ACCA

ADVANCE AUDIT AND ASSURANCE

TECHINICAL ARTICLES

PAGE

**EXAM TECHNIQUE FOR ADVANCED AUDIT AND ASSURANCE 3**

* **IAASB exposure draft – Proposed International Standard on Auditing 540 (Revised) Auditing Accounting Estimates and Related Disclosures 34**
* **Responding to non-compliance with laws and regulations (NOCLAR) 42**

**AUDITOR REPORTING 46**

* **Corporate governance and its impact on audit practice 52**
* **THE AUDITOR'S REPORT 57**
* **AUDITING DISCLOSURES IN FINANCIAL STATEMENTS 64**

**PERFORMANCE INFORMATION IN THE PUBLIC SECTOR 67**

**LAWS AND REGULATIONS 71**

**AUDIT QUALITY – A PERPETUAL CURRENT ISSUE 75**

**PROFESSIONAL SCEPTICISM 78**

* **USING THE WORK OF INTERNAL AUDITORS 82**

**ACCOUNTING ISSUES 90**

* **FORENSIC ACCOUNTING 94**

**AUDITOR LIABILITY 99**

**THE CONTROL ENVIRONMENT OF A COMPANY 103**

**CONTINUE TO BE REST ASSURED 109**

**SA 315 (REVISED), IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT 113**

**PLANNING AN AUDIT OF FINANCIAL STATEMENTS 117**

**COMPLETING THE AUDIT 200**

* **AUDIT AND INSOLVENCY 124**

**GROUP AUDITING 127**

**ACCEPTANCE DECISIONS FOR AUDIT AND ASSURANCE ENGAGEMENTS**

132

**AUDITING IN A COMPUTER-BASED ENVIRONMENT 136**

* **AUDIT OF ESTIMATES AND FAIR VALUES 140**

**ANALYTICAL PROCEDURES 145**

* **GOING CONCERN 149**

**AUDIT RISK 153**

**AUDITING IN A COMPUTER-BASED ENVIRONMENT (2) 157**

* **MASSAGING THE FIGURES 163**

**ISA 240 (REDRAFTED) - AUDITORS AND FRAUD 165**

**THE IMPORTANCE OF FINANCIAL REPORTING STANDARDS TO AUDITORS 169**

* **FORENSIC AUDITING 173**

**AUDITORS' REPORTS TO THOSE CHARGED WITH GOVERNANCE 176**

**GROUP AUDIT ISSUES 178**

**EXAMINING EVIDENCE 182**

**AUDIT WORKING PAPERS 186**

**ADVANCED AUDIT AND ASSURANCE – EXAMINER’S APPROACH 190**

* **HOW TO TACKLE AUDIT AND ASSURANCE CASE STUDY QUESTIONS**

193

**AUDIT AND ASSURANCE CASE STUDY QUESTIONS 198**

**EXAM TECHNIQUE FOR ADVANCED AUDIT AND ASSURANCE**

Part 1 – Ethics

Ethical standards and their application form a major part of the Advanced Audit and Assurance syllabus and are examined regularly. Often the marks for this area will be spread over more than one question and may be combined with planning, professional issues or as a standalone.

The basic ethical standards at this level are the same as those examined previously in Audit and Assurance; what sets apart the level of the questions is your ability to apply those standards to more complex situations and show that you understand both threats and safeguards. This is an area of the exam where candidates can use good exam technique to increase the marks attained without having to rote learn much additional information above that learnt for previous exams.

This article will demonstrate how to maximise marks on these areas using good technique. It is, however, specific to the context of auditing and assurance and will therefore have a different focus and application to the way ethics is examined in other areas of the ACCA Qualification.

**WHAT YOU NEED TO KNOW**

The starting point for preparing for any exam is to know the underlying knowledge that is required for this part of the syllabus. At this level the content of the guidance is what you should focus on. Marks are not awarded for memorising or quoting standard numbers, it is the application of the content of those standards that is important. For the Advanced Audit and Assurance exam the following standards are examinable:

* ACCA’s Code of Ethics and Conduct (2016)
* IESBA’s Code of Ethics for Professional Accountants (Revised May 2015)
* IESBA–Changes to the Code Addressing Certain Non-Assurance Services Provisions for Audit and Assurance Clients
* Ethical Considerations Relating to Audit Fee Setting in the Context of Downward Fee Pressure (January 2016)

In addition, for the UK exam candidates will be examined on the Financial Reporting Council’s Revised Ethical Standard 2016, for the IRL exam candidates will be tested on the IAASA’s Ethical Standard for Auditors (Ireland) 2016, and SGP candidates should also refer to the ISCA Code of Professional Conduct and Ethics (Revised November 2015).

You will be familiar with ACCA’s Code of Ethics from the Audit and Assurance exam. This mirrors the IESBA’s Code of Ethics so you will be familiar with the five basic principles of Integrity, Objectivity, Professional Competence and Due Care, Confidentiality, and Professional Behaviour. You will also be familiar with the general areas of threat to the fundamental principles of Self Review, Self Interest, Advocacy, Familiarity, and Intimidation.

The situations you will be appraising at this level will usually involve an assessment of those same principles within scenarios given in the question. In addition, you may be expected to identify situations where the auditor is at risk of assuming a management responsibility with respect to providing additional services to audit clients or appreciate the differences between listed (or other public interest entities) and non-listed clients when it comes to applying these principles.

With regards to objectivity and independence, the general conceptual approach in the codes is as follows:

**(a) Identify threats to independence**

**(b) Evaluate the significance of the threats identified, and**

**(c) Apply safeguards, when necessary, to eliminate the threats or reduce them**

**to an acceptable level.**

**When the professional accountant determines that appropriate safeguards are not available or cannot be applied to eliminate the threats or reduce them to an acceptable level, the professional accountant shall eliminate the circumstance or relationship creating the threats or decline or terminate the audit engagement.**

**HOW TO APPLY THE KNOWLEDGE**

When addressing ethical situations in the exam, you will usually have to demonstrate these skills:

* that you can identify an ethical threat
* that you understand how it arises and the implication of the threat, and
* that you can relate the guidance to the specific scenario to determine the safeguards or course of action required.

Each of these skills can be illustrated through the examples below (note that the answers provided here are focusing on the ethical issues arising and do not cover the professional or other issues you might also need to discuss arising from the scenarios). These answers are not fully comprehensive and give an example of the content which could be produced in an exam. There are further points in each case that could be developed and additional outcomes available within the ethical codes; however, they do represent a well-developed answer a candidate could use to attain the full marks available.

|  |
| --- |
| **Example 1**  The audit committee of, Mumbai Co, has asked the partner to consider whether it would be possible for the audit team to perform a review of the company’s internal control system. A number of recent incidents have raised concerns amongst the management team that controls have deteriorated and that this has increased the risk of fraud, as well as inefficient commercial practices. The auditor’s report for the audit of the financial statements of Mumbai Co for the year ended 31 March 2016 was signed a few weeks ago. Mumbai Co is a listed company.    **Required:**Comment on the ethical issues raised and the actions your firm should take in response to the client’s request.  *(6 marks)* |

In this example, we are asked to provide an additional service to an audit client – a review of systems and controls. This is going to give rise to a self-review threat and may possibly lead to assuming a management responsibility. This identification is the first step to answering the question, but these points alone will not score credit in the exam until you have developed them. In order to do this you can use the steps described to build up marks as follows. The important phrases are in bold.

*Demonstrating you understand the threats, how they arise and the implication*

|  |
| --- |
| Providing a review of the company’s system and controls gives rise to a self-review threat as these controls will then be **reviewed by the firm when determining our audit strategy.** The firm may be **reluctant to highlight errors** or adopt a substantive approach during the audit as this may highlight deficiencies in the firm’s work on the additional service. *(1 mark)*  The **design of systems and controls is a management responsibility** so a review of such may give rise to a situation where the auditor is assuming a management responsibility by **taking on the role of management.***(1 mark)* |

*Apply the guidance to the scenario – evaluate the significance and suggest safeguards*

|  |
| --- |
| The code states that the threat to independence of undertaking management responsibilities for an audit client is so significant that there are **no safeguards** which could reduce the threat to an acceptable level. *(1 mark)* |

However, this answer could score three marks, it is likely that more marks are available. From an exam technique point of view, you should be looking for additional points to make. At this stage, don’t start speculating about relative fee size; try to focus on the information the examiner has given you. Here, the company is flagged as listed, so there must be further development available on this area. Think about how you’ve seen management responsibility issues overcome during your studies and past question practice. It is these points that you can use to attract further marks.

|  |
| --- |
| Management responsibility can be avoided if the **client takes responsibility** for monitoring the reports made and taking the decisions on recommendations.  *(1 mark)*  However, as this **client is listed, we are prohibited** from undertaking internal audit services which relate to a significant part of the controls over financial reporting. *(1 mark)* |

*Conclude*

|  |
| --- |
| As such we must **decline** the additional work. *(1 mark)* |

In other circumstances, the safeguard of using separate teams to overcome self-review threats or considering the competence of the firm to provide this service would attain credit; however, in this case, the client is listed so these points are irrelevant here.

Note that, in the exam, no marks are awarded for simply listing self-review or management responsibility as they will need to be described before marks are awarded. As such, ensure that you take the time to explain the threats rather than simply writing terms.

|  |
| --- |
| **Example 2**  Your firm’s advisory department has been carrying out a due diligence assignment on a potential acquisition target of an audit client, Blue Co. The management team of Blue Co has also approached White & Co to ask whether representatives of the firm would be available to attend a meeting with the company’s bankers, who they are hoping will finance the acquisition of Red Co, to support the management team in conveying the suitability of the acquisition of Red Co. For the meeting the bank requires the most up-to-date interim accounts of Red Co with the accompanying auditor’s independent interim review report. Your firm is due to complete the interim review shortly and the management team of Red Co has requested that the interim review is completed quickly so that it does not hold up negotiations with the bank, stating that if it does, it may affect the outcome of the next audit tender, which is due to take place after the completion of this year’s audit.    **Required:**Comment on the ethical issues raised and recommend any actions your firm should take in response to the client’s requests.  *(8 marks)* |

In this example we have additional services and pressure relating to existing services to an audit client. The issues we face are advocacy, self-review, management responsibility and intimidation.

*Demonstrating you understand the threats, how they arise and the implication*

|  |
| --- |
| Attending a meeting with the bank would give rise to an advocacy threat as we would be perceived as **promoting the interests of our client and confirming the client’s assertions** in negotiations. *(1 mark)*  In addition, this may give rise to **legal proximity** exposing the firm **to potential litigation.** *(1 mark)*  Attending the meeting may result in the firm being perceived to support the acquisition of Red Co. As these are **decisions which should be taken by management** we could be perceived as taking on a **management role**.  *(1 mark)*  Self-review threats may also arise when we **later audit** the finance and acquisition in **the financial statements** of the group as we may be **reluctant to highlight errors** or are **less sceptical** about the values in the subsidiary as we have provided the due diligence work. *(1 mark)*  Further, an intimidation threat exists as the client **has threatened** that if the interim report is delayed it would affect the outcome of the tender for audit in the future **and there is a risk that quality is reduced in order to meet the client’s demands.** *(1 mark)* |

*Apply the guidance to the scenario – evaluate the significance and suggest safeguards and conclude*Here, there are different directions that the answer could take – for example, discussing in depth the exact nature of the assignment and meeting attendance; however, it is possible to attract marks without such detail in your answer as follows:

|  |
| --- |
| Assuming a management responsibility can be avoided if the **directors confirm in writing** that they are **responsible** for any decision regarding the acquisition. *(1 mark)*  The firm should **decline to attend the meeting** with the bank. *(1 mark)*  The self-review threat can be reduced by having **an independent partner review** the audit work prior to signing the auditor’s report. *(1 mark)*  The intimidation threat should **be reported to those charged with governance**. *(1 mark)* |

Note that, in this instance, a separate team for the due diligence and audit assignments was not suggested as the scenario already told us that a different department had been carrying out the due diligence work.

**CONCLUSION**

The above two examples aim to cover a range of issues and illustrate how candidates can attract strong marks when answering ethics questions. As with most areas of the Advanced Audit and Assurance exam, it is the application of knowledge to a scenario rather than the knowledge itself that will attract marks. This means that when preparing for this exam, a good grasp of the knowledge underpinning the syllabus is important but practising questions and developing the skills of applying that knowledge is key to passing.

**Written by a member of the P7 examining team**

Last updated: 2 Feb 2018



Part 2 – Risk

/ Element: Page Intro Block: Text

Risk is examined in several ways within the Advanced Audit and Assurance syllabus and understanding the difference between these can be key to scoring good marks in the exam. Quite often, risk forms part of a planning question but it is also examined with respect to financial reporting issues elsewhere in the exam.

The key to attaining good marks for risk comes from understanding the types of risk you are looking for and explaining them in the correct context. As with many areas of the exam, good exam technique can be used to increase the marks attained without having to rote learn much additional information. It is application and understanding that is important at the Professional level.

This article will demonstrate how to maximise marks on these areas using effective exam technique. It is, however, specific to the context of auditing and assurance and will therefore have a different focus and application to the way risks are examined in other areas of the ACCA Qualification.

**What you need to know**

The three main types of risk you might be asked to evaluate in the exam are business risk, risk of material misstatement and audit risk. These are defined as follows:

**Business risk** *A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity’s ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies (ISA 315)*

**Risk of material misstatement (RoMM)** *‘The risk that a material misstatement exists in figures or disclosures within the financial statements prior to audit’* *(IAASB – glossary of terms)*

**Audit risk** *‘The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of material misstatement and detection risk’ (IAASB – glossary of terms)*

**How they interact** You should know from your study of Audit and Assurance that the audit risk model is comprised of:

Audit risk = RoMM x detection risk

For a risk of misstatement to occur there must be an inherent risk of an item being misstated and a risk that the client’s controls did not identify and correct this misstatement. When you are asked to evaluate RoMM in an exam, the examiner is looking for those inherent and control risks and, in many cases, these arise from underlying business risks.

For something to be an audit risk, there must be either a RoMM or a detection risk, the risk that the auditor’s procedures do not identify a material misstatement in the financial statements.

**How to apply the knowledge**

Knowing these definitions will help you to remember which type of risk is which or to categorise risks into these sub types but it is not something you will be awarded direct credit for in an Advanced Audit and Assurance exam.

Remember that you are often being asked to prepare an answer for the attention of the audit engagement partner, who will certainly not need these terms explained. Therefore, these definitions are so that you know what type of risk you are looking for in a question but the marks will be awarded for your evaluation of these risks.

Let’s consider an example of information that may be provided in the exam and how your answer would differ for each of the risk types you might be asked to evaluate. The following is an extract from the published September/December 2015 sample questions:

|  |
| --- |
| Dali Co was established 20 years ago and has become known as a leading supplier of machinery used in the quarrying industry, with its customers operating quarries which extract stone used mainly for construction.  The machines and equipment made by Dali Co are mostly made to order in the company’s three manufacturing sites. Customers approach Dali Co to design and develop a machine or piece of equipment specific to their needs. Where management considers that the design work will be significant, the customer is required to pay a 30% payment in advance, which is used to fund the design work. The remaining 70% is paid on delivery of the machine to the customer. Typically, a machine takes three months to build, and a smaller piece of equipment takes on average six weeks. The design and manufacture of bespoke machinery involving payments in advance has increased during the year. Dali Co also manufactures a range of generic products which are offered for sale to all customers, including drills, conveyors and crushing equipment. |

Block: Text

**Business risk** For the purpose of the exam, these risks can usually be thought of in terms of conditions that may prevent a business from meeting its objectives and might include risks to achieving future profits or cashflows or to business survival. This is a simplified explanation, but will help you describe the implications of most risks you come across in the exam. There will be some risks whose explanation is more involved and you can find examples of these in past exams.

In general, you are looking for risks in the information that the examiner has presented to you within the scenario. You will be asked to evaluate **those** risks. At this level you **will not** be credited for defining business risk, nor will you receive credit for describing what a client could do to mitigate those business risks.

As set out in the ISAs, the focus of business risk evaluation as part of the audit process is identifying matters that could impact on audit planning, in particular matters that could give risk to risks of material misstatement or audit risks.

The focus in the Advanced Audit and Assurance exam is therefore quite different from other strategic level exams where you might be expected to consider risks from a business perspective and to describe methods the business may use to manage those risks. If you stray into risk mitigation from a business perspective rather than an auditor’s perspective you are wasting valuable time on making points that cannot score marks.

As such, you need to consider how to frame the information which is provided as a business risk. As a general rule, marks for business risks will be awarded along the following lines:

* For identifying only without meaningful explanation, ½ mark
* For a briefly explained business risk, 1 mark will be awarded, and
* Full marks will only be awarded where a well explained business risk is presented.

Marks will not be awarded for points that are purely speculative – ie not based on specific information provided in the question scenario – nor will marks be awarded for business risks that do not impact on the audit.

Let’s now apply that logic to the example provided above:

|  |
| --- |
| **Identification only** – worth ½ mark  The company manufactures bespoke machines for clients which may take six months to complete.  In an exam, an answer that merely repeats facts from the question is unlikely to attain many marks – in a business risk question it can score ½ mark for identification only as the implications for the company have not been considered. |

|  |
| --- |
| **Identified and briefly explained** – worth 1 mark  The company manufactures bespoke machines for clients which may take six months to complete. During this time the company has funds tied up in work in progress.  This point cannot score full marks as there is no development of why this is a risk; how does it impact on the business or the audit? |

|  |
| --- |
| **Identified and well explained** – worth full marks  The company manufactures bespoke machines for clients which may take six months to complete. During this time the company has funds tied up in work in progress, which could give rise to cashflow problems, especially as the 30% deposit may not cover all the upfront costs. This service has increased in the year putting further strains on cash flow. |

Block: Text

It is also possible that a risk can have other implications or alternative descriptions that are valid and, if the answer was developed in one of these directions, that would still attract credit. For example, the following would also be an appropriate way to fully explain the same risk:

|  |
| --- |
| **Identified and well explained** – worth full marks  The company manufactures bespoke machines for clients which may take six months to complete. There is a risk that the customer cancels the order after the company has spent significant funds on the design and manufacture of the machine. This will have put strain on the company cash flow and it is unlikely that the machine can be sold to a different customer for the same price due to its bespoke nature. This may mean that the company makes a loss on the sale of the inventory or cannot sell it at all. |

Block: Text

In an exam such as this, it’s reasonable to assume that the examiner has given you each piece of information for a reason. It is likely to be relevant to one of the requirements and the examiner will often flag if there are areas which you should not consider. A good technique is to try and identify risks in each paragraph – there could be more than one but there is unlikely to be a section of text that does not flag something relevant for at least one requirement.

Another thing to watch for is describing risks that are speculative or insignificant in the context of the scenario you are given. There will be sufficient risk areas described in the scenario to score maximum credit if they are well described. If you find yourself hypothesising about potential issues that may affect the client, but you don’t have enough information to know if it’s a risk or not, then you are likely to be making irrelevant or marginal points. While it is true that valid risks – beyond those on the marking guide – can attract credit, it is much easier and less risky to use those that are flagged by the examiner.

**Risks of Material Misstatement (RoMM)** RoMM often follow from business risks and are the impact that those risks might have on the financial statements. It can be good practice during preparation for the exam to try and think of how a business risk might affect the financial statements every time you are analysing them. You are looking to convert that business risk into an impact on the calculation or disclosure of items within the financial statements.

When describing RoMMs, an effective approach is to use the following steps to construct your answer

* Calculate and conclude on the materiality of the issue where sufficient information is available – a mark will be given for a correct and relevant calculation of materiality with an appropriate conclusion – this will only be awarded once per issue and materiality marks may be capped in an exam question.
* Briefly describe the relevant financial reporting requirement – note that no credit is awarded for the accounting standard names or numbers, only the accounting treatment.
* Relate the risk in the scenario to the accounting treatment.
* Illustrate the impact of the risk on the financial statements

In general, there will be credit available for each of these processes and you should recall this approach every time you tackle a question requirement on evaluating RoMM.

Let’s consider the business risk we looked at above. The issue of bespoke machinery with an upfront payment can affect the financial statements in terms of revenue recognition, when dealing with the upfront payments, and inventory valuation. For the purposes of the exam, these two accounting issues are likely to be assessed as two separate RoMMs.

Applying this to the scenario we have above, the following illustrates a possible answer that could be written under exam conditions and would score full marks for each of the addressed risks.

|  |
| --- |
| Revenue recognition The company receives a 30% deposit for the design of bespoke machinery.  Revenue should be recognised over time or at a point in time **when control is passed**. Such points will be **determined by the contractual terms**. Payments received in advance of control passing should be **recognised as deferred income**.  There is a risk that **revenue might be recognised early** when payment is received **rather than being deferred.**  This would result in an **overstatement of revenue** and an **understatement of liabilities** for deferred revenue**.**   Inventory valuation The company manufactures machines over a period of up to three months. This gives rise to work in progress.  Work in progress is valued at the **lower of cost and NRV** where cost includes **all the costs of purchase and conversion** including overheads of getting the item to its present location and condition.  There is a risk that an order for bespoke machinery is **cancelled** and the inventory **NRV falls below** the net **costs** incurred.  This would result in an **overstatement of inventory** (or assets) in the statement of financial position and an understatement of cost of sales, therefore **an overstatement of profit**.  Note that we did not have sufficient information to calculate materiality in these examples. |

Block: Text

**Audit risks** Where you are asked to evaluate audit risks in an exam, much of your answer would be the same as for a requirement asking for risks of material misstatements as these form the major part of audit risk. The difference here is that detection risk is now also relevant. Examples of detection risk could include a recent appointment as the auditor, inexperience in a client’s new market or time pressure for the audit.

If the information provided in the example we have been using included the following information:

|  |
| --- |
| You are the audit manager of Dali Co, a new audit client of your firm. The partner has asked you to plan the audit for 31 December 2015 and has provided you with the following information after a discussion with the client. |

Block: Text

Then, in addition to the RoMMs we have discussed, there would be an additional audit risk.

|  |
| --- |
| We are newly appointed auditors of the client and, as such, do not have the same level of understanding of the client’s business and controls as we would for an existing client. As such, we may fail to recognise certain RoMMs or may apply inappropriate procedures due to this lack of understanding  In addition, we have not audited the opening balances, so there is a risk that the opening balances may be incorrect or inappropriate accounting policies have been used. |

Block: Text

There are two common errors candidates make in the exam around the issue of a new client. First, some candidates consider that a new auditor is a business risk or gives rise to a RoMM. This is incorrect. The underlying business is the same regardless and it is only detection risk that alters.

The second is to assume that a new manager on an assignment is the same as having a new client. The audit partner and the knowledge of the client within the firm is unaltered, so the discussion of a new manager to the audit resulting in a significant audit risk does not attract credit.

It is also important to note that, from an exam point of view, none of these examples require a definition to be given of risk types nor do they require any explanation of theories as part of the answer – if the examiner asks you to evaluate risks, then presenting your answer using the approach of a subheading for each risk and answers like those shown in the examples above is sufficient.

**Conclusion**

This article has focused on planning type questions where there is a specific requirement to describe one or more of business risk, RoMM and audit risk, and has laid out an effective approach for how you can tackle these questions to maximise your marks.

Note that RoMM is also relevant for matters and evidence questions where the structure of the answer in those questions may be broader but the basic thought process is similar. This will be addressed further in a separate article on accounting issues for Advanced Audit and Assurance.

**Written by a member of the P7 examining team**

Part 3 – Accounting issues

/ Element: Page Intro Block: Text

In the Advanced Audit and Assurance exam you will be required to discuss accounting issues in many contexts. It could be that during planning you are asked identify areas of audit risk or risk of material misstatement arising from accounting issues.  You may be expected to discuss accounting issues and their treatment in a completion question, where the appropriateness of a treatment is considered, or areas of risk exist. Accounting issues could arise in reporting questions where there may be an impact on the auditor’s report and the type of opinion which will be given. This list is not exhaustive but illustrates how important it is to have a good understanding of the accounting and financial reporting issues covered in all of the financial reporting areas of the qualification. In addition you will be required to recommend audit procedures or explain the evidence you would expect to see in the audit file in order to conclude on the appropriateness of these treatments and amounts.

