oral, directly obtained evidence better then evidence provided by a client.

2.6 Assurance Report

The practitioner provides a written report containing a conclusion.

In a reasonable assurance engagement the practitioner's conclusion is worded in the positive form, for example: "In our opinion internal control is effective, in all material respects, based on XYZ criteria."

In a limited assurance engagement the conclusion is worded in the negative form, for example, "Based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on XYZ criteria."



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2.7 Positive and negative assurance

Examples:

Positive

- The financial statements show a true and fair view
- The value of amount of inventory lost is $x

Negative

- We have discovered nothing wrong with the financial statements
- The basis of the forecast is not unreasonable
- There is no evidence of discrimination in the appointment.

All statutory audits attempt to provide positive assurance ie the financial statements show a true and fair view. There are some types of assurance assignment where giving a positive assurance is not possible. For example, it would be impossible to give assurances that a budget is correct because it depends on so many assumptions and factors that cannot be verified with certainty, such as the state of the economy next year, competitors' plan and sales forecasts.

Positive assurance is also known as **reasonable assurance** because even there practitioners will only offer reasonable assurance that the financial statements are free of material misstatement.

Negative assurance is also known as **limited assurance**.

A practitioner would not express an unqualified conclusion for either type of assurance engagement when:

There is a limitation on the scope of the practitioner's work ie sufficient appropriate evidence cannot be obtained; or

The assertion is not fairly stated, and the subject matter information is materially misstated (ie the assertion is incorrect).

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Chapter 2

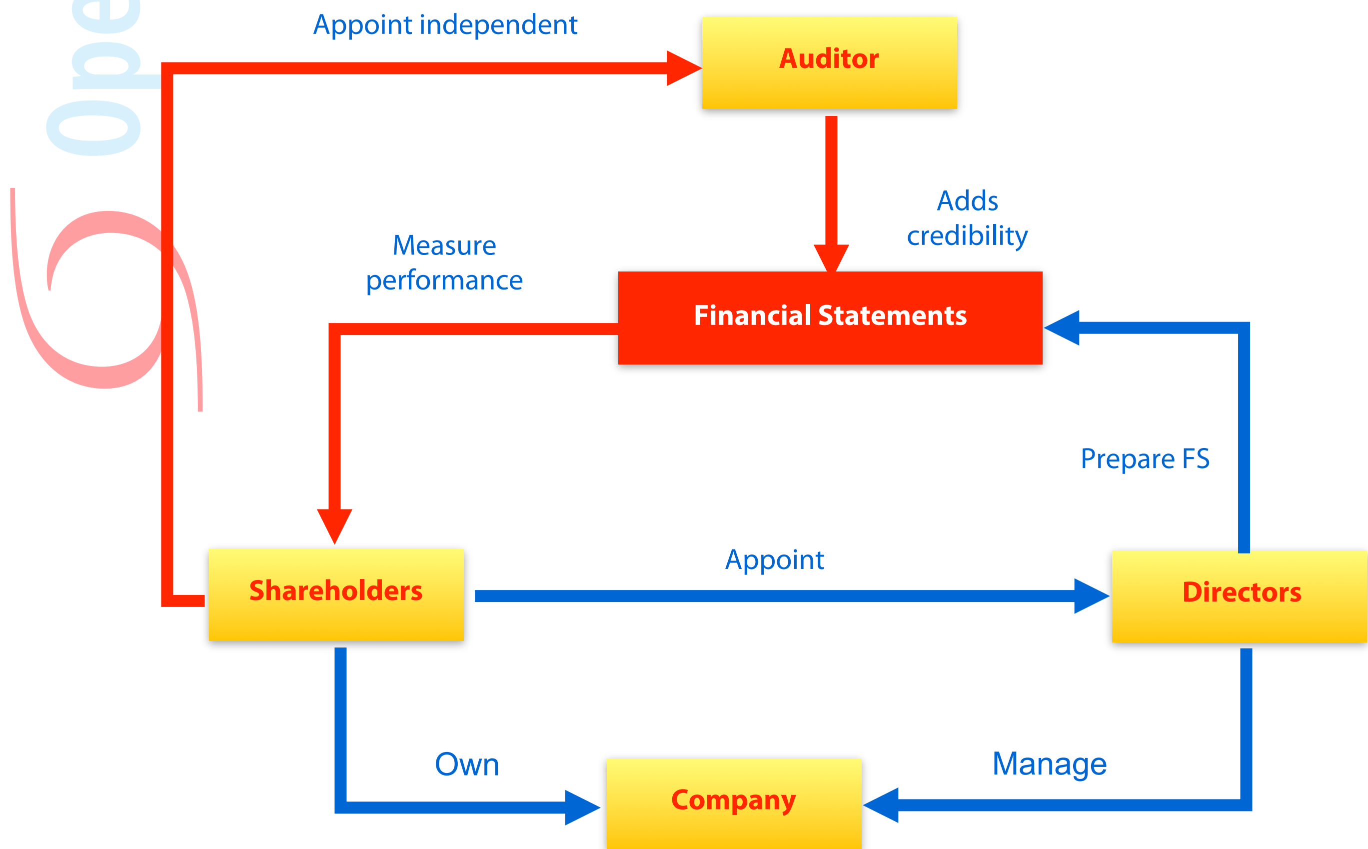
CORPORATE GOVERNANCE

1. Why corporate governance is needed

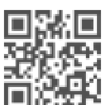
Corporate governance is the system by which companies are directed and controlled.

The problem with bad corporate governance is that although the shareholders own companies, the day-to-day management and direction of companies is given to the Board of Directors. In large companies many shareholders are relatively passive and the Board of Directors is given more or less free rein to make whatever decisions they wish.

Auditing was instituted so at least once a year, when the financial statements were presented to the members of the company, the auditors would examine them and give some expression of opinion to the members of the company as to whether the financial statements were true and fair. Without that assurance the members of the company really would have a little idea whether or not the information could be relied on. The auditors therefore examine the financial statements and this adds credibility to those statements, the share-holders have a much better idea of the performance of the directors and the company.



Note that shareholders appoint the independent auditors, they also appoint the directors. The problem is that once directors were appointed, shareholders often didn't take much further interest in what the directors were doing and there were annual gaps between financial statements being issued This hands-off approach has recently been found entirely inadequate



and additional safeguards have been instituted to try to ensure that directors act in the best interests of the members of the company. Directors should act for the shareholders but often acted for themselves – the agency problem. In agency terms, the shareholders are the principals and the directors are their agents. Agents should act in the best interests of their principals.

2. Principles of corporate governance

The Organisation of Economic Cooperation Development (OECD) has put forward some principles of corporate governance:

- Corporate governance frameworks should protect shareholders rights, ensuring fair treatment of all shareholders, particularly minority and foreign shareholders. For example all shareholders should have access to the same information.
- The corporate governance framework should also recognize the rights of all stakeholders, not just shareholders, and should encourage active cooperation between the entities and stakeholders in creating wealth, jobs and sustainability of financially sound entities.
- There should be disclosure and transparency.
- The corporate governance framework should ensure that timely accurate information is made available in all material matters.
- Responsibility of the board is also covered, and the corporate governance framework should ensure the strategic guidance of the entity, effective monitoring of management by the board and the board's accountability to the entity and their shareholders. In particular the board should set its own objectives, monitor its own performance and have its own performance assessed.

3. The UK Corporate Governance Code

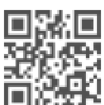
The OECD principles are put into effect in a variety of ways in different countries. The ACCA has specified that for F8 the UK Corporate Governance Code can be referred to as an example of best practice.

The code states that the purpose of corporate governance is to facilitate effective entrepreneurial and

prudent management that can deliver long-term success of the company. It then goes on to list the main principles of the code:

Main principles

- Leadership
- Effectiveness
- Accountability
- Remuneration
- Relations with shareholders



Comply or explain

The code has no force in law and is enforced on listed companies through the Stock Exchange. Listed companies are expected "comply or explain" and this approach is the trademark of corporate governance in the UK.

Listed companies have to state that they have complied with the code or else explain to shareholders why they haven't. This allows some flexibility and non-compliance might be acceptable in some circumstances.

Leadership

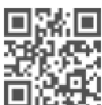
- Every company should be headed by an effective board which is collectively responsible for the longterm success of the company.
- There should be a clear division … between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision. This means that the roles of CEO and Chairman should not be performed by one person as that concentrates too much power in that person.
- The chairman is responsible for leadership of the board
- Non-executive directors (NEDs) must be appointed to the board and they should constructively challenge and help develop proposals on strategy. NEDs sit in at board meeting and have full voting rights, but do not have day to day executive or managerial responsibility. Their function is to monitor, advise and warn the executive directors.

Effectiveness

- The board should have an appropriate balance of skills, experience, independence and knowledge. In large companies NEDS should be at least 50% of the board; in small companies there should be at least 2 NEDS.
- New directors should be appointed by a Nomination Committee to ensure a formal, rigorous and transparent procedure for their appointment. The Nomination Committee consists of NEDs. This provision is to prevent directors appointing their friends and colleagues to the board and ensures that the best people for the job are considered and appointed.
- All directors should be able to allocate sufficient time to company business
- There should be induction on joining the board and a programme to update and refresh directors' skills and knowledge.
- The board should be supplied in a timely manner with necessary information
- The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.
- All directors should be submitted for re-election at regular intervals

Accountability

- The board should present a balanced and understandable assessment of the company's position and prospects.
- The board is responsible for determining the … significant risks …and should maintain sound risk management and internal control systems.
- The board should establish formal and transparent arrangements for applying the corporate reporting, risk management and internal control principles, and for maintaining an appropriate relationship with the company's auditor. This means that an



Audit Committee (NEDs again) should be established to liaise with both internal and external auditors. Before audit committees, the finance director liaised with auditors, but this was not satisfactory because the finance director was often the person responsible for accounting problems. Therefore auditors were often reporting problems to the person who caused them. The directors are responsible for establishing an internal control system and must review the need for internal audit.

Remuneration

- Levels of remuneration should be sufficient to attract, retain and motivate directors of sufficient quality… but avoid paying more than is necessary.
- A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance. In other words, profit related pay is encouraged. Directors should not receive high pay irrespective of company performance.
- There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration. This means that a Remuneration Committee (NEDs) should be formed to fix directors' remuneration.

Relations with shareholders

One of the problems with achieving good corporate was encouraging shareholders to take an active interest in the company. Too often they did not fully participate at AGMs and would wave through motions. This passive attitude might well have been encouraged by directors to move power towards them and away from members.

The code therefore specifies:

- There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.
- The board should use the AGM to communicate with investors and to encourage their participation.

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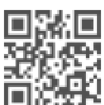
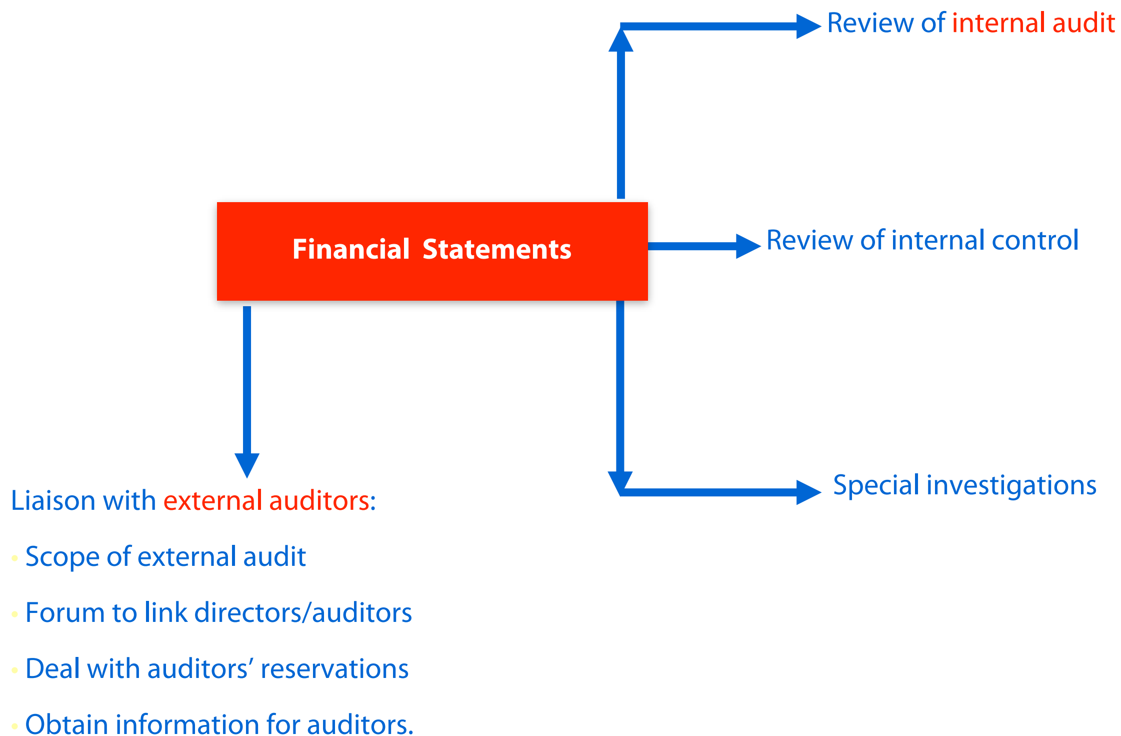


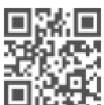
4. The role of the audit committee

The audit committee is now very important part of corporate governance.



The committee should be dominated by non-executive directors. The functions are as follows:

- They will review the work of internal audit. Companies don't have to have an internal audit department, but corporate governance rules now stated that management should keep the need for internal audit on the review.
- The audit committee will review the system of internal control. Corporate governance now imposes on management the requirement that they implement a system of internal control.
- From time to time the audit committee may launch special investigations. For example, if a fraud had been discovered within the organisation the audit committee may ask for a report on how it happened and how to prevent it in the future.
- Liaison with external auditors. It used to be that external auditors would communicate almost exclusively with the finance director, but of course the finance director may not be sufficiently independent of the finance function and the system of internal control. Now, the audit committee will set the scope for the external audit. They act as a forum to link directors and auditors. Auditors will typically write to the audit committee about any problems they may be having on the audit or obtaining all the information they require. If the auditors are worried in someway about the financial statements they will raise those concerns with the audit committee.
- If the auditors can't find information in any other way and feel perhaps they are being obstructed, they can go to the audit committee and explain the problem and the audit committee can try and investigate on their behalf.



Liaise on the process of appointing auditors and setting their fees. (Note that the external auditors are appointed by members in general meeting, but the audit committee is likely to make recommendations.)

5. Small entity exemptions

Many countries have legislation which exempts small entities from the requirement to be audited. The main justification for this is that the managers and directors are likely to be the owners so therefore the need for independent monitoring of management doesn't arise. Besides that, these small entities often have simple trading, simple records and limited internal controls which management can anyway override. In such environments, auditing the financial statements is seen as an unnecessary expense.

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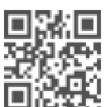

Chapter 3

AUDITORS' RIGHTS, APPOINTMENT, REMOVAL, RESIGNATION AND REGULATION

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1. Auditors' rights and duties

So that they can carry out their duties properly, auditors have very powerful rights. For example:

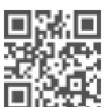
- They have access to all records they require.
- They have a right to receive information and explanations of all transactions.
- They have a right to attend and receive notice about general meetings and they have right to speak at general meetings on relevant matters.

A general meeting is where the shareholders of the company come together, and the annual general meeting ensures that there should be at least one of these meetings every year. The auditors have the right to receive in advance information about any resolutions that are proposed to be put at these general meetings. And finally they have the right to require that the company's financial statements should be presented at the general meeting, otherwise of course if the financial statements contained information which the directors wanted to keep secret, the directors could delay presenting those.

Their right to be informed about, attend and speak at general meetings gives the auditors an opportunity to communicate directly with the shareholders – by whom they have been appointed and for whom they are acting.

Typical duties:

- To issue an audit report, giving opinions on:
- truth and fairness of the Financial Statements
- whether the Financial Statements are properly prepared
- any other opinions required.
- When leaving a client, to issue a Statement of Circumstances
- After resignation, to supply information to the new auditors.



An auditor:

- Must pass an approved set of professional examinations, set by a **Recognised Qualifying Body (RQB)** eg the **ACCA**
- Must become a member (and stay a member!) of a **Recognised Supervisory Body (RSB)** eg the ACCA
- The auditor must not be a **director or employee** of the company, or of any associated companies

The auditor must not be an **employee or business partner** of a director or employee of the company, or of any associated companies.

2. Appointment of auditors

Auditors have to be reappointed by resolution at every annual general meeting. Note that reappointment is not automatic. This is to prevent the incumbent auditors from simply staying in office. The requirement for a resolution means that the members have to take positive action to get auditors appointed.