As such, bringing forward a sound knowledge of financial reporting is crucial when preparing for the Advanced Audit and Assurance exam. Some of those areas may be relatively straight forward, for example the valuation of inventory at the lower of cost and net realisable value while others can be more involved or complex such as financial instruments, revenue recognition or pensions.

The purpose of this article is to utilise past questions from the Advanced Audit and Assurance exam to illustrate how accounting issues could be examined and to recap the accounting treatment on some of the areas candidates typically find difficult in this exam.

**Example 1 – Impairment**

It is rare to see an Advanced Audit and Assurance exam which does not cover impairment and the requirements of IAS 36 *Impairment of Assets*. This is a crucial standard which you need to understand as impairment considerations apply to so many assets within a set of financial statements.

A summary of the key financial reporting principles from IAS 36 is provided below:

* An asset is impaired if its carrying amount is higher than recoverable amount.
* The recoverable amount of an asset is the higher of its value in use (the present value of future cash flows deriving from the asset – or group of assets) and its fair value less disposal costs (the price which would be received in an orderly transaction between market participants – eg what you could sell it for).
* Where an asset is impaired it should be written down to its recoverable amount and generally that loss would be taken to the statement of profit or loss for the year.
* An impairment review is required for assets where there is an indicator of impairment such as a change in technology, increase in interest rates or possible obsolescence.
* There is also a specific rule to perform annual impairment reviews on intangible assets with indefinite lives, intangible assets not yet available for use and purchased goodwill (remember that internally generated goodwill isn’t recognised).
* Where an asset cannot be assessed for its recoverable amount individually it can be assessed as part of a cash generating unit. Where this is done the impairment is written off against the assets of the cash generating unit by allocating first against goodwill then against the other assets on a prorated basis but no asset should be reduced below the higher of its fair value less costs of disposal or value in use

IAS 36 paragraph 36.2 lists the assets which fall outside the scope of the standard including inventories, deferred tax assets, financial assets and non-current assets held for sale.

**Recent example – sample March/June 17, Question 4**

This is an example from a matters and evidence style question. These questions are typically set at the completion stage of an audit. Materiality, accounting treatment and risks are typical areas which would count as matters to be considered. In these questions the auditor’s report implication is only relevant if you are asked specifically to consider this area.

|  |
| --- |
| You are the manager responsible for the audit of Osier Co, a jewellery manufacturer and retailer. The final audit for the year ended 31 March 2017 is nearing completion and you are reviewing the audit working papers. The draft financial statements recognise total assets of $1,919 million (2016 – $1,889 million), revenue of $1,052 million (2016 – $997 million) and profit before tax of $107 million (2016 – $110 million).  At the year end management performed an impairment review on its retail outlets, which are a cash generating unit for the purpose of conducting an impairment review. While internet sales grew rapidly during the year, sales from retail outlets declined, prompting the review. At 31 March 2017 the carrying amount of the assets directly attributable to the retail outlets totalled $137 million, this includes both tangible assets and goodwill. During the year management received a number of offers from parties interested in purchasing the retail outlets for an average of $125 million. They also estimated the disposal costs to be $1·5 million, based upon their experience of corporate acquisitions and disposals. Management estimated the value in use to be $128 million. This was based upon the historic cash flows attributable to retail outlets inflated at a general rate of 1% per annum. This, they argued, reflects the poor performance of the retail outlets. Consequently the retail outlets were impaired by $9 million to restate them to their estimated recoverable amount of $128 million. The impairment was allocated against the tangible assets of the outlets on a pro rata basis, based upon the original carrying amount of each asset in the unit. (7 marks) |

|  |
| --- |
| In this question you can open with the materiality of the impairment. The impairment loss of $9m represents 0.47% of total assets and 8.41% of profit before tax and is material to the statement of profit or loss **(*1 mark for an appropriate calculation and conclusion).***  You should then state the underlying rule that an indicator of impairment triggers an impairment review and define impairment and recoverable amount. **(*1 mark*)** |

Block: Text

Most of the credit will be available for determining and explaining the risks arising and applying the accounting treatment to the information you have available.

We’re told that

* *Carrying value is $137m*
* *Net realisable value is $125m - £1.5m = $123.5m (you will generally receive ½ mark for calculating this figure)*
* *Value in use is estimated at $128m*
* *Recoverable amount is therefore $128m based on management’s calculations*
* *Impairment write off was based on value in use and has been pro-rated against assets based on the original carrying value of the assets in each unit.*

As auditors we need to look for risks in the process and treatment. Based on the information you can conclude that the carrying value is relatively low risk – we audited last year’s figures and it’s not an inherently risky area in general so in the absence of other information to the contrary you need to focus on the more risky areas.

The net realisable value carries some risk – external offers though are a good source of evidence and while not set in stone there have been several parties interested so it’s likely that the company would be able to sell the retail outlets for that price.

|  |
| --- |
| **So what are the key risk areas and the matters which should be considered?**  **Risk 1** – Management has estimated the costs of sale. An estimation is inherently risky as it is not certain. It’s also been estimated by management who could be biased.  **Risk 2** – The value in use is the major source of risk. The calculation is complex and judgemental and so is inherently risky. It has been calculated by management who may be biased to keep the impairment loss as low as possible. The calculation was based on historic cash flows with 1% annual growth which appears unrealistic given that retail sales have fallen not grown at 1%.  If the forecast used is overly optimistic then the impairment write off is insufficient and therefore assets are overstated and profit is overstated (as expenses are understated).  **Risk 3** – The treatment of the impairment write off may be incorrect as goodwill should be reduced before reducing the assets on a prorate basis and it should be ensured that no individual asset is reduced to below its own recoverable amount. |

Block: Text

The matters part of this question as illustrated within the boxes above and answer points which focussed on these risk areas would attract maximum credit for that part of the question.

As this was a matters and evidence question remember that you also need to go on to explain evidence you would expect to find on the audit file. The requirement is for the evidence to be **explained** in these questions so listing sources of evidence is not sufficient. Your answer points must also explain what they are providing evidence of in order to attract high marks. If you write out evidence as a list of described procedures then this will be acceptable and well described, relevant procedures will generally receive a mark each.

**Example 2 – Intangibles**

Intangible assets are non-monetary assets without physical substance such as patents, trademarks, customer lists, quotas, brands, franchise agreements etc

A summary of the key financial reporting principles from IAS 38 *Intangible Assets* is provided below:

* Intangible assets must be - identifiable (capable of being separated and sold/transferred and arise from contractual or other legal rights) - controlled - provide future economic benefits
* In order to be recognised as an asset there must be a probable future economic benefit arising from the asset and the cost must be capable of reliable measurement. If this is not possible then expenditure on the asset must be recognised as an expense. This is why internally generated brands and customer lists are not allowed to be recognised but purchased ones can be (including those purchased as part of the acquisition of another company)
* Subsequent treatment of intangible assets will be either on a historical cost basis or under a fair value model if it is possible that fair value can be determined by reference to an active market (eg production quotas, taxi licences).

|  |
| --- |
| **Exam focus**  **By definition brands are unique and therefore it would not be possible to compare to an active market hence the fair value model does not apply and they cannot be revalued upwards.** |

Block: Text

* Intangible assets will either have a finite life (a limited period of benefit to the company over which the asset will be amortised with the amortisation expense being charged to profit and loss) or an indefinite life (where no foreseeable limit to the period of economic benefits exist – hence no amortisation is charged)
* Where an asset is deemed to have an indefinite life it is not amortised but the useful life should be reviewed every reporting period to determine whether events continue to support an indefinite life and additionally, the asset should be assessed for impairment each reporting period.
* All intangible assets are subject to an impairment review where there is an indicator of impairment.

**Recent example – Sample March/June, Question 1**

This is an extract from a planning question which asked candidates to evaluate risks of material misstatement arising from a scenario where the Group holds several purchased brand names for products.

|  |
| --- |
| Acquired brand names are held at cost and not amortised on the grounds that the assets have an indefinite life. Annual impairment reviews are conducted on all brand names. In December 2016, the Chico brand name was determined to be impaired by $30 million due to allegations made in the press and by customers that some ingredients used in the Chico perfume range can cause skin irritations and more serious health problems. The Chico products have been withdrawn from sale. |

|  |
| --- |
| *When answering a requirement to evaluate risks from a scenario relating to specific accounting issues you should start by calculating the materiality of the issue- in this question, total assets were $358 million and PBT $28million.* The impairment of the Chico brand is 8.4% of total assets and more than 100% of PBT and is therefore material to both the statement of financial position and the profit and loss for the year.  **(*1 mark for an appropriate calculation and conclusion).***  *You should then state the underlying accounting rule* (***1 mark*).**  Acquired brand names should be capitalised and amortised over their useful life. Where this is indefinite, no amortisation is required, however an annual review of the appropriateness of the assumption of indefinite life should be performed and an annual impairment test is also required. |

Block: Text

*How this should be written up in a risk question has been illustrated in the* [*second article*](https://www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/exam-tech2.html) *in this series.*

Here, the company has decided to hold brands at cost as they deem them to have an indefinite life – this is an acceptable treatment under IAS 38 however the important part of the standard which we need to consider is that this should only be done if there is no foreseeable limit to the periods of benefit. There’s also a requirement that this assumption should be reviewed annually and additionally an impairment review performed. The scenario tells us that an impairment review has been performed but not that a review of the indefinite life has occurred hence there is a risk that this may not have been done

That decision to hold the brands with an indefinite life is a judgement call on behalf of management – judgements are subjective and therefore are a source of inherent risk. Quite often the justification for such a decision would be linked back to expenditure on the brand and marketing efforts along with market research. These costs cannot be capitalised but do provide evidence to support an indefinite life.

Similarly, impairment reviews for a brand would be looking at value in use based on the discounted value of future expected cash flows which is complex and judgemental.

In the exam you need to communicate these risk areas arising above- an example of a description for each that would be sufficient in an exam is shown below:

|  |
| --- |
| **Risk 1** – Management’s judgement that the brands have an indefinite life may be incorrect  **Risk 2** – Management may not have reviewed the useful life of the brands in the reporting period to ensure that the assumption of indefinite life is still correct  **Risk 3** – The impairment review may not be accurate as the assumptions used by management may not be appropriate as the calculation is complex and judgemental. (IAS 36) |

Block: Text

The scenario goes on to describe the impairment of the Chico brand after allegations made about the products. The products have been withdrawn from sale. This brings in the impairment consideration in more detail. Here there has been a specific indicator of impairment for both the brand and inventory relating to Chico and therefore poses more risks.

|  |
| --- |
| **Risk 4** – The impairment of the Chico Brand may not be sufficient (*we can’t tell if it has been fully written down IAS 36)*  **Risk 5** – The inventory relating to Chico products may need to be written off if its net realisable value is below cost (*IAS 2 Inventories)*  **Risk 6** – Other brands and inventory may be affected by the negative publicity regarding Chico and may also need to be written down (IAS 36) |

|  |
| --- |
| **Exam focus**  **No credit is awarded for the name or number of auditing and financial reporting standards.**  **You should avoid describing audit approach or evidence/procedures unless you have been asked to do this in the requirement.** |

Block: Text

**Conclusion**

The above examples aim to demonstrate how candidates can effectively apply their accounting knowledge in the Advanced Audit and Assurance exam in order to maximise their marks in a variety of questions including those which cover planning and matters and evidence considerations. As with most areas of the Advanced Audit and Assurance exam, it is the application of that accounting knowledge to a scenario rather than the knowledge itself which will attract marks. This means that when preparing for this exam, a good grasp of the accounting knowledge underpinning the syllabus is important but practising questions and developing the skills of applying that knowledge is the key to passing.

**Written by a member of the P7 examining team**

Part 4 – Audit procedures

/ Element: Page Intro Block: Text

The *Advanced Audit and Assurance* (AAA) exam would not be complete without testing the ability to design relevant procedures by which assertions can be assessed. This core skill, started at the applied skills level in *Audit and Assurance* (AA), is further developed and tested in AAA. In this exam the issues being audited will be extended to more complex areas of financial reporting and the more judgemental areas of a set of financial statements such as KPIs, forecasts and documents used for other services. It is important that candidates can move beyond learnt lists of procedures or generic tests to specific focused procedures which will examine specific assertions. Candidates must ensure they can describe the appropriate action, source and purpose for a procedure.

This article examines the key syllabus requirements in relation to procedures and considers the level of detail needed in order to obtain credit at this level. It will also look at some examples of past questions on this syllabus area and explain the difference between a strong answer and a weak answer to illustrate the detail and specificity that candidates should produce in their answers to attain marks in the exam.

**Syllabus requirements**

Audit procedures are covered in several areas of the AAA syllabus and the relevant learning outcomes require candidates to 'identify and describe audit procedures to obtain sufficient appropriate evidence from identified sources' or to 'design appropriate audit procedures' with respect to the audit of historical financial statements, or for other assignments to 'describe and recommend appropriate substantive, exam or investigative procedures which can be used to gather sufficient appropriate evidence in the circumstances'.

Note that these learning outcomes require candidates to design or describe audit procedures not simply provide a list of sources of evidence or a verb with no purpose such as review. When audit procedures are required as part of the exam it is expected that for credit to be awarded, candidates will describe the procedure in sufficient detail to demonstrate that they understand what it is trying to corroborate and what underlying piece of evidence will assist with that process. A good rule of thumb is to ask, if you gave your list of procedures to a new trainee auditor, would they know what to do, how to do it and why they are doing it? If there is a specific source of information and an action that is aimed at a specific purpose, then the answer is more likely to be complete and understandable.

**Structuring procedures**

In the AAA exam, procedures are often examined in planning questions where you may be required to plan audit procedures over a specific area of risk, or later in the audit, when reviewing the evidence you would expect to find on the audit file when it is reviewed by the manager or partner. For both requirements, the basic principle is the same. The marking guides in published questions state 'up to 1 mark for each well described audit procedure' hence a poorly described procedure will not obtain 1 mark, it will obtain at most ½ mark.

Simple example (note this is for illustration and is not indicative of an AAA scenario)

*The client has purchased a new machine for use in production of widgets. Design the principle audit procedures to be performed in respect of the new machine.*

A good start to answering the question would be to consider what assertions need to be covered. Here the auditor will want to know whether the machine is owned by the company, its existence, and its valuation.

We can address valuation and ownership at the same time for an outright purchase using the invoice in most cases. This should be an easy mark in the exam and everyone should be aiming for a full mark for this procedure. Consider the answers below

**Strong answer**

*Obtain the purchase invoice for the machine and confirm the purchase value to the non-current asset register and ownership of the machine -* **1 mark**

**Weak answers**

*Review purchase invoice* – ***this would score ½ mark***- this does not state what the invoice is being reviewed for or what assertion is being targeted.

*Purchase invoice –* ***this would score no marks*** *–* this is a source of evidence but without an action is not a procedure.

*Review the relevant document*- ***this would score no marks*** – there is no detailed action or purpose and no identifiable source.

For the existence of the machine, we could physically examine it

**Strong answer**

*Physically examine (or inspect) the asset to confirm it exists -* **1 mark**

**Weak answers**

*Physically examine machine -* ***this would score* ½ mark** – not tied to an assertion so does not explain why the asset is being examined.

*Observe assets –* ***this would score no marks*** *-* there is no detailed action or purpose and no identifiable source.

**Adapting the basic technique to the AAA exam**

The basic process illustrated above applies to the more complex situations that you will come across in the AAA exam questions however you will be facing more challenging areas than those seen in the AA exam. Rather than the existence of PPE, candidates may be required to consider the existence and valuation of intangible assets such as a brand (March/June 2017 Q1), the classification of an investment (March/June 2018 Q4) or the appropriateness of a forecast for assessing going concern or applying for finance (March/June 2018 Q2). Here candidates will be working with procedures that that can’t be rote learned and which need to be tailored to the scenario. There will often be judgements involved in areas examined where candidates will need to decide to what extent management can be relied upon and where candidates may be expected to demonstrate professional scepticism.

Practising past questions is important to extend your range of sources of evidences and develop an understanding of the sort of approaches which can be taken relating to specific judgements. However, it is also important to be able to think of original procedures to adapt to the differences in the scenario each time. What was appropriate in one exam may not be appropriate in another. The syllabus requirement to design procedures is the underlying skill being tested not the ability to learn a list of procedures for every occasion.

**Example AAA procedures questions**

The following is an extract from Question 2 in the September/December 2017 sample questions:

|  |
| --- |
| A provision of $430 million (2016 – $488 million) is recognised as a long-term liability. The provision is in respect of decommissioning a number of gas production and storage facilities when they are at the end of their useful lives. The estimate of the decommissioning costs has been based on price levels and technology at the reporting date, and discounted to present value using an interest rate of 8% (2016 – 6%). The timing of decommissioning payments is dependent on the estimated useful lives of the facilities but is expected to occur by 2046, with the majority of the provision being utilised between 2025 and 2040.  The accounting policy note discusses the methodology used by management for determining the value of the decommissioning provision and states that this is an area of critical accounting judgements including key areas of estimation uncertainty. The estimate has been made by management. In previous years, a management expert was engaged to provide the estimate but as this was expensive, management decided to produce the estimate for the year ended 30 June 2017. |

Block: Text

This example relates to a decommissioning provision for an event which is occurring the future. This means that the exact amounts will be unknown and that a level of estimation and judgement is inherently part of the amount. This illustration will focus on only the amount (completeness and accuracy) of the provision (ignoring for this illustration the need to establish that the obligation exists to decommission the facilities). The provision should be measured at the best estimate of future costs discounted to present value. When the provision is created the debit is to PPE but changes in estimates thereafter affect the profit for the year. In order to assess that the amount is appropriate certain issues must be evaluated:

* The estimate of useful life and timing of the predicted decommissioning costs (most will be used between 2025 and 2040 but some as far ahead of 2046)
* The discount factor used to calculate the provision (it’s gone up which will decrease the present values of the cash flows)
* The estimates of the cost of decommissioning (based on information available today)
* The process of the calculation of the provision amount (management has previously used an external expert but have calculated the figures themselves this year and the provision has reduced so management might be using the release of the provision to increase profits)

From a testing point of view each of these elements should be considered and the appropriateness of them assessed. Before that can happen, we need to obtain the calculation we are performing work on. The table below shows a range of procedures to answer this question which would score full marks and examples of weaker answers with how many marks they would obtain shown against each.

Block: Text

|  |  |
| --- | --- |
| **Strong answers - 1 mark each** | **Weak answers – 0 to ½ marks** |
| Obtain a copy of management’s calculation of the provision and source documents to support the underlying figures to understand how the provision had been derived | Review management’s calculation (½)  *The term review without a specific purpose is vague and there is no purpose provided for the procedure* |
| Assess management’s key assumptions and consider the validity of these assumptions in light of the auditor’s understanding | Review managements assumptions (½)  *This does not state why the assumptions are being reviewed or make an attempt to confirm they are valid* |
| Review any decommissioning agreements to confirm estimate of useful life of the assets and date of decommissioning | Check useful life (0)  *There is no source given for identifying the useful life nor is there a purpose given for checking it* |
| Assess the reasonableness of the increase in discount rate by reference to movements in market interest rates | Ask management why interest rate has increased (½)  *There is no purpose given for investigating the interest rates and the auditor is aiming to corroborate managements figure – interest rates are generally readily available from independent sources* |
| Review a list of decommissioning costs and compare to quotes or prices of current decommissioning if available to corroborate management’s estimates | Check costs to invoice (0)  *These costs are in the future, so we have no invoice to corroborate costs. There is also no purpose given for the procedure* |
| Compare methodology used this year to that used last year to confirm consistency or differences and assess whether changes are appropriate | Compare provision to last year’s provision (½)  *This lacks purpose for the procedure* |
| Cast the provision schedule for arithmetical accuracy and agree to figure in the financial statements | Cast provision (½)  *The purpose of casting the provision is omitted* |
| Use an auditor’s expert to provide an independent calculation of the decommissioning costs and compare to management’s figures to support the appropriateness of the figures | Use expert (0)  *This does not specify that the expert is independent or what they would be used for*  Obtain independent expert calculation (½)  *This mentions independent but does not specify a purpose* |
| Review the notes to the financial statements to ensure that the disclosure on the movement in the provision and the description of the nature and timing of the costs and the assumptions are appropriate | Check disclosures (0)  *This does not specify what the disclosures should be or the source* |
|  | Get written representation (0)  *See below* |
|  | Review board minutes (0)  *See below* |
|  | Agree to the financial statements (0)  *See below* |

Block: Text

There are a few things to note about this table. Firstly, the testing has been tailored to the information which was available in the question – the change in interest rates, the change in how the estimate is prepared (management vs external expert). Secondly the procedures must be specific to obtain credit – try to use an action, (it can be useful to refer to the testing techniques in ISA 500, *Audit Evidence* – for example, inspect, recalculate etc), a source and a purpose. Without these you are not describing enough detail at this level of exam. And thirdly, the final three answers in the weak answer section are not obtaining credit here. This third point is a common area where candidates use rote learnt points without considering their appropriateness and relevance to the scenario and each is considered further below.

**Written representations from management**

Written representations from management are used to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements. They are often requested where management’s intentions can affect the validity of a judgement. They should not be used as the only audit evidence to support an assertion, and should not be used if it is possible to obtain the evidence without need of a written representation. In the previous example, obtaining a written representation that management’s judgement of the discount factor is correct is not wholly appropriate. The auditor can assess the discount factor with respect to external factors and actual rates incurred by the company, so there are other more relevant and reliable sources of evidence

If the scenario focuses on management’s intentions, written representations could be appropriate, for example the intent to sell a building, or to close down a division. There would still be a requirement however to obtain corroborative evidence. If candidates use a written representation from management as a procedure in the exam then it must be appropriate and the specific content and purpose of the representation should be described. An example of the appropriate use of a written representation and the contents is illustrated below:

March/June 2018 Q2b procedures to be performed on a profit forecast to be used to obtain bank funding

* Obtain written representation from management regarding the completeness of significant assumptions **AND** accepting their responsibility for the forecast (this is required by ISA 3400, *The Exam of Prospective Financial Information* and therefore is appropriate), or
* Obtain written representation from management the bank overdraft will be repaid by 1 September 2019 (*note this is management’s intention and can be part of the evidence for justifying that it is appropriate that there is no overdraft interest in the forecast after that date*)

A final point on written representations from management, is that where management are not believed to be reliable, for example they have been showing signs of earnings management and inappropriate judgements, then written representations are not likely to be a reliable form of evidence.

**Review board minutes**

Often candidates include this as part of every answer to every requirement without considering whether it is likely to be discussed at board level or in what detail. This procedure might be relevant when supporting management’s intentions regarding strategy or approval regarding major decisions such as acquisitions, but it is not likely to be the case that the board of directors approve every individual asset purchase (rather than the capex budget as a whole) or every allowance for slow paying customers. If it isn’t something the board discuss then candidates won’t be credited for this as a procedure. In addition, the purpose of reviewing the board minutes will need to be stated in order for any credit to be awarded.

**Strong answer**

Confirm that the acquisition of the new subsidiary was approved by the board through review of board minutes - **1 mark**

**Weak answers**

Review board minutes for approval (***½ mark*** – not stated approval of what)

Review board minutes for acquisition (***½ mark*** - does not state what information regarding the acquisition is being obtained from the board minutes)

Review board minutes (***would score no marks*** – this will not receive credit as it is not specific to the scenario at all)

**Agree to the financial statements**

This is another area where candidates appear to make a general statement that is often not appropriate. For example, in the March/June 2018 Q4 candidates testing the elimination of the intercompany balances often stated to check the elimination of a single transaction between two of the group companies to the financial statements. By their nature financial statements are aggregate figures and do not show every transaction. The elimination would be something that could be agreed to a consolidation schedules but will not be visible in the financial statements issued by a company. The distinction between detailed management accounts, breakdowns of the figures in the financial statements, consolidation schedules and the financial statements themselves should be something that candidates at this level appreciate. To obtain marks for agreeing something to the financial statements it will be necessary that the item can be seen in the financial statements or the notes and that the specific detail of what is being agreed is stated.

**Strong answer** – for example, for an acquisition in the year

Confirm disclosures in the financial statements include the date of acquisition, the fair value of consideration and the fair value of the net assets acquired (**1 mark** – *note this isn’t everything that IFRS® 3 Business Combinations requires to be disclosed but it does give some specific details that shows understanding of the sorts of disclosures required*)

**Weak answers**

Agree to financial statements – ***this would score no marks*** – no detail of what is being agreed

Agree the amounts for the acquisition have been disclosed in the financial statements – ***this would score ½ marks*** – no specific detail of the items to be disclosed

**Conclusion**

As can be seen from the discussion above, a good structure for presenting procedures (action- source-purpose) is key to obtaining strong marks on this section of the exam. For a candidate to score well they will need to be able to adapt the procedures to the details given in a scenario and question whether the source is appropriate. Past question practice is a good start for expanding the range of procedures in a candidate’s toolkit and the ability to tailor answers to the specific circumstances in the exam they are sitting.

**Written by a member of the *Advanced Audit and Assurance* examining team**

Part 5 – Auditor reporting

/ Element: Page Intro Block: Text

Auditor reporting forms an important part of the *Advanced Audit and Assurance* syllabus and exam. Prior to September 2018 auditor reporting typically featured in one of the optional questions and was often the least popular question each session. Candidates should be aware that as the exam moves to its new syllabus format all questions will be compulsory and one of the 25-mark questions each session will be drawn from the completion and reporting area of the syllabus. Questions could focus on syllabus areas including final evaluation of audit evidence, matters such as going concern and subsequent events, and the reports which auditors produce at the final stage of the audit, including the auditor’s report to shareholders and reports to those charged with governance. This article focuses on auditor reporting to shareholders. It is imperative for candidates to be prepared to answer questions on auditor reporting and will need an understanding of the format of the report, the types of opinions which may be given by the auditor and the other modifications which could be required to an auditor’s report.

Exam questions on the auditor’s report have often taken one of two forms. The first is an appraisal of information provided within a scenario and a requirement to consider further actions and possible reporting implications, the other a critique of draft wording for an auditor’s report. These requirements are slightly different as one is at an earlier stage than the other and hence it is important to focus the answer to what the requirement is asking for. There are also different wordings of the requirements which mean that the answers to two questions may look similar but conclusions have been reached for different reasons.

**Audit opinions**

The audit opinion is perhaps the most important thing to understand for an auditor’s report question. Where the auditor has gathered sufficient and appropriate evidence that the financial statements are free from material misstatements an unmodified opinion can be issued.

**Unmodified opinions**

ISA 700 (revised) *Forming an Opinion and Reporting on Financial Statements* gives two alternative forms for an unmodified opinion. These are:

* In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the company as at 31 December 20X1 and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRS®), or
* In our opinion, the accompanying financial statements give a true and fair view, in all material respects, the financial position of the company as at 31 December 20X1 and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRS®).

|  |
| --- |
| ***Common error in the exam – candidates often state that the first of these opinions is incorrect and that the report should state the financial statements are true and fair – this is not the case, either wording is allowed by the standard.*** |

Block: Text

**Modified opinions**

The next thing a candidate needs to have clear in their mind are the possible modifications for opinions. These arise if the auditor

* is not able to obtain sufficient appropriate audit evidence
* determines uncorrected material misstatements exist, or
* has concluded that the financial statements are NOT prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework which includes consideration of the qualitative aspects of the entity’s accounting practices, including indicators of possible bias in management’s judgments.

Where this is the case the auditor will need to assess whether the issues considered are material or material and pervasive.

ISA 705 (revised)*, Modifications to The Opinion in The Independent Auditor’s Report* identifies three types of modified opinion:

* **Qualified opinion** – where the auditors concludes either that the misstatements in the financial statements are material but not pervasive (**qualified on the basis of material misstatement**) or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion but conclude the possible effects on the financial statements of undetected misstatements would be material but not pervasive (**qualified on the basis of an inability to obtain sufficient audit evidence**). Qualified opinions are given in the form of 'except for' opinions and examples of the wording for such opinions can be found in ISA 705 (revised) para 17
* adverse opinion – where the auditor concludes that the material misstatements in the financial statements are pervasive (therefore they **do not present fairly/are not true and fair**) and,
* a disclaimer of opinion where the auditor concludes that there is insufficient evidence on which to base an opinion and the possible effects of undetected misstatements are material and pervasive

In order to distinguish between these types of modified opinion a candidate must determine two things

* Is there a material misstatement or is there insufficient evidence to know whether there is a material misstatement, and
* Is the effect material or material and pervasive?

In determining whether a misstatement is pervasive ISA 705 (revised) gives the following definition:

**Pervasive** – A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor’s judgment:

**(i)** Are not confined to specific elements, accounts or items of the financial statements

**(ii)** If so confined, represent or could represent a substantial proportion of the financial statements, or

**(iii)** In relation to disclosures, are fundamental to users’ understanding of the financial statements.

Block: Text

|  |
| --- |
| ***Common errors in the exam – candidates often identify correctly there is a material misstatement in the accounts that is not pervasive, then state that the opinion should be unmodified or that the misstatement should be covered by an emphasis of matter paragraph. This is incorrect; a material misstatement which is not pervasive will result in a qualified opinion.*** |

Block: Text

**Basis for opinion paragraph**

The auditor’s report contains a paragraph **after** the opinion paragraph describing the basis on which auditors form their opinion. Where a modified audit opinion is given the details of the misstatements or the inability to obtain sufficient appropriate audit evidence will be provided.

Block: Text

|  |
| --- |
| ***Common error in the exam – using outdated standards and stating the basis for opinion paragraph is presented before the audit opinion.*** |

Block: Text

**Other modifications to the auditor’s report**

In a requirement that asks candidates to consider the effect on the auditor’s report rather than the effect on only the audit opinion, there are other modifications which should be considered.

**Emphasis of matter (EoM) –** used by auditors where they consider that there is amatter ***correctly presented or disclosed*** in the financial statements that the auditor deems to be of fundamental importance to a user’s understanding of the financial statements. This paragraph is used to draw attention to the matter being emphasised by referring to where it is presented and disclosed in the financial statements. This paragraph is not used for going concern uncertainties.

Block: Text

|  |
| --- |
| ***Common errors in exams***   * ***Using an EoM paragraph for a material misstatement or failure to obtain evidence – these give rise to qualified opinions*** * ***Using an EoM paragraph for uncertainties surrounding going concern – these have a separate paragraph*** * ***Using an EoM paragraph for something which would be a key audit matter for a listed company.*** |

Block: Text

**Other matter (OM)** – used by auditors where they consider it necessary to communicate a matter other than those presented or disclosed in the financial statements that is relevant for a user’s understanding of the audit, auditor’s responsibilities or the auditor’s report.

**Other information**

ISA 720 (Revised), *The Auditor’s Responsibilities Relating to Other* *Information* also requires the inclusion of an Other Information paragraph which includes:

* A statement that management is responsible for the other information
* An identification of:
  + other information, if any, obtained by the auditor prior to the date of the auditor’s report, and
  + for an audit of financial statements of a listed entity, other information, if any, expected to be obtained after the date of the auditor’s report
* A statement that the auditor’s opinion does not cover the other information and Accordingly that the auditor does not express (or will not express) an audit opinion or any form of assurance conclusion thereon
* A description of the auditor’s responsibilities relating to reading, considering and reporting on other information as required by this ISA, and
* When other information has been obtained prior to the date of the auditor’s report, either:
  + a statement that the auditor has nothing to report, or
  + if the auditor has concluded that there is an uncorrected material misstatement of the other information, a statement that describes the uncorrected material misstatement of the other information

Block: Text

|  |
| --- |
| ***Common exam error – not appreciating that the audit has a responsibility for reporting misstatements in the other information in addition to inconsistencies.*** |

Block: Text

**Material Uncertainty Related to Going Concern –** ISA 570 (revised) *Going Concern* requires auditors to include a paragraph drawing attention to uncertainties relating to going concern which are **adequately disclosed** in the financial statements by reference to those disclosures.

Block: Text

|  |
| --- |
| ***Common exam errors***   * ***Including going concern issues in an EoM paragraph – this is no longer in line with revised ISAs 570 and 706*** * ***Stating that an uncertainty arising due to going concerns means the break up basis of accounting should be used – an uncertainty such as withdrawal of one form of finance or the loss of a major customer may give rise to uncertainties but do not always mean a company will cease trading and be required to use the break up basis of accounting. Candidates should appreciate that it is extremely rare to see 'break-up basis' financial statements, which are only used where a reporting entity has no option but to wind up operations.*** * ***Using the uncertainty paragraph where the uncertainty is not disclosed in the financial statements – this would give rise to a material misstatement and require a qualified or adverse opinion.*** |

Block: Text

Note that all three of these modifications do not result in a qualified opinion. They modify only the report. None of these is an alternative to a qualification of the audit opinion.

**Key audit matters**

For listed companies, auditors are required to include a Key Audit Matters (KAM) section within the auditor’s report ISA 701 *Communicating Key Audit Matters in the Independent Auditor’s Report* defines key audit matters as —those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with Those Charged with Governance. They are areas of high risk, high levels of management judgement or significant events or transactions arising within the period.  The auditor is required to explain why each matter was deemed important and how it was addressed during the audit.

This section cannot be used to avoid giving a qualified opinion.

**Exam focus**

Auditor reporting is covered by many ISAs and it is often hard to visualise how an auditor’s report should look. Many candidates in the exam still refer to outdated auditing standards or do not seem to understand how the auditor’s report flows. Listed companies generally publish their annual report online and these can be accessed freely. Candidates should take time to read the auditor’s reports for several real companies to appreciate this fundamental part of the syllabus. The profession revolves around the auditor’s report, the audit process and the ethics and professional issues that surround it all lead to this crucial document that is the output of the audit. [View an example of a real auditor’s report](https://www.santander.com/csgs/Satellite/CFWCSancomQP01/en_GB/pdf/Auditors_report_and_annual_consolidated_accounts_2017.pdf)

Exam questions on reporting can take different forms. Here’s some examples from past questions and common misstates that have been seen in candidate answers. The links below can be used to see the scenario details relating to the question:

[**March/June 2018, Q5**](https://www.accaglobal.com/content/dam/acca/global/PDF-students/acca/p7/exampapers/int/p7int-2018-jun-q.pdf)

**Scenario summary**

Candidates were presented with an extract from a proposed auditor’s report for a listed company, comprising KAM, qualified opinion and EoM paragraphs.

***Requirement***

Critically appraise the extract from the auditor’s report on the consolidated financial statements of the Blackmore Group for the year ended 31 March 2018.

**Exam focus**

To critically appraise candidates should consider each piece of information and assess whether it is correct or incorrect, describing why and how to amend it as necessary.

**Commons mistakes in the exam**

* stating the qualification matter should have been an EoM
* stating the financial statements should be prepared on a break up basis because of a potential breach of funding covenants (it’s an uncertainty over going concern but the company is not about to commence winding up)
* stating that the auditor should not disclose the potential uncertainty regarding going concern because it hasn’t happened yet (the uncertainty exists therefore it will impact the auditor’s report)
* not identifying that the uncertainty discussion did not refer to adequate disclosures in the accounts (these are needed if the opinion will not be qualified)
* not identifying that the EoM paragraph should have been a Material Uncertainty Relating to Going Concern paragraph
* saying the report was missing a title and signature – this was an extract not a complete report

[**September/December 2017, Q5b(ii)**](https://www.accaglobal.com/content/dam/acca/global/PDF-students/acca/p7/exampapers/int/SD17_Hybrid_P7INT_Clean_Proof.pdf)

**Scenario summary**

Candidates were presented with material misstatements identified during the audit. Part b(i) asked candidates to explain matters which should be discussed with management in relation to the uncorrected misstatements and then lead to b(ii) below

***Requirement***

Assuming that management does not adjust the misstatements identified, evaluate the effect of each on the audit opinion.

**Commons mistakes in the exam**

* considering the effects on wider areas of the auditor’s report not specifically the opinion
* assuming that misstatements in disclosures didn’t need a qualification and recommending using an EoM instead – a material misstatement in disclosure still requires a qualified audit opinion
* believing that the auditor’s disagreement with management regarding the reduction in provision was an inability to obtain sufficient appropriate evidence rather than a material misstatement
* suggesting putting qualification matters that were material but not pervasive in an EoM paragraph rather than qualifying the opinion.

[**September/December 2016**](https://www.accaglobal.com/content/dam/acca/global/PDF-students/acca/p7/exampapers/int/p7int-2016-dec-q.pdf)

**Scenario summary**

Candidates were presented with two unresolved issues arising from the audit of a non-listed company. The first was an imposed limitation in scope arising from a confidentiality agreement signed by the client and the second was a significant event properly disclosed in the financial statements.

***Requirement***

In respect of each of the matters described above, discuss the implications for the auditor’s report and recommend any further actions necessary.

*Note this requirement covers the auditor’s report not simply the opinion and is for a non-listed company.*

**Commons mistakes in the exam**

* ignoring the requirement for further actions in addition to the auditor’s report implications – this includes trying to resolve the limitation of scope with management and the requirement to communicate the matter to TCWG
* recommending an EoM paragraph for the limitation of scope – this has to give rise to a qualified opinion
* omitting the description of the effect on the basis for opinion paragraph or stating it should be placed before the audit opinion
* not stating that an EoM paragraph needs to draw attention to the significant event disclosure in the notes to the financial statements or that this matter does not modify the audit opinion

**Key points for exam technique**

In summary, candidates should expect to answer a question on auditor reporting in exams under the new syllabus. To perform well in this area candidates must:

* Have an understanding of the types of audit opinion available
* Understand the different additional components of the auditor’s report
* Read the requirements carefully to identify the correct areas to cover and whether:
  + the company is listed,
  + the question asks for more than effects on the auditor’s report such as actions to be taken
  + the response is relating to the audit opinion only or the wider effects on the auditor’s report

**Conclusion**

With good preparation and a logical approach this area of the exam can enable candidates to score strong marks and question practice will help to hone those skills.

**Written by a member of the *Advanced Audit and Assurance* examining team**

res

* **IAASB EXPOSURE DRAFT – PROPOSED INTERNATIONAL STANDARD ON AUDITING 540 (REVISED) AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES**

**Exam and syllabus**

The syllabus and study guide for *Advanced Audit and Assurance (AAA)* includes section G1a on professional and ethical developments which requires candidates to ‘discuss emerging ethical issues and evaluate the potential impact on the profession, firms and auditors’ and G1b ‘Discuss the content and impact of exposure drafts, consultations and other pronouncements issued by IFAC and its supporting bodies.’ This article is intended to provide insight into recent proposed changes to ISA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures. The article is relevant to all versions of the AAA exam.

**Introduction and background**

In April 2017, following outreach activities with regulators and other key stakeholders, the IAASB issued *Proposed International Standard on Auditing 540 (Revised) Auditing Accounting Estimates and Related Disclosures* (ED 540). The IAASB commenced a project in early 2015 to address issues relevant to the audits of financial institutions as well as to ISA 540 more generally. The project indicated that regulators and auditors of financial institutions believed that the IAASB needed to focus on the issues for audits of financial institutions arising from IFRS® 9 *Financial Instruments* prior to the effective date for the implementation of the standard for annual periods commencing on or after 1 January 2018.

The main catalyst for the revisions proposed by ED 540 therefore was the development and implementation of IFRS 9 *Financial Instruments* and the introduction of its expected losses model for assessing the impairment of financial assets. The expected losses model fundamentally changes the way that reporting entities will account for their loan assets and other credit exposures. The model involves a complex and subjective estimation process which presents a particular challenge to auditors in terms of developing a robust approach to appraising management’s prospective assessment of the credit risks associated with an entity’s portfolio of financial assets.

Feedback from the IAASB’s outreach projects also revealed a perceived lack of consistency in the extent to which auditors obtained an understanding of accounting estimates together with evidence of insufficient and inappropriate work effort by auditors in this area. The consultation process identified:

* a lack of professional scepticism being exercised by auditors and a need for more specific risk assessment requirements and more granular requirements regarding obtaining audit evidence, and
* a need to enhance communication between auditors and those charged with governance about accounting estimates and in particular the auditor’s views about significant qualitative aspects of the entity’s accounting practices.

After consulting with key stakeholders, the IAASB therefore concluded that many of the issues identified with respect to IFRS 9’s expected credit losses model were also equally relevant when auditing other complex accounting estimates. As a result the IAASB concluded that a full revision of ISA 540 was required as a matter of priority. ED 540 proposes that the revised standard will apply to the audit of all accounting estimates and to all audits regardless of the size or status of the reporting entity.

**Objectives and overall approach**

The objective of ED 540 is to enable the auditor to obtain sufficient and appropriate audit evidence in order to evaluate whether accounting estimates and their related disclosures are reasonable in the context of the applicable financial reporting framework or whether they are misstated. ED 540 includes enhanced requirements for risk assessment procedures and the work effort required of the auditor in responding to the assessed risks of material misstatement.

Although it was IFRS 9 which triggered the need for change, the IAASB has sought to make ED 540 scalable and the revised standard will apply to all accounting estimates from the simplest depreciation calculation through to the most complex of derivative financial instruments and expected credit losses. While the simpler accounting estimates will not generally give rise to high audit risk, many measurements based on estimates, including fair value measurements and impairments in relation to financial instruments, are imprecise and subjective in nature and will give rise to high inherent risk. Such fair value and impairment assessments are likely to involve significant, complex judgements for example regarding market conditions, the timing of cash flows and the future intentions of the entity. The valuations will often involve complex models built on significant assumptions such as the predicted timing of cash flows, the most appropriate discount factor to use and judgements about probability weighted averages. Management may not always have sufficient knowledge and experience in making these judgements. Moreover, there may even be a deliberate attempt by management to manipulate the value of an estimate in order to window dress the financial statements. The IAASB recognises the central role that professional scepticism plays in the audit of accounting estimates and ED 540 contains key provisions which are designed to enhance the auditor’s application of professional scepticism and a consideration of the potential for management bias. The key provisions include the following:

* Enhanced risk assessment requirements in order to provide a better basis for identifying and assessing the risks of material misstatement related to accounting estimates.
* More granular requirements in relation to obtaining audit evidence when inherent risk is assessed as not low.
* A requirement to ‘stand back’ and evaluate the audit evidence obtained regarding the accounting estimates, including both corroborative and contradictory audit evidence.

**Responding to the assessed risks of material misstatement**

The proposed approach requires the auditor to assess the inherent risk attached to accounting estimates as either low risk or not low risk.

When inherent risk is assessed as low, the auditor will follow a similar approach to that previously required by ISA 540. Here the auditor will determine whether one or more of the following further audit procedures would provide sufficient and appropriate audit evidence regarding the assessed risk of material misstatement:

* Obtaining evidence from the review of subsequent events up to the date of the auditor’s report.
* Testing the processes used by management in making the accounting estimate and testing the underlying data on which it is based.
* Developing the auditor’s own estimate or range of estimates based on the available audit evidence to evaluate management’s estimate.
* If the auditor intends to rely on internal controls relating to accounting estimates or if substantive procedures alone cannot provide sufficient appropriate audit evidence, the auditor should design and perform tests of control in order to obtain sufficient appropriate evidence that they are operating effectively.

When inherent risk is not low, ED 540 will require a more rigorous risk assessment. ED 540 states that an increased work effort is required in order to determine how three key factors have impacted on a specific accounting estimate. The three factors which the auditor must specifically consider are as follows:

**(i) Complexity:**

Complexity in relation to accounting estimates can arise from both the estimation method used and the underlying data on which the estimate is based. Given the increased emphasis on the use of external sources in IFRS 13 *Fair Value Measurement* and in making accounting estimates such as fair values, ED 540 aims to improve and clarify the requirements on the use of such information as it is in the public interest to do so.

Where the reasons for an increased risk of material misstatement is due to management’s use of a complex method (including complex modelling) or the use of specialised skills and knowledge, ED 540 requires the auditor to obtain sufficient appropriate evidence in relation to a series of specific matters including:

* the appropriateness of the method, data and assumptions in the context of the applicable financial reporting framework
* whether the data is relevant and reliable
* whether management has appropriately understood and interpreted the significant data used
* whether the integrity of the data and assumptions has been maintained in the development of management’s methodology, and
* whether the calculations are mathematically accurate and appropriately applied.

**(ii) Need for management judgement:**

Where accounting estimates rely upon significant management judgement, the risk of material misstatement is increased due to intentional or unintentional management bias. When the risk of material misstatement relates directly to the use of management judgement (including the judgement used in management’s application of complex modelling), ED 540 gives detailed guidance on a series of specific matters on which the auditor must obtain sufficient appropriate audit evidence. These matters include whether management’s judgements and assumptions are in compliance with the measurement requirements of the applicable financial reporting framework; whether significant assumptions are consistent with those used in other areas of the entity’s business activities including any other accounting estimates; and whether management’s judgements about changes from previous periods are appropriate.

**(iii) Estimation uncertainty:**

ED 540 emphasises the need to understand and address estimation uncertainty and the impact that this has on the auditor’s evaluation of the reasonableness of management’s estimates and related disclosures. As with the previous two factors, ED 540 again contains requirements for the auditor to obtain sufficient appropriate audit evidence by addressing key matters in the context of the applicable financial reporting framework. These key matters include whether management has taken the necessary steps in order to understand the source of the estimation uncertainty and whether its estimates and disclosures in this regard are reasonable. Where the auditor concludes that management has not taken adequate steps, ED 540 requires the auditor to develop their own estimates to be based on data which is supported by the audit evidence and which complies with the applicable financial reporting framework.

**Other matters**

ED 540 highlights a number of other matters which should be considered in the audit of accounting estimates and related disclosures. These other matters include the following:

**Disclosures**

The IAASB has noted the increasing importance of the role of disclosures in financial reporting and particularly in relation to accounting estimates. The IAASB believes that disclosures relating to accounting estimates are critical to users’ understanding of the accounting policies applied, the nature and extent of estimation uncertainty and the key judgements made by management. ED 540 therefore requires the auditor to obtain sufficient appropriate audit evidence about whether the disclosures relating to accounting estimates are reasonable in the context of the applicable financial reporting framework. In the context of a compliance based framework, the auditor must ensure that sufficient appropriate audit evidence has been obtained to confirm that the disclosures included are those necessary for the financial statements not to be misleading. In the case of a framework based on fair presentation principles, the auditor must obtain sufficient appropriate audit evidence that management has provided the additional disclosures beyond those specifically required by the framework that are necessary in order to achieve the fair presentation of the financial statements as a whole.

**Communication with those charged with governance**

The IAASB recognises the importance of a two-way dialogue between the auditor and those charged with governance (TCWG). ED 540 therefore includes a new requirement to place more emphasis on communications with TCWG in relation to the auditor’s views about accounting estimates. ISA 260 (Revised) *Communication with Those Charged with Governance* and ISA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* already require the auditor to communicate with TCWG about significant qualitative aspects of the reporting entity’s accounting practices and significant deficiencies in internal controls. ED 540 additionally requires the auditor to communicate whether the accounting estimates and their related disclosures are impacted by the key factors identified by the standard including complexity, the need for management judgement and estimation uncertainty.

**Documentation**

The documentation requirements of ISA 230 *Audit Documentation* already apply to many of the auditor’s judgements but ED 540 also includes additional application material which highlights aspects of the auditor’s work on accounting estimates and related disclosures which would be likely to give rise to judgements which would require documentation under ISA 230. ED 540 also extends the existing documentation requirements of ISA 540 to include documentation of indicators of management bias where applicable and the auditor’s evaluation of any such bias in forming his opinion on the financial statements as a whole.