Prior to the first annual general meeting the directors can appoint the first auditors or if an auditor resigns, for example, because he or she falls ill, the directors can appoint another auditor to fill a casual vacancy. This appointment will only last till next AGM.

If all else fails, in the UK, the Secretary of State, in other words the government, will ensure that all companies have an auditor.

The actions that the auditor should take when approached by a potential client are explained later.

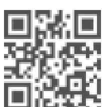
3. Resignation of auditors

Auditors can resign by giving written notice and a statement of circumstances to the company.

A statement of circumstances explains why they have resigned. Written notice must also be sent to the regulatory authority and the members by the company by the company.

The thinking behind the statement of circumstance is that auditors may have resigned because they are deeply concerned about some aspect of the company's activities. So the statement of circumstances explains why the auditor has resigned, which could, of course, have been caused by perfectly innocent reasons, for example that the auditor wishes to cut back on work, or the auditor feels that the company is now too large for the auditing firm to deal with.

If the auditors are really concerned about the company and that's why they have resigned, they could also require the directors to call an extraordinary general meeting. The auditors can speak at these meetings, and therefore they can address the members and explain their concerns and why they have resigned.



4. Removal of auditors

Auditors can be removed from office. This would normally be at instigation of the directors, but does have to be ratified by the shareholders. They could be removed from office for perfectly legitimate reasons. Perhaps the auditors failed to the find a material fraud in the company and the directors have lost faith in them, or perhaps the company has now become international and a larger firm of auditors is needed.

However, the big fear is that the auditors were, perhaps, too good, too strict on insisting that certain aspects of the financial statements should be changed, or perhaps they issued a critical audit report that the directors didn' the accounts.

This is why the auditors are given the right to make representations about why they should stay in office. They have to deposit a statement of circumstance at company's office and this should be sent to the regulatory authority. The auditors can also receive notices, speak at a general meeting at which the term of their appointment would have expired. This allows the auditors, if necessary, to explain to shareholders what has happened and that they may have been removed without due cause.

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5. Regulation

Auditors are regulated by:

- Professional bodies (eg ACCA)
- International bodies (eg IFAC, the International Federation of Accountants)
- National bodies (in the UK the FRC, Financial Reporting Council)

The purposes of IFAC are to serve public interest, strengthen the worldwide accountancy profession, establishing and promoting adherence to high-quality professional standards.

- **IAASB** (International Auditing and Assurance Standards Board): ISAs and other assurance standards
- **The International Ethics Standards Board for Accountants (IESBA)**: IFAC Code of Ethics.
- **TAC** (Transnational Auditors Committee): international dimension of audits.

IFAC ISAs are adopted by the FRC in the UK which has local regulatory power.

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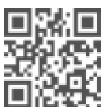


Chapter 4

PROFESSIONAL ETHICS

1. Introduction

The ACCAs guide to professional ethics sets out certain fundamental principles about how its members should behave. It also recognizes how its members could be subject to certain threats which would compromise their behaviour and suggests ways in which members can safeguard themselves against the operation of those threats.

The guide applies to all members of ACCA and also to all ACCA students. Note that its operation is not restricted to auditors and covers ACCA members working in industry and commerce.

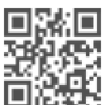
The ethical framework recognises that there are:

- Ethical principles to be followed.
- These are subject to risks
- Accountants should use safeguards to avoid or to respond to risks.

2. Fundamental principles

The ACCA's fundamental principles are as follows:

- First, **integrity**, basically this means that members should be honest, straightforward. If they see something is amiss, they should say so and shouldn't try to conceal it; they shouldn't 'turn a blind eye'; they shouldn't try to be ambiguous; they should state things plainly.
- Secondly, **objectivity**, members should be influenced by the facts and the facts only. They must avoid bias, conflict of interest and undue influence.
- Third, members should exercise **professional competence and due care**. They must keep themselves up-to-date with legislation and recent developments. They shouldn't take on work which they are not qualified for or for which they have no skills. They must be diligent, they must be careful.
- Fourth, **confidentiality**. Members, particularly perhaps those who are auditors, have access to information that is highly confidential and which is price sensitive. That information must be held confidentially. Members should not disclose confidential information unless they have a legal or professional duty to do so. An example of a legal duty to disclose information can arise if a member thinks that a client or the person they are working for is involved in money laundering. Many countries have very strong regulations nowadays so that money laundering suspects should be reported to the authorities.
- Finally, members should show **professional behaviour.** They should comply with the law and they should avoid any actions which discredit the profession. So, for example, when they are trying to advertise their services they shouldn't say that other members



are bad or poor. They should confine themselves to promoting what they are good at; they shouldn't criticise other professionals.

3. Threats to professional ethics

Threats to professional ethics arise from

- Self-interest
- Self review
- Advocacy
- Familiarity
- Intimidation.

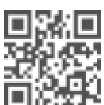
Note also there are management threats, where the auditor performs managerial functions for the client. These are not listed by the IESBA, but covered under several of the above, such as self-interest and familiarity.

Where such threats exist, the auditor must put in place safeguards that eliminate them or reduce them to clearly insignificant levels. Safeguards apply at three levels: safeguards in the work environment, safeguards that increase the risk of detection, and specific safeguards to deal with particular cases. If the auditor is unable to implement fully adequate safeguards, the auditor must not carry out the work.

3.1 Self-interest threats

Self-interest threats are the following:

- Financial: For example if an auditor own shares in the client, the auditor could be accused of wanting the client's profits to look good, so that the share price rises thereby enriching the auditor.
- Close business relationships are also threats. For example, if a partner retired from an audit partnership and then immediately went to work for a client, they could be accused for having lined themselves up for a job and to do that they perhaps did not do their audit rigorously. A period of at least two years should pass before an ex-partner takes up an appointment with a client. Having a partner on the client board is also unacceptable.
- Close family and personal relationships between the auditor and owners or directors of the company they are auditing lay the auditor open to suggestions that the audit has been neither objective nor independent, and that the auditor did not show the proper degree of integrity.
- Loans and guarantees from the client to the auditor should be looked at carefully. If the audit client is a bank and it makes a loan on a normal business terms to a member of the audit staff, for example a mortgage, this would normally be regarded as acceptable. If however the bank (the audit client) makes a large loan into the partnership then this again could leave the audit firm open to accusations of having being treated faithfully by the bank. Certainly no loans or financial relationships should exist between a client and an auditor if it is not normal business for the client to make loans.
- Overdue fees put the auditor at some risk as there is a possibility that client will never pay those fees. This could lead to accusations that the auditor has not qualified the audit report to reduce the likelihood that a worried creditor triggers the company's liquidation. If there are overdue fees the auditor should not make the situation worse



and should not incur any more chargeable time until those fees have been settled. If fees remain outstanding, the auditor should resign.

- Contingent fees are obviously dangerous. A contingent fee, for example, would be where the auditor is paid a small fee if the auditor report is qualified, but a larger fee if the audit report is clean.
- High percentage fees. If the auditor earns a high percentage of total income from one audit client, then the auditor will rely too much on that client and can't afford to lose them. This can give the client too much leverage over the auditor. For a public interest company, such as a company listed on a stock exchange, the maximum proportion of fees arising form that client should not be more than 15% of total fees in two consecutive years. No figure is mentioned for non-public interest companies, but auditors need to be mindful of this threat..
- Low-balling refers to the practice of quoting a very low audit fee to a client and then hope that profits would be made another work awarded by the client. This means really that the audit does not pay for itself so how, therefore, could a proper audit be done? Winning an audit is a competitive business and the audit fee is an important factor to clients. However, an auditor could find it difficult to claim that a proper audit has been carried out if a loss were made on the audit. Fees should be profitable for the auditor.
- Recruiting staff on behalf of a client should not be undertaken. The danger here is that if members of staff are recruited by the auditor, particularly financial staff, then subsequently the auditor might be reluctant to criticise the performance of those staff members as the advice they gave on recruitment looks bad. Similar considerations should be taken into account when the auditor performs any management function for the client.

3.2 Self review threats

Self review threats arise when an auditor does work for a client and that work may then be subject to self-checking during the subsequent audit. For example, if the auditor prepares the financial statements, and then has to audit them, or the auditor performs internal audit services and then has to check that the system of internal control is operating properly. Auditors could obviously be reluctant to criticise the work which their own firms have earlier undertaken, and this could interfere with independence and objectivity.

Generally auditors must be very careful when undertaking such work. Certainly it is common for auditors to do additional work for their clients, but what is important that the work is done by an entirely different team from the audit firm.

Really, checking your own work is a waste of time.

3.3 The supply of other services

The issue of auditor supplying multiple services to their clients, such as taxation and management consultancy, is a controversial one and there are both pros and cons. For example, auditors will know a great deal about the operations of their clients and this can make the performance of other work much more efficient. If entirely new companies have to be brought in to supply these services, much of the information they find out about the client will already be known by the auditor and there is a real duplication of effort.

The danger, of course, is that the auditors come to rely too heavily on the fees earned from the other work and are therefore reluctant to risk losing a client because of an adverse audit opinion. Large audit firms can at least use separate departments, though this may be difficult with small firms.

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In United States, listed companies are not allowed to obtain other services from their auditor. This is to ensure that the auditor is independent and performs only the audit. In most jurisdictions, there are no hard and fast rules but the overall guidance on ethics relating to objectivity and independence should be adhered to.

3.4 Advocacy threats

Advocacy is where the assurance or audit firm promotes a point of view or opinion to the extent the subsequent objectivity is compromised. An example would be where the audit firm promotes the shares in a listed company or supports the company in some sort of dispute. Advocacy can interfere with professional scepticism.

As always, the audit firm should weigh up the risks to its objectivity, integrity and independence and should withdraw from performing further work if those risks are too high.

3.5 Familiarity threats

Familiarity threats arise because of the close relationship between members of the assurance or audit firm and the client. The close relationship can arise by friendship, family or through business connections. There is no general definition of what's meant by close relationships, but if you were an auditor and your brother was the Finance Director of a client firm then there probably is a close relationship! If however the finance director was a remote cousin of yours, there might not be a close relationship. Note that there does not have to be any family or legal relationship: friendship can threaten independence and integrity.

When dealing with close business relationships between the auditor and the client firm, the ACCA suggests, the lead partner should be changed at least every five years and other partners involve change at least every seven years. This is to prevent too close a relationship and friendship growing between the two parties. The problem is that when a close relationship does grow, objectivity and skepticism are liable to be lost.

3.6 Intimidation

The final groups of threats are intimidation threats. These can deter the assurance team from acting properly.

Examples could be threatened litigation, blackmail, or there might even be physical intimidation, though it is to be hoped that that is rare. Blackmail could be more subtly applied and might relate back, for example, to a period where the auditor was not acting in accordance with the required ethical standards.

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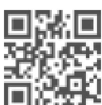


Chapter 5

THE AUDIT REPORT

1. Introduction

Now we begin to look at the audit report. For many people, this is the only purpose of an audit and it's one of the few parts of the financial statements they really look at.

Note that the audit report is a clear expression of opinion on the financial statements as a whole.

The two important phrases are:

- 'Opinion': there is nothing absolute here. Different firms of auditors could quite legitimately come to different opinions.
- 'Financial statements as a whole'. We are not just looking at the statement of financial position and isolation from the statement of profit or loss or the notes. What's important is the impression given by the financial statements as a whole.

The audit has to be based on evidence obtained in the course of the audit. We will see later that the audit report is nowadays quite long, almost a page of A4.

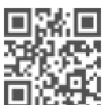
2. Financial statements

The audit report refers to financial statements and you need to know what these are. They consist of the following:

- The statement of financial position (or balance sheet).
- The statement of profit or loss.
- The statement of changes in equity.
- The cash flow statement.
- The notes to the account.

and any other material identified is being part of the financial statements.

Note in particular that the Director's report and Chairman's report are ***not*** part of the financial statements. They are referred to in the audit report but only to confirm that they are consistent with and do not contradict anything which is in the financial statements.



3. The parts of an audit report

Now we are going to look at some of the key parts of an audit report. You can see a real, recent audit report for Tesco plc on the next page.

3.1 Independent Auditor's Report

First of all, it is clearly titled 'Independent Auditors' Report.' That should mean that no one has any doubt about what this document is. It next states to whom the audit report is addressed - and that's members of the company. We will see shortly that audit reports go to some lengths to point out that only the members should rely on the audit report.

3.2 The financial statements

Next it says what they have audited: the financial statements. It lists what these actually comprise: generally the statement of financial position, the statements of profit or loss, the statement of changes in equity, the cash flow statement and the notes.

3.3 Management and the auditors' respective responsibility

The next paragraphs are very important. They point out that it is management's responsibility to prepare the financial statements in accordance with the International Financial Reporting Standards or International Accounting Standards where appropriate, and that it is the the auditor's responsibility to express an opinion on the financial statements. It will state that the audit will provide only reasonable assurance that the financial statements are free of material misstatement: no guarantees!

3.4 International standards of auditing

If the auditor adheres to international standards, it will be a powerful defence if it is subsequently discovered that there is something wrong with the financial statements.

3.5 Planned

The standards require that the audit is planned

3.6 Basis of opinion

A summary of why a particular audit opinion has been reached. It is here that details of any problems would be noted.

As appropriate, this paragraph can be named:

- Basis of audit opinion
- Basis of qualified audit opinion
- Basis of adverse audit opinion
- Basis of disclaimer of audit opinion

3.7 Opinion

The opinion paragraph is the heart of the matter. The report shown below shows an unmodified audit report. We will have to see later the various sorts of modification that are sometimes seen in audit reports if the auditors are unable to say without reservation that the accounts give a true and fair view.

As appropriate, to match the basis of opinion paragraph, this paragraph can be named:

- Opinion
- Qualified opinion
- Adverse opinion
- Disclaimer of opinion

The title is modified to alert users about problems.

3.8 Other requirements

The audit report may continue by reporting on other legal and regulatory requirements. For example, banks and insurance companies may have additional legal requirements to be reported on.

3.9 Signature and date

Finally, the auditors must sign the audit report and must give their address and the date at which it is signed.

The date of the audit report is very important because before that date the auditor has an active duty: the audit is not yet over. The auditor should still be investigating whether receivables are being paid and inventory is selling at above cost. After that date the auditor has a passive duty only. This means that the auditor is not 'on the lookout' for events affecting the truth and fairness of the financial statements, but if any are brought to his attention he might have to act.

Independent auditors' report to the members of Tesco PLC

We have audited the Group financial statements of Tesco PLC for the 53 weeks ended 28 February 2009 which comprise the Group Income Statement, the Group Balance Sheet, the Group Cash Flow Statement, the Group Statement of Recognised Income and Expense and the related notes. These Group financial statements have been prepared under the accounting policies set out therein.

Respective responsibilities of Directors and auditors

The Directors' responsibilities for preparing the Annual Report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as endorsed by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the Group financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the Group financial statements give a true and fair view and whether the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you whether in our opinion the information given in the Report of the Directors is consistent with the Group financial statements. In addition we report to you if, in our opinion, we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the Company's compliance with the nine provisions of the Combined Code (2006) specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited Group financial statements. The other information comprises only the Introduction, the Financial highlights, Chairman's statement, Tesco at a glance, the Chief Executive's Q&A, the Report of the Directors, the Corporate governance statement, the unaudited part of the Directors' remuneration report and the Five year record. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Group financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Group financial statements. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the Group financial statements, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

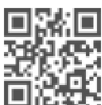
We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Group financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the Group financial statements.

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as endorsed by the European Union, of the state of the Group's affairs as at 28 February 2009 and of its profit and cash flows for the 53 weeks then ended;
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation; and
- the information given in the Report of the Directors is consistent with the Group financial statements.

PricewaterhouseCoopers LLP, Chartered Accountants and Registered Auditors
London 1 May 2009



4. What is meant by 'true and fair'?

As near as probably matters, the word 'true' means that the information is accurate. It doesn't mean accurate to the last cent, but accurate enough to conform with reality. 'Fair' is a more difficult concept. You can have information which is accurate but which is nevertheless presented in a way which is unfair, and which perhaps conceals or does not reflect the commercial substance of transactions.

Let's say, for example, that a statement of financial position shows that the net current assets of a company amounted to 1 million. That might look good, however what it might mean is that current assets are 20 million and current liabilities are 19 million. So the current ratio is quite close to one. In that case the company's health perhaps doesn't look quite so good. Then if you began to inquire into how the current assets were made up and discover that the 20 million of current assets was substantially all inventory, then the original net current asset figure of 1 million, which didn't look too bad, begins to look rather worrying because it could take a very long time for the inventory to be converted into cash.

If nearly all current assets are inventory and nearly all current liabilities have to be paid within a few weeks then the company could be in serious difficulties. In that case, simply showing net current assets of one billion would be unfair; it would certainly be misleading.

5. Materiality

Again, we emphasise the point that an audit gives only a reasonable assurance that the financial statements are free from material misstatement.

- A matter is material if it omission or misstatement would reasonably influence the economic decisions by a user of the audit report
- It is affected by the size and nature of the misstatement

The auditor's judgment flows all the way through the audit process, from planning and deciding the amount of work that should be done, to deciding what action should be taken should errors be found in the accounts.

We are looking for material misstatements, and a material misstatement is defined through its effect on decisions made by an user of the audit report. For example, if a misstatement would cause an investor to keep those shares rather than selling those shares, then has been a real effect on that investor and the misstatement would be material.

If misstatements are so small that they don't really spark any reaction in the members, then they are rather superficial. That's not to say that auditors don't want to get things right, but errors only really matter when they trigger incorrect action.

Materiality has to be decided for the financial statements as a whole and it is the audit partner's judgements about whether or not a statement is material.

6. Guidance on materiality

It's all very well saying that a matter is material if it would reasonably influence decisions upon a user of the audit report, but that gives very little guidance to the audit team (or to you when you are doing a question).

Therefore, some rules of thumb have been developed. These are only guidelines, but if something is wrong to the extent of:

- 0.5% to 1% of revenue,
- 1% to 2% of total assets or
- 5% to 10% of profit

then you should assume that the matter is material. These percentages should take into account the auditor's knowledge of which items users will focus on, the nature of the entity (life cycle/environment), its ownership, structure and financing and the volatility of the benchmark.

Additionally, a lesser amount should be set for materiality when designing and carrying out audit procedures to reduce the risk that misstatements in aggregate exceed financial statement materiality. This is known as **performance materiality**: the materiality that is important in the performance of the audit work.

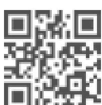
Errors which are less than the suggested guidelines could still be regarded as being material. An error which turns a small loss into a small profit could cause unfounded optimism in some situations, perhaps a feeling that the company has turned a corner. So, although in absolute terms, the size of an error is relatively small, the way in which the accounts are then interpreted could lead to unreasonable decisions being made.

Therefore, you can talk about both quantitative and qualitative materiality.

Finally, there are some amounts in the financial statements where no errors are tolerable. For example, there is often a statutory duty to disclose directors' remuneration and that has to be stated with absolute accuracy.

All misstatements identified should be communicated to management who should be asked to correct them or to explain why not. The auditors must assess the materiality of uncorrected statements and obtain written representations from management that they believe uncorrected misstatements to be not material.

If management refuse to correct an error that the auditor thinks is material then the auditor will issue a modified (critical) audit report.



7. Other implications of the audit report

An audit report will explicitly state whether in the auditor's opinion the accounts show a true and fair view.

In addition, there are certain other implications of the audit report which might not be explicitly stated and those implications are:

- Proper records kept.
- Proper returns from branches not visited.
- Accounts agree with the records and returns.
- All necessary explanations received.
- Details of directors' emoluments properly disclosed.
- Details of directors' loans and other transactions correct.
- Information in directors' report consistent with the financial statements.

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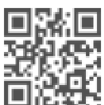

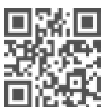

Chapter 6

TYPES OF AUDIT REPORT: MODIFIED/ UNMODIFIED

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1. Unmodified

Now we are going to look at the types of audit report that exist.

First and simplest is the unmodified audit report. This is the audit report that you have seen with Tesco. Amongst the 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. Once this starting point is departed from, the audit report becomes modified and there are two types of modified audit report.

- Unmodified, or
- Modified

Modified

Matters that do not affect the auditor's opinion	Matters that do affect the auditor's opinion
Emphasis of matter and other matters	• FS do contain a material misstatement; or • Unable to obtain sufficient appropriate audit evidence to conclude FS free from material misstatement

Qualified = 'except for'

Disclaimer = unable to form an opinion

Adverse = the FS do NOT show a true and fair view

As set out in the diagram above, the audit report can then be modified in several ways:

- Emphasis of matter. In respect of matters that do not affect the auditor's opinion. In other words, the auditor will still state that the financial statements show a true and fair view. However, the auditor wants to emphasis some matter. In other words, to make sure that some matter **already properly disclosed in the financial statements** is brought to the members' attention. The auditor is frightened that something which has been properly disclosed in the notes may be overlooked by the users of the financial statements and therefore that they get a misleading impression. So, the auditor is simply wishing to emphasise those matters. It's like waving a red flag. This is **not** a modification of the audit opinion.
- Other matters. Refers to a matter not in the financial statements, but which appears to be wrong. Typically this is used to point out that a statement by the directors in their report is inconsistent with the financial statements. The auditors cannot issue a qualified opinion because the director's report is not part off the financial statements. An 'other matter' paragraph not a modification of the audit opinion.
- Other types of modification are for matters which do affect the auditor's opinion and where the audit opinion is modified. There is something wrong in the financial statements, they contain a misstatement, or there is something about which the auditor has been unable to obtain sufficient appropriate audit evidence. Here the financial statements will either not show a true and fair view, or the auditor will be unwilling to express an opinion, or the auditor may include a phrase pointing out there are certain aspects in the accounts about which there is uncertainty or disagreement.

2. Emphasis of matter and other matters

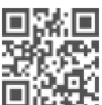
An emphasis of matter modification is where there is a paragraph in the auditor's report which draws attention to some matter already properly disclosed within the financial statements. Such a paragraph is not a qualification: it is simply drawing attention to an important note in the financial statements that shareholders ought to be aware of to properly appreciate the financial statements.

Here is an example:

> "Without qualifying our opinion above, we draw attention to Note 10 to the financial statements. Five days before the directors formally approved the financial statements, the company received notification that they are to be named as defendants in a proposed legal action ….
>
> At this early stage it is not possible to estimate the ultimate outcome of... this matter, and no provision has been included within the financial statements."

Note that the financial statements do contain a note explaining this legal action. The financial statements are therefore as comprehensive and as open as they can be. But obviously if the legal action could end up on a large liability, to properly understand the company's future, you need to be aware that this action is pending.

Therefore the auditors use the audit report to emphasise this matter (and remember many people don't get far past the audit report and very few pore over the notes) and to draw users' attention to it.



As said above, an other matter refers to something which is NOT in the financial statements, nor should be. The commonest example is when something in the directors' report contradicts what is in the financial statements and the auditor should point out the discrepancy in case users are misled by the directors' claims. Therefore an other matters paragraph is added to explain the contradiction.

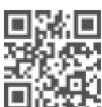
Both emphasis of matter and other matter paragraphs come immediately after the opinion paragraph. It is emphasises again that these do not mean that the financial statements are 'qualified', wrong or in any way criticised.

3. Going concern

One of the commonest reasons for an emphasis of matter paragraph in an audit report is to do with going concern. Generally if the directors or the auditors think the company might not survive the 12 months from date of the statement of financial position, there is a going concern problem. If there is a going concern problem all sorts of issue are going to arise over valuation of assets and the payment of a certain statutory liabilities to employees.

Signs that the company may have going concern difficulties include the following:

- Negative operating cash flows.
- An inability to pay suppliers when due (and auditors are usually rather sensitive if they see that the payment of creditors has slowed down, so that the company is borrowing more from its suppliers).
- Operating losses. These do not mean that the company is going to fail immediately; going concern tends to be rather more concerned with cash. An operating loss can be sustained for a number of years provided that cash doesn't run out. In the longer term, losses usually result in cash flow problems.
- If the borrowing facilities are coming to an end and the new ones haven't been agreed, what's the company going to do to repay the loan, when no cash is available?
- The loss of key staff or key customers can mean the company is unable to trade or unable to sell its products.
- Technology changes can render the company's purpose and main product redundant. Legislative changes may mean that the company's operations become illegal or the company has to go through some sort of regulatory requirements before it can continue trading and that this is going to be difficult for it.
- Non-compliance with regulations may mean a business loses its right or license to trade and in such a case the company may simply have to be wound up. Non-compliance can also result in crippling penalties and harmful damage to the organisation's reputation.



4. Effect of going concern problems on the audit report

So what are the effects of going concern issues on the audit report? If the worries are fully disclosed in a note to the financial statements, then it will be appropriate for an emphasis of matter paragraph to appear in the audit report to refer uses to the note. The financial statements are not qualified, assuming that the auditor feels that drawing up those accounts on a going concern basis is fair. The accounts are open and upfront about admitting with a going concern problem, and the emphasis of matter is used to make sure that uses of the accounts do not overlook this important piece of information.

If the going concern worries are not disclosed then the financial statements cannot be true and fair and they are effectively concealing something which is important for the proper understanding of them. In such a case modified opinion will be appropriate.

A modified opinion would also be appropriate if the auditor felt that it was wrong to draw up the financial statements on a going concern basis. That would happen if the company was in such a precarious position that it had no realistic chance of survival.

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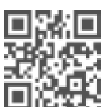


5. Modified audit opinions

With respect to modified opinions there are two potential reasons for modification:

- FS contain a material misstatement
- The auditor has been unable to obtain sufficient appropriate audit evidence.

There are two degrees of seriousness for each of these problems

First let's look at material misstatement. This is where the auditor disagrees with the figure in the financial statements. It could be the figure itself or the way the figure is presented or the disclosures which must be made to comply with accounting standards. First of all, if the misstatement is not a material the audit opinion would not be modified, so the first hurdle is a that disagreement must be for a material amount. In such a case the auditor would put a paragraph in the report saying **except for** certain items in other respects the financial statements show a true and fair view: the opinion has been qualified.

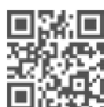
If however the misstatement is so large and so material that it renders the financial statements, useless then the auditor would issue **an adverse** opinion and the auditor would say the financial statements do not show a true and fair view.

The other reason for a modified opinion is where the auditor has been unable to obtain sufficient appropriate audit evidence.

For some reason the auditor has not been able to get all the information required to draw the proper conclusions. If the matter about where there is missing information is relatively small but material then the auditor will qualify the accounts using **an except-for** paragraph. For example, except that we could not verify the adequacy of the bad debt provision, the financial statements showed a true and fair view. If, however, the missing information is so large that the auditors really have no idea whether the financial statements showed a true and fair view, then they will issue **a disclaimer of** opinion stating that they are unable to form any opinion on the accounts.

The choices can be described in a matrix. Think of 'pervasive' as an error or gap in evidence that affects everything:

Nature of circumstance	Material but not pervasive	Pervasive
FS contain a material misstatement	A qualified opinion: Except for ...	Adverse opinion
Unable to obtain sufficient, appropriate evidence	A qualified opinion: Except for ...	Disclaimer of opinion



6. Example of insufficient appropriate audit evidence

Here is an example of a qualification because insufficient appropriate audit evidence that that makes it difficult to say that the financial statements show a true and fair view. Here the problem is material, but limited and the report says the auditors are unable to determine the inventory quantities and then says in their opinion, except for the effects of such adjustments for inventory, if any, the financial statements give a true and fair view. So this is an 'except for': the financial statements are showing a true and fair view except for one particular item which is material enough to cast some doubt on them.

> …Except as discussed in the following paragraph…
>
> We did not observe the counting of inventories at 31/12/200X…unable to determine inventory quantities by other methods…
>
> In our opinion, except for the effects of such adjustments to inventory, if any, had we been able to satisfy ourselves as to physical inventory…. The financial statements give a true and fair view.

7. Example of disclaimer of opinion

Here is a modified opinion caused by lack of sufficient appropriate audit evidence but which is leading to disclaimer of opinion. The cause of the problem is the same ie difficulty in verifying physical inventories, but here because of the significance of the inventories the auditors prefer to say that they cannot express an opinion on the financial statements.

> …Except as discussed in the following paragraph…
>
> We were not able to observe all physical inventories at 31/12/200X…unable to determine inventory quantities by other methods…
>
> Because of the significance of the matters discussed…we do not express an opinion on the financial statements.

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8. Material misstatement/'except for'

> As discussed in paragraph 17, no depreciation has been provided…….not in accordance with International Accounting Standards…
>
> The provision for the year should have been £X….profits would be decreased by £Y.
>
> In our opinion, except for the matter referred to above, the financial statements give a true and fair view…

Here is an example of a qualified opinion caused by the auditors believing that there is a material misstatement about something in the financial statements. Here the problem is that no depreciation has been provided where they think it should have been. Note, where there is a material misstatement auditors will normally be able to quantify its extent and the effect on the profits and is useful to the members for them to do that. Here the amount of depreciation in dispute is material, but not so great that it has made the financial statements not show a true and fair view.

9. Material misstatement/'adverse opinion'

Finally, a modified opinion caused by a material misstatement but it is so large that the auditors feel the financial statements do not give a true and fair view. Here the matter in dispute is about the provision for a bad or irrecoverable debt and the auditors feel the amount of $10 million which is not been provided for is of such significance that the financial statements do not show a true and fair view.

> As discussed in paragraph 15, no provision for irrecoverable debts has been established for a major customer owing $10 million and who has gone into liquidation with little prospect of substantial recovery of amounts owed. This provision would reduce profits and receivables by $10 million.
>
> In our opinion, because of the effects of the matter referred to above, the financial statements do not give a true and fair view.

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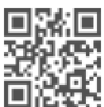

Chapter 7

THE STAGES OF AN AUDIT – APPOINTMENT

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1. Overview

Appointment
↓
Plan the audit
↓
Understand entity
↓
Assess risk of material misstatement
↓
Respond to risk

Expect effective controls → Tests of controls → Satisfactory → Restricted substantive tests → Overall review of F/S

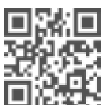
Tests of controls → Unsatisfactory → Report significant deficiencies to those charged with governance to management and all weaknesses to management

Expect ineffective controls → Report significant deficiencies to those charged with governance to management and all weaknesses to management → Full substantive tests → Overall review of F/S

Overall review of F/S → Report to management

Overall review of F/S → Auditor's report

This is an important and useful diagram and it sets out the stages or approach to an audit.



2. The appointment process: before you say 'Yes'…

Auditors must exercise great caution if asked to be the auditors of an organisation.

- Are they professionally qualified to act? Is it legal and ethical for them to do so? For example, they shouldn't accept an appointment if the fees from that appointment are above the suggested 15% limit for public interest companies.
- Do they have adequate resources in terms of staff, time, and expertise? If the potential audit client acts in a specialist area of business and the auditors have no prior experience of that, it would be very unwise for them to accept the appointment.
- Investigate the client, its management, and directors. Many firms of auditors have access to databases which, for example, will allow them to search on directors' names to see if any of the directors have been banned from being directors of companies because of their past behaviour. They may discover that it is too risky to become the auditor of a company if they have no trust in the honesty of the directors. The audit fee is often modest, why risk your reputation by undertaking an audit where the directors are likely to be fraudulent?
- Communicate with present auditors. There is a professional requirement to do this and it is essential to find out why the old auditors are retiring or being removed.

3. Communication with existing auditors

If the auditor is approached by new audit client, if it's a new business and this is the first audit there will be no previous auditors to communicate with and new auditors must make their own decision.

If it is not a new business and there is an existing auditor then the new auditor must ask the client for permission to contact the old auditor. If permission is not given, the appointment should be declined. Why would permission not given? Is a client trying to conceal something? Why else would they not allow a new auditor to communicate with the existing auditor?

Assuming permission is given the new auditor will write to the old auditor for information. The old auditor can't simply send that information to the new auditor because that is confidential, and the old auditor has to ask the client for permission in turn. If that permission is not given the new auditor should decline the appointment because again the client is trying to stop communication between the old and new auditors.

If the old auditor provides information then the new auditor is more fully equipped to make their accept or reject decision. If the existing auditor decides not to provide information the new auditor should try to persuade the old auditor to provide it, but otherwise might have to rely on information as been found in other ways.

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4. The engagement letter

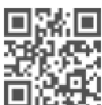
Upon appointment, auditors should send an engagement letter to their new client.

Engagement letters are often regarded as rather dull documents, sent once and then forgotten. However, they are of crucial importance because they set out the contractual relationship between the auditor and the client. If the engagement letter is not sent out it's very difficult for an auditor subsequently to complaint that the client hasn't done what was expected, or it might be difficult for the auditor to defend the firm against a claim that the auditor has not done what was expected. Engagement letters:

- Define the auditor's responsibilities
- Provide written evidence of the auditor's acceptance of the appointment.
- Should be send to the board of directors or audit committee prior to the first audit.
- Identify any reports to be produced in addition to the audit report. For example, for banking or insurance clients who may come under additional scrutiny
- Should be updated for all changes. For example, if the auditor begins to undertake tax work for the client.