**Conclusion**

Overall there has been much support for the IAASB’s objectives in revising ISA 540. Respondents to ED 540 have been generally supportive of its additional focus on the role of professional scepticism in the audit of accounting estimates and related disclosures and have been sympathetic to the need to finalise the standard quickly given the implementation of IFRS 9 for annual periods commencing on or after 1 January 2018. Some commentators have, however, expressed concerns about the clarity and operability of the proposed standard and have questioned whether its approach is over-complicated in relation to simple accounting estimates. Some have maintained, for example, that more guidance is needed on how to distinguish between ‘low inherent risk’ and ‘non-low inherent risk’ and have asked for greater development of ED 540’s scalability concept through the inclusion of further examples in the application material. Respondents have also commented more generally on a perceived lack of specificity in the audit procedures to be performed and have requested more guidance from the IAASB on how to test valuation models and the internal controls which management have utilised in developing their accounting estimates.

At the time of writing, the IAASB is in the process of completing its deliberations in response to the feedback received before finalising its revision of ISA 540 on a timely basis for the audit of financial statements prepared under IFRS 9.

**Written by a member of the *Advanced Audit and Assurance* examining team**

The completion stage of the audit is when the auditor reviews the work performed and considers the implications for the auditor’s report. A crucial part of this review is the evaluation of misstatements found during the audit. This article describes and discusses the requirements of ISA 450, *Evaluation of Misstatements Identified during the Audit* and provides some examples of the application of the ISA in the context of the Advanced Audit and Assurance exam.

**ISA 450 – Objectives and definitions**

According to ISA 450, the objectives of the auditor are to evaluate:

* The effect of identified misstatements on the audit, and
* The effect of uncorrected misstatements, if any, on the financial statements

A misstatement occurs when something has not been treated correctly in the financial statements, meaning that the applicable financial reporting framework, namely IFRS, has not been properly applied. Examples of misstatement, which can arise due to error or fraud, could include:

* An incorrect amount has been recognised – for example, an asset is not valued in accordance with the relevant IFRS requirement.
* An item is classified incorrectly – for example, finance cost is included within cost of sales in the statement of profit or loss.
* Presentation is not appropriate – for example, the results of discontinued operations are not separately presented.
* Disclosure is not correct or misleading disclosure has been included as a result of management bias – for example, a contingent liability disclosure is missing or inadequately described in the notes to the financial statements.

**Specific requirements and application of ISA 450**

ISA 450 requires that ‘the auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial’.

The auditor should set a monetary benchmark below which misstatements are considered to be clearly trivial and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. The application notes to ISA 450 make it clear that ‘clearly trivial’ is not another expression for ‘not material.’ The auditor will need to use judgement to decide whether matters are clearly trivial, and this may be affected by a range of issues including but not limited to the monetary size of the matter, for example, the level of audit risk being applied in the situation.

ISA 450 also requires that ‘The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements.’

Simply put, this means that the auditor keeps a note of all misstatements (other than those which are clearly trivial), raises them with management and asks for the misstatements to be corrected in the financial statements.

It is useful, when evaluating misstatements and in making requests to management for misstatements to be corrected, to consider and apply the framework as laid out in ISA 450, which categorises misstatements as follows:

* **Factualmisstatements** are misstatements about which there is no doubt. An example would be a clear breach of an IFRS requirement meaning that the financial statements are incorrect, for instance if a necessary disclosure is missing – for example, non-disclosure of EPS for a listed company.
* **Judgmental misstatements** are differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate. There are of course many examples of using judgement in financial reporting, for instance, when determining the fair value of non-current assets, the level of disclosure necessary in relation to a contingent liability, or the recoverability of receivables.
* **Projected misstatements** are the auditor’s best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn.

For the auditor it is important to distinguish between these types of misstatements in order to properly discuss them with management, and ask for the necessary corrections, where relevant, to be made. For example, with a factual misstatement, there is little room for negotiation with management, as the item has simply been treated incorrectly in the financial statements. With judgemental misstatement there is likely to be more discussion with management. The auditor will need to present their conclusion based on robust audit evidence, in order to explain the misstatement which has been uncovered, and justify a recommended correction of the misstatement.

With projected misstatements, because these are based on extrapolations of audit evidence, it is normally not appropriate for management to be asked to correct the misstatement. Instead, a projected misstatement should be evaluated to consider whether further audit testing is appropriate.

**Correction of Misstatements**

Management is expected to correct the misstatements which are brought to their attention by the auditor. If management refuses to correct some or all of the misstatements, ISA 450 requires the auditor to obtain an understanding of management’s reasons for not making the corrections, and to take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

**Evaluating the Effect of Uncorrected Misstatements**

The auditor is required to determine whether uncorrected misstatements are material, individually or in aggregate. At this point the auditor should also reassess materiality to confirm whether it remains appropriate in the context of the entity’s actual financial results. This is to ensure that the materiality is based on up to date financial information, bearing in mind that when materiality is initially determined at the planning stage of the audit, it is based on projected or draft financial statements. By the time the auditor is evaluating uncorrected misstatements at the completion stage of the audit, there may have been many changes made to the financial statements, so ensuring the materiality level remains appropriate is very important.

Some misstatements may be evaluated as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than materiality for the financial statements as a whole. Examples include, but are not restricted to the following:

* Misstatements which affect compliance with regulatory requirements
* Misstatements which impact on debt covenants or other financing or contractual arrangements
* Misstatements which obscure a change in earnings or other trends
* Misstatements which affect ratios used to evaluate the entity’s financial position, results of operations or cash flows
* Misstatements which increase management compensation
* Misstatements which relate to misapplication of an accounting policy where the impact is immaterial in the context of the current period financial statements, but may become material in future periods

**Communication with those charged with governance**

ISA 450 requires the auditor to communicate uncorrected misstatements to those charged with governance and the effect that they, individually or in aggregate, will have on the opinion in the auditor’s report. The auditor’s communication shall identify material uncorrected misstatements individually and the communication should request that uncorrected misstatements be corrected. The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, and possible implications in relation to future financial statements. Perhaps the key issue here is that that auditor should discuss the potential implications for the auditor’s report, which is likely to contain a modified opinion, if material misstatements are not corrected as requested by the auditor.

In addition the auditor is required to request a written representation from management and, where appropriate, those charged with governance with regard to whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole.

**Documentation**

Finally, ISA 450 requires certain documentation in relation to misstatements:

* The amount below which misstatements would be regarded as clearly trivial
* All misstatements accumulated during the audit and whether they have been corrected, and
* The auditor’s conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

This is an important part of the audit working papers, as it shows the rationale for the auditor’s opinion in relation to material misstatements.

**Conclusion**

Candidates preparing for the Advanced Audit and Assurance exam should ensure that they are familiar with the requirements of ISA 450 as ultimately in forming an opinion on the financial statements the auditor must conclude on whether reasonable assurance has been obtained that the financial statements as a whole are free from material misstatements and this conclusion takes into account the auditor’s evaluation of uncorrected misstatements.

**Written by a member of the P7 examining team**

Responding to non-compliance with laws and

* **RESPONDING TO NON-COMPLIANCE WITH LAWS AND REGULATIONS (NOCLAR)**
* A guide to the IESBA pronouncement

/ Element: Page Intro Block: Text

**The P7 exam and syllabus**

The syllabus and study guide for P7 (INT) and P7 (UK), *Advanced Audit and Assurance* includes section G1 (a) on professional and ethical developments which requires candidates to ‘discuss emerging ethical issues and evaluate the potential impact on the profession, firms and auditors’ and G1 (b) ‘Discuss the content and impact of exposure drafts, consultations and other pronouncements issued by IFAC and its supporting bodies.’ This article is intended to provide insight into recent developments to the International Ethics Standards Board’s Code of Ethics for Professional Accountants (IESBA) in relation to the auditor’s response to non-compliance with laws and regulations. The article is also relevant to all other P7 exams.

**Introduction**

The International Ethics Standards Board (IESBA) issued their final pronouncement on Responding to Non-Compliance with Laws and Regulations (NOCLAR) in July 2016. The pronouncement is an examinable document from the exam year starting September 2017. In practice, the pronouncement is effective from July 2017 with earlier adoption permitted. The new standard adds sections 225 and 360 to the IESBA’s Code of Ethics for Professional Accountants (the Code). The purpose of the new sections is to address the responsibilities of Professional Accountants in Public Practice (including auditors) and Professional Accountants in Business when they become aware of NOCLAR. The standard also contains consequential and conforming amendments to a number of existing sections of the Code.

**What is NOCLAR?**

NOCLAR is defined by the new standard as comprising acts of omission or commission, intentional or unintentional, committed by a client, or by those charged with governance, by management or by other individuals working for or under the direction of a client which are contrary to the prevailing laws and regulations.

The non-compliance which the standard addresses is concerned with laws and regulations which are generally recognised to have a direct effect on the determination of material amounts and disclosures in the client’s financial statements. It also addresses other laws and regulations which may be fundamental to the operating aspects of the client’s business, to its ability to continue its business or to avoid material penalties. It is worth noting that the standard does not include within its scope any matters that are clearly inconsequential or any personal misconduct which is unrelated to the business activities of the client or employer.

**Background and aims**

The NOCLAR project originated from an attempt to address concerns from the regulatory community and other stakeholders that the Professional Accountant’s (PA’s) duty of confidentiality under the Code was acting as a barrier to the disclosure of possible NOCLAR to appropriate public authorities. While emphasising the binding nature of the duty of confidentiality, the existing Code identified general circumstances where disclosure may be appropriate including when a PA considers it to be in the public interest. The existing Code acknowledged that this is a difficult area to decide on and that as a result, it will often be appropriate to take legal advice.

The new standard aims to raise the ethical bar for the global accountancy profession and to increase the emphasis on PAs’ duties and responsibilities in this area. It importantly represents the first time that accountants have been permitted to set aside the duty of confidentiality, which is a fundamental principle in the Code, in order to disclose NOCLAR to appropriate public authorities in the circumstances prescribed. The new standard is intended to sit alongside and supplement the existing guidance on this area contained within the International Standards on Auditing (ISAs). It is noteworthy in this regard that in October 2016, the International Auditing and Assurance Standards Board (IAASB) amended the ISAs in order to enhance auditor focus on non-compliance with laws and regulations and to enable the ISAs to be applied effectively alongside the IESBA Code by clarifying and emphasising key aspects of the IESBA Code in the IAASB’s Standards. The most significant revisions have been to ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements which now directly references the Code and the additional responsibilities under law, regulation or relevant ethical requirements regarding an entity’s non-compliance with laws and regulations. It acknowledges that these may differ from or go beyond the ISA itself.

Concerns were also expressed that auditors were simply resigning from client relationships as a result of suspected or identified NOCLAR without the matter being appropriately addressed. Moreover, it was felt that there was a lack of guidance in the Code about the thought process and the relevant factors to consider in determining how best to respond to potential NOCLAR in the public interest. While the existing Code implicitly required PAs not to turn a blind eye to potential NOCLAR, there were no clear and explicit requirements on how to respond. There was a risk that the duty of confidentiality would put PAs in a conflict situation and confuse their response. NOCLAR enables PAs to override their duty of confidentiality where there is a strong public interest in the matter.

The NOCLAR guidance therefore aims to ensure that PAs respond to identified or suspected NOCLAR on a timely basis in order to rectify, remediate or mitigate its potentially adverse impact on stakeholders and the general public. The increased emphasis on PAs’ duties and responsibilities in this area should also serve to stimulate increased reporting of NOCLAR and even to act as a deterrent to non-compliance by audited entities.

**A differential approach**

The NOCLAR guidance prescribes a differentiated approach for auditors, other PAs in public practice as well as for senior level and other PAs in business. While the basic ethical principles are the same for all PAs, the implementation of these principles differs according to their roles, levels of seniority, spheres of influence and the different levels of public expectations. In the context of the P7 exam, however, we will concentrate on the prescribed approach to NOCLAR for the auditing profession.

**Responsibilities of auditors**

The NOCLAR guidance provides a clear framework for auditors to follow when addressing an instance of non-compliance or suspected non-compliance.

**Obtaining an understanding of the matter** The first step in this framework is that the auditor should obtain a full and clear understanding of the matter including the nature of the act and the circumstances in which it has occurred.

An auditor has always been required to obtain a good understanding of the environment in which a client operates including any relevant laws and regulations. However, the auditor is not expected to be an expert on a wide range of laws and regulations and the new standard does not specifically increase the auditor’s responsibilities in this regard. Rather, the auditor is expected to apply their knowledge, professional judgement and expertise but they are not expected to have a knowledge of laws and regulations that is greater than that which is required to undertake the assignment in the first place.

In order to clarify whether an instance of non-compliance has occurred, the auditor should consider consulting with other members of the firm on a confidential basis, with a network firm or relevant professional body. The auditor should also consider taking legal advice.  If the auditor suspects non-compliance has occurred, they should discuss the matter with the appropriate level of management and, where appropriate, those charged with governance in order to clarify understanding of the facts and circumstances surrounding the matter together with its potential consequences. In assessing the appropriate level of management, the auditor should consider any potential involvement or collusion in the matter together with the ability of management to carry out investigations and take appropriate action.

**Addressing the matter** In discussing an instance of non-compliance or suspected non-compliance with management and, where appropriate, those charged with governance (TCWG), the auditor should advise them to take timely and appropriate actions in order to resolve the situation, to deter possible non-compliance or to disclose the matter to an appropriate authority where it is required by law or regulation or it is considered necessary in the public interest. The auditor must also ensure their own compliance with laws and regulations together with the requirements under auditing standards. With respect to auditing standards, the auditor should have particular regard to those relating to:

* Identifying and responding to non-compliance, including fraud.
* Communicating with those charged with governance.
* Considering the implications of the non-compliance or suspected non-compliance for the auditor’s report.

**Communication with respect to groups** In the context of a group audit, the auditor should consider their responsibilities to report instances of non-compliance or suspected non-compliance to the group engagement partner unless prohibited from doing so by law or regulation.

**Determining whether further action is needed** The auditor should assess the appropriateness and effectiveness of the response of management and TCWG to the matter, including the timeliness of the response and the extent of investigation and remedial action, and in the light of this response, the auditor must determine objectively if further action is needed in the public interest. This will involve the exercise of professional judgement and the auditor must take into account whether a reasonable and informed third party would, after weighing all of the specific facts and circumstances, be likely to conclude that the auditor has acted appropriately in the public interest.

Where the auditor decides that further action is necessary, it might include, for example, disclosing the matter directly to the appropriate authority and withdrawing from the engagement and client relationship. In response to the concerns that auditors were simply resigning from client relationships as a result of suspected or identified NOCLAR without the matter being appropriately addressed, however, the guidance clarifies that withdrawing from an engagement should not be a substitute for taking other actions which may be needed to achieve the auditor’s objectives. The standard does though recognise in this regard that in some jurisdictions there may be limitations on the further actions which the auditor is able to take and acknowledges that withdrawal may be the only available course of action. Following withdrawal, the outgoing auditor is required to co-operate with the proposed successor auditor and on request, to provide all of the facts and information concerning the identified or suspected non-compliance which the latter needs to be aware of.

**Determining whether to disclose the matter to an appropriate authority** The determination of whether to disclose the identified or suspected non-compliance to an appropriate authority, assuming such disclosure is not precluded by law or regulation, depends on the nature and extent of the actual or potential harm which might be caused to investors, creditors, employees or the general public. The guidance gives examples of indicative situations where disclosure might be appropriate and of external factors to consider. These examples include references to an entity being involved in bribery and tax evasion or to breaches of regulation which might impact adversely on operating licences, financial markets or public health and safety. The standard also clarifies that in exceptional circumstances where the auditor believes there may be an imminent breach of a law or regulation, they may need to disclose the matter immediately. The decision to disclose will always be a matter for the auditor’s judgement and where the disclosure is made in good faith, it will not constitute a breach of the duty of confidentiality under Section 140 of the Code. This latter clarification, in particular, should serve to increase the auditor’s confidence in their ability to breach the principle of confidentiality where they deem it to be necessary under the NOCLAR guidance. This should also help to resolve the potential conflict for the auditor between their ethical duty of confidentiality and their professional duty of disclosure in the public interest.

**Documentation** The auditor is required to document the process of compliance with the NOCLAR guidance including the response of management and those charged with governance, the courses of action considered, the judgements made and the decisions taken.

**The need for support**

The IESBA acknowledges that the accountancy and auditing profession will not resolve the NOCLAR issue in isolation and that it requires the support and co-operation of other professions together with governments, legislators and regulators. In particular it is hoped that governments will introduce and strengthen legislation addressing NOCLAR and will provide protection for whistle blowers and to auditors and other PAs who implement the standard. The ultimate success of the project is also dependent on governmental authorities acting appropriately in response to the NOCLAR reports which they will receive under the requirements of the standard.

**Conclusion**

In practice auditors will often have to deal with instances of non-compliance with laws and regulations and the IESBA’s NOCLAR standard provides important additional guidance and clarification of their duties and responsibilities in this key area. In the context of the P7 Advanced Audit and Assurance exam, candidates need to be prepared to discuss the recent developments outlined in this article as well as to consider the new guidance in their answer points to scenario based exam questions.

**Written by a member of the P7 examining team**

* **AUDITOR REPORTING**

An update for P7 students on Key Audit Matters (P7 INT) and the Extended Auditor’s Report (P7 UK)

Candidates preparing for P7, *Advanced Audit and Assurance* will be aware that the auditor’s report is the key output of the audit process, used to communicate primarily with the shareholders of the audited entity, as well as other stakeholders.

Recently, there have been some considerable changes in the requirements relating to auditor’s reports, with the regulatory bodies issuing new and revised International Standards on Auditing and other supplementary guidance.

The objective of this article is to outline the key changes, focusing on the new requirements relating to the Key Audit Matters paragraph for P7 International candidates, and Extended Auditor Reporting for P7 UK and Ireland candidates. It should be read in conjunction with the article entitled ‘The new auditor's report’ (see ‘Related links’), which is relevant for both F8 and P7 students and serves as an introduction to the issue.

***The detail of the changes outlined below in relation to Key Audit Matters are relevant to P7 (INT) candidates from the September 2016 exams onwards.***

***P7 UK and Ireland candidates should note that the UK’s Financial Reporting Council (FRC) did not adopt the new ISA requirements into UK standards until June 2016, therefore ISA 701 (UK and Ireland) will not become a UK and Irish examinable documents until September 2017. However, candidates should be aware that the FRC Invitation to Comment on the IAASB Exposure Draft Reporting on Audited Financial Statements: Proposed new and Revised International Standards on Auditing, which includes the original proposals of the ISA 701 requirements, is examinable as a current issue in the exam year commencing September 2016.***

***Further, candidates sitting the UK exam are expected to understand the Extended Reporting requirements that are expected in the UK and these are discussed below.***

**Background to the changes to IAASB standards in relation to Key Audit Matters**

In 2015 the IAASB issued a range of changes to auditor reporting, with the objective of enhancing auditor’s reports for investors and other users of financial statements. According to the IAASB, research and public consultations indicate that enhanced auditor reporting is critical to influencing the perceived value of the financial statement audit. The auditor’s report is the key deliverable communicating the results of the audit process. Investors and other financial statement users have asked for a more informative auditor’s report—in particular for auditors to provide more relevant information to users.

The IAASB suggests that the intended benefits of enhanced auditor reporting include the following:

* Enhanced communication between auditors and investors, as well as those charged with corporate governance.
* Increased user confidence in auditor’s reports and financial statements.
* Increased transparency, audit quality, and enhanced information value.
* Increased attention by management and financial statement preparers to disclosures referencing the auditor's report.
* Renewed auditor focus on matters to be reported that could result in an increase in professional scepticism.
* Enhanced financial reporting in the public interest.

Thus, the changes should be viewed not just as a development affecting individual financial statement audits, but as a move to enhance audit quality generally, which in turn will improve the credibility of financial reporting and the audit profession.

**Key Audit Matters**

ISA 701, *Communicating Key Audit Matters in the Independent Auditor’s Report* is a new standard that is required to be applied to the audit of all listed entities. According to ISA 701, the purpose of communicating key audit matters (KAM) is ‘to enhance the communicative value of the auditor’s report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements’.

It may be helpful to review the definition of KAM from ISA 701: ‘Those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance’.

**Determining Key Audit Matters**

ISA 701 requires the auditor to include in the KAM paragraph those matters that required the most significant auditor attention in performing the audit. Thus, when preparing an auditor’s report for listed entities, the auditor will need to carefully select the matters that should be communicated in the KAM paragraph. This is likely to require the use of significant judgement in order for the auditor’s report to contain information on the matters that are most relevant to the intended users of the report, while avoiding information overload, which could obscure the important messages contained in the KAM paragraph.

There are three types of matter, according to ISA 701, which should be considered when determining key audit matters. All of these should have been communicated to those charged with governance as part of the audit process.

* *Areas of higher assessed risk of material misstatement, or significant risks identified.* During the audit, especially at the planning stage, the auditor will identify risks of material misstatement. A significant risk as an identified and assessed risk of material misstatement that, in the auditor’s judgment, requires special audit consideration. Significant risks, including areas of management judgement and significant unusual transactions are often areas that require significant auditor attention, and thus should be considered for inclusion in the KAM paragraph.
* *Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.* Critical accounting estimates and related disclosures are likely to be areas of significant auditor attention and may be identified as significant risks. This could include, for example, fair value estimates in relation to financial instruments, estimates relating to the measurement of provisions, impairment and the recoverability of assets.
* *The effect on the audit of significant events or transactions that occurred during the period.* This could include a one-off transaction or event within the reporting entity that has required significant auditor attention, for example the acquisition of a significant subsidiary within a group. In addition, significant economic, accounting, regulatory, industry, or other developments that affected management’s assumptions or judgments may also affect the auditor’s overall approach to the audit and result in a matter requiring significant auditor attention.

Given the multitude of matters that can arise during the audit process, the auditor may find that there are many matters that potentially could be included in the KAM paragraph. The auditor may need to prioritise the matters in order to ensure that, as required by ISA 701, it is the matters of most significance that are reported as KAM. ISA 701 explains that the concept of matters of most significance is applicable in the specific context of the entity and the audit that was performed. As such, the auditor’s determination and communication of key audit matters should identify matters specific to the audit and to involve making a judgment about their importance relative to other matters in the audit.

Specificity is therefore a key issue, and vague or boiler-plate disclosures are not in keeping with the requirements or spirit of the standard.

ISA 701 therefore gives further guidance on determining significance and whether a matter should be reported as a key audit matter:

* The importance of the matter to intended users’ understanding of the financial statements as a whole, and in particular, its materiality to the financial statements.
* The nature of the underlying accounting policy relating to the matter or the complexity or subjectivity involved in management’s selection of an appropriate policy compared to other entities within its industry.
* The nature and materiality, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements due to fraud or error related to the matter, if any.
* The nature and extent of audit effort needed to address the matter, including the extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any.
* The nature of consultations outside the engagement team regarding the matter.
* The nature and severity of difficulties in applying audit procedures, evaluating the results of those procedures, and obtaining relevant and reliable evidence on which to base the auditor’s opinion, in particular as the auditor’s judgments become more subjective.
* The severity of any control deficiencies identified in relation to the matter.
* Whether the matter involved a number of separate, but related, auditing considerations. For example, long-term contracts may involve significant auditor attention with respect to revenue recognition, litigation or other contingencies, and may have an effect on other accounting estimates.

ISA 701 does not state a particular number of key audit matters that should be communicated, discussing that the volume of disclosure will be affected by the size and complexity of the entity, the nature of its business and environment, and the facts and circumstances of the audit engagement. The standard is very clear in stating that ‘lengthy lists of key audit matters may be contrary to the notion of such matters being those of most significance in the audit’, requiring the use of professional judgement in prioritisation of matters to be communicated within the KAM paragraph.

**Communicating Key Audit Matters**

ISA 701 requires that the description of each key audit matter in the auditor’s report shall include a reference to the related disclosure(s), if any, in the financial statements and shall address:

* why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter, and
* how the matter was addressed in the audit.