5. Typical contents of an engagement letter

- Description of the objective of an audit: to determine whether or not the financial statement show a true and fair view.
- Defining responsibilities: management's are to prepare the financial statements and to set up a system of internal control. It is the auditor's responsibility to audit the financial statements.
- Reference to the applicable reporting framework. For example, a particular company's act or a particular national legislation,
- Emphasis that audits depend on sampling that there are no guarantees. The audit look for only material misstatements. It will examine records on a test bases that can only give a reasonable assurance.
- The auditors will state that they expect unrestricted access to the company's records and they expect full explanations for any queries they might have.
- They will state that the audit report is a matter between them and the addressees of the audit report (the members of company) and that the audit report should not be provided or relied upon by other parties.
- There will be certain matters about planning the audit, such as arranging the interim audit and final audit, attending the stock take, organising a circularisation of receivables, and liaison with the internal audit department.
- Almost certainly there will be something about fees, and remember fees should never be absolute. They should be estimate but subject to the proviso that if more work needs to be done, it will be done and additional fees will be required.
- Description of the expected relationship between the external auditor and internal audit; how the work of internal audit might be reviewed and then relied on by the external auditors.



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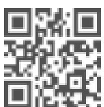

Chapter 8

THE STAGES OF AN AUDIT – AFTER APPOINTMENT

1. Overview

Appointment
↓
Plan the audit
↓
Understand entity
↓
Assess risk of material misstatement
↓
Respond to risk

Expect effective controls
↓
Tests of controls — Unsatisfactory → Report significant deficiencies to those charged with governance to management and all weaknesses to management
↓
Satisfactory
↓
Restricted substantive tests
↓
Overall review of F/S

Expect ineffective controls
↓
Report significant deficiencies to those charged with governance to management and all weaknesses to management
↓
Full substantive tests
↓
Overall review of F/S

Overall review of F/S → Report to management
↓
Auditor's report

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All audits start by:

- Planning
- Understanding.

After these stages auditor can assess the risk of material misstatement and respond to that risk. We will see later how the risk of material misstatement can be broken down into several causes, but if you are dealing with a relatively new company with inexperienced staff, and which has high value, portable inventory and many cash transactions, you will probably see that the risk of material misstatement is relatively high. If the auditors concluded that is the case then they have to arrange for their audit work to reduce the risk of material misstatement finding its way into the financial statements.

The audit approach, above, then divides:

- Left hand branch. Here, the auditor has reason to expect that there are effective internal controls operating. If there are effective internal controls then the auditor puts a lot of reliance on, for example, employees of the company checking on one another, reliance on reconciliations and comparisons being performed, and reliance on authorisations. If there is good internal control the chances of errors getting through into the financial statements are relatively remote. Therefore rather than test the high volume of transactions auditors tend to test the effectiveness of controls.
- Right hand branch. If the auditors do not expect there to be effective internal controls then the only way the auditors will be able to get assurance that the financial statements are free of material misstatement will be to carry out what are known as substantive tests which means very high volume testing.

Of course one can start off going down the left hand part of this diagram expecting there to be internal controls and then once the testing begins the auditors discover those internal controls are not operating satisfactory. In which case the auditors will have to change their approach and go across to the right hand part of the diagram and carry out full substantial tests.

Management will be written to with an outline of why the controls are ineffective or are operating unsatisfactorily. Hopefully managerial will take action so that in the following year the problems are less.

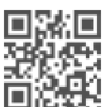
After all the detailed testing, either of the transactions themselves or of the controls, there is an overall review of the financial statements. Think of this as sitting back and looking at a financial statements as a whole: taken as a whole, do the auditors think they show a true and fair view? Finally the auditor's report can be issued.

2. Audit planning

Audit planning is very important and the auditors state in the audit report that the they state they **planned** and performed their audit.

2.1 The reasons why planning is important:

- If you don't plan it you won't carry out the audit effectively. You would not know something as obvious as when the year-end is, or how many branches or factories a company has, or how many staff members you may need to conduct the audit, or whether the company has a lot of valuable inventory.



- You have to think both of a general strategy in a detailed approach. For example, in some very large companies auditors do not visit all the branches every year. They may visit only a quarter of the branches one year, another quarter the next year and so on. They have to decide whether or not to attend a stock take. They may have to decide whether or not opinions from other experts are required. For example, on the adequacy of the company's pension scheme.

2.2 The planning objectives are:

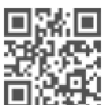
- To give appropriate attention to important areas. Is there a high inventory? Is there a high volume of cash transactions? Are debtors particularly significant?
- To identify potential problems. For example, if the company has recently changed its computerised accounting system there may well have been problems at the switch-over time, and staff may still be inexperienced.
- To carry out the work expeditiously. That really means reasonably quickly and efficiently.
- To ensure that the right numbers of staff are in the audit team with the right skills. They have to be timetabled so that the work for this client and other clients can be accommodated.
- To coordinate, if necessary, with other parties. For example, the internal audit department of the company.
- To facilitate review. The work performed in an audit is subjected to many reviews. The audit staff member in-charge of the audit first of all reviews the working papers, then the audit manager will review them, and finally the partner in-charge will review them. All of this has to be timetabled and time must also be left to clear the review points, for example, if additional work is required.

3. Understanding the entity

Pretty much inseparable from the planning process is the process of gaining an understanding of the entity.

This includes:

- Nature of the entity. We have to understand the nature of the entity. For example, we simple have to understand what it does, is it in a financial sector, the retail sector, the manufacturing sector? This may seen trivial and it may help you to think of a new audit client. You can often tell very little from the name of the client. You have to go and find out about the entity itself.
- Particular regulations. Banks, insurance companies, and many other operations in the financial sector are subject to regulation and sometimes the auditor has to ensure that these regulations have been adhered to.
- Accounting policies. We need to understand what the entity's accounting policies are; different entities have different ways of valuing inventories perhaps. If you are a building company you will have specific accounting policies with regard to taking profits from long-term contracts.
- Objectives and strategies. The auditors must gain an understanding of the entity's, objectives, and strategies. The entity's management defines objectives ,and strategies are devised to try and achieve those objectives.
- Nature of business risks. Business risks can arise from circumstances which mean that the objectives and strategies may not be achieved. Business risk is broader than the risk



of material misstatement of the financial statements. Most business risks will eventually have financial consequences and therefore an effect on the financial statements. It is important for the auditors, therefore to understand what the businesses objectives and strategies are.

- Internal controls. The auditor has to gain an understanding of the entity's internal controls. Whether they exist and to what extent they are expected to operate. We will see soon that this is a profound effect on how the audit is likely to be conducted.
- The control environment. This refers to the context in which the internal controls operate. The management of some companies have a very high regard for careful control, for careful recording, and for attention to detail. Other management teams may have less regard for this. For example, it may be far more interesting in making a sale, which is of course important, but are not so interested in recording that sale correctly. They will see some aspects of internal control as being nuisance.
- How does management identify business risks? It is important for management to identify business risks. Management has a real expertise of the business sector and if they can't identify business risks it can be relatively difficult for the auditor to ensure that all business risks have been covered.
- Financial performance. Finally, the auditor should obtain an understanding of the measurement and review of the entity's financial performance. Performance measures and the review indicate to the auditor aspects of the entity's performance that management and others considered be important. Obtaining an understanding of the entity's performance measures assists the auditor in considering whether such pressures result in management actions that may have increased the risks of material misstatements.

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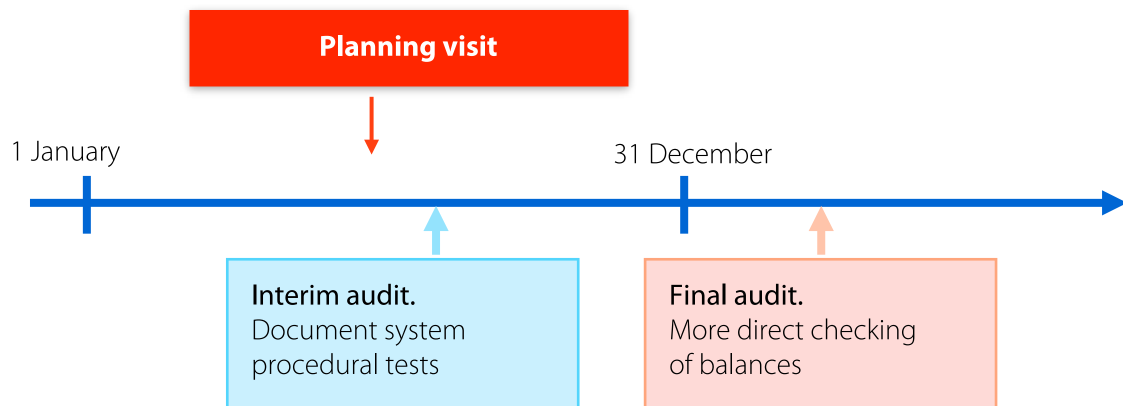
4. Audit timing

Now we are going to look in more detail that how an audit exactly performed. Here is a typical timetable.



The first thing that has to happen is a planning visit, or if not a visit at least a telephone call. There would certainly be a visit before the first audit of a new client commenced.

Contact is necessary because, at the very least, you have to agree with the client when the audit staff will visit. Also at this planning stage, enquiry should be made about what changes may have taken place at the client's since the previous audit. For example, they may have a new accounting system, or there maybe changes in staff, or they might have expanded so instead of having one shop they maybe have two, and that will have implications for inventory verifications.

The next stage is what's known as the interim audit. The interim audit would typically happen perhaps in July or August of the year to 31 Dedember. What the auditors can do then is to understand the system of internal control and carry out what are known as procedural tests (tests of controls), to ensure that the system of internal control as they understand it and as specified by the client is actually working in practice.

After the year-end, the auditors will return and carry out a final audit. At this point the client should have prepared the financial statements and the auditor will be concentrating on gathering evidence to support the assertions of the financial statements.

Remember this is only a typical timetable, sometimes it has to change. For example, if it is a very tight reporting deadline early in January, a lot of the final audit might actually be done on the November financial statements and then, in early January, a review is performed to make sure that the full year's results appeared to be consistent with what was audited in more detail for 11 months. Occasionally there might be more than one interim audit particularly if the organisation is rather dispersed and the auditors have to visit a number of different locations.

Usually after the interim audit a management letter is send by the auditor. This will report any weakness or deficiencies found when they carried out their interim audit and look at the internal control system.

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Chapter 9

RISK

1. The sources of risk

International standard on auditing 315, states that the auditor should:

"…obtain an understanding of the entity and its environment sufficient to identify and assess the risk of a material misstatement in the financial statements".

The total risk of material misstatement can be split into two:

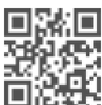
- Business risks
- Audit risks.

Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entities ability to achieve its objectives and execute its strategies. The business risks can itself be split into:

- Financial risk
- Operational risk, and
- Compliance risk.

Financial risks could arise because of high borrowings and a rise in interest rates. This will put to business under severe pressure and could increase the risk of material misstatement, perhaps with regards to going concern problems. Operational risks arise from operational errors. For example, if the products are made incorrectly then there might be warranty claims and a loss of reputation. Compliance risks arise from a failure to comply with regulations. This can mean that the business has large penalties or fines to pay or it may result in the business been prevented from continuing to trade.

The auditor does not have a responsibility to identify or assess all business risks, but an understanding of business risks increases a likelihood of identifying risks of material misstatement. Other than potential implications for going concern assumptions, business risk is not something to worry about at the F8 stage.



2. Audit risk

The second component of total risk is the audit risk. This is the risk that the auditor gives an inappropriate opinion on the financial statements. For example, the audit report states the financial statements show a true and fair view when, in fact, they contain a material misstatement.

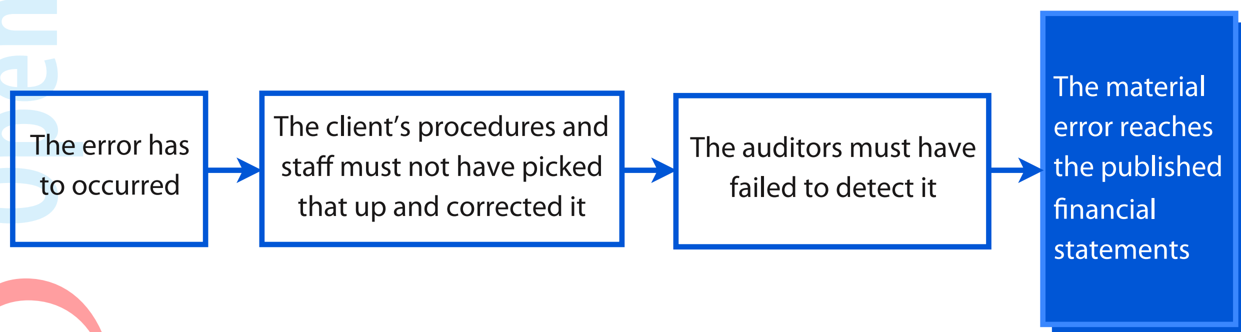
Audit risk comprises two elements:

- The risk that the draft financial statements actually contain a material misstatement.
- The risk that the auditors fail to detect it, so that the financial statements are published with the misstatement still present. This is **detection risk**.

In turn, we can ask why the financial statements might contain a material misstatement. That depends on two other risks:

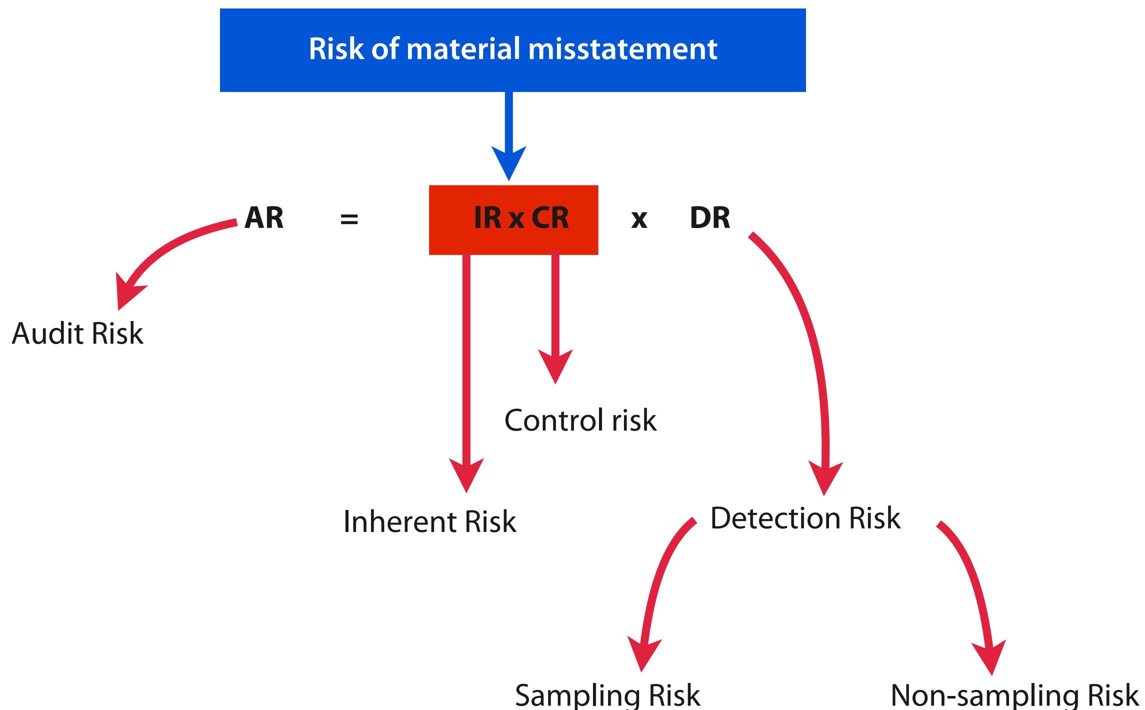
- The risk that the error occurs in the first place. This is **inherent risk.**
- The risk that the client's own procedures don't pick up and correct that error. This is **control risk**.

Therefore, for an inappropriate opinion to have been expressed



3. The audit risk equation

The risks found of an audit can be expressed as an equation. This equation is saying that the audit risk depends on inherent risks, the control risks, and the detection risk.

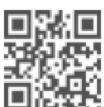


Don't look upon this too mathematically. What it is saying is that auditors will want the audit risk to be low: they don't want to make an error in their audit opinion. If they want the audit risk to be low then the terms on the right hand side of the equation, or at least some of them, have to be low.

If both inherent risk and control risks are high,then the only way you will get the audit risk low is to be very sure that your detection risk is low. This means you would have to do an enormous amount of audit work.

If, however, the inherent risk and control risks are low themselves, in other words that there is only a small chance the error occurs in the first place and the client systems and staff are very good, then you can achieve a relatively low audit risk even with a relatively high detection risk. In other words the auditor doesn't have to do so much work.

In the short-term the auditor cannot control the inherent risk and the control risks; those are givens in an audit. The auditor must respond by varying the amount of work which is actually performed so that the detection risk is appropriate.



The detection risk itself depends on two components:

- Sampling risk
- Non-sampling risk.