Though there is not a specific requirement in terms of placement of the KAM paragraph within the auditor’s report, ISA 701 does comment that placement of the KAM paragraph ‘in close proximity to the auditor’s opinion may give prominence to such information and acknowledge the perceived value of engagement-specific information to intended users’. Thus, the auditor may need to use judgement in deciding on the best position of the KAM paragraph.

The ordering of items within the KAM paragraph itself is also a matter of professional judgement. ISA 701 suggests that the information may be organized in order of relative importance, based on the auditor’s judgment, or may correspond to the manner in which matters are disclosed in the financial statements.

In deciding the amount and nature of description of each item within the KAM paragraph, the auditor is required to use their professional judgement, in order to ensure that each matter is adequately described in an understandable way.

The description of each key audit matter should be a succinct and balanced explanation to enable intended users to understand why the matter was one of most significance in the audit and how the matter was addressed in the audit. ISA 701 suggests that technical jargon should be avoided, stating that ‘limiting the use of highly technical auditing terms also helps to enable intended users who do not have a reasonable knowledge of auditing to understand the basis for the auditor’s focus on particular matters during the audit’.

It is likely that many key audit matters will have been discussed in the financial statements. For example, information in relation to a significant estimated value for a provision should have been disclosed in the notes to the financial statements in accordance with the relevant IFRS requirement. ISA 701 suggests that the description of a key audit matter should not be a duplicate of information that is already disclosed in the financial statements. However, a reference to any related disclosures should be included to enable intended users of the auditor’s report to further understand how management has addressed the matter in preparing the financial statements.

The amount of detail to be provided in the auditor’s report to describe how a key audit matter was addressed in the audit is also a matter of professional judgment. The auditor may choose to describe:

* aspects of the auditor’s response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement
* a brief overview of procedures performed
* an indication of the outcome of the auditor’s procedures, or
* key observations with respect to the matter.

In summary, the introduction of ISA 701 will require auditors to exercise significant judgement in preparing the KAM section of the auditor’s report. To help with implementation of the standard, the IAASB has published a range of supplementary guidance to assist auditors of listed entities.

Note than the KAM paragraph is therefore not a substitute for expressing a modified opinion or reporting on going concern issues in accordance with the requirements of the relevant ISA. The interaction between ISA 701 and ISA 705 is explained in the article ‘The new auditor's report’ (see 'Related links'), which is relevant for both F8 and P7 students.

**The Extended Auditor’s Report**

***Note – this section is relevant to candidates attempting the UK and Irish P7 adapted papers only. The FRC document Extended auditor’s reports – A review of experience in the first year is an examinable document for UK and Irish students.***

The UK Financial Reporting Council has issued additional requirements that form part of revised ISA 700 (UK and Ireland) *The independent auditor’s report on financial statements*. ISA 700 requires the auditor’s report issued in relation to the financial statements of entities adopting the UK Corporate Governance Code to include information that addresses similar issue to those seen in respect of Key Audit Matters discussed in the previous section of this article. The objectives are to provide more information about key issues that arose during the audit, how they affected the audit process, and to allow better understanding of areas where the auditor used judgement, particularly in relation to materiality.

Specifically, ISA 700 requires the auditor’s report of companies that apply the UK Corporate Governance Code to include:

* a description of those assessed risks of material misstatement that were identified by the auditor and that had the greatest effect on the overall strategy; the allocation of resources in the audit; and directing the efforts of the engagement team
* an explanation of how the auditor applied the concept of materiality, and
* a summary of the audit scope, including an explanation of how the scope was responsive to the assessed risks of material misstatement and the concept of materiality as described above.

Similar to the issues discussed above in respect of Key Audit Matters, when UK and Irish auditors are applying these requirements of ISA 700, they will need to use judgement to decide which risks of material misstatement should be described, and in deciding how much information to provide in relation to each aspect of the disclosure.

The FRC encourages audit firms to be innovative in the way they communicate information in the Extended Auditor’s Report. The auditor should consider the most effective way to present and describe the information, which should be tailored as far as possible to give specific and therefore useful information. Disclosures of a ‘boiler-plate’ type are discouraged as they do not provide worthwhile information. Explanations, for example on the application of materiality, need to be sufficiently detailed so that they are understandable, but not so detailed that there is information overload. Providing just the right amount and type of information is a matter of judgement and can be difficult to achieve.

**Conclusion**

It can be seen that both the IAASB and the FRC have taken steps to enhance disclosures provided in the auditor’s reports of listed entities. The overall objective is that these disclosures enhance the value of the auditor’s report by better communication of key issues relevant to the audit process. Auditors will need to use their judgement in deciding what to report, and how to communicate, and some auditor’s reports will be more useful than others, but the regulatory bodies are in agreement that the additional disclosure adds value to reporting by auditors to those who have appointed them.

**Written by a member of the P7 examining team**

* **CORPORATE GOVERNANCE AND ITS IMPACT ON AUDIT PRACTICE**
* The syllabus for P7 (INT), *Advanced Audit and Assurance* contains the following learning outcome:

Outline and explain the need for the legal and professional framework including: i) public oversight of audit and assurance practice ii) the role of audit committees and impact on audit and assurance practice.

Note: the syllabus and study guide for the UK adapted paper is worded slightly differently in that they refer to jurisdiction specific Corporate Governance Code. For both INT and UK and IRL adapted papers, the UK Corporate Governance Code is included in the list of examinable documents, as is the UK Financial Reporting Council Guidance on Audit Committees (Revised September 2012) as examples of guidance on best practice in relation to corporate governance principles and specific guidance in relation to audit committees. For the SGP adapted exam, The Singapore Code of Corporate Governance is the relevant code of best practice.

Candidates attempting P7 are expected therefore to be conversant with corporate governance principles, many of which they will have seen in previous exams F8, *Audit and Assurance* and P1, *Governance, Risk and Ethics*. The focus in P7 is on the impact that corporate governance principles and practice can have on the audit process, and this article explores some of these issues.

**Basic principles of corporate governance – a reminder**

Corporate governance is the system by which organisations are directed and controlled. It encompasses the relationship between the board of directors, shareholders and other stakeholders, and the effects on corporate strategy and performance. Corporate governance is important because it looks at how these decision makers act, how they can or should be monitored, and how they can be held to account for their decisions and actions.

The published audited financial statements and related information are therefore of key importance. They will usually be the main information set to which shareholders and other stakeholders have access and this is why having credible financial statements supported by the auditor’s opinion is crucial.

Many regulatory authorities, including the UK, use a code of best practice, often termed a ‘comply or explain’ approach to corporate governance. Under this approach the regulatory authority issues a set of principles with which company directors of listed companies are expected to comply. In many jurisdictions disclosures are required in the financial statements to demonstrate compliance. Non-compliance is not expected, but in its event, the facts of the non-compliance must be clearly disclosed and explained.

In some jurisdictions, such as the US, a more prescriptive approach is used, whereby corporate governance requirements are set by legislation. Both the principles and the legislative approaches are broadly similar in the matters they address. They both deal with the importance of the board of directors having a balanced structure, emphasising the need for non-executive directors, and for robust procedures in relation to the appointment of board members, and their remuneration. They both describe the merits of audit committees and the need to monitor the effectiveness of internal controls. They both demand disclosure about these and other matters in the annual report.

**The main principles of the UK Corporate Governance Code**

The content of the UK and Singapore Corporate Governance Codes are very similar and for the purpose of this article the principles and provisions of the UK Code will be used to highlight some of the key areas that the board should consider when assessing their system of corporate governance.

The Code comprises five sections, each containing main principles:

**Leadership**

Every company should be headed by an effective board which is collectively responsible for the long-term success of the company, and should lead and control the company’s operations.

There should be a clear division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.

Non-executive directors should constructively challenge and help develop proposals on strategy. The board should include a balance of executive and non-executive directors such that no individual or small group of individuals can dominate the board’s decision taking.

**Effectiveness**

The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively.

There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance.

**Accountability**

The board should present a balanced and understandable assessment of the company’s position and prospects. For UK companies, this is also required by the Companies Act 2006, which requires that the directors disclose a business review as part of the directors’ report to be included in the financial statements.

The board should maintain sound risk management and internal control systems. The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company’s auditor.

**Remuneration**

Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance.

**Relations with shareholders**

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 Annual General Meeting to communicate with investors and to encourage their participation.

**The role of audit committees**

The audit committee is such an important part of corporate governance that it is the subject of its own guidance document in the UK, the Financial Reporting Council’s *Guidance on Audit Committees*. The audit committee should be made up of at least three independent non-executive directors, one of whom should have recent and relevant financial experience. The committee has many roles, including several that are specifically related to the external auditor, which are discussed below.

**Review of published financial information**

The audit committee should monitor the integrity of the company’s financial statements and any formal announcements relating to the company’s performance. Significant financial reporting judgements should be specifically reviewed. This means that committee members should scrutinise all published financial information, and question and be ready to challenge the finance director and external auditors on any contentious matters arising.

**Systems and controls**

The audit committee members have responsibility to review the company’s internal financial controls and systems, and the risk management systems, unless there is a separate risk committee.

Most large companies have an internal audit function, in which case the audit committee should extend its monitoring role to include that function, including the evaluation of the effectiveness of that function.

Where there is no internal audit function, the audit committee should consider annually whether there is a need for internal audit and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

**Fraud prevention and detection**

Finally, the audit committee plays a part in fraud prevention and detection in that whistleblowing arrangements should be made so that staff of the company may raise concerns about possible improprieties in respect of financial reporting matters.

**External auditors – general principles**

The audit committee has specific responsibilities in respect of the external auditors, including recommending the appointment, reappointment and removal of the external auditor, approving fees paid for audit and non-audit services, and agreeing on the terms of engagement with the external auditor. A point specific to the UK adapted paper is that following a revision to the UK Corporate Governance Code in 2012, there is now a requirement for FTSE 350 companies to put the external audit out to tender every 10 years.

One of the key issues is that the audit committee should annually assess the independence, objectivity and effectiveness of the external audit process, considering of the ethical framework applicable in the jurisdiction in which the organisation is operating. The audit committee should report annually to the board on their assessment with a recommendation on whether to propose to the shareholders that the external auditor be reappointed. The audit committee section of the annual report should also discuss the annual assessment of the external audit process by the audit committee and also include information on the length of tenure of the current audit firm, when a tender was last conducted, and any contractual obligations that acted to restrict the audit committee’s choice of external auditors.

In relation to potential threats to objectivity, the audit committee should seek reassurance that the auditors and their staff have no financial, business, employment or family and other personal relationship with the company which could adversely affect the auditor’s independence and objectivity. The audit committee should seek from the audit firm, on an annual basis, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including current requirements regarding the rotation of audit partners and staff.

**External auditors – the annual audit cycle**

The audit committee should be involved at all stages of the audit, to obtain comfort that a quality audit will be performed. The *Guidance on Audit Committee*specifically requires the following to take place:

At the start of each annual audit cycle, the audit committee should ensure that appropriate plans are in place for the audit. This includes consideration of planned levels of materiality, and the proposed resources to execute the plan, having regard also to the seniority, expertise and experience of the audit team. In practice this means that before any audit fieldwork takes place, the audit firm should meet with the audit committee to discuss the audit strategy and audit plan, demonstrating that auditing standards and quality control principles have been adhered to in their development.

The audit committee should review, with the external auditors, the findings of their work. In the course of its review, the audit committee should discuss with the external auditor major issues that arose during the course of the audit and have subsequently been resolved and those issues that have been left unresolved; review key accounting and audit judgements; and review levels of errors identified during the audit, obtaining explanations from management and, where necessary, the external auditors as to why certain errors might remain unadjusted. The audit committee should review and monitor management’s responsiveness to the external auditor’s findings and recommendations. Thus, all key audit findings should be shared with the audit committee and discussed with them as the audit progresses.

At the end of the annual audit cycle, the audit committee should assess the effectiveness of the audit process, by:

* reviewing whether the auditor has met the agreed audit plan and understand the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks
* considering the robustness and perceptiveness of the auditors in their handling of the key accounting and audit judgements identified and in responding to questions from the audit committee
* obtaining feedback about the conduct of the audit from key people involved, for example the finance director and the head of internal audit
* reviewing and monitoring the content of the external auditor’s management letter (report to those charged with governance), in order to assess whether it is based on a good understanding of the company’s business and establish whether recommendations have been acted upon and, if not, the reasons why they have not been acted upon, and
* reporting to the board on the effectiveness of the external audit process.

In summary, the audit committee carefully monitors the conduct of the audit, and plays an important part in ensuring the quality and rigour of the external audit of the financial statements.

**External auditors – provision of non-audit services**

Specifically, the audit committee should develop and implement a policy on the engagement of the external auditor to supply non-audit services, taking into account the relevant ethical principles and requirements. The audit committee’s objective should be to ensure that the provision of such services does not impair the external auditor’s independence or objectivity. The audit committee should consider:

* whether the skills and experience of the audit firm make it the most suitable supplier of the non-audit service
* whether there are safeguards in place to eliminate or reduce to an acceptable level any threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditor
* the nature of the non-audit services
* the fees incurred, or to be incurred, for non-audit services both for individual services and in aggregate, relative to the audit fee, and
* the criteria which govern the compensation of the individuals performing the audit.

The audit committee should set and apply a formal policy specifying the types of non-audit service:

* for which the use of the external auditor is pre-approved (i.e. approval has been given in advance as a matter of policy, rather than the specific approval of an engagement being sought before it is contracted)
* from which specific approval from the audit committee is required before they are contracted, and
* from which the external auditor is excluded.

One of the non-audit services specifically referred to in the *Guidance on Audit Committees* is the provision of internal audit by the external auditor. If the external auditor is being considered to undertake aspects of the internal audit function, the audit committee should consider the effect this may have on the effectiveness of the company’s overall arrangements for internal control and investor perceptions in this regard.

**Conclusion**

Candidates preparing to attempt P7 should be familiar with the corporate governance principles outlined in this article, and they are encouraged to read the source documentation to obtain a full understanding of general corporate governance principles and the role of audit committees in particular. It is the impact of these matters on the audit process that is particularly important to understand, and candidates should be ready to include points relating to corporate governance in their answers where appropriate.

**Written by a member of the P7 examining team**

* **THE AUDITOR'S REPORT**
* *Relevant to ACCA Qualification exams AA and AAA*

The International Auditing and Assurance Standards Board (IAASB) finalised its project on auditor reporting in 2015, which resulted in a set of new and revised standards on auditor reporting as well as revised versions of ISA, 570*Going Concern* and a number of other International Standards on Auditing (ISAs).

Candidates attempting *Audit and Assurance* (AA)and *Advanced Audit and Assurance (AAA)* are required to have a sound understanding of these standards.

This article will focus primarily on: the requirements of ISA 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*; how ISA 701 interacts with the other reporting standards (ISA 705 and 706); and the reporting requirements in ISA 570 (Revised), *Going Concern*.

Candidates often find auditor’s reports a challenging part of the syllabus and in preparation for exams it is imperative that candidates can:

* describe the different elements of the auditor’s report (particularly relevant for AA candidates)
* determine the most appropriate type of audit opinion in a given scenario, often through an explanation of why a certain opinion is appropriate which will test the application of the candidate’s knowledge
* understand the issues that may arise during the course of an audit that could require an Emphasis of Matter or Other Matter paragraph to be included in the auditor’s report, and
* identify Key Audit Matters (KAM) that are required to be disclosed in an auditor’s report.

Candidates will not be expected to draft an auditor’s report in either AA or AAA, but may be asked to present reasons for an unmodified or a modified opinion, or the inclusion of an Emphasis of Matter paragraph. Candidates attempting AA may be required to identify and describe the elements of the auditor’s report and therefore candidates should ensure that they have a sound understanding of ISA 700, *Forming an Opinion and Reporting on Financial Statements*. AAA questions may require a candidate to determine whether a transaction, or a series of transactions and events or other issues arising during the audit, gives rise to a KAM and should also be prepared to critique the content of a KAM section of an auditor’s report. AA candidates should be able to discuss what should be included in the KAM section to ensure the auditor’s report is compliant with ISA 701.

Candidates may also be presented with extracts from an auditor’s report and be asked to critically appraise the extracts, or challenge the proposed audit opinion. Candidates are therefore reminded to ensure they have a sound understanding of the relevant *Syllabus and Study Guide* and ensure the revision phase in the lead-up to the examination includes plenty of exam-standard question practise, particularly if this is an area of the syllabus which a candidate finds challenging.

**Key Audit Matters (KAM)**

In January 2015 the IAASB issued ISA 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*. This standard is required to be applied to the audit of all listed entities. The objectives of ISA 701 are for the auditor to:

* determine those matters which are to be regarded as KAM; and
* communicate those matters in the auditor’s report.

The term ‘key audit matters’ is defined in ISA 701 as:

*‘Those matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.’* (1)

**Determination of KAM**

The definition in paragraph 8 of ISA 701 states that KAM are selected from matters which are communicated with those charged with governance. Matters which are discussed with those charged with governance are then evaluated by the auditor who then determines those matters which required significant auditor attention during the course of the audit. There are three matters which the ISA requires the auditor to take into account when making this determination:

* Areas which were considered to be susceptible to higher risks of material misstatement or which were deemed to be ‘significant risks’ in accordance with ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.
* Significant auditor judgments in relation to areas of the financial statements that involved significant management judgment. This might include accounting estimates which have been identified by the auditor as having a high degree of estimation uncertainty.
* The effect on the audit of significant events or transactions that have taken place during the period.

The auditor must determine which matters are of most significance in the audit of the financial statements and these will be regarded as KAM.

**Communicating KAM**

Once the auditor has determined which matters will be included as KAM, the auditor must ensure that each matter is appropriately described in the auditor’s report including a description of:

* Why the matter was determined to be one of most significance and therefore a key audit matter, and
* How the matter was addressed in the audit (which may include a description of the auditor’s approach, a brief overview of procedures performed with an indication of their outcome and any other key observations in respect of the matter).

**Reporting in line with ISA 570, Going concern**

Exam questions might ask the candidate to recognise indicators that an entity may not be a going concern, or require candidates to arrive at an appropriate audit opinion depending on the circumstances presented in the scenario. It may be the case that candidates are presented with a situation where the auditor has concluded that there are material uncertainties relating to going concern and the directors have made appropriate disclosures in relation to going concern and candidates must understand the auditor reporting requirements in this respect.

The auditor’s work in relation to going concern has been enhanced in ISA 570 (Revised), *Going Concern* and the ISA includes additional guidance relating to the appropriateness of disclosures when a material uncertainty exists.

Under ISA 570 (Revised), if the use of the going concern basis of accounting is appropriate but a material uncertainty exists and management have included adequate disclosures relating to the material uncertainties the auditor will continue to express an unmodified opinion, but the auditor must include a separate section under the heading ‘Material Uncertainty Related to Going Concern’ and:

* draw attention to the note in the financial statements that discloses the matters giving rise to the material uncertainty, and
* state that these events or conditions indicate that a material uncertainty exists which may cast significant doubt on the entity’s ability to continue as a going concern and that the auditor’s opinion is not modified in respect of the matter.

The section headed ‘Material Uncertainty Related to Going Concern’ is included immediately after the Basis for Opinion paragraph but before the KAM section. It should be noted that where the uncertainty is not adequately disclosed in the financial statements the auditor would continue to modify the opinion in line with ISA 705, *Modifications to the Opinion in the Independent Auditor’s Report.*

Over and above the reporting requirements under ISA 570, candidates need to understand how issues identified regarding going concern interact with the requirements of ISA 701. By their very nature, issues identified relating to going concern are likely to be considered a key audit matter and hence need to be communicated in the auditor’s report. Where the auditor has identified conditions which cast doubt over going concern, but audit evidence confirms that no material uncertainty exists, this ‘close call’ can be disclosed in line with ISA 701. This is because while the auditor may conclude that no material uncertainty exists, they may determine that one, or more, matters relating to this conclusion are key audit matters. Examples include substantial operating losses, available borrowing facilities and possible debt refinancing, or non-compliance with loan agreements and related mitigating factors.

In summary if a confirmed material uncertainty exists it must be disclosed in accordance with ISA 570 and where there is a ‘close call’ over going concern which has been determined by the auditor to be a KAM it will be disclosed in line with ISA 701. This is illustrated in the following example:

|  |
| --- |
| **Example – unmodified audit opinion but material uncertainty exists in relation to going concern and the disclosures are adequate**  **Report on the Audit of the Financial Statements (extract)**  **Opinion**In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at 31 December 20X5, and its financial performance and its cash flows for the year then ended in accordance with IFRS® Standards.    **Basis for opinion**We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor’s Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in Farland, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.    **Material uncertainty related to going concern**We draw attention to Note 6 in the financial statements, which indicates that the Company incurred a net loss of $125,000 during the year ended 31 December 20X5 and, as of that date, the Company’s current liabilities exceeded its total assets by $106,000. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company’s ability to continue as a going concern. Our opinion is not modified in respect of this matter.    **Key audit matters**Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Material Uncertainty Related to Going Concern* section, we have determined the matters described below to be the key audit matters to be communicated in our report.    [Include a description of each key audit matter] |

Block: Text

**Application of ISA 701 when a Qualified or Adverse Opinion is issued**

ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor’s Report* outlines the requirements when the auditor concludes that the audit opinion should be modified. ISA 705 (Revised) requires that the auditor includes a Basis for Qualified/Adverse Opinion section in the auditor’s report. When the auditor expresses a qualified or adverse opinion, the requirement to communicate other KAM is still relevant and hence will still apply.

When the auditor issues an adverse opinion it means that the financial statements do not give a true and fair view (or present fairly) because the auditor has concluded that misstatements, individually and in aggregate, are both material and pervasive to the financial statements.

Depending on the significance of the matter(s) which has resulted in the auditor expressing an adverse audit opinion, the auditor might determine that no other matters are KAM. In this situation, the auditor will deal with the matter(s) in accordance with applicable ISAs and include a reference to the Basis for Qualified/Adverse Opinion or the Material Uncertainty Related to Going Concern section(s) in the KAM section of the report as illustrated below.

|  |
| --- |
| **Example – Qualified ‘except for’ opinion issued but no key audit matters**  The audit of Turquoise Industries Co has been completed and the auditor discovered a material amount of research expenditure which had been capitalised as an intangible asset in contravention of IAS 38® *Intangible Assets*. The finance director refused to derecognise the research expenditure as an intangible asset and include it in profit or loss and the auditor therefore issued a qualified ‘except for’ opinion on the basis of disagreement with the entity’s accounting treatment for research expenditure.    The auditor has concluded that there are no KAM which require to be communicated in the audit report. The KAM section of the report will therefore be as follows:    **Key audit matters**Except for the matter described in the Basis for Qualified Opinion section, we have determined that there are no key audit matters to communicate in our report. |

Block: Text

When the auditor has expressed an adverse opinion on the financial statements and communicates KAM, it is important that the descriptions of such KAM do not imply that the financial statements as a whole are more credible in light of the adverse opinion.

**Disclaimer of Opinion issued**

A disclaimer of opinion is issued when the auditor is unable to form an opinion on the financial statements. ISA 705 states that when the auditor expresses a disclaimer of opinion then the auditor’s report **should not** include a KAM section.

**Emphasis of Matter and Other Matter paragraphs**

Emphasis of Matter and Other Matter paragraphs are still retained in ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report* and the concepts involved have not been overridden by the ISA 701 requirements. The IAASB have noted that in some cases, matters which the auditor considers to be KAM will relate to issues that are presented and/or disclosed in the financial statements. Therefore, communicating these as KAM under ISA 701 will serve as the most useful and meaningful mechanism for highlighting the importance of the matter.