Sampling risk	arises because, in most audits, auditors only look at a very small proportion of transactions and documents. There is always a risk that they happen to look at all the documents and transactions which are correct and don't find any which are incorrect. That can just be bad luck in sampling and could lead the auditor to do too little work. Sampling risk can be reduced by examining larger samples.
Non-sampling	risk arises from reasons other than sampling. For example, if the staff and the audit were inappropriately qualified then there is a high risk they wouldn't properly understand what was going on or detect the regularities in the financial statements. Non-sampling risk can be reduced by better planning of the audit, and ensuring that audit staff are better trained, have appropriate skills and are that their work is well-supervised and reviewed.

4. Examples of the three types of risk

Let's look at the three types of risks in a little bit more detail.

Inherent risk	is the risk that there is a misstatement that could be material, if there were no related internal controls which could identify and trap that misstatement. Inherent risks can be increased by complex transactions which are difficult to understand, inexperience staff, a cash-based business (because cash is usually more difficult to record that bank transfers), a pressure to perform (which may mean that some staff members who have optimistic view of sales and costs), and short reporting deadlines.
Control risk	is a risk that the material misstatement, having occurred, will not be prevented, detected, or corrected by the internal control system. The three elements which affect control risk are the control environment (that is really the status that the internal control system has in the organisation), the design of the internal control system itself, and finally how well and consistently the internal control system operates.
Detection risk	is the failure of the auditor to detect the material misstatement in the financial statements. This will be increased if the auditor was relatively inexperienced, if it was a new client, if there was a lot of time and fee pressure, if planning was poor so the entity was poorly understood, and if the auditor was straying into an industry where they had little previous experience or expertise.

5. Where audit risk can be found

Audit risk has to be reduced to an acceptable amount at both the

- Financial statement level
- Assertion levels.

Dealing first with the assertion level, essentially any single figure which appears in the financial statements is making assertions.For example, it is saying something about its size, its accuracy, its valuation, completeness and occurrence. There are some figures, for example, director's emoluments which in the overall scheme of things may not be terribly material, but which by law are required to be disclosed accurately and a relatively small misstatement would mean that the financial statements are not showing a true and fair view.

Dealing with the financial statement level, all the figures appearing in the financial statements could be true, but overall the financial statements could still not show a true and fair view. For example, liquidity issues could be concealed or in some way the overall effect of the accounts is to be misleading.

To get a higher assurance at the assertion levels audit procedures must be designed and performed in line with the assessed risks of material misstatement. For example, if you are worried about receivables valuation you have to do a lot more work verifying the receivables are recoverable. Perhaps you could try to wait for several months after year end to see which customers actually pay.

At a financial statement level just to doing more work as such is probably insufficient. You need more experienced and better staff. Misstatements at the financial statement level are potentially more subtle and require a higher level of skill to detect.

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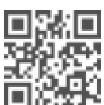

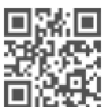

Chapter 10

THE AUDIT PROCESS AND AUDIT EVIDENCE

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1. Gathering audit evidence

The procedures for obtaining audit evidence are:

- **A**nalytical procedures (to be explained shortly)
- **E**nquiry and confirmation. For example, asking client staff what checks they do when goods are received, or asking third parties (such as a bank) to confirm a balance.
- **I**nspection. For example, the physical condition of inventories or non-current assets
- **O**bservation. For example, watch what staff do in the warehouse as deliveries are received.
- Recalc**U**lation and re-performance. For example, recalculate the wage calculations to check they have been correctly carried out.

Note that these five procedures can be remembered by the vowels, A, E, I, O and U.

2. Analytical procedures

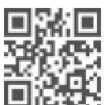
Analytical procedures consist of looking at amounts in the financial statements, calculating ratios and then comparing the amounts and ratios to:

- Last year's results
- Budgets
- Industry standards

Also the trends and changes in the company's financial statements over time will be examined.

Analytical procedures are a powerful source of evidence and is used in three places:

- **Planning.** If last year's inventory amounted to 34 days' of supply and this year amounted to 97, then you have identified an area that will need attention during the audit. Why has inventory increased so much? Was this planned? Is there an error? Will it sell? What value should it have?
- **Substantive tests.** If last years collection period was 32 days and this years is 31.5, then this gives some confidence that the figures this year are correct. Similarly if sales are very close to budget, this implied some support for the figures being correct



- **Final review.** Here, just before the audit report is signed, the partner stands back and looks at the financial statements as a whole. Do the figure seem to make sense?

Analytical procedures allow the auditor to assess whether or not the financial statements are consistent with their understanding of the entity. If they believed that the entity was substantially dealing in cash transactions yet it had a large receivables balance they might wonder why.

If the receivables balance changes dramatically from one year to the next, but sales hadn't really changed, the auditors might begin to question the recoverability of those balances. If the days of inventory held by the organisation rapidly increased they might begin to worry about the valuation of inventory and whether or not it could all be sold at above cost.

Auditors can look at how expenses move. If a business keeps about the same level of activity you wouldn't expect the expenses such as telephone, post, heating, and lighting to increase much more than the rate of inflation.

If, however, the telephone costs had increased markedly the auditors need to find out why. It might be because the company had gained an important overseas customer and there are now many high cost overseas telephone calls. If the increase can't be explained in a reasonable manner then an error may have been made and wrong amounts may have been posted to the telephone account.

3. Sufficient, appropriate audit evidence

So now we know the various sources of audit evidence (analytical procedures, enquiry and confirmation, inspection, observation, and recalculation and re-performance), but how much audit evidence is needed?.

ISA 500 states that there should be:

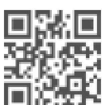
- Sufficient
- Appropriate

audit evidence, to be able to draw reasonable conclusions on which to base an audit opinion.

Sufficient is to do with the quantity of audit evidence.

Appropriate is to do with how relevant and reliable it is. With respect to the relevance and reliability of audit evidence we can say that:

- External evidence is better than the entities records. For example, looking at a bank statement or a bank certificate is very good evidence about how much cash was in the bank account at a particular date.
- Evidence obtained directly by the auditor is better than evidence passed on by the clients. The problem is that if the evidence is passed on by the client you don't know if it's complete. The client could be suppressing information they don't want you to see.
- Audit evidence is better if there is a good internal control system. A good internal control system should mean that the checking performed by the client reduces a likelihood of errors been made.



- Written evidence is much better than oral. Someone once said oral evidence isn't worth the paper it is written on. If evidence is oral what evidence can you, the auditor, show to prove you actually received it.
- Originals are better than photocopies. Nowadays with scanners and graphics programs it's very easy to alter documents and these alterations are very difficult to spot. Therefore original contracts and documents of title should be sighted. The auditors may take a photocopy to keep on their audit file, but they should be taken from the original documents.

4. The financial statement assertions

Earlier, we talked about reducing audit risks to an acceptable level of both the financial statement level and the assertion level. Now, we return to look in more detail at what is meant by the financial statement assertions.

Essentially a financial statement assertion means whenever a figure appears in the financial statements it is making certain claims, proclamations or assertions. It is for example saying, "Here I am, I am the receivables figure, and because I am printed in the balance sheet I am saying certain things".

Amounts in the financial statements can say:

- **A**ccurate.
- **C**omplete. For example, that all receivables are included
- **C**ut-off is correct. In other words, a receivable is present if a sale was made during the financial year and not yet paid for.
- **A**llocated. More to do with expense items that might need to be allocated properly into inventory values.
- **C**lassification and understandability, the transactions giving rise to the receivable have been recorded in the proper accounts and are properly presented in the financial statements. For example that current liabilities and long-term liabilities are properly shown.
- **O**ccurrence that the sale giving rise to the receivable occurred in the period.
- **V**aluation. That the receivable is properly valued, taking into account the risk of non-recoverability.
- **E**xistence. That the receivable balance actually exists.
- **R**ights and obligations. That the client owns the receivable, that it hasn't, for example, been assigned to a third party.

Note that these assertions form the phrase 'ACCA COVER'

We return to assertions in a later chapter.

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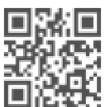

Chapter 11

SAMPLING

1. Sampling

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Unless an audit client is very small almost all auditing relies on sampling rather than looking at all transactions and documents. This is because there simply isn't time to look at all documents and it wouldn't be economically viable to do so. If, however, valid statistical conclusions are to be drawn about a population by relying on a sample, then the sample must be free of bias. In other words every document or transaction of the population has an equal chance of being included in the sample. This is known as statistical sampling.

Sampling methods include:

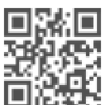
- **Random sampling.** The best way to remove bias and to obtain statistical sampling is to adopt what's called random selection. Let's say we wanted to look at purchase invoices throughout the year. There might be 20,000 purchase invoices and we want to inspect 20 of them. What you would do is to number the 20,000 invoices consecutively and then use a random number generator to produce 20 numbers and you would then go and look at the corresponding invoices. The difficulty with this approach is that very often the population is not pre-numbered and to set out initially numbering all 20,000 invoices is very time-consuming.

- **Systematic sampling.** As an approximation to pure random selection, systematic selection or systematic sampling might be used. Again, if with 20,000 invoices and wanted to look at about 20 invoices out of that you could do that by looking at about every 1,000th invoice. So what you would do is that near the beginning of the population you would choose an invoice at random and then count through selecting every 1,000th one. Provided there isn't some weird correspondence of every 1,000 invoice being from exactly the same supplier, you are going to get pretty close to random selection.

- **Haphazard sampling** is frequently used because it is rather convenient. It's essentially the auditor opening a file at random and picking the invoice at which the file is opened. There can be obvious problems with this. For example, the file might always open at a slightly thicker invoice or a slightly larger invoice and that invoice could be from the same small group of suppliers. There might be a relatively small chance of the physically small invoice being chosen. It gets even worse because it's open to some abuse. Inevitably if the auditors are closely involved with choosing the invoice and they look at the invoice before making a final choice, and in looking at the invoice may be tempted to choose only those invoices which appear to be correct or which are simple to deal with. This is introducing very obvious bias and reducing the chances of finding transactions or documents which need to be investigated further.

- **Sequence or block selection** will mean choosing 20 invoices all in a sequence. They may all be from different suppliers, but they are probably all from the same week or even the same day and to be no assurance that the controls which operated during that restricted period have operated during the whole financial year.

- **Stratification.** If we know that there are 20,000 invoices, 10 of those are above 100,000 then it might make sense to make sure we choose at least all of those 10 invoices plus



another 10 chosen randomly. Stratification means dividing your population into different layers, usually based on size, and making sure your sample is deliberately biased so that the larger and more significant transactions have a greater chance of being covered. This does rank as statistical sampling provided samples are drawn from every layer.

- **Monetary unit sampling**. This is rather more complex…

2. Monetary unit sampling

Monetary unit sampling can be regarded as a form of stratified sampling. Here is an example to indicate

Invoice value ($)	Cumulative invoice value		
80	80		
70	150		5,000/4 = 1,250
400	550		
90	640	←	Choose first at random – say, 605
1,600	2,240	←	Then: 1,855 (= 605 + 1,250)
20	2,260		
700	2,960		
50	3,100		
1,010	4,020	←	Then: 3,105 (= 1,855 + 1,250)
80	4,100		
30	4,130		
600	4,730	←	Then: 4,355 (= 3,105 + 1,250)
380	5,110		

What we have is a list of say customer invoices 80, 70, 400, 90, all the way down to 380.

The right hand column of the table is a cumulative total, so the first one is 80, then 80 plus 70 is 150, 150 plus 400 is 550, 550 plus 90 is 640, so our total receivables is 5110.

We want to look at four invoices out of these receivables. So you take the total, and if we round it to 5000 and divide by 4 that give 1250. Choose the first interval at random, here is say 605, and then go up 1250 at a time. So after 605 plus 1250 will be 1,855, plus 1250 will be 3,105, plus 1250 will be 4,355 and you see where a cumulative total of those values lie. So 1,855 falls within the cumulative total of 2240 and that is opposite the account of value 1600. The next one 3,105 falls within the cumulative 4020 and that points to account with value 1010.

What this process does is to give you a better chance at picking the higher value balance. For example the balance of $1600 spans a range of $1600 and there is a much higher chance of that balance being chosen. The next balance of $20 only spans a value of $20, and has little chance of being picked. So monetary unit sampling skews the selection towards picking larger values and therefore more significant items for you to check.

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Chapter 12

INTERNAL CONTROL

1. Recording the client's accounting system

One of the first things that the auditor has to do in a new audit is to record the client's accounting system.

This will allow the auditor to evaluate the internal control system and will allow the audit to be conducted more efficiently.

Where it's a repeat audit, the auditor must ensure that their records of the client system are updated and remain accurate.

There are three ways of recording the system:

- Narrative notes
- Flowcharts
- Questionnaires.

With narrative notes, the auditor simply writes a few paragraphs explaining, for example, exactly what happens to a supplier's invoice when it's received: how it may be matched with goods received notes, how the calculations are checked, how it is filed, how it is posted to the payables ledger, and how the amount is eventually paid.

Narrative notes can be relatively quick to prepare. Typically you observe what happens, you ask the client what happens, and you may also look at the accounting procedures which they have established more formally.

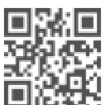
The main problem that arises with narrative notes is the lack of structure or discipline. It's very easy for documents to appear in narratives and then not be mentioned again and the audit team is then wondering what happens to these documents, and where they can be found.

In flowcharts, diagrams are used to show the documents, the files, the calculations, and the checks that are performed. Flowcharts can be somewhat slower to produce and are certainly more difficult to amend (though nowadays, flowcharting has been helped greatly by computer graphics systems). Flowcharting imposes a great discipline on how systems are recorded as it has very specific rules about how flowcharts are to be drawn. In addition, there is usually a special symbol which is reserved to show where checks are performed. Auditors are particularly interested where checks are performed because this is helping the client to reduce their control risk.

Questionnaires can be used to record the accounting system, but they go slightly further than mere recording: they actually begin to evaluate the accounting system.

There are two main patterns of questionnaire:

- Internal Control Questionnaire (ICQ).
- Internal Control Evaluation Questionnaire (ICEQ)



In ICQs, when you get the answer "yes" to a question, it is a good sign. An example of a question could be, "Are suppliers' invoices cancelled when they are paid?" The answer "Yes" is good, the answer "No" is bad because it means that those invoices could be inadvertently paid a second time.

The other type of questionnaire is an internal control evaluation questionnaire (ICEQ). Here the answer "No"is good and a typical question might be "Can suppliers' invoices be paid twice?"

One of the ways that they might not be paid twice is that they are cancelled after they are paid, but there may be other ways in which this is done. For example, they could simply be moved from one file to another, from an unpaid invoice file to a paid invoice file. That might not be a perfect control but it is a control.

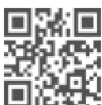
Internal control evaluation questionnaires are rather more open-ended and flexible. What they are addressing are internal control objectives: the mistakes and errors that we want to stop. Internal control questionnaires seek out specific internal controls which can help internal control objectives to be achieved. ICEQs will almost certainly require greater skill from the auditor. Instead of simply having to find out if invoices cancelled, the auditor has to assess whether or not invoices are liable to be paid twice and that's a rather more highly skilled operation.

2. Components of internal control systems

These are the five components of internal control systems:

- The control environment. We have mentioned this before. We said that it was essentially the regard with which the internal control system is held. It's to do with the ethics and the culture of the organisation and whether internal control and careful recording are held in high esteem by the management of the company and indeed everyone working for it. Under this heading we can also include how people are recruited, trained, the structure of the organisation, responsibility, and accountability.
- The risk assessment process. This looks at how the entity itself assesses material risks which might arise. It has to estimate the significance of those risks and the likelihood that are occurring. Having identified a risk, having assessed the likelihood of its occurring, the entity then has to decide what to do about it. WHat controls would address the risks identified?
- The information system. An example of how a good information system is useful in control can be seen in how the company produces and uses its management accounts. Comparing actual results to budgets can give management warnings that something had gown wrong or been mis-recorded in the accounting system. The auditors also have to have an understanding of the significant accounting estimates and judgments which may be present in the financial statements.
- Control activities. These are defined as those policies and procedures, in addition to the control environment, which are established to achieve the entity's specific objectives
- Monitoring controls. The operation of controls can be monitored first by supervisors, then by managers, then by the finance director, or perhaps nowadays more likely the audit committee. If the operation of controls is not monitored they are likely to fall into this repair.

The heart of establishing a good internal control system is asking what could possibly go wrong and then asking how that can be prevented.



3. Control Activities

Control activities consist of the following:

- Segregation of duties. This means that no single transaction can be carried out by just one person. If a transaction can be carried out by one person, it's very difficult to control that transaction. The person and his work undergo no checking procedures meaning that errors are likely to go uncorrected; it also opens the door to fraud. So, if one person could order the goods, receive the goods, receive the invoice and pay the invoice, then it will be very easy for those goods to be deflected to that person's home or friends and family. In fact, although we always have to be mindful of fraud, the more important aspect of segregation of duties is the fact that one person is checking the work of another and so errors are likely to be identified and corrected.
- Authorisation. The authorisation or approval and control of documents is very important. Transactions should be approved by the appropriate person. For example the purchase of fixed assets, the granting of credit, the writing off of a bad debt, and the approval of employees' overtime.
- Comparison. Comparing, for example, the results of stock takes to the book records of stocks. Another example would be comparing goods receive notes with the original purchase orders to make sure that what has been received was, in fact, what was ordered. Constant comparison means that errors, if they do occur, are much more likely to be discovered.
- Computer controls. More and more entities rely on computerised accounting systems and computer controls are very important. We will see a whole section on these later but, for example, it will be important to ensure the backups of the data are regularly taken. It's worth pointing out at this stage that once a transaction gets into a computerised system it's liable to be automated from then on and there is less chance for 'common sense' to be applied to that transaction later in its life.
- Arithmetic controls. These are perhaps slightly less important now that more calculations are done by computer systems. But nevertheless it's important to make sure that simple calculations are correct, and in many cases it may still be appropriate to re-perform those calculations at least on a test basis.
- Maintaining trial balances and control accounts. If the trial balance doesn't balance or the control accounts don't reconcile then something is amiss, and the sooner that is found, the better.
- Accounting reconciliations. Reconciliations mean comparing a particular balance in the accounting records with what another source says. For example comparing the cash balance with a bank statement or comparing a payables balance with the supplier statement.
- Physical. There should be physical safeguards established over certain assets particularly inventories and cash. These assets can often be desirable, portable and valuable. If they are not safeguarded, they are liable to go missing. Physical controls would also apply to making sure inventories kept in conditions in which they do not deteriorate, for example the warehouse may need to be adequately heated or ventilated to ensure that the inventory doesn't get damp.

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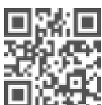

4. The inherent limitations of internal controls

Although auditors place reliance on internal controls, you must understand that there are certain inherent limitations:

- **Cost v benefit.** The cost of establishing a system of internal control may be greater than the benefits. To take a ridiculous example, it's very unlikely that anyone is going to establish a system of internal control over the issue of paperclips or envelopes. The amount of management time taken up with authorising trivial amounts of expenditure simply makes it uneconomic. At some stage however the benefits may outweigh the costs and, for example, when it comes to photocopying many organisations do have some sort of authorisation or at least accounting system to track who uses most of the photocopying resource.
- **Human error.** For example, one person makes out an invoice using the wrong selling price and another one checks it and doesn't see the error. This is always a possibility even in the best regulated circumstances.
- **Collusion.** Where two or more employees cooperate to get around the internal control system. The collusion might be to carry out a fraud or it might be to cover up some error that was made. The more segregated duties are, the more people it would need to collude to carry out an entire transaction.
- **Bypass of controls.** Say someone has forgotten to order a vital piece of equipment and that to speed matters up, instead of getting the proper authorisation for the purchase, they issue the purchase order without that authorisation. They are bypassing the controls: it may be done with the best possible intentions, but if bypass of controls becomes too common essentially the controls are not operating.
- **Non-routine transactions.** These are transactions that are so rare that no system of internal control has been devised. An example can be the disposal of non-current assets. Many of these assets are scrapped when they are disposed of, and to establish a system of internal control might not have been thought worthwhile. However, occasionally an asset with a substantial value might be disposed of, and if there is no system for getting the right price and for ensuring that the proceeds come to the organisation, then there is a possibility that those transactions are not properly recorded.

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5. A reminder of the audit approach

Let's just review again how audits are carried out.

First of all, the system is evaluated. If suitable controls exists then the audit will tend to proceed by testing those controls and audit tests will be carried out to see if the controls are indeed operating effectively.

If however, it is found that there is no set of internal controls or the internal controls are not operating effectively, then substantive procedures have to be carried out. Substantive procedures means looking at a very high proportion of transactions for direct verification rather than relying on the operation of controls.

Both testing internal controls and substantive procedures can provide evidence that the financial statements are free from material misstatements. Other than choosing the most efficient and effective way of gathering evidence, the auditor does not really care how audit evidence is obtained, though it will usually be more efficient and cost effective to rely on the operation of internal controls if that is feasible.

In some audits, particularly those of small business rather than documenting the system of internal control and testing controls it may actually be more efficient to apply substantive procedures to the relatively small number of actual transactions.

6. Testing internal controls

Internal controls can be tested by the following mechanisms:

Enquiry	Ask employees how they carry out certain transactions. Seek management's views by asking them if they feel the system of internal control is operating effectively. Ask whether at some point in the year, such as when people were on holidays or there were staff shortages, the system of internal control was known to have broken down. Ask management how internal control could be improved. You might be able to find some evidence of management views by looking into board minutes or the minutes of departmental meetings.
Inspection	Look at a result of internal control procedures. For example, inspect the file of paid supplier invoices to see if they have indeed been cancelled or initialed to indicate that they had been paid.
Observation	Watch employees as they carry out certain transactions and procedures. Of course, employees would be on their best behaviour if they knew they were being observed.
Recalculation and re-performance	For example, recalculate the invoice, or the wages and salaries. Re-perform what the employees have done to make sure that they have done it correctly.

7. The management letter/report

If the auditors find that the internal control system is inadequate, or is not operating efficiently, then they will send what is known as a management letter or letter of control weakness to the board of the company (or the audit committee).

The almost universal layout for such a letter is three parts;

1. Say what the problem is.
2. Say what the implications or consequences of those problems might be.
3. Recommend how the problem can be fixed.

So the problem might be that supplier invoices are not cancelled when paid; the consequence of that could be that supplier invoices are paid more than once; the way to prevent that is that you mark or stamp invoices 'Paid'.

Auditors will normally also say that they may not have found all control weaknesses and that others may exist and that is duty of the board of directors, now enshrined in the corporate governance codes, to ensure that there is an adequate system of internal control operating within the company.

- Significant deficiencies should be communicated to those charged with governance. Significance deficiencies are defined as:
- When a control is designed, implemented, or operated …is unable to prevent or detect misstatements on a timely basis; or
- Such a control is missing.

- Other deficiencies should be communicated to management.

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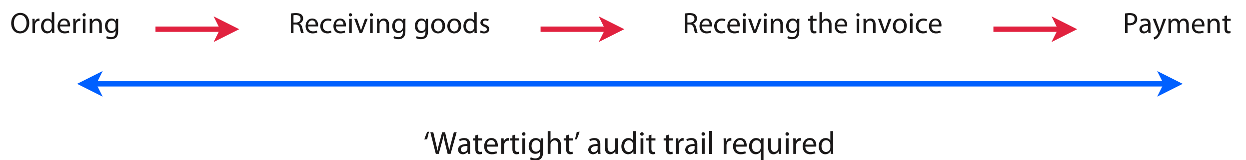
Chapter 13

SOME ACCOUNTING SYSTEMS

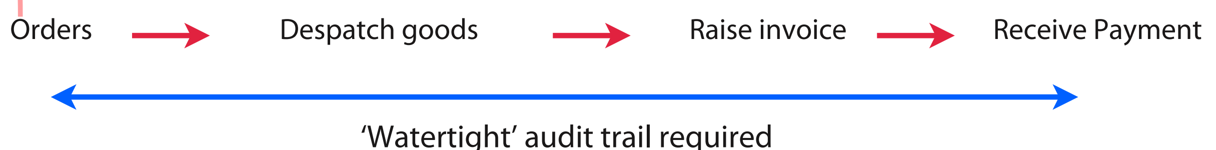
1. The purchases system



A good internal control system for purchases will ensure:

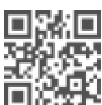
- Goods are ordered only as and when needed
- They are ordered at competitive prices, in the required quantities and are of the required quality
- They are ordered from authorised suppliers
- The goods are received as expected (correct time, type, quantity and condition)
- They are booked into inventory
- Invoices are checked to goods received notes and orders
- Invoices are entered properly into the payables ledger
- Payments are made properly to suppliers.
- It should be possible to trace from order through to cash account entry and from cash account entries back to orders and goods requisition notes.

2. The sales system



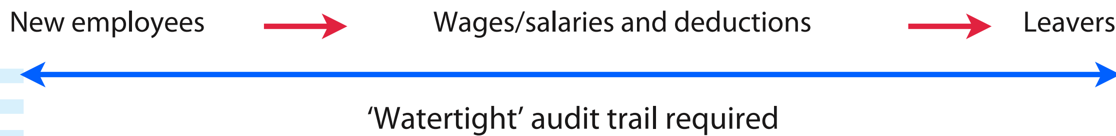
A good internal control system for sales will ensure:

- Orders are accepted from credit-worth customers only.
- The ordered goods are promptly dispatched
- The goods are received by customers
- All deliveries are invoiced promptly and accurately.
- Invoices are entered properly into the receivables ledger.
- Payment is received when due
- Receipts from customers are accurately recorded



- Credit control procedures should target long-outstanding receivables
- It should be possible to trace from order through to cash account entry and from cash account entries back to orders and dispatch notes.

3. The wages and salaries system



A good internal control system for wages and salaries will ensure:

- Employees are hired only as necessary
- Employees are paid competitive rates
- Hours worked are accurately recorded
- Overtime is authorised
- Net pay and deductions are accurately calculated
- Payments are made accurately to employees, the government and others as necessary
- Employees leaving are promptly removed form the wages system

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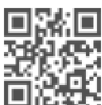

Chapter 14

COMPUTER SYSTEMS

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1. Types of control

Computer systems have two sorts of controls:

- General controls
- Application controls

General controls are controls over the access to the computer and its records, the development of programs, prevention of unauthorised changes to systems, to ensure that regular backups are taken, the implementation and use of antivirus programs and firewall defences.

It is probably worth pointing out at this stage the dangers that are inherent in poor development or unauthorised changes in programs. For example if I wanted to commit a fraud using the wages in salary system, there are two ways. First I could change my salary, in other words a change of data, so that every time I was paid, I would be paid too much. That's an easy but very obvious way of committing a fraud. The second way it could be done is that instead of changing the data, I change the salaries program so that when my personnel number is being processed, my salary is increased. That needs a simple 'if – then' statement so that if the employee being processed has my personnel number then the program increases my salary by, say, 25%. Numerically that will work just as well, but it will probably work much better in terms of fraud because it will be much more difficult to detect how it was done.

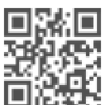
Although this has been dramatised using fraud, the greater potential of improperly authorised programs lies in simple mistakes. If you alter a program, for example, the wages and salary income tax calculations or the VAT calculations, so the amounts of tax are incorrectly calculated, then the organisation can be liable for very large penalty payments to the tax authorities.

2. Application controls - input

The second family of controls are known as application controls and these are controls with specific applications such as sales, purchases, wages and salaries. You need controls over:

- The initiation of input
- Recording the transactions
- Processing of transactions
- Output

Control over input is particularly important as once a transaction gets into a computerised system, often there is no further human intervention. Therefore, if incorrect data is input, there is a high chance that it will be processed to its conclusion.



Input controls can be described as giving controls over completeness (C) or accuracy (A). Methods include:

Sequence checks (C)	For example ensuring all sequentially pre-numbered documents are accounted for in the system.
Edit checks (A)	Examining the data for content and format to identify unfeasible or otherwise incorrect data. Edit checks include range checks (the input has to be within a certain range of values), format checks (for example, every account number is six digits long), dependency checks (so that a date like 31/2 would not be permitted, check digits (where numbers are specially constructed to obey certain mathematical rules).
One-for-one checks (C)	For example, checking that every hourly-paid employee has submitted a clock card.
Control (or batch) totals (A and C)	Add up the value of documents before they are input. The computer then re-performs the calculation to check accuracy and completeness of input.

3. Controls over standing data

Standing data, sometimes called reference data, is data which doesn't change very much but which is used or referred to many times. A good example is the selling price of a product or wage rate for an employee or discount rate for a customer. The problem is that once these amounts are put in, they tend not to be examined continually by employees. A price once set up could last for many months and if it's wrong can affect many invoices. So you have this rather unfortunate situation where the data once input is then subsequently largely ignored by the people involved, but it is capable of producing errors over and over and over again.

The only way we can be sure that that data is correct is to take deliberate steps to check it. So some organisations print out their standing data, perhaps 10% every month, and distribute that to people who should know whether or not it is correct. These people sign off the print-outs to certify that the data appears to be right.

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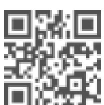

4. Application controls - processing controls

With respect to processing controls, really we want to know what processing has been done, and ideally we would like some indication if processing appears to be odd or out of sequence. As a simple example, let's say that the wages and salary accountant is off sick towards the end of the month. How do you know whether or not that month's salaries haves been done? You don't want to do it twice, but if you don't do it at all employees be very upset. Therefore, some kind of trace needs to be kept of what processing has been done, when it was done and, ideally, showing by whom.

Run logs and transaction logs can do this. Run logs give a high level description of the processing which has been performed. For example it might say monthly salaries run 29th of July, 1:45 p.m. initiated by J. Smith.

- Run logs should be scrutinized regularly by a responsible official to look for runs which appeared to be odd, out of sequence or initiated by on expected people. Transaction logs are also sometimes produced. These are much more detailed printouts of exactly what transactions have been input and processed. For example, a transaction log might simply be a printout of all dispatches which have been turned into invoices in the week or all timesheets which have been submitted. These would not normally be scrutinized as a matter of course, but can be looked at if the run logs appear to show something which is suspicious.

5. Output controls

Finally there is control over output. Output could be on a VDU/screen (that would be soft output), or could be printed (that's hard output). Control over output can be established by the use of passwords if the output is displayed on a VDU. If it's printed, then you rely on the normal confidential ways of distributing confidential printed material: it should be put in envelopes, there should be a check on the number of copies produced, the date of production of the printout should also be present otherwise you can get confused between different editions, and the pages should be numbered. If the pages aren't numbered, you won't know whether or not you got all the printout, some printouts put 'End of Report' at the bottom of the last page so users know that some pages haven't become detached.

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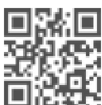
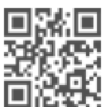




Chapter 15

COMPUTER ASSISTED AUDIT TECHNIQUES

1. Technique types

These are two types of computer assisted audit techniques, or CAAT:

- Audit programs
- Test data

The techniques can add greatly to audit efficiency and effectiveness. For example, audit programs can very quickly read thousands of records, examining each according to the criteria set by the auditor. Test data can be used to investigate the operation of accounting programs that could not be easily tested in any other way.

1.1 Audit programs

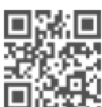
Audit programs are used to examine and interrogate clients' accounting data. The auditor will have a program which can read the clients' files. That program can be used for the following:

- To select a sample of transactions to investigate.
- The samples could be automatically stratified.
- The program might be set to identify odd transactions or balances. For example, credit balances on a receivables ledger, or inventory which hasn't moved for some time.
- It could also re-perform calculations. For example it is important to check that the sum of the receivables accounts add up to the balance shown in the nominal ledger and hence in the financial statements.

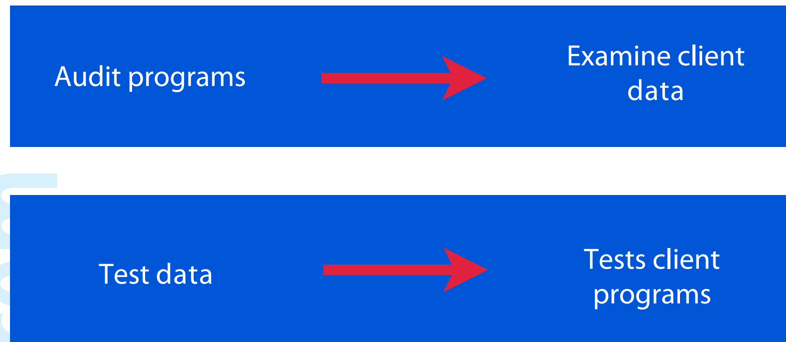
1.2 Test data

Test data is used to investigate the operations of client programs. The auditor chooses data and this is processed by the client's programs. This enables the auditor to check whether or not the client's programs are operating correctly and as expected, and whether or not the various controls which were supposed to be present are actually operating. For example what happens if a dispatch entered for a zero quantity, or for a non-existing product, or for a non-existing customer, or a dispatch which would raise the balance on the debtor's account to above the credit limit. Test data is specially chosen data to check that the controls are present. There would be some normal items, some unusual items and some extreme or unexpected items.

The auditor should predict what the client's program should do and then compare those predictions with what the client's program actually produces.



A problem with test data is that the auditor is processing artificial false transactions into the client's system and many clients dislike that. Therefore it is usual for test data to be what's known as 'dead test data'. This means that it is not actually used on the client's file but is used on the copy of the client's file but using the client's programs.



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Chapter 16

THE FINAL AUDIT – THE ASSERTIONS REVISITED

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1. Introduction

We now come to look at the final audit and consider some of the work that is typically done to verify some of the assertions that are made about major items in the client's financial statements.