Candidates should appreciate that when the auditor communicates matters as KAM, the intention is to provide additional information beyond that which would be included in an Emphasis of Matter paragraph. In recognition of this ISA 706 (Revised) states:

* The auditor is prohibited from using an Emphasis of Matter paragraph or an Other Matter paragraph when the matter has been determined to be a KAM. To that end, the IAASB has emphasised that the use of an Emphasis of Matter paragraph is not a substitute for a description of individual KAM.
* If a KAM is also determined to be fundamental to users’ understanding, the auditor may present this issue more prominently in the KAM section. Alternatively, the auditor might also include additional information in the KAM description to indicate the importance of the matter.
* There may be a matter which is not determined to be a KAM, but which, in the auditor’s judgement is fundamental to users’ understanding and for which an Emphasis of Matter paragraph may be considered necessary.

**Additional requirements for candidates attempting AAA**

Candidates attempting AAA may be required to determine matters which should be treated as KAM and to discuss the content of the KAM section of the auditor’s report. Typical examples of issues which could be regarded as KAM include:

**Impairment testing on goodwill**

IFRS® 3, *Business Combinations* requires goodwill to be tested for impairment at each reporting date and the annual impairment test may be regarded as a KAM where the carrying amount of goodwill is material. Impairment tests are inherently complex and judgmental and therefore management’s assessment process may also be a KAM.

**Effects of new IFRS standards**

New accounting standards may be introduced by the International Accounting Standards Board (such as IFRS 15, *Revenue from Contracts with Customers)* that will involve a material change of accounting treatment. For example, IFRS 15 requires the application of a new framework in respect of revenue recognition, and hence the implementation of IFRS 15 may give rise to the new accounting requirements becoming a KAM as they will impact on the reporting entity’s financial position and performance.

**Valuation of financial instruments, and other assets and liabilities at fair value**

Significant measurement uncertainties in some financial instruments (for example those for which quoted prices are not available) may give rise to the valuation of financial instruments becoming a KAM because such valuations would invariably rely on entity-developed models. This can also apply to other assets and liabilities, particularly those measured using fair value techniques which can be complex and subjective.

Please note that the examples above are included for illustrative purposes and do not form an exhaustive list of all issues that could be identified as KAM.

**Conclusion**

The auditor’s report was significantly changed by the IAASB in response to the users of financial statements requesting a more informative auditor’s report and for the report to include more relevant information for users. Candidates attempting AA will need to be able to identify and describe the basic elements contained in the auditor’s report.

Candidates sitting either exam need to understand the requirements and responsibilities of the auditor as set out in the reporting standards, as well as be able to determine the form and content of an unmodified/modified auditor’s report or where the use of an Emphasis of Matter or Other Matter paragraph would be appropriate.

In addition, AAA candidates may be required to identify matters relating to the financial statements which should be treated as a KAM and to critically assess the content of the KAM section of a proposed auditor’s report.

**Reference** (1) ISA 701 paragraph 8

**Written by a member of the *Audit and Assurance* examining team**

* **AUDITING DISCLOSURES IN FINANCIAL STATEMENTS**

In recent years, the International Auditing and Assurance Standards Board (IAASB) has considered the issue of auditing disclosures in financial statements, prompted by a number of factors including developments in IFRS requirements and the increased level of complexity and subjectivity involved in the preparation of information to be disclosed in financial statements. This article examines this issue, and reminds candidates to review the examinable documents list for guidance.

**Disclosures in financial statements**

Auditors are required to express an opinion on the financial statements as a whole. This includes the notes to the financial statements which are an integral part of the accounts, providing additional information on balances and transactions and other relevant information. Therefore, it is important that during all stages of the audit the auditor gives appropriate consideration to, and plans to obtain sufficient and appropriate audit evidence in relation to the disclosures made in the notes to the financial statements.

ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* specifies that the financial statements include related notes which ‘comprise a summary of the significant accounting policies and otherexplanatory information’.

The notes to financial statements contain different types of information, some quantitative and some qualitative, as required by IFRS. Some examples are given below:

Quantitative disclosures:

* Disaggregation and analysis of balances and transactions included in the financial statements, for example of property, plant and equipment, intangible assets, provisions, lease obligations, financial instruments.
* Segmental analysis of revenue, profit and certain other items, and information about major customers (for listed companies).
* Summarised financial information in relation to associates and joint ventures.

Qualitative disclosures:

* Descriptions of significant accounting policies and areas where critical accounting judgement has been exercised, and rationale for any changes in accounting policies.
* Confirmation that the going concern assumption is appropriate, or discussion of significant doubt over going concern.
* Information on related parties, and related party transactions.
* Explanation of impairment losses recognised in the year.
* Discussion of areas of risk, for example those relating to financial instruments.

A key driver for the IAASB’s consultation and the exposure draft, *Addressing Disclosures in the Audit of Financial Statements*, issued in May 2014, is that in recent years, IFRS requirements in relation to disclosures in the notes to financial statements have become more onerous. The exposure draft states that ‘over the past decade, financial reporting disclosure requirements and practices have evolved. They now provide more extensive decision-useful information that is more detailed and often deals with matters that are subjective such as assumptions, models, alternative measurement bases and sources of estimation uncertainty. As these financial reporting disclosures continue to evolve, challenges have arisen for preparers and auditors in addressing new types of quantitative and non-quantitative information’.

**The challenges for auditors**

**Risk of irrelevant disclosures and determining materiality**

The IAASB is concerned that in some financial statements excessive disclosure is being provided, sometimes of immaterial matters that do not need to be disclosed. This makes it difficult for the reader of the financial statements to focus on the important matters due to the ‘information overload’. This is a difficult area for the auditor because often judgement is needed to decide whether or not a matter should be disclosed. Companies might prefer to provide too much information rather than too little, in the aim of full transparency, but end up providing irrelevant or unnecessary disclosures which obscure the rest of the information included.

Linked to the point above, it can be very difficult to apply materiality to disclosures, especially those of a quantitative nature. The IAASB has considered whether additional guidance should be given to auditors to help them to determine whether qualitative disclosures are material or not by making a preliminary determination at the planning stage of the audit of those disclosures that could reasonably be expected to influence the economic decisions of users. This would help the auditor to better identify disclosures material by their nature or their monetary value, and to plan appropriate audit procedures.

**Sources of information**

A key concern of the IAASB is that the information included in the notes to the financial statements, whether quantitative or qualitative in nature is derived from systems and processes that are not part of the general ledger system. Examples could include, forward looking statements, descriptions of models used in fair value measurements, descriptions of risk exposures and other narrative disclosures. This gives rise to several potential problems to the auditor, and respondents involved in the IAASB’s consultations noted that this issue poses some of the most challenging aspects of preparing and auditing disclosures.

One problem is whether the system or process from which information is derived, when it is outside of normal accounting processes, has any internal control to provide assurance on the completeness, accuracy and validity of the information. For example, information on financial instruments may be provided by a company’s treasury management function, which could have very different systems and procedures to the accounting function, with a different level of control risk attached. The systems and controls may be deficient, creating higher audit risk. This may particularly be the case when dealing with one-off disclosures, for example in relation to the situation causing an impairment loss. In some cases, due to lack of the documentation that would normally be expected for more routine transactions or events captured by the accounting system, it may be difficult to obtain sufficient, appropriate audit evidence on disclosures.

**Timing considerations**

The IAASB notes that often disclosures are prepared by management very late in the audit process. Often, when the auditor is planning the audit, draft disclosures are not available, so it is not possible for the auditor to plan the audit of disclosures until much later in the audit process. This could lead to higher audit risk in that there may not be much time to assess the risk relating to disclosures and to perform the necessary audit procedures. This is especially the case where disclosures are complex, for example in relation to financial instruments, or subjective, for example in relation to fair value measurement.

**The IAASB proposals**

The IAASB has proposed additional guidance to help establish an appropriate focus on disclosures in the audit and encourage earlier auditor attention on them during the audit process. There is also a proposal to amend the definition of financial statements contained in the ISAs, to ensure an appropriate emphasis on the importance of disclosures as part of the financial statements.

Proposed changes to the ISAs include new application material to:

* Amend the term ‘financial statements’ as used in the ISAs to include all disclosures subject to audit and to include that such disclosures may be found in the related notes, on the face of the financial statements, or incorporated by cross-reference as allowable by some financial reporting frameworks.
* Emphasise the importance of giving appropriate attention to, and planning adequate time for addressing disclosures in the same way as classes of transactions, events and account balances, and early consideration of matters such as significant new or revised disclosures.
* Focus auditors on additional matters relating to disclosures that may be discussed with those charged with governance, in particular at the planning stage of the audit.
* Emphasise that, when agreeing the terms of engagement, the auditor should emphasise management’s responsibility, early in the audit process, to make available information relevant to disclosures.
* Provide additional examples of misstatements in disclosures to highlight the types of misstatements that may be found in disclosures, and to clarify that identified misstatements, including those in disclosures and irrespective of whether they occur in quantitative or non-quantitative information, need to be accumulated and evaluated for their effect on the financial statements.

In terms of specific planning considerations, the IAASB recommends improvements to some aspects of risk assessment and materiality determination in order to encourage a more robust risk assessment relating to disclosures:

* Expanding the guidance on matters to consider when the auditor is obtaining an understanding of the entity and its environment, including the entity’s internal control, and assessing the risks of material misstatement for disclosures, including materiality considerations for non-quantitative disclosures.
* Highlighting disclosures, including examples of relevant matters, for consideration during the discussion among the engagement team of the susceptibility of the entity’s financial statements to material misstatement, including from fraud.
* Integrating the separate category for assertions relating to presentation and disclosure into the categories for account balances and transactions to promote their more consistent and effective use.
* Acknowledging, and giving prominence to, disclosures where the information is not derived from the accounting system, and related considerations pertaining to this source of audit evidence.
* In relation to materiality, clarifying that the nature of potential misstatements in disclosures, in particular non-quantitative disclosures, is also relevant to the design of audit procedures to address the risks of material misstatement.

**Conclusion**

The IAASB has acknowledged that while disclosures have an increased prominence in financial statements, the audit of disclosures is difficult for a number of reasons. Through a process of public consultation, the IAASB has proposed additional guidance in this area, which should provide auditors with practical guidance and serve to reduce audit risk.

**Written by a member of the P7 examining team**

* **PERFORMANCE INFORMATION IN THE PUBLIC SECTOR**

The syllabus and study guide for P7 (INT), *Advanced Audit and Assurance* (and SGP adapted paper) includes a section entitled ‘The audit of performance information (pre-determined objectives) in the public sector’. This article is intended to provide insight into this syllabus area and explain some of the issues of which candidates should be aware when studying this aspect of the syllabus.

**Background**

While the specifics will vary from country to country, in general public sector organisations are funded wholly or partly by the government, and in turn by the tax payers in a particular jurisdiction. Public sector organisations may include hospitals and other health care facilities such as ambulance services, schools and universities, the police force and organisations responsible for public transport and the road network. In some cases, such as the UK university sector, organisations do charge for services provided but still rely on government funding to support their activities.

The government as well as other stakeholders will pay close attention to the performance of these organisations to evaluate whether public funds are being used appropriately. The organisations should aim to demonstrate that public monies allocated to them are being used effectively, that specific targets are being met, and that appropriate decisions are being made in respect of long term planning. Essentially the management and those charged with governance of a public sector organisation need to show that the organisation is meeting its objectives and performing its role in society, and performance information is likely to be required in order for this to be demonstrated. If a public sector organisation is not performing well then its funding may be cut and its management may be replaced; in extreme situations the organisation may even be shut down.

This is supported by guidance issued by the public sector board of IFAC which notes that the primary function of governments and most public sector entities is to provide services to constituents. Consequently, their financial results need to be assessed in the context of the achievement of service delivery objectives. Reporting non-financial as well as financial information about service delivery activities, achievements and/or outcomes during the reporting period is necessary for a government or other public sector entity to discharge its obligation to be accountable.

An example of how this is implemented is given below, taken from the UK’s National Health Service (NHS) website:

|  |
| --- |
| In the NHS, performance monitoring should:    • help to define performance targets/goals across the key aspects of service delivery, including management of resources (personnel, infrastructure), customer service and financial viability    • provide a comprehensive picture of the organisation's progress towards achieving its performance targets/goals    • provide an early indication of emerging issues/cost pressures that may require remedial action    • indicate where there is potential to improve the cost effectiveness of services through comparison with other organisations |

Block: Text

**Measuring performance information**

Candidates will be familiar with the concept of Key Performance Indicators (KPIs) which are widely used by private sector organisations in relation to non-financial information such as social and environmental reporting; there have been several examination requirements in past P7 exams focussing on this syllabus area. In the public sector the same principles apply in that target KPIs will be established as a performance objective and the organisation’s performance against the target KPIs will be measured.

Performance measures should be measurable and relevant if they are to be effective. Measurability means trying to ensure that there is consistency in how performance information is captured and reported. The measures should be clearly defined and unambiguous, but measurability is sometimes difficult where the subject matter of the performance information is subjective in nature. For example for an ambulance service it would be quite easy to measure the average time taken for an ambulance to respond to an emergency as this is quantifiable, but more difficult to measure the patient’s satisfaction with the service provided as this is based on the patient’s opinion.

An issue linked to measurability is the existence of data to generate the performance information. Much of the work involved in setting up a good system for reporting on performance information is focussed on ensuring the completeness and accuracy of supporting information and that the information is sufficiently robust to withstand scrutiny.

Relevance means that the performance information addresses a valid concern and public sector organisations should consider the specific needs of their stakeholders in developing relevant performance measures. Continuing to using the UK’s NHS as an example, identified stakeholders who regularly review the NHS performance information include:

* The government department responsible for health services
* Medical staff
* NHS management team and non-executive committee members
* Patients
* Private companies who supply to the NHS
* Academics and students researching the NHS

The NHS therefore has to produce a range of performance measures relevant to the needs of this wide range of stakeholders. Different stakeholders have different needs, for example patients may focus on the effectiveness of a certain medical procedure, whereas management may focus on the cost of providing that procedure. Therefore a very wide range of performance information may be required yet it would be pointless to set targets and produce performance information on an issue which is not relevant to any stakeholder.

**The audit of performance information**

It is worth reiterating the difference between the audit of performance information and performance auditing as both are likely to occur in the public sector. Candidates are reminded that the audit of performance information is concerned with the audit of reported performance information against predetermined objectives. The auditor’s role here is usually to report on the credibility, usefulness and accuracy of the reported performance. Performance auditing is related to the evaluation of how the public sector body is utilising resources and often focuses on determining how the public sector body is achieving economy, efficiency and effectiveness, sometimes referred to as value for money auditing. It is the former that is the focus of this area of the P7 syllabus.

In some jurisdictions it is part of the audit requirement for public sector organisations that the auditor should report on performance information. In jurisdictions where this is not a requirement, the auditor may be asked to perform a separate engagement to the financial statement audit, the objective of which is to report specifically on the performance information. In either case, the auditor will need to plan procedures in much the same way as in a conventional audit scenario. Candidates are therefore encouraged to apply their existing knowledge of audit planning (risk assessment) and evidence gathering techniques to this type of information. The auditor is still looking to ultimately report on the validity of the information included in this respect. The auditor may find the principles of ISAE 3000 *Assurance Engagements other than Audits or Reviews of Historical Financial Information* provide a useful framework for planning and performing the work on performance information.

As with any engagement to provide assurance, this would likely start with an understanding of the entity to ensure knowledge of the predetermined performance measures, an evaluation of the systems and controls used to derive and capture the performance information and also performing substantive procedures on the reported measures. The auditor will also need to understand the rationale behind the measures that are being reported on, considering the relevance and suitability of them in terms of the objectives of the public sector organisation in order to help assess the usefulness of the information being provided.

Audit procedures may include:

* Tests of controls on the systems used to generate performance information
* Performing analytical review to evaluate trends and gauge the consistency of the information
* Discussion with management and other relevant individuals, for example those responsible for the reporting process
* Review of minutes of meetings where performance information has been discussed
* Confirmation of performance information to source documentation; this may be performed on a sample basis
* Recalculation of quantitative performance information measures

Of course, the procedures must be specifically tailored to the performance information subject to the audit. Further as in any audit, the working papers must contain a summary of findings and clear conclusions on the procedures that have been performed.

**Reporting on performance information**

There is no specific format or wording that is prescribed by international regulations for reporting on public sector performance information, though in some jurisdictions the national regulators may issue country-specific requirements.

Generally, the auditor will provide a conclusion on whether the public sector entity has achieved its objectives as shown by the reported performance information and concludes on the information itself. This conclusion may be in the form of a reasonable assurance conclusion – ie an opinion is expressed, or may be in the form of a negative assurance conclusion – ie no opinion is expressed. Essentially, in the absence of any jurisdiction specific requirements, the auditor will agree the type of conclusion with the public sector organisation and usually its regulating body.

Often the performance information will be provided as part of the public sector organisation’s integrated report, in which case the auditor’s conclusion will be included within the integrated report.

**Conclusion**

The audit of performance information in public sector organisations can be approached in a similar way to the audit of KPIs in private sector organisations, and conventional audit techniques can be employed, though they will need to be tailored to the specific measures that are subject to audit. In approaching scenarios based on this syllabus area, candidates are encouraged to apply their understanding of audit techniques to the specific information in the question and to avoid vague and unfocussed remarks.

**Written by a member of the P7 examining team**

* **LAWS AND REGULATIONS**

An important part of an external audit is the consideration by the auditor as to whether the client has complied with laws and regulations.

It is important that candidates preparing for *Audit and Assurance* (AA)and *Advanced Audit and Assurance* (AAA) have an understanding of how laws and regulations affect an audit, not only in terms of the work the auditor is required to do, but also to appreciate the responsibilities of both management and the auditor where laws and regulations are concerned.

The auditing standard that is relevant to this article is ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, and the objectives of the auditor according to paragraph 11 in ISA 250 are:

* to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements
* to perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements
* to respond appropriately to identified or suspected non-compliance with laws and regulations identified during the audit.

The standard defines an act of ‘non-compliance’ as follows:

*‘Acts of omission or commission intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individualsworking for or under the direction of the entity which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity.’*

**Respective responsibilities of management and auditors**

Candidates need to go into the exam with an understanding as to who is responsible for compliance with laws and regulations and who is responsible for the detection of non-compliance with laws and regulations.

It is the responsibility of management to ensure that an entity complies with relevant laws and regulations. It is ***not*** the responsibility of the auditor to either prevent or detect non-compliance.

Question 1(c) of the December 2011 F8 exam (now AA) for four marks required candidates to:

*‘Explain the responsibilities of management and auditors of Chuck Industries Co in relation to compliance with laws and regulations under ISA 250,*Consideration of Laws and Regulations in an Audit of Financial Statements*.’*

The question itself was linked to a brief scenario where Chuck Industries Co had received a visit from the tax authority who had discovered incorrect levels of tax had been deducted from the payroll as tax rates had not been updated in the previous year and the finance director was questioning the audit firm as to why they had not identified this non-compliance with tax legislation.

To secure a pass in this part of the question, candidates would have had to:

* understand that it is role of the management of Chuck Industries Co to ensure the operations of the entity are conducted in accordance with laws and regulations (this applies to tax legislation also)
* appreciate that an auditor is not responsible for prevention of non-compliance with laws and regulations and is not expected to detect instances of non-compliance
* acknowledge in the answer that it is the auditor’s responsibility to obtain reasonable assurance that the financial statements are free from material misstatement. To that end the auditor will take into account the legal and regulatory framework within which the entity operates
* make reference to the auditor’s responsibility to consider those laws and regulations that have both a **direct** and an **indirect** effect on the determination of material amounts and disclosures in the financial statements.

**Direct and indirect laws and regulations**

There are many laws and regulations that a reporting entity may have to comply with in order to continue in business. For example, many entities will have to comply with strict health and safety legislation; a food manufacturer may have strict food hygiene legislation to comply with, and an accountancy firm will have a code of ethics to follow from its professional body. Such laws and regulations will have both a *direct* effect on the financial statements and an *indirect* effect.

For those laws and regulations that have a direct effect on the financial statements, the auditor will be concerned about gathering sufficient and appropriate audit evidence that the entity has complied with such laws and regulations. For example, when auditing the payroll the auditor will be concerned with gathering sufficient and appropriate audit evidence to ensure that tax legislation has been correctly applied by the entity because if it has not (as in Question 1(c) in the December 2011 F8 exam), there is risk that the entity could be fined for non-compliance and the fines could be material, either in isolation or when aggregated with other misstatements. In addition, amounts within the financial statements may also be misstated as a result of the non-compliance with laws and regulations.

For those laws and regulations that have an indirect effect on the financial statements, the auditor will undertake procedures with the objective of identifying *non-compliance* with such laws and regulations. ISA 250 gives examples in paragraph 6(b) of:

* compliance with the terms of an operating license
* compliance with regulatory solvency requirements, or
* compliance with environmental regulations.

When designing procedures to help to identify non-compliance with laws and regulations, ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* requires an auditor to obtain a general understanding of:

* the applicable legal and regulatory framework, and
* how the entity complies with that framework.

Identifying non-compliance with laws and regulations can be tricky for auditors, particularly where fraud and/or money laundering is concerned (see later in the article). It is for this reason that the auditor must maintain a degree of professional scepticism and remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor’s attention, and such procedures could include:

* reading minutes of board meetings
* enquiring of management and/or legal advisers concerning litigation or claims brought against the entity, and
* undertaking substantive tests on classes of transactions, account balances or disclosures.

**Reporting identified or suspected non-compliance with laws and regulations**

Where the auditor discovers non-compliance with laws and regulations, the auditor must notify those charged with governance. However, care must be taken by the auditor because if the auditor suspects that those charged with governance are involved, the auditor must then communicate with the next highest level of authority, which may include the audit committee. If a higher level of authority does not exist, the auditor will then consider the need to obtain legal advice.

The auditor must also consider whether the non-compliance has a material effect on the financial statements and, in turn, the impact the non-compliance will have on their report.

If the auditor identifies or suspects non-compliance, the auditor will need to consider whether law, regulation and ethical requirements either require the auditor to report to an appropriate authority outside the entity, or establish responsibilities under which this may be appropriate.

There may be occasions when the auditor’s duty of confidentiality may be overridden by law or statute. This can be the case when the auditor discovers non-compliance with legislation such as drug trafficking or money laundering.

**Money laundering**

The *Study Guide* to AAA covers the issue of money laundering separately to that of laws and regulations in A2(a) to (g). ACCA’s Code of Ethics and Conduct defines ‘money laundering’as:

*‘...the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activity, allowing them to maintain control over the proceeds and, ultimately, providing a legitimate cover for their sources of income.’*

Auditors need to be particularly careful where money laundering issues are concerned – especially for a business that is predominantly cash-based because the scope for money laundering in such businesses is wide. There are usually three stages in money laundering:

* *Placement* – which is the introduction or ‘placement’ of illegal funds into a financial system.
* *Layering –*which is where the money is passed through a large number of transactions. This is done so that it makes it difficult to trace the money to its original source.
* *Integration* – which is where the ‘dirty’ money becomes ‘clean’ as it passes back into a legitimate economy.

Money laundering offences can include:

* concealing criminal property
* acquiring, using or possessing criminal property
* becoming involved in arrangement which is known, or suspected, of facilitating the acquisition of criminal property.

There are many countries in which money laundering is a criminal offence and, where an accountant or an auditor discovers a situation which may give rise to money laundering, the accountant or auditor must report such suspicions to a ‘money laundering reporting officer’ (MLRO) whose responsibility it is to report such suspicions to an enforcement agency (in the UK, this enforcement agency is the National Crime Agency (NCA)).

It is an offence to fail to report suspicions of money laundering to NCA or the MLRO as soon as practicable, and it is also an offence if the MLRO fails to pass on a report to the NCA. Where the entity is actively involved in money laundering, the signs are likely to be similar to those where there is a risk of fraud, and can include:

* complex corporate structure where complexity does not seem to be warranted
* transactions not in the ordinary course of business
* many large cash transactions when not expected
* transactions where there is a lack of information or explanations, or where explanations are unsatisfactory, or
* transactions with little commercial logic taking place in the normal course of business.