This part of the audit is still sometimes referred to as the 'balance sheet audit' because it tries to ensure directly that the amounts in the financial statements are free from material misstatement.

In particular, ISA315 states the following:

"…management…makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures. Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:

2. Assertions about classes of transactions and events for the period under audit

- Occurrence – transactions and events that have been recorded have occurred and pertain to the entity.
- Completeness – all transactions and events that should have been recorded have been recorded.
- Accuracy – amounts and other data relating to recorded transactions and events have been recorded appropriately.
- Cut-off – transactions and events have been recorded in the correct accounting period.
- Classification – transactions and events have been recorded in the proper accounts.

3. Assertions about account balances at the period end

- Existence – assets, liabilities, and equity interests exist.
- Rights and obligations – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- Completeness – all assets, liabilities and equity interests that should have been recorded have been recorded.
- 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.

4. Assertions about presentation and disclosure

- Occurrence and rights and obligations – disclosed events, transactions, and other matters have occurred and pertain to the entity.
- Completeness – all disclosures that should have been included in the financial statements have been included.
- Classification and understandability – financial information is appropriately presented and described, and disclosures are clearly expressed.
- Accuracy and valuation – financial and other information are disclosed fairly and at appropriate amounts.

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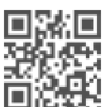

Chapter 17

THE AUDIT OF RECEIVABLES

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1. The relevant assertions

If you want to audit the receivables balance you have to find ways of testing each assertion that the receivables balance makes: existence, rights and obligations, completeness, valuation and allocation.

2. Receivables circularisations

Assuming receivables are material, it's almost universal that a receivable circularisation will be carried out. This means writing to the client's customers and asking them to verify the balance. This is extremely good for checking the existence of a receivable and its accuracy, but it says very little about the value that receivable. It could well be that the customer who is in trouble will verify that the receivable exists so as to play for time: they don't want to arouse suspicions. Quite a separate valuation exercise has to be done later.

There are two types of circularisation,

- Positive
- Negative

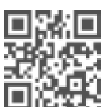
In a **positive circularisation** you want a reply from everyone who has been written to, whether or not they agree with the balance. This is by far the strongest type of circularisation.

In a **negative circularisation** you ask for a reply only if the balance is out of agreement. But if you don't get a reply how do you know whether that person agrees with the balance or whether they simply haven't bothered replying?

Circularisation letters have to be written on the client's notepaper and signed by the client. This gives the customer permission to disclose confidential information to the auditor. The letters must be posted by the auditor to endure that all are sent and it's important a stamped addressed envelope is enclosed with a letter for the reply to be sent directly to the auditor's office. You may remember when we looked at the standard of audit evidence that auditor-directly obtained evidence is much stronger than client-obtained evidence. Here, if the customers of clients replied to the client, the client could simply throw away those letters which shows disagreement and pass on only those letters which show agreement. That would give the auditor quite a wrong impression of the accuracy of the receivables.

Very often stratification will allow a very large percentage of the receivables balance to be covered by writing relatively few letters. Perhaps the key accounts of the client will account for 80% of the receivables balance.

In addition some of the balances will be selected at random for circularisation, together with those balances which have not moved for some time, credit balances and perhaps nil balances.



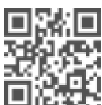
The auditor has to keep a careful schedule of customers written to, replies received, where replies agree, where they don't agree, where the lack of agreement could simply be explained by timing difference on payments.

If some of the client's customers don't reply, then it's normal for the auditor to follow-up the original letter by letter on the auditor's notepaper. If the auditor is really worried about the balance for which there is no confirmation received, the auditor might, as a last resort, phone that customer. However this can only be done with the client's permission. One of the last things the auditor should be doing is to poison the relationship between client and customer.

3. Other work on receivables

Other work on receivables includes the following:

- Reconcile the sum of the balances on the receivables ledger to the control account. The individual balances represent the individual assets and they have to be reflected in the control account which in turn is what appears in the financial statements.
- Aged listings. These are essential for receivable valuations. Very old debts are unlikely to be paid and quite often a general provision for irrecoverable debts is calculated based on the age of the debts.
- Correspondence with customers should be scrutinised. It may become clear that a customer disputes an invoice and it will be difficult ever to receive that amount of money; they might be denying the goods were received; they might be disputing the quality of the goods.
- Scrutiny of board minutes. Large receivables which look as though they might be going bad should be reflected in board discussions and there should be records of that in the board minutes.
- Collection period, that is a number of days of debtors and it is calculated as receivables divided by sales per day. It is usually regarded as very sensitive indicator as to the recoverability of receivables and also the efficiency of the credit control operation. There may, of course, be good reasons why the collection period increases: the company might have increased the terms of sale to be competitive or it may be making a greater proportion of sales abroad where usually the collection period is longer. But all other things being equal, an increase in the collection period is usually regarded as bad news.
- On a test basis trace items outstanding on customer's accounts to the copy invoice, copy dispatch note and order received from the customer. This provides evidence that the amount is a genuine receivable.
- On a test basis test recent orders in the order file to dispatch notes and to copy invoices and to the receivable ledger to obtain evidence of completeness of amount owing.
- Trace amounts showing as having been paid in customers' accounts to cash book Dr entries to verify that they have indeed been paid and should not be in receivables.
- Wait, if possible, for payment. An absolute proof that a receivable is good is if it is received after year end. Quite often if there is a very material amount due, auditors will try and delay signing the audit report until that amount is received. If it is received, there is no doubt; if it is not received maybe after two or three months, then there may be serious doubt as to the recoverability of that amount and some sort of irrecoverable receivable provision ought to be set up.
- Scrutiny of credit notes issued after year-end is very important. It is possible for a company to debit a receivable account and credit sales just before year-end, and then



very early in a new year to reverse that transaction by issuing a credit note. This gives a mechanism for the company to boost its income and profit for the year which is then quietly reversed out.

The tests above fall into two classes of substantive tests:

- Analytical procedures: collection period, compare receivables to last year etc.
- Tests of detail: where the auditor traces and inspects the details which provide evidence that an amount is free from material misstatement

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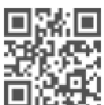

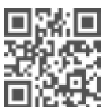

Chapter 18

THE AUDIT OF PAYABLES

Many of the audit steps that are carried out on the payables balance are similar in principle to those that were carried out with receivables balances.

Note, however, that the auditor will be particularly worried about the possible understatement of payables: how can the auditor detect a payable that is missing form the financial statements?

- It's important to reconcile the individual payables balances to the control account. In other words, the total of payables in the balance sheet of the financial statements agrees to the detailed amounts payable to each supplier.
- Correspondence with suppliers and board minutes may allow identification of disputes or amounts which might not be paid, or amounts which may not yet appear in the payables ledger, but which are been claimed by suppliers or other parties. It's often by reviewing correspondence in board minutes that contingent liabilities are discovered. Contingent liabilities arise because of some event which has already happened, but whose outcome is uncertain. For example, a legal claim. Later you will see how contingent assets and contingent liability should be handled.
- Trace from orders to credits in suppliers' accounts. Trace from credit entries in the accounts to copy invoices then back to orders.
- Trace from cash book payments (before and just after year end) to suppliers' accounts and vice versa.
- The payables period would be looked at with some interest. If the payables period increases, it may indicate that the company is being more careful about when payments are made, but it could indicate that the company is having a difficulty making payments as they become due and by increasing the payables period, the company might begin to lose out on receiving cash discounts. This can become quite expensive of the company and need some explanation.
- On some occasions payables circularisations will be carried out. That's where we write to suppliers and ask them to confirm the amount that we owe. However, this is not as important as a receivable circularisation because very often payables balances would be substantiated by statements received from suppliers which can then be reconciled or agreed to balance on the supplier's accounts.
- Looking at payments made shortly after year end will often give evidence of the existence of a liability at year end.
- A review of credit notes received or debits made to payables accounts just after year-end is important. There may be some situations where a company wants to reduce its apparent profit in a particular year and one way in which this could be done will be the debit in expense account in a nominal ledger and credit a supplier, and then early in new the year reverse that transaction. So looking at transactions made at just after year-end can be very important in verifying the validity of transactions made just before year-end.

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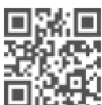

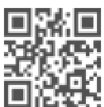

Chapter 19

THE AUDIT OF ACCRUALS AND PREPAYMENTS

Prepayments and accruals are likely to be small relative to receivables and payables, but they can nevertheless be material and need to be audited.

- Compare to last year. One of the first steps it's normally carried out is to compare this year's accruals and prepayments with last year's. Many accruals and prepayments arise because of periodic payments whose pattern doesn't change very much for one year to another. So for example if at the end of December last year two months of rent have been paid in advance, probably that is going to be the case this year because the rent will be payable at particular times of the year. Similarly if there was an accrual for wages in last year's financial statements because the workforce is normally paid a week in arrears, almost certainly you would expect to find a similar accrual in this year's financial statements.
- Scrutinise payments made shortly after/shortly before year end. To identify accruals it is going to be very important to look at payments made just after year-end and to see whether or not any of those relate to the period covered by the financial statements. Similarly, with respect to prepayments looking at invoices paid in the last few months of the year may identify some which partially relate to services which are not going to be enjoyed after the year-end.
- Analytical procedures. The overall level of expenses can also be important. If an expense varies widely from one year to another, one potential explanation of this is that there simply been a tiny difference in date of the payment of that expense and that an accrual or prepayment is needed to ensure that the financial statements are drawn up using the accruals or matching principle.
- Letter of representation. We will cover this in more detail later. Suffice to say at the moment that it is a letter from the directors to the auditors making certain representations, for example, that all liabilities have been accounted for in the financial statements.

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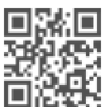


Chapter 20

THE AUDIT OF INVENTORY

1. Introduction

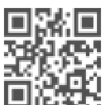
Inventory is one of the most difficult areas to audit. The auditor has to check:

- The quantity of the inventory and must make sure that it is properly described. If it's not properly described it is going to be difficult to decide what its value should be as its condition has to be assessed. This obviously includes its physical condition, but also consideration has to be given as to whether the inventory is old and therefore not as saleable, or perhaps whether there is too much inventory so that it will have to written down to selling value.
- The value of the inventory. Its cost can often be ascertained by looking at purchase invoices, but there can be considerable disagreement over whether or not the costs are lower or higher than the inventory's is net realisable value, and indeed what the net realisable value should be.
- Ownership. Just because an item of inventory is in a client's warehouse doesn't mean that it is owned by the client. It may be third party inventory which is being held there, or in fact the items may have been sold but have not been despatched yet.

2. Year-end inventory counts

Very frequently your examination will ask you to consider inventory counts or stock-takes. Here the main aspects of the stock-take that you have to pay attention to.

- Instructions. Remember, the many stock-takes will take place only once a year and the procedures are therefore not that well-known or practised by many staff members. It's very important that there is very careful advance planning. Instructions have to be given out. Staff members have to be briefed. There may be training sessions.
- Preparation of the count area. The inventory area has to be prepared by tidying and sorting items. It's important that slow moving, damaged, old, and third party inventories can be identified.
- Pre-number each inventory location. All the shelves or inventory locations should be pre-numbered, ideally sequentially. Labels are often attached and the labels will have a number. They will describe the inventory location. They may have space in which the type and quantity of inventory can be recorded and there should be one or two spaces on the label which are signed off once the items have been counted and checked.
- Sequentially pre-numbered inventory sheets. The inventory is going to be listed on inventory sheets and it's essential that these are sequentially pre-numbered so that we can check that all inventory sheets have been returned and that the inventory is therefore likely to be complete.
- Count teams. Inventory counters or stock-takers will often go round in pairs. Sometimes it may be members of the warehouse who go around but there is potential control difficulty there as the people who work in the warehouse are being asked to count the items in the warehouse for which they are responsible. However, it's difficult to get a



team consisting of two other people to go round because they are not always aware what inventory they are seeing and counting. Probably the best solution is to have a mixed team. One person from the warehouse who knows about the inventory and one who is independent and who is less likely to alter inventory counts to cover up errors. They go round together, one will count, one will check. They sign off and mark each location as it is counted so that that inventory wouldn't be counted twice. They mark the inventory location number on the stock sheets and the stock sheet numbers on the location label so that items can be later checked.

Note that it is **not** the responsibility of auditors to carry out the stock take: it is their job to decide if the stock take can be relied upon. What the auditors should do is:

- Look at the instructions that are issued in advance and to see whether there are any shortcomings in that.
- On the stocktaking day the auditor will observe the count in progress to make sure that the instructions are been properly followed by the counting teams, to make sure that the counters are well-organised, and to ensure that the count is proceeding in a proper manner.
- The auditor will make some counts himself, noting down the description of the items, the quantity, and the location. They will also note down the number of the stock sheet in which that inventory item should be recorded.
- At some stage the auditor will have to make test checks on the accuracy of the count. Like at many audit tests this involves in tracking amounts both ways. The auditor will count some inventory quantities on the shelves and trace this to the inventory sheets and will then pick some items on the inventory sheets and go back to the inventory location and count the amount which is actually there to make sure that it agrees.
- Make a note of the last few goods received noted and dispatch notes of the year. This will be used later in cut-off tests.
- At the end of the count it is essential for the auditor to check that all inventory sheets are recovered to make sure that no inventory is left out of a count.

These sheets bear the physical quantity and perhaps description of the inventories only. There is no value there yet. After the stock-take it is important to put value on the stock items. Most are going to be valued at cost, and the cost could be obtained from suppliers' invoices. There could be many calculations to do here.

Value = Cost/unit x Quantity

The values of the individual items will be added up to form a grand total of the inventory. It's very important that these calculations are checked, including the addition of the final column. Remember any value you like can be put in for closing inventory and the accounts will always balance, but for every dollar added to the value of closing inventory there is a straight dollar added to the profit being shown by the company.

At this stage identify slow moving or obsolete stock needs to be identified and may need to be written down below cost. This can be difficult because the auditor is not necessary an expert of the subject matter of the inventory count and so may rely more than is perhaps desirable on assurances given by client staff.

3. Cut-off: purchases

Cut-off is a very important aspect of auditing. It really refers to the consistency that must be present between sales, receivables, purchases, payables and inventory. If a goods receive note is dated shortly before year end then, assuming those items have not been sold already, we would expect them to be found in inventory and if they are counted in inventory, they should also be counted in purchases and payables.

If they were counted in inventory but not in purchases and not in payables, the calculation of profit would be entirely incorrect. The purpose of the closing inventory adjustment is to adjust the purchases figure to give a cost of sales figure.

If a goods received note, however, is dated after year end, the likely assumption should be that the goods were not an inventory at the year end date and therefore were not counted. If they are not in inventory they shouldn't be in purchases and they shouldn't be in payables.

We are looking here at consistency. At one level that doesn't really matter whether goods are included in inventory or have not yet been received. But we must be consistent: if they are in closing inventory we have to recognise that we have purchased them; if they are not in closing inventory because they haven't arrived yet, we mustn't recognise that we have purchased them.

Part of what the auditor is likely to do when attending a physical stock take at year end is to note down the numbers of good received notes issued in the last few days of the year so that later the auditor can check that the company has properly accounted for those items being purchased and being in payables.

4. Cut-off: sales

Checking cut-off in sales is also important. If an item is recorded as having been sold, in other words it has been debited to receivables and credited to sales, it should not also appear in inventories. To verify this, at the stock take the auditor would normally note down details of the last goods dispatched notes issued at the end of the year and perhaps the numbers of the first few issued in the New Year.

If a goods dispatched note has been issued before year end then, generally speaking, we would say that those goods been sold and the items should be in sales and receivables. Those goods should not be included in inventories (even if physically still on the client's premises because that haven't yet been delivered).

If a goods dispatched note was issued after year end then the normal assumption is that the goods have not been sold at year end. The item should not be in sales, should not be in receivables but if it hasn't been sold, it should be counted in closing inventories.

Although shifting the saleable item from one financial year to another will alter the profits in those two years, what's really important in cutoff is consistency. If something is regarded as having been sold it should be counted as enclosing inventory, if it is not regarded as having been sold at yearend, it should be enclosing inventory.

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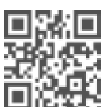

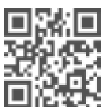

Chapter 21

THE AUDIT OF CASH

Cash is one of the simplest balance sheet items to audit. Almost certainly the auditor will write it to the client's bank to get a bank certificate. The bank certificate will certify the amounts in the various accounts of the client and it should also tell the auditor about any security which the bank has for overdrafts and for loans, together with details of any assets which the bank is holding on behalf of the client, such as share certificates. It should also show any accrued interest or bank charges.

The auditor will make sure that the amount in the client's cash book agrees with the amount on the statement of financial position and will carry out a bank reconciliation as evidence that that amount of cash is correct. (Note that the amount on the bank statement or bank certificate will not usually be the balance shown on the statement of financial position: a bank reconciliation is needed.)

If the client has a material amount of cash, for example if the client runs a chain of shops each with a cash float, then at least some cash counts will be carried out to check on the existence and accuracy of the cash balance.

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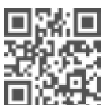

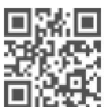

Chapter 22

THE AUDIT OF NON-CURRENT ASSETS

1. The audit of non current assets (or fixed assets) will normally contain the following procedures:

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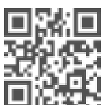
- Physical inspection. Remember many non-current assets have got a very high value. One of the simplest ways to check on the existence of the asset is to actually see it. In addition to checking with the asset exists, physical inspection may allow the auditor to detect if the asset needs to be written down (impairment) because it is damaged or seem to fall into disuse.
- Invoices and receipts. Additions of new non-current assets and disposals of old fones should be checked to invoices and to sales receipts respectively. If the addition is material you would probably expect to trace it back to a purchase requisition and if it is very material, it is likely that the acquisition of the asset will have been discussed in the board meeting and should be found in board minutes. Similarly larger material disposals will often be discussed at board level.
- Scrutiny of repairs and maintenance. One of the common errors when dealing with non-current assets is for the client to get mixed up between whether something is a non-current asset addition (which should be capitalised) or whether the expenditure relates to repairs and maintenance (expense). Therefore it is important to scrutinise the repairs and maintenance account for items which should be more properly described as non-current asset additions.
- Reconciliation to the non-current asset register. The financial statement balances are supported by the detail in the non-current register and should reconcile to the cost and accumulated depreciation amounts.
- Reperformance of depreciation calculations. It is important that the depreciation calculations are re-performed. It is impossible to do this simply by looking the balance in a nominal ledger as the chances are that some fixed assets will have been fully depreciated and should generate no further depreciation charges. The only way in which depreciation calculations can be calculated is to go the non-current asset register and look at the detailed calculations that have been carried out for each asset and to make sure that the depreciation charge in the profit and loss account reflects some of these charges.
- Check disposals. When checking disposals it is important to make sure that the non-current asset register is properly adjusted, the cost of the item is taken out of the cost account and that the accumulated depreciation is taken out of the accumulated depreciation account, and that the profit or loss of disposal is properly calculated.
- Inspect documents of title. This really looks at ownership: physical inspection merely tells you the asset exists but how do you know the company owns it? They could have sold an asset and could be renting it back. Therefore documents of title are extremely important.
- Verify economic benefit. Finally it is important to check with no assets need to written down faster than depreciation is implying. If a fixed asset has no further economic benefit then it should written down much more quickly (impairment).



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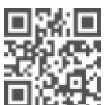


Chapter 23

INTERNAL AUDIT AND OTHER THIRD PARTIES

1. Introduction to internal audit

The internal audit function is an appraisal and monitoring activity established by management and directors for the review of internal control as a service to the entity.

Remember that the directors are required under corporate governance codes to review the need for internal audit. Normally to achieve an element of independence from the executive directors, you would expect internal audit to report to the audit committee.

The main function of the internal audit department is to examine, evaluate and report to management and directors on the adequacy and effectiveness of internal control. They will play a major part in designing internal control system and will report on departures from that system and give suggestions about where it can be improved.

2. Internal audit functions

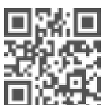
Here is the list of the typical functions of an internal audit department. There is nothing perhaps terribly surprising here, read each of the bullet points and understand them.

- Helps achievement of corporate objectives (how could a company make profits if it doesn't safeguard its assets or properly record transactions?)
- Aids risk assessment and management.
- Improves efficiency, effectiveness and economy.
- Designs internal control system.
- Checks operation of internal controls system.
- Value for money audits.
- Test IT controls.
- Liaises with external auditors/shares work.

It is perhaps the last three which you need to be particularly aware of. There is something called a 'value for money audit'. This isn't so much looking at internal control but it is looking at efficiency and economy: could something be done more cheaply, more efficiently so that the company can make better profits? Or if they are non-profit making organisation can't that organisation achieve more for the same amount of expenditure?

Testing information technology controls is also part of internal audit responsibilities.

And finally internal audit often plays a major part in liaising with external auditors and sharing work. Typically in very large organisations the external auditors do not visit every department or every branch, every factory or every outlet. Quite a lot of that audit work is achieved by the



internal audit department and the external auditors will review the working papers and findings of internal audit. Generally the external auditors will move around to different departments and branches so that over a period of few years, external auditors have visited every part of the client.

3. Relying on the work of 3rd parties

Using the work done by internal audit is one example of where auditors rely on the work of 3rd parties. Other examples include:

- Having to rely on experts such as estate agents, actuaries, lawyers.
- Relying on the work of other external auditors (for example, if some companies in a group have different auditors)

The auditors should ensure that the third parties are

- Qualified
- Experienced
- Independent
- Professional

The auditors should also be willing to challenge experts' opinions, show professional skepticism and, if necessary, bring additional experts in for a second opinion.

Should agree the following in writing:

- Nature, scope and objectives of work
- Respective responsibilities
- Nature, scope and timing of communications
- That the expert observes confidentiality

Auditor must examine the expert's work with respect to:

- Consistency with other evidence. For example, if a property valuer reported a decrease in the value of a client's property portfolio, yet the newspapers were full of news about a property boom, the auditor should challenge the valuer's results.
- Assumptions made. For example about the rate of returns that might be earned on pension funds.
- Use and accuracy of source data. To value property the valuer must start with an up-to-date list of the properties the company owns.

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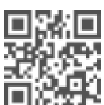

Chapter 24

AUDIT DOCUMENTATION

1. The purpose of audit documentation

Audit documentation fulfills the following very important purposes:

- To show that the audit work has been done properly. An audit really means collecting sufficient appropriate evidence that will support the auditor's opinion on the financial statements. It is essential that this evidence is recorded so that, if need be, the auditor can demonstrate that a proper audit was carried out.
- To enable senior staff to review the work of junior staff. The review process is essential in carrying out a competent audit: the work of junior staff is reviewed by their supervisor, the supervisor's work is reviewed by the manager, and finally the partner, who will sign the audit report, will review everyone else's work. Review is not possible without recording the work carried out and evidence obtained.
- To help the audit team in future years. An immensely useful planning exercise at the start of the audit is to examine last year's file. Were there problems? Were there any errors? How did last year's audit team go about gathering evidence?
- To encourage a methodical, high-quality approach. The audit documentation contains information documenting the client's accounting system, the tests that have to be performed (eg select 20 invoices at random and ensure that they are authorised). As each part of the audit is completed the audit program is signed off by the person who carried it out. Outstanding matters are easy to see.

2. The types of audit file

There are two types of audit file:

- Permanent audit file: this contain information that does not change a lot such as a description of the accounting system, names and addresses of the company's bankers and lawyers, organisation charts, memoranda and articles of association (the company's constitution). Also a history of the ratios used in analytical procedures will be maintained so that trends can be seen.
- Current audit file: this contains the financial statements being audited and details all the audit work that has been carried out to collect sufficient appropriate audit evidence about those financial statements.

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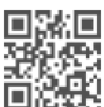


3. Structure of the current audit file

The amounts on the financial statements are referenced to section of the file (separate sections for non-current assets, inventory, receivables, payables etc). Within this section the make-up of the figures are examined and the work carried out on each figure is recorded in detail on working papers.

Statement of financial position as at 31/12/2015

		$000	$000
Non-current assets			
Machinery	Ref F1		2,000
Current assets			
Vehicles		1,400	
Office equipment		1,300	
		4,700	
.		.	

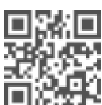
Machinery	F1		**$'000**
Cost			
b/f	Agreed to last yr's c/f		3,800
Additions	REF F2	1,200	
Disposals	REF F3	(1,000)	200
c/f			4,000
Depreciation			
b/f	Agreed to last yr's c/f	2,200	
Disposals	REF F4	(1,000)	
Charge	REF F5	800	
c/f			2,000
NBV	SOFP		2,000

Schedule F2 would show the work done to verify additions

Schedule F3 would show the work done to verify disposals

Schedule F4 would show the work done to verify depreciation on disposals

Schedule F5 would show the work done to verify the depreciation charge



4. Typical contents of working papers

- Title
- Date prepared
- Person who prepared the paper and their signature
- References to other schedules
- Purpose of the audit tests being performed
- Precise details of work performed, such as invoices examined, assets inspected, calculations re-performed.
- Conclusion from the work performed
- Reviewers signatures and date of review

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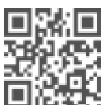
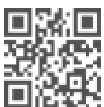




Chapter 25

FRAUD AND ERROR

1. Definitions

Fraud is the deliberate falsifying of records or misappropriation of company assets.

Fraud can be:

- Fraudulent financial reporting. For example, overstating profits to attract investors and lenders.
- Misappropriation of assets. For example, the theft of cash, inventory or non-current assets.

Error is the innocent misstatement of amounts or loss of assets.

2. Fraud

It is management's responsibility to prevent and detect fraud – not the auditor's. Auditors are not expected to find every fraud, but they are expected (with reasonable assurance) to find material misstatements, whether innocent or fraudulent.

At the planning state the susceptibility of an entity to fraud should be discussed.

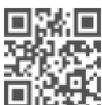
All instances of fraud should be reported to those charged with governance. It is important, even for what appears to be a small fraud, to investigate how long it has been going on for, how much is involved and who is behind the fraud.

3. Misstatements identified

- All should be communicated to management
- Management asked to correct them or explain why not. Often the audit committee will be involved in these discussions.
- Assess materiality of uncorrected misstatements
- Obtain written representations from management that they believe uncorrected misstatements are not material

If management refuses to correct a misstatement which the auditor thinks is material then the auditor will have to issue either a qualified or adverse opinion.

Note it is management responsibility to correct errors in the financial statements. Auditors cannot unilaterally adjust the financial statements that have been prepared by management.



Chapter 26

EVENTS OCCURRING AFTER THE REPORTING PERIOD

1. Event Types

Now we are going to look at the effect of events which occur after the end of the reporting period but before the audit report has been signed. These events fall into two types.

- **An adjusting event** as its name might suggest, means that the accounts have to be adjusted in the light of what's happened. The rule is that adjustments are only put through the accounts if the event produces **evidence of conditions that existed** at the date of the statement of financial position, in other words at the balance sheet date.

  An example would be a major customer going into liquidation, let's say at the end of January, the year end being the end of December. That event tells us that the receivable at the end of December was probably bad and should have been written off or fully provided against then. It's very unlikely that the customer's financial position worsened so remarkably during January. What the liquidation tells us is that the customer was in the bad situation at the end of December and if only we had known that then the receivable would have been provided against.

- **A non-adjusting event** relates to conditions which **arose after the date of the statement of financial position**.

  A good example is the company's factory burning down, let's say in mid January. At the end of December the company's factory was perfectly healthy, it was standing, it was operating, it was a non-current then. It was only after the end of the year that it was destroyed. If the statement of financial position is telling us the position at the year end, then the factory would have to appear in non-current assets. It would be, of course, important to disclose in the notes that the factory was no more. This will be a good example of an emphasis of matter paragraph in the audit report.

2. Active and passive duty

Until the audit report is signed auditors have an active duty to look out for events that might tell them more about the financial statements. After signing the audit report, the auditors have a passive duty only. Occasionally events will occur after the accounts have been signed and issued and these come to the auditor's attention. Exceptionally it may be important for the auditors to alert the addressees of the audit report that something is wrong in the accounts and they will try to persuade the directors to re-isue corrected financial statements.

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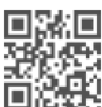
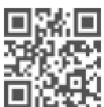




Chapter 27

CONTINGENT ASSETS AND LIABILITIES

1. Contingent liability

A **contingent liability** is a possible liability arising from past events but the existence of that liability will only be confirmed by future events.

Note it's very important that the possible liability arises from **past events.** We are not trying to foresee events which may arise in the future and which give rise to liabilities.

The treatment of the liability depends on how probable it is that there will be an outflow resources from the company:

- If the present obligation probably requires the outflow of resources then a provision is recognised and disclosures are required. In other words an expense account could be debited and some sort of accrual or liability account will be credited.
- If it is a possible obligation that will probably not require the outflow resources, no provision is required but disclosure should be made by way of notes.
- If the outflow of resources is remote, in other words very unlikely, no provision and no disclosure is required.

A good example of contingent liability is a legal action arising from some past event: if it is probable that you are going to have to pay up, set up a provision; if it's merely possible you have to pay up, no provision is needed but the risk should be disclosed. If it is very unlikely that you are going to have to pay up, no provision and no disclosure.

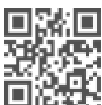
It can be difficult to assess probability of a liability actually crystallizing and auditors will have to review correspondence with, for example, solicitors and also look at board minutes.

2. Contingent asset

Contingent asset is a possible asset arising from past events but whose existence will only be confirmed by future events.

The treatment of contingent asset is very similar to that of contingent liabilities, but slightly more cautious.

- If an inflow of economic benefits is virtually certain then the asset is not contingent: it's a real asset and should be showed in the statement of financial position.
- If the inflow of economic benefits is merely probable, not virtually certain, then it would be imprudent to recognise that asset in the balance sheet but disclosures by way of note will be useful and therefore should be made.
- If the inflow is not probable, then it would not make sense to recognise the asset or to give any type of disclosure.



Note that the treatment of contingent assets and liabilities though similar is not identical:

Contingent liability	Contingent asset	Treatment
Probable outflow of resources	Virtually certain inflow of benefits	Recognise fully in the financial statements
Possible outflow of resources	Probable inflow of resources	Disclose by way of note
Remote likelihood of outflow of resources	Not probable inflow of resources	No disclosure of any kind

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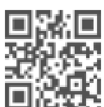

Chapter 28

WRITTEN REPRESENTATIONS

1. Introduction

The final letter to be discussed is the management representation or letter of representation. This is sent by management to the auditors. It should be obtained on specific matters and also on matters material to the financial statements when other appropriate audit evidence cannot reasonably be obtained.

In particular, letters of representation are important where it could be difficult for the auditors to make sure that certain problems do not exist, or that management does not have certain intentions or plans. If you don't know about a liability it can be difficult to discover. It can also be difficult to discover management plans if they have now been discussed at board meetings and recorded in the board minutes.

Management representations cannot substitute for other audit evidence except where knowledge has confined to management and where the auditor is relying on the management's judgment and opinion, for example on the future sales price of inventories.

Otherwise, when a letter of representation is received, the auditors should look for corroboration from other resources to support what management has said, and to evaluate whether the representations made by management appear to be reasonable and consistent with other audit evidence that has been obtained by the auditors.

2. Typical contents of a letter of representation

Here are some examples of content of a typical letter of representation:

- No material irregularities. In other words the directors are not aware of any material frauds that have taken place during the period.
- That they have disclosed all liabilities and these are reflected in the financial statements.
- That management is not aware of any pending legal actions.
- That there have been no subsequent events that is events occurring after the balance sheet date which may require the financial statements to be adjusted or if not requiring it to be adjusted, at least requiring some disclosure.
- That the directors have no plans to shut down any parts of the operations of the organisation. If there were plans to shut down part of the organisation that would probably affect the valuation of certain assets.
- That inventory is valued at the lower of cost of net realisable value.
- That the directors do not believe that there is a going concern problem.
- That all charges and assets have been disclosed, that is any assets which have been pledged for security of a loan for example, that would affect the rights and obligation assertion of those assets.

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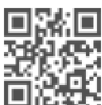

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Chapter 29

THE AUDIT REPORT - REVISITED

1. The purpose of the audit

Remember that the aim of an audit is to be able to report to the members on whether or not the financial statements show a true and fair view. All the planning, investigation of internal control and substantive tests were organised for this purpose. The audit report was discussed in Chapters 5 and 6 so that you got an early insight into where the audit steps were heading. It is important to briefly remind you of the possible outcomes from the audit.

2. Outcome of the audit process

There are two sources of difficulty:

- Material misstatements
- Lack of sufficient appropriate audit evidence

Unmodified audit opinion

Neither of these difficulties has arisen

Qualified audit opinion (except for)

One or both has arisen. The problem is material but not pervasive, so the problem can be isolated. The financial statements show a true and fair view except for…

Adverse opinion

A material misstatement that is so serious as to be pervasive so that the financial statements are deeply misleading.

Disclaimer of opinion

A lack of sufficient appropriate audit evidence that is so serious as to be pervasive so that the auditor can form no opinion on the financial statements.

Additions to the audit report

Remember also that there can be additions to the audit report that do not affect the opinion. These are:

- **Emphasis of matter paragraph**

  Draws attention to a matter already properly disclosed in the financial statements.

- **Other matter**

  Typically, drawing attention to a statement in the directors' report or chairman's report which is at odds with what is in the financial statements.