Question 3(b) in the March/June 2016 P7 (Int) Sample Questions (now AAA) gave candidates a scenario where they were placed in the position of audit manager. The audit senior had noted as part of their review of the cash book, a receipt of $350,000 for which the source was unclear followed by a transfer of the same amount to a bank account held in another country. When questioned, the financial controller had referred the audit senior to the business owner. Documentary evidence had been requested but had not yet been received.

This particular question did not make reference to the term ‘money laundering’ in the scenario or in the question requirement; the question required the candidate to evaluate the implications for the completion of the audit, recommending any further actions which should be taken by the firm.

The fact that no mention of money laundering was made either in the scenario or in the question requirements is reflective of the fact that in real life those committing money laundering will not openly admit to committing such offences. Money laundering is therefore very similar (if not identical in many ways) to fraud and, therefore, auditors should set aside any beliefs concerning the integrity and honesty of the audit client and keep a sceptical mindset where such issues are concerned.

**Tipping off**

The term ‘tipping off’ means that the MLRO discloses something that will prejudice an investigation. It is an offence to make the perpetrators of money laundering aware that the auditor has suspicions or knowledge regarding their money laundering activities or that these suspicions or knowledge have been reported. It is unnecessary for the auditor to gain all the facts, or to ascertain without a doubt, that an offence has occurred. The auditor only needs to satisfy themselves that their suspicions are reasonable, and obtain sufficient evidence to show the allegations are made in good faith.

**Conclusion**

Candidates attempting AA and AAA are advised to gain a sound understanding of laws and regulations, not only in the context of the *Syllabus* and *Study Guide* but also in the context of real-life situations to allow for greater application of knowledge.

Keep in mind the fact that questions in AAA will not always flag up that candidates need to consider laws and regulations; the challenging nature of AAA will mean that candidates will have to conclude for themselves that questions are testing a specific subject area of the syllabus.

* **AUDIT QUALITY – A PERPETUAL CURRENT ISSUE**

The issue of audit quality has always been a key consideration for auditors. Performing a high quality audit means that audit risk is reduced and the audit firm is less likely to issue an inappropriate audit opinion. However, periodic reviews by regulatory authorities on the work performed by audit firms often conclude that audits performed are not always of high quality, despite this being in the best interest of the audit firm. The objective of this article is to provide some insight into why audit firms sometimes compromise audit quality, giving examples of how this happens, and the implications of compromising on audit quality for the profession.

This issue is relevant to P7 in that the *Syllabus* and *Study Guide* contains a specific section, C1, which contains a number of learning outcomes in relation to quality control in the context of practice management. In particular, learning outcome C 1 (d) states the following capability: ‘Assess whether an engagement has been planned and performed in accordance with professional standards and whether reports issued are appropriate in the circumstances.’ This requires candidates to apply their knowledge of quality control to a given scenario and a requirement of this nature has appeared several times in past papers.

**A reminder of the sources of requirements in relation to quality control**

The International Auditing and Assurance Standards Board (IAASB) has issued two documents relating to quality control. ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* applies to all firms of professional accountants in respect of audits and reviews of financial statements, and other assurance and related services engagements. It should therefore also be applied to non-audit engagements such as reviews of prospective financial information and engagements to perform agreed upon procedures.

ISA 220, *Quality Control for an Audit of Financial Statements* is specific to audit engagements and contains specific requirements that should be adhered to in the performance of any audit. ISA 220 contains requirements in relation to:

* Leadership responsibilities for quality on audits
* Relevant ethical requirements, in particular independence
* Acceptance and continuance of client relationships and audit engagements
* Assignment of engagement teams
* Engagement performance, meaning the direction, supervision and review of an audit, including consultation and engagement quality control reviews
* Monitoring and documentation

A detailed review of all of the requirements is outside the scope of this article, and candidates are encouraged to ensure that they are familiar with the contents of ISA 220 so that they can apply this knowledge to a given scenario and comment on whether an audit has been performed in accordance with the requirements of the ISA.

**Recent developments in relation to quality control**

The IAASB makes specific reference to the issue of audit quality in its latest annual report published in June 2014. The IAASB chairman, Arnold Schlider, in his chairman’s statement, discusses audit quality as a key issue that the IAASB is focussing on. He refers to the IAASB publication entitled *A Framework for Audit Quality*, the objective of which is to raise awareness of the key elements of audit quality; encourage stakeholders to reflect on ways to improve audit quality; and facilitate greater dialogue among stakeholders on the topic. (The Consultation Paper on which this Framework document is based is listed as an examinable document for P7 INT for June 2015). He also mentions the IAASB webpage, ‘Focus on Audit Quality,’ which was launched in early 2014 to provide supplemental material supporting awareness and use of the Framework. It is clear that the IAASB want to engage not only with auditors but also with users and preparers of financial statements to encourage debate on audit quality.

The IAASB Work Plan for 2015–16 is entitled *Enhancing Audit Quality and Preparing for the Future*, emphasising the prominence of audit quality in the work programme of the IAASB. In addition, the board has recently commenced a survey on audit quality, focussing on how audit firms apply ISQC1 and the difficulties faced by smaller audit firms in meeting the requirements.

It is not just the IAASB that perceives audit quality as a matter of debate. Other regulatory bodies such as the UK Financial Reporting Council (FRC) is interested in promoting audit quality and its Annual Reports on Audit Quality Inspections feature detailed commentary on the improvements that audit firms can make to enhance audit quality.

**Why is audit quality a concern?**

The regulatory bodies have a role to play in promoting audit quality as this will in turn increase public confidence in the audit process and in financial reporting. As mentioned in the introduction, it is in the best interests of audit firms to conduct a high quality audit. So, it may be surprising to find that when inspections are carried out on the conduct of audits, the regulatory bodies come across many instances where audit quality is lacking.

Audit firms are faced with great pressures which may lead to them compromising audit quality. Pressures can be in the form of tight deadlines and restrictions on audit fees, issues relating to competence, ethical dilemmas, and the extent of judgment that is required when auditing certain balances and transactions. Some examples are given below to illustrate the effect of these pressures on audit quality.

Tight deadlines and restrictions on audit fees – the FRC comments in its 2011 – 2012 Annual Report on Audit Quality Inspections that ‘a company’s audit should represent value for money. Nevertheless, substantial fee reductions may lead the auditor to reduce valuable audit work and therefore compromise audit quality.’ Fee pressures are a commercial reality and audit firms will react to fee pressure by seeking efficiencies in the audit. This can manifest in many ways, for example, reducing sample sizes, and increasing materiality levels especially in group situations. A particular way to make the audit more efficient is to ‘offshore’ certain audit procedures in an arrangement whereby some of the audit work is performed by audit personnel who are not ‘full’ members of the audit team, they may be located in a foreign country where the labour costs are lower. This practice raises audit quality issues in that these personnel may not have a good knowledge of the audit client and the quality of the audit evidence produced may be questionable.

Competence – if auditors are not technically competent to perform audit work there is a clear impact on the quality of work performed. For example, the IAASB comments in its 2015–16 Work Plan that audit inspections have found instances where the person selected to perform engagement quality control reviews was not competent to do so. Given that engagement quality reviews are conducted for high risk audit engagements using inexperienced auditors to perform such reviews can create a potentially serious hazard for the audit firm in that it is much more likely that an inappropriate opinion could be issued.

Ethical dilemmas – a common example is where the audit firm provides non-audit services to the audited entity. Audit firms should be familiar with the concept that providing non-audit services creates a threat to objectivity, in particular a self-review threat, and audit firms also should be accustomed to assessing the significance of the risk and responding with the use of appropriate safeguards or by not providing the non-audit service. However there may be circumstances where the threat is overlooked, so compromising audit quality. For example, if an audited entity changes status and becomes listed (a public interest entity) then while it may previously have been acceptable to provide a non-audit service with the appropriate safeguards, the provision of the non-audit service may not be acceptable given the new status of the audited entity. This issue was picked up by the FRC in its 2014 round of audit quality inspections.

Extensive use of judgment – this is very much linked to professional scepticism (see ‘Related links’ for further reading). Audit inspectors often comment that the audit of judgmental balances such as fair values and impairment is lacking in quality. The FRC’s 2014 Annual Report on Audit Quality Inspections states that ‘Limited evidence that [audit] firms have robustly challenged management particularly in respect of the appropriateness of key assumptions and other judgments was a key concern. Firms, with the assistance of audit committees, should ensure they appropriately challenge management.’ The report comments that audit firms often fail to challenge the feasibility of business plans prepared by management, as well as assumptions relating to fair value, impairment and the valuation of tangible and intangible assets.

These are just some examples of instances where audit quality has been compromised, as identified by audit inspections. The objective of the inspections is to highlight the weaknesses in audit quality and to recommend improvements. It is up to the audit firm whether or not they respond to the recommendations, but it is in their interest to do so, and there are calls by the IAASB to formalise the means by which audit firms demonstrate that they have taken such recommendations on board.

**Conclusion**

By emphasising the issue of audit quality in its current Work Plan, the IAASB is making it clear that audit quality is something to be taken seriously. Higher quality audits and public confidence in audit reports issued should reduce the ‘expectation gap’. However with audit firms coming under pressure to cut fees, produce competitive tender documents and provide ‘added value’ to the audit in the form of non-audit services, it is easy to see why audit quality is often compromised. Future changes to make the requirements of ISQC1 and ISA 220 more robust could help, as will promoting the use of professional scepticism in the conduct of all audits.

**Written by a member of the Paper P7 examining team**

*Note: Some of the documents referred to in this article*

* **PROFESSIONAL SCEPTICISM**

In recent years regulatory bodies including the International Auditing and Assurance Standards Board (IAASB) and the UK Financial Reporting Council (FRC) have issued documents highlighting the importance of professional scepticism in an audit of financial statements. The objective of this article is to explain the importance of professional scepticism as an essential part of the auditor’s mindset, and to consider the reasons why approaching an audit with an attitude of professional scepticism is becoming increasingly important.

**What is professional scepticism?**

The glossary of terms contained in the IAASB’s *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements* contains the following definition of the term ‘professional scepticism’:

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

ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing,* contains more guidance on how and why the auditor should act with an attitude of professional scepticism. ISA 200 contains a specific requirement in relation to professional scepticism:

*The auditor shall plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.*

This overall objective is the fundamental driver for the relevant learning outcomes within the Paper P7 syllabus, namely:

* To discuss the importance of professional scepticism in planning and performing an audit (B1e), and
* To assess whether an engagement has been planned and performed with an attitude of professional scepticism, and evaluate the implications (B1f).

The application paragraphs of ISA 200 contain more guidance on what is meant by applying professional scepticism when conducting an audit: *Professional scepticism includes being alert to, for example:*

* *Audit evidence that contradicts other audit evidence obtained.*
* *Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.*
* *Conditions that may indicate possible fraud.*
* *Circumstances that suggest the need for audit procedures in addition to those required by the ISAs.* (ISA 200 A.18).

Essentially, ISA 200 requires the use of professional scepticism as a means of enhancing the auditor’s ability to identify risks of material misstatement and to respond to the risks identified. Professional scepticism is closely related to fundamental ethical considerations of auditor objectivity and independence. Professional scepticism is also linked to the application of professional judgment by the auditor. An audit performed without an attitude of professional scepticism is not likely to be a high quality audit. At its core the application of professional scepticism should help to ensure that the auditor does not neglect unusual circumstances, oversimplify the results from audit procedures or adopt inappropriate assumptions when determining the audit response required to address identified risks, all of which should improve audit quality.

**How does the auditor apply professional scepticism?**

The auditor is likely to apply professional scepticism at various stages from client acceptance and at various points during the audit process, and some typical examples are given below:

* *When assessing engagement acceptance –* at this stage the auditor should consider whether the management of the intended audit client acts with integrity and whether there are any matters that may impact on the auditor being able to act with professional scepticism if they accept the engagement, such as ethical threats to objectivity.
* When performing risk assessment procedures – an auditor should be sceptical when performing risk assessment procedures at the planning stage of the audit. For example, when discussing the results of analytical procedures with management, the auditor should not accept management’s explanations at face value, and should obtain corroboratory evidence for the explanations offered.
* *When obtaining audit evidence* – the auditor should be ready to challenge management, especially on complex and subjective matters and matters that have required a degree of judgement to be exercised by management. The reliability and sufficiency of evidence should be considered, especially where there are risks of fraud. There may also be specific issues arising during an audit which impacts on professional scepticism – for example, if management refuses the auditor’s request to obtain evidence from a third party. The auditor will have to consider how much trust can be placed on evidence obtained from management – for example, evidence in the form of enquiry with management or written representations obtained from management. ISA 200 states that ‘*a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional scepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance*’.
* *When evaluating evidence* – the auditor should critically assess audit evidence and be alert for contradictory evidence that may undermine the sufficiency and appropriateness of evidence obtained.

The auditor should also apply professional scepticism when forming the auditor’s opinion, by considering the overall sufficiency of evidence to support the audit opinion, and by evaluating whether the financial statements overall are a fair presentation of underlying transactions and events.

Ultimately, the application of professional scepticism should reduce detection risk because it enhances the effectiveness of applied audit procedures and reduces the possibility that the auditor will reach an inappropriate conclusion when evaluating the results of audit procedures.

**Specific applications of professional scepticism**

***Fraud*** ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements,* specifically refers to professional scepticism stating that ‘*when obtaining reasonable assurance, the auditor is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud*’ (ISA 240.8).

ISA 240 goes on to state a specific requirement for the auditor: ‘*The auditor shall maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience of the honesty and integrity of the entity’s management and those charged with governance*’ (ISA240.12).

The application paragraphs of ISA 240 emphasise the importance of assessing the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance. In addition, ISA 240 states that ‘*management is often in the best position to perpetrate fraud. Accordingly, when evaluating management’s responses to inquiries with an attitude of professional scepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information*’ (ISA 240.A17). This is significant in that ISA 240 reminds the auditor that when management provides the auditor with audit evidence – be that in the form of answers to enquiries, written representations or other forms of documentary evidence – the auditor should carefully consider the integrity of that evidence and whether additional corroboratory evidence should be obtained from a more reliable source.

***Other aspects of an audit where professional scepticism may be important*** The IAASB has issued a Staff Questions and Answers document entitled *Professional Scepticism in an Audit of Financial Statements*, which outlines some of the areas of the audit where the use of professional scepticism may be important. These are outlined below and largely relate to areas of the audit that are complex, subjective or highly judgmental.

* Accounting estimates – this can include fair value accounting estimates, the use of significant assumptions by management in developing accounting estimates, and reviewing the judgements and decisions used by management for management bias in developing accounting estimates.
* Going concern – the auditor should review management’s assessment of going concern and whether management’s plans are feasible, this being particularly important where there is a significant doubt over the entity’s ability to continue as a going concern.
* Related party relationships and disclosures – it can be difficult to obtain information on related parties, as knowledge may be confined to management meaning that the auditor may have to rely on management to identify all related parties The auditor should also be sceptical when assessing the business rationale behind related party transactions.
* Consideration of laws and regulations – the auditor should be alert throughout the audit for indications that there may have been a suspected non-compliance with laws and regulations.

**The increasing importance of professional scepticism**

The IAASB Staff Questions and Answers document contains a foreword by Arnold Schilder, IAASB chairman, which emphasises the increasing need for auditors to apply professional scepticism. One reason for this is the increased use of judgment and subjectivity in management’s financial reporting decisions. This is due to the application of International Financial Reporting Standards (IFRS), which are largely principle-based, and often require the preparers of financial statements to exercise significant judgment when making decisions on accounting treatments.

The global financial crisis of 2008–2009 also focused attention on professional scepticism. Auditors in many jurisdictions were criticised for not applying sufficient professional scepticism at that time, particularly in relation to the audit of fair values, related party transactions and going concern assessments. One of the reasons for the IAASB issuing the Staff Questions and Answers document was to re-emphasise the importance of professional scepticism especially in the audit of financial statements where there is a high risk of material misstatement due to financial distress.

The UK’s Financial Reporting Council (FRC) has issued a Briefing Paper on professional scepticism which suggests that professional scepticism is the cornerstone of audit quality. It proposes that the auditor should actively look for risks of material misstatement, and that this is only possible when a high degree of knowledge of the audited entity’s business and the environment in which it operates is obtained. The document contains proposals for how audit firms can encourage audit teams to approach audits with a sceptical mindset, and it considers that some audit firms may need to change their culture to allow this to happen.

The IAASB’s Work Plan for 2015–16, *Enhancing Audit Quality and Preparing for the Future* – issued in December 2014 – prioritises the issues that impact on audit quality, including group audits, quality control, and professional scepticism. It is clear the professional scepticism is to stay on the agenda of the regulatory authorities for some time to come, as it is so intrinsically linked to other key audit issues such as audit quality, ethics and independence and, ultimately, the confidence that the public has in the auditing profession.

**Conclusion**

The IAASB states that ‘the need for professional scepticism cannot be overemphasised’ and that ‘adopting and applying a sceptical mindset is ultimately a personal and professional responsibility to be embraced by every auditor’. Given the increasingly complex and subjective nature of IFRS requirements, auditors must be confident to challenge management on a range of matters relevant to the preparation of the financial statements and the IAASB and national bodies such as the FRC are keen to support auditors in the application of professional scepticism. This, they believe, is an essential element of quality control, and in safeguarding the credibility of the audit opinion.

**Written by a member of the Paper P7 examining team**

* **USING THE WORK OF INTERNAL AUDITORS**

Can internal auditors be used to provide direct assistance to the external auditor for purposes of audit?

/ Element: Page Intro Block: Text

*Relevant to ACCA Qualification exams AA and AAA*

International Standard on Auditing (ISA) 610, *Using the Work of Internal Auditors* was revised and published in 2013. This standard focuses on whether the external auditor can use the work of the internal audit function for purposes of audit, and the revised version of the standard, clarified whether the internal auditors could be used to provide direct assistance to the external auditor.

Candidates taking AA and AAA should familiarise themselves with this aspect of the standard as they are expected to be able to discuss the extent to which external auditors are able to rely on the work of internal auditors (section D6  of the AA *Study Guide*) and to assess the appropriateness and sufficiency of the work of internal auditors as well as the extent to which reliance can be placed on it (section D4) of the AAA *Study Guide*).

**External and internal auditors**

Much of the work performed by a company’s internal audit function can overlap with the work conducted by the external auditor, specifically in areas dealing with the assessment of control processes. It is likely that in carrying out detailed work evaluating and reviewing the company’s internal control framework internal audit perform procedures on financial controls relevant to the external audit. As such, the external auditor, rather than duplicating these procedures, may be able to place reliance on the work carried out by the internal auditor.

Block: Text

This article focuses on the provision of direct assistance by the internal auditors, which historically has been a very controversial issue. Internal auditors are the **employees of the entity,** which could result in **threats to independence** (either in fact or perceived) if direct assistance is provided by the internal auditors. On the other hand, the following benefits relating to provision of direct assistance by the internal auditors cannot be ignored:

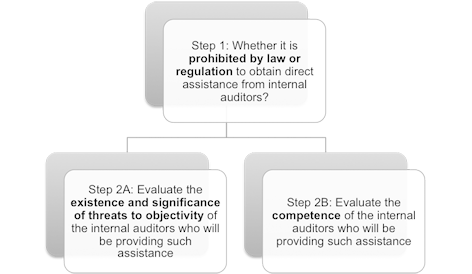
* There will be a **strengthened relationship** between the external and internal auditors through a more effective dialogue
* With the **knowledge** of the internal auditors, the external auditor can gain additional insights into the entity
* The external auditor can use internal auditors who may have relevant **expertise** in particular areas, and
* The external audit team can focus on the **more significant audit issues**.

Where such use is not prohibited by law or regulation, the ISA provides a robust framework to ensure that direct assistance is obtained only in appropriate circumstances, that the external auditor considers the relevant limitations and safeguards, and that the auditor’s responsibilities are clearly set out.

**Guidance on determining if it is appropriate for internal auditors to provide direct assistance**

**When can internal auditors be used to provide direct assistance?**

The external auditor, in the course of discharging their responsibilities must decide if it is appropriate in the circumstances to use internal audit to provide direct assistance. The ISA identifies a number of steps that the external auditor should work through when determining to what extent, if any, direct assistance can be provided.

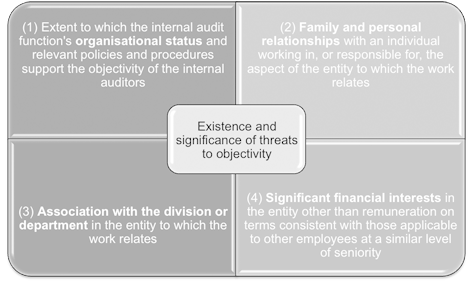
[](https://www.accaglobal.com/content/dam/acca/global/images-students/f8p7-audit-fig2-large.png)

Block: Text

*Click to enlarge image*

*Step 1: Prohibition by law or regulation* The external auditor **may be prohibited** by law or regulation from obtaining direct assistance from internal auditors; therefore, the first task is to understand the law or regulation of the jurisdiction in which the auditor is operating. In the United Kingdom for example, the Financial Reporting Council (FRC) prohibits external auditors from using internal auditors as ‘direct assistance’ members of the audit team in order to enhance the principle of auditor independence. Consequently the guidelines in relation to direct assistance are irrelevant to audits conducted in accordance with ISAs (UK).

*Step 2A: Evaluation of the existence and significance of threats to objectivity of the internal auditors* This is considered as an important element in the external auditor’s judgment as to whether internal auditors can provide direct assistance. Objectivity is regarded as the ability to perform the tasks without allowing bias, conflict of interest or undue influence of others to override professional judgment. The following factors are relevant to the external auditor’s evaluation of objectivity:

[](https://www.accaglobal.com/content/dam/acca/global/images-students/f8p7-audit-fig3-large.png)

Block: Text

*Click to enlarge image*

It should be noted that the main purpose here is to evaluate **threats to objectivity**. Take the first factor as an example – if evidence shows that the internal audit function’s organisational status supports the objectivity of the internal auditors, the external auditor will feel more comfortable using direct assistance from the internal auditors. The following situations are likely to support the objectivity of the internal auditors:

* The internal audit function reports to those charged with governance (eg the audit committee) rather than solely to management (eg the chief finance officer)
* The internal audit function does not have managerial or operational duties that are outside of the internal audit function
* The internal auditors are members of relevant professional bodies obligating their compliance with relevant professional standards relating to objectivity.

*Step 2B: Evaluation of the level of competence of the internal auditors* Competence of the internal audit function is likely to be deemed satisfactory where it can be evidenced that the function as a whole operates at the level required to (i) enable assigned tasks to be performed diligently and (ii) in accordance with applicable professional standards. To make such evaluation, the external auditor can take into consideration the following factors:

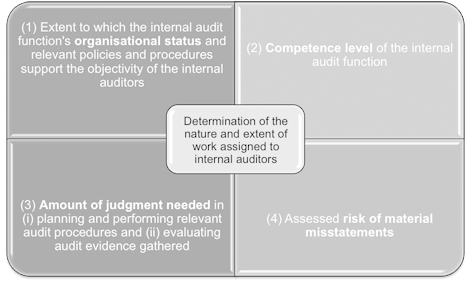
* Whether there are established policies for **hiring**, **training** and **assigning** internal auditors to internal audit engagements
* Whether the internal auditors have adequate technical training and proficiency in auditing (eg with relevant professional designation and experience)
* Whether the internal auditors possess the required knowledge relating to the entity’s financial reporting and the applicable financial reporting framework
* Whether the internal audit function possesses the necessary skills (for example, industry-specific knowledge) to perform work related to the entity’s financial statements.

*Points to note in the evaluation* The above evaluation regarding the internal auditors’ objectivity and competence should not be new to candidates as it forms the basis for any assessment by the external auditor when determining if reliance can be placed on the work of internal auditors. The external auditor should bear in mind that the assessment of competence and objectivity are of equal importance, and should be assessed individually and in aggregate. For example if the internal auditors are deemed appropriately competent but the external auditor identifies significant threats to objectivity it is unlikely that the external auditor will be able to use the internal auditors to provide direct assistance and vice versa.

**What can be assigned to internal auditors providing direct assistance?**

Following the above detailed evaluation, if the external auditor determines that internal auditors, can be used to provide direct assistance for purposes of the audit, the next decision to be made by the external auditor is to determine the **nature and extent of work** that can be assigned to internal auditors.

This is a matter that requires the auditor to exercise professional judgment, due to the fact that extensive use of direct assistance could affect perceptions of the independence of external auditors. ISA 610 (Revised 2013) limits the circumstances in which direct assistance can be provided. The external auditor is advised to consider the following factors in such determination:

[](https://www.accaglobal.com/content/dam/acca/global/images-students/f8p7-audit-fig4-large.png)

Block: Text

*Click to enlarge image*

The external auditor should have performed the assessment of the first two factors when determining whether the internal auditors can provide direct assistance in the first instance. The less persuasive the evidence regarding the internal auditors’ objectivity and competency, the more restrictive the nature and extent of work that can be assigned.

As a starting point the external auditor should consider the amount of judgment needed in (i) planning and performing relevant audit procedures and (ii) evaluating audit evidence gathered. The **greater the level of judgment** required, the **narrower the scope** of work that can be assigned to internal auditors. The following activities are deemed to involve significant judgment and therefore are not expected to be assigned to internal auditors providing direct assistance:

* Assessing risks of material misstatements
* Evaluating the sufficiency of tests performed
* Evaluating significant accounting estimates, and
* Evaluating the adequacy of disclosures in the financial statements and other matters affecting the auditor’s report.

For any particular account balance, class of transaction or disclosure, the external auditor has to take into consideration the assessed risk of material misstatement when determining the nature and extent of work that they propose to assign to internal auditors. The **higher the assessed risk**, the **more restricted** **the nature and extent** of work that should be assigned to internal auditors. If the risk of material misstatement is considered to be anything other than low, the more judgment that has to be involved and the more persuasive the audit evidence required. Therefore, in these circumstances, in order to reduce audit risk to an acceptably low level it is expected that the external auditor has to perform more procedures directly and place less reliance on assistance provided by internal auditors when collecting sufficient appropriate evidence. The ISA provides some specific examples of areas where reliance should be restricted.

ISA 610 (Revised 2013) states that internal auditors cannot carry out procedures when providing direct assistance that:

* Involve making *significant* judgment in the audit
* Relate to higher assessed risks of material misstatements where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathering is *more than limited*
* Relate to decisions the external auditor makes in accordance with ISA 610 (Revised 2013) regarding the internal audit function and the use of its work or direct assistance
* Relate to work with which the internal auditors have been involved and which has already been or will be reported to management (or those charged with governance) by the internal audit function. This restriction intends to minimise self-review threats.

ISA 610 (Revised 2013) also states that the following should not be assigned to or involve internal auditors providing direct assistance:

(i) discussion of fraud risks (ii) determination of unannounced (or unpredictable) audit procedures as addressed in ISA 240, The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements, and (iii) maintaining control over external confirmation requests and evaluation of results of external confirmation procedures.

**Responsibilities of the external auditor using internal auditors to provide direct assistance**

The external auditor should note the following responsibilities at different stages of the audit when using internal auditors to provide direct assistance:

*(1) After determining the use of internal auditors to provide direct assistance* The external auditor has to:

* Communicate the nature and extent of the planned use of internal auditors with those charged with governance (in accordance with ISA 260, *Communication with Those Charged with Governance*) so as to reach a mutual understanding that **such use is not excessive** in the circumstances of the engagement. This communication not only dispels any perception that the external auditor’s independence might be compromised by the use of direct assistance but also facilitates appropriate dialogue with those charged with governance.
* Evaluate whether the external auditor is still sufficiently involved in the audit.

*(2) Prior to the use of internal auditors to provide direct assistance* The external auditor has to **obtain written agreement** from two parties:

* From an **authorised representative** of the entity stating that: (i) the internal auditors will be allowed to follow the external auditor’s instructions, and (ii) the entity will not intervene in the work the internal auditor performs for the external auditors.
* From **internal auditors** stating that they will: (i) keep confidential specific matters as instructed by the external auditor and (ii) inform the external auditor of any threat to their objectivity.

*(3) During the audit* The external auditor has to:

* Direct, supervise and review the work performed by internal auditors on the engagement, bearing in mind that the **internal auditors are not independent** of the entity. It is therefore expected that such supervision and review will be of a different nature and more extensive than if members of the audit engagement team perform the work.
* Remind the internal auditors to bring accounting and auditing issues identified during the audit to the attention of the external auditors.
* Check back to the underlying audit evidence for some of the work performed by the internal auditors.
* Make sure the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

*(4) Documenting the audit evidence* The documentation requirements evidencing the application of the important safeguards in ISA 610 (Revised 2013) have been expanded when the external auditor uses the internal auditors to provide direct assistance. The external auditor should document the following in the working papers:

* **Evaluation** of the existence and significance of the **threats to the objectivity** of the internal auditors and the level of **competence** of the internal auditors used to provide direct assistance
* The **basis** for the decision regarding the nature and extent of the work performed by the internal auditors
* Who **reviewed the work performed** and the date and extent of that review in accordance with ISA 230, *Audit Documentation*
* The **written agreements** obtained from an authorised representative of the entity and the internal auditors
* The **working papers** prepared by the internal auditors providing direct assistance on the audit engagement.

**Conclusion**

The external auditor has to exercise professional judgment when determining whether the internal auditors, subject to law and regulation, can be used to provide direct assistance in the financial statement audit of an entity. Candidates are expected to understand (i) how the external auditor makes such evaluations and (ii) for which processes or tasks the internal auditors can provide direct assistance to the external auditor. The most important principle is, in any circumstances, the external auditor should be **sufficiently involved** in the audit as the external auditor has the **sole responsibility** for the audit opinion expressed.

**Eric YW Leung, CUHK Business School, The Chinese University of Hong Kong, FCCA**

**Reference** ISA 610 (Revised 2013), *Using the Work of Internal Auditors, together with its Basis for Conclusions*

* **ACCOUNTING ISSUES**

A very common theme in Paper P7 questions is to present you with information that embodies an accounting issue. Sometimes the information is presented as a standalone requirement but is often, for example, included in a set of notes of a conversation with an audit client’s finance director.

For example:

*December 2012 Question 1 contains:* Work has recently started on a new production line which will ensure that Grohl Co meets new regulatory requirements prohibiting the use of certain chemicals, which come into force in March 2013. In July 2012, a loan of $30m with an interest rate of 4% was negotiated with Grohl Co’s bank, the main purpose of the loan being to fund the capital expenditure necessary for the new production line.

*June 2012 Question 1 contains:* Starling Co received a grant of $35m on 1 March 2012 in relation to redevelopment of its main manufacturing site. The government is providing grants to companies for capital expenditure on environmentally friendly assets. Starling Co has spent $25m of the amount received on solar panels which generate electricity, and intends to spend the remaining $10m on upgrading its production and packaging lines.

*December 2011 Question 1 contains:* On 1 July 2011, Oak Co entered into a lease which has been accounted for as a finance lease and capitalised at $5m. The leased property is used as the head office for Oak Co’s new website development and sales division. The lease term is for five years and the fair value of the property at the inception of the lease was $20m.

Typically the question requirements will then be something along the lines of:

* Evaluate the business risks faced by X Co.
* Identify and explain the risks of material misstatement to be considered in planning the audit of X Co.
* In respect of the risks of material misstatement, suggest suitable audit procedures.

**Business risks**

Remember that when you are describing business risks, you should say nothing about potential misstatements in the financial statements. Business risks exist quite independently of the financial statements and they do not depend on audit procedures. Business risk is where the directors make wrong decisions or where events have occurred which threaten the business’s future. Business risks are often classified as:

* Strategic risks (for example, investing in out-of date technology).
* Operational risks (for example, manufacturing products which have faults).
* Regulatory risks (for example, the fines and damages that might be payable as a consequence of breaching health and safety regulations).
* Financial risks (for example, an inability to pay interest or rent because of poor cash flow).

Although drafting financial statements does not affect the business risks, understanding the business risks can give insights into where the financial statements might contain material misstatements. For example, investing in out-of date technology could cause going concern problems and queries about the impairment of the out-of date, though possibly relatively new, machinery. Regulatory risks can give rise to problems over assessing and presenting liabilities or contingent liabilities.

**Risks of material misstatement**

The risk of material misstatement refers to the risk that a material misstatement is present in the financial statements that are being audited. It is the purpose of the audit to ensure that these misstatements do not appear in the published financial statements – or if they do that there is an appropriately modified audit opinion.

Material misstatements at the assertion level arise if a relevant assertion is wrong. For example, the amount could be incomplete, a valuation could be wrong, a transaction might not have occurred.

Assertions also cover presentation and disclosure. For example, the classification and understandability assertion requires that ‘financial information is appropriately presented and described, and disclosures are clearly expressed’ (ISA 315).

Broadly, therefore, misstatements can be divided into two groups:

* The treatment of the transaction, event or balance, including its presentation and disclosure could be incorrect.
* The amount of the transaction, event or balance could be incorrect.

The auditor must devise suitable procedures to collect sufficient appropriate audit evidence about the assertions lying behind *both* of these aspects of items in the financial statements.

Remember, the treatment must be right, the amounts must be right and sufficient appropriate audit evidence is needed for both.

So when you are presented with a question in the exam about financial statement risk and audit procedures, don’t sit scratching your head: TAP it instead and remember:

**T**reatment **A**mount **P**rocedures

**Treatment and amount**

IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, requires that financial statements comply with any specific IAS or IFRS applying to a transaction, event or condition, and provides guidance on developing accounting policies for other items that result in relevant and reliable information. In the absence of a Standard or an Interpretation that specifically applies to a transaction, other event or condition, IAS 8.10 states that management must use its judgment in developing and applying an accounting policy that results in information that is:

* relevant to the economic decision-making needs of users and
* reliable so that the financial statements:
  + represent faithfully the financial position, financial performance and cash flows of the entity
  + reflect the economic substance of transactions, other events and conditions, and not merely the legal form
  + are neutral, ie free from bias
  + are prudent and
  + are complete in all material respects

In applying its judgment, IAS 8 requires management to consider the definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the IFRS conceptual framework.

So, looking again at the three question examples given at the start of this article:

The December 2012 Question 1 raises the matter of the treatment of interest payments. To quote the ACCA answer:

‘The new production process would appear to be a significant piece of capital expenditure, and it is crucial that directly attributable costs are appropriately capitalised according to IAS 16, *Property, Plant and Equipment* and IAS 23, *Borrowing Costs*. Directly attributable finance costs must be capitalised during the period of construction of the processing line, and if they have not been capitalised, non-current assets will be understated and profit understated.’

The June 2012 Question 1 raises the matter of the treatment of government grants. To quote the ACCA answer:

‘Starling Co has received a grant of $35m in respect of environmentally friendly capital expenditure, of which $25m has already been spent. There is a risk in the recognition of the grant received. According to IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance* government grants shall be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate. This means that the $35m should not be recognised as income on receipt, but the income deferred and released to profit over the estimated useful life of the assets to which it relates. There is a risk that an inappropriate amount has been credited to profit this year.’

The December 2011 Question 1 raises the matter of treatment of a lease. To quote from the ACCA answer:

‘The lease taken out in July 2011 has been treated as a finance lease. However, there are indications that it is in fact an operating lease. First, the lease is for only five years, which for a property lease is not likely to be for the major part of the economic life of the asset.

According to IAS 17, *Leases*, an indicator of a finance lease is that the lease term is for the major part of the economic life of an asset. Second, the amount capitalised of $5m represents only 25% of the fair value of the asset. Under IAS 17, for a lease to be classified as a finance lease, the present value of minimum lease payments (the amount capitalised) should amount to at least substantially all of the fair value of the asset. 25% is not substantially all of the fair value, indicating that this is actually an operating lease.’

Having determined the correct treatment for a transaction, event or balance, its amount can then be tackled. Sometimes the accounting standard can be very prescriptive. For example, the correct treatment of inventory is to value it at the lower of cost and NRV and cost can be based on average costs or FIFO but not LIFO. Another example is found in the calculation of impairment where the carrying amount (the amount at which an asset is recognised in the balance sheet after deducting accumulated depreciation) cannot be more than its a recoverable amount, ie the higher of fair value less costs of disposal and value in use). Calculations will be needed to determine both of these amounts.

**Procedures**

If material misstatements can be caused by either wrong treatment or wrong amounts, then audit evidence is needed to verify that both of these are acceptable.

Taking the capitalisation of a lease in the December 2011 example, evidence is needed as to whether or not it should be treated as a finance or operating lease and, depending on its treatment, evidence is then needed about either the amount capitalised or the amount appearing as an expense. Sometimes, as here, the evidence will be provided in the question, but sometimes you can be asked to suggest what procedures are needed to find the evidence.

ISA 500, *Audit Evidence*, categorises the procedures available to auditors as:

* Inspection
* Observation
* External confirmation
* Recalculation
* Analytical procedures
* Enquiry

These are high level categories of procedures and specific, precise procedures have to be described which will both verify the correct treatment and the correct amount. Where a relevant International Standards in Auditing exists any procedures stipulated must be followed. For example:

* ISA 501 describes procedures for auditing inventory, litigation claims and segment reporting information.
* ISA 505 sets out procedures for obtaining external confirmations.
* ISA 530 sets out procedures and other matters relevant to audit sampling.
* ISA 560 sets out procedures relating to post balance sheet events.
* ISA 570 sets out procedures relating to the validity of the going concern assumption.

Block: Text

However, by no means all procedures covered by ISAs and candidates must be able to suggest procedures that will help in the collection of appropriate audit evidence for both the treatment of items in accordance with the accounting standards and for their amounts.

So, procedures relevant to collecting evidence about the receipt of a government grant (Q1 from June 2012):

*Treatment:*

* Inspect the grant application and subsequent correspondence with the government department to verify the amount and purpose of the grant (ie to ensure it is a grant relating to non-current assets).
* Trace the credit entry in respect of the grant either to a deferred income account or to the credit of the appropriate non-current asset register entries and the appropriate non-current asset control account.
* If credited to a deferred income account, inspect entries showing that it is being released to income over the expected life of the asset.

*Amount:*

* Inspect the grant application and subsequent correspondence with the government department to verify the amount and purpose of the grant.
* Inspect the board minutes for mention of the grant.
* Trace receipt of the grant to the bank account.
* If the amount is being released form a deferred income account, reperform the calculation relating to the amount released to income in the current financial period.
* If the amount is credited to the cost of the asset reperform the depreciation calculation to ensure that depreciation is based on the net cost of the asset after the grant is credited.

**Conclusion**

Remember ‘TAP’:

* Financial statements will not provide a true and fair view if they include material misstatements.
* Misstatements can be caused by either incorrect accounting **T**reatment or incorrect **A**mounts.
* An audit requires **P**rocedures to collect evidence about both treatment and amounts.

**Ken Garrett is a freelance author and lecturer**

* **FORENSIC ACCOUNTING**

With at least one requirement relating to forensic accounting in three out of five Paper P7 exams between December 2011 and December 2013, this is an area of the syllabus that students cannot afford to overlook. This article explores some of the issues relevant to forensic accounting. Forensic accounting has been a regular feature in the Paper P7 exam in recent sittings but the examiner has commented that it is an inadequately understood part of the syllabus.

**Terminology**

The syllabus requires an understanding of three key terms: ‘forensic accounting’, ‘forensic investigation’ and ‘forensic audit’. Recent exam sittings have shown that students have rote-learnt the definitions or meaning of these terms, but do not necessarily understand them.

The terms are not strictly defined in regulatory guidance and the meaning of forensic accounting is quite broad: it is the application of accountancy skills and knowledge in circumstances that have legal consequences. There are many circumstances with legal consequences in which accountancy might be required; the most well known of which is investigating alleged fraudulent activity.

Forensic accounting is the term used to describe the type of engagement. It is the whole process of carrying out a forensic investigation, including preparing an expert’s report or witness statement, and potentially acting as an expert witness in legal proceedings.

Forensic investigation is a part of a forensic accounting engagement. Forensic investigation is the process of gathering evidence so that the expert’s report or witness statement can be prepared. It includes forensic auditing, but incorporates a much broader range of investigative techniques, such as interviewing witnesses and suspects, imaging or recovering computer files including emails, physical searches of premises etc.

Forensic auditing is the application of traditional auditing procedures and techniques in order to gather evidence as part of the forensic investigation.

**Application**

The major applications of forensic accounting include fraud investigations, negligence cases and insurance claims.

An insurance claim would require determination of how much the client should claim from the insurer. The first step would be a detailed review of the insurance policy to determine ‘coverage’, ie what is insured and any clauses that might restrict the amount that can be claimed or invalidate the claim.

The second step would be to gather evidence to quantify the loss, ie the amount to be claimed. Insurance claims might include claims following misappropriation of assets, ie theft of goods or money. In such cases, the forensic accountant will review inventory or cash records and details of sales and purchases to reconcile the amounts held and determine the value of the goods or cash stolen. They will also test the reliability of the information held by counting a sample of inventory or cash currently held in comparison with the client’s records. The forensic accountant will not assume that there has been a theft; they will consider other possibilities such as an error in the data held.

Insurance claims may however, be much more complicated than this, such as in the case of business interruptions arising as a result of fire or flood. In these types of engagements the forensic accountant will review prospective financial information in comparison with reported outturn to evaluate the loss of profit arising as a result of the business interruption. The forensic accountant will not assume that there has been any loss of profit due to the business interruption; they will consider other possibilities such as a straightforward loss of market share to a competitor.

Forensic engagements often require the forensic accountant to quantify a loss. One such engagement is in professional negligence claims, ie when another accountant has breached their duty of care to a client or third party resulting in a loss for that client. In these types of engagement, the forensic accountant would also provide an opinion on whether the duty of care owed has been breached, ie whether the audit or other accountancy service was performed in accordance with current standards in practice, legislation and techniques. In relation to an audit, this would require consideration of whether the International Standards on Auditing were followed.

The need for a forensic accountant may also arise because two parties cannot agree on the amount owed by one party to another, and the accountant is engaged to provide an expert valuation, of a business for example.

This might be the case in a matrimonial dispute, where a divorcing couple whose assets include shares in a company or partnership, engage a forensic accountant to value the company so that a settlement can be reached. A similar process might apply in partnerships, when one partner wishes to leave the partnership and is being bought out by the remaining partner(s).

**The role of an expert witness**

An expert witness is quite different to any other witness in court proceedings. Most witnesses are 'witnesses of fact', ie they can only provide evidence on what they saw, did or heard. Most importantly, they cannot give their opinion on any of the matters about which they give evidence. By contrast, an expert witness is specifically called to give their opinion on a particular matter.

An accountant can be called to give evidence as a professional witness, ie a witness of fact, or an expert witness. In order to give evidence as an expert witness they must be just that, an expert. They must be able to demonstrate a level of expertise that means their opinion is valuable to the court. This means not only expertise in accountancy, but also expertise in the particular area of accountancy that they are giving evidence on.

A witness will provide a written report/statement to the court, and may also be required to attend court to give live evidence, in person, and be cross-examined by the ‘other side’.

However, not all forensic engagements will require evidence to be submitted to a court. Often, the engagement will simply require a report for the client’s own purposes or sometimes a report for use by the insurer.

Either way, a key skill necessary in being a successful forensic accountant is the ability to explain complex accounting concepts in simple terms to someone who is not themselves an accountant, whether that be as an expert witness explaining matters to the judge or jury, or when explaining matters to the client. Forensic accounting integrates investigative, accountancy, and communication skills.

**Planning**

Forensic accounting engagements are agreed-upon procedures engagements, not assurance engagements. The forensic accountant will not provide an assurance opinion – that is the role of the auditor when reviewing the amount of loss included in the financial statements.

This will normally involve determining an appropriate value or quantifying a loss as discussed above; this is quite distinct from an assurance engagement in which the engagement team would review an amount determined by the client.

As an agreed-upon procedures engagement, the forensic accountant will normally prepare a report for the client that sets out their findings, based on the scope agreed in the engagement letter. This report may be addressed to management, often in the case of a fraud, or to the insurer.

It may be that a witness statement/report for submission to the court/arbitrator is required in addition to or instead of a report to the client.

However, planning the investigation is likely to be similar to planning an audit or any other assurance engagement.

Planning will commence with a meeting with the client in which the engagement team will develop an understanding of the issue/events (the fraud, theft etc) and actions taken by the client since it occurred.

A key part of planning is to confirm exactly what format the output is required in, and exactly what matters are required to be covered within it.

At this stage any key documentation will be obtained and scrutinised – for example, the insurance policy, the partnership agreement, the evidence that led to the discovery of the fraud, etc.

The team will agree with the client, what access to other information or personnel will be required and this will be arranged.

Based on the above, the team will design procedures that enable them to meet the requirements of the client, as agreed. This may or may not include test of controls, depending on the circumstances. There would be no need to tests control when valuing a business for a matrimonial dispute. However, testing controls will be key to determining how a fraud took place.

**Procedures and evidence**

Any method of obtaining evidence can be used in a forensic accounting engagement – this is not a limited assurance engagement in which procedures are likely to be restricted to enquiry and analytical procedures.

Forensic engagements will include a detailed and wholesale review of all documentation and electronic evidence available. The opinion given by the expert accountant must be reasoned, and backed up by evidence. Their opinion cannot be objective if only based on what they are told; they must corroborate that information.

To be awarded marks in the exam, your procedures cannot be vague. They must be specific enough that the engagement team could actually follow your instructions.

For example, it would not be sufficient to write 'interview the suspect'. You must suggest questions that should be asked of the suspect in interview, depending on the circumstances in the scenario. For example, the suspect could be asked to explain their job role and what access that gives them to systems, cash, inventory etc.

This also applies when recommending enquires of or discussions with management – it must be clear in your answer what it is the engagement team should ask of them, eg have they informed the police, has the suspect been suspended, have they informed the insurer etc.

Equally it is not sufficient to suggest the use of computer assisted auditing techniques (CAATs). You must specify how the CAATs could be used. For example, data matching bank accounts used for paying suppliers with bank accounts for paying employees, exception reports identifying employees who are not taking holiday, etc.

In order to design appropriate procedures you must identify the type of forensic accounting engagement, and the specific type of fraud, insurance or negligence claim. For example, quantifying the theft of goods will be very different from quantifying a loss from payroll or ‘ghost employee’ fraud or loss of profits following a business interruption (as discussed above).

**Fundamental ethical principles**

The range of ethical and professional issues will be similar to any other type of engagement. However, the importance of ethics is arguably much greater in relation to forensic accountancy.  Often both ‘sides’ will bring an expert witness to the hearing where they do not agree. The decision maker must decide which evidence they ‘prefer’ – the credibility of the witness is often the primary factor on which they can base that decision and the credibility of an accountant is reliant on their compliance with the fundamental ethical principles.

In the exam, you will also need to note whether the client requesting the forensic accounting service is an audit client, if so, this will present an additional and particularly important threat to objectivity; a self-review threat. The investigation is likely to involve the quantification of an amount, which will then be reviewed as part of the financial statements audit.  The significance of the threat will be affected by the materiality of the amount and the subjectivity involved in quantifying it, eg if for loss of profits following business interruption this will be more subjective than quantification of the value of stolen inventory.

Remember that the decision to prosecute is a matter for the client. Often, clients do not want to prosecute for fear of damaging their reputation. The forensic accountant can provide the client with an analysis of all of the facts, but must not make the decision to prosecute (a management threat to objectivity). The forensic accountant has a duty of confidentiality, unless it is in the public interest to do so, they must not disclose the fraud to any third party including the police, without client permission.

**A final note**

Remember that a forensic accountant is just that; an accountant! Their role is to provide an accountant’s expert opinion or analysis of the facts. They are not the law-enforcer, prosecutor or judge. Be careful in the exam not to detract from an otherwise professional answer by getting carried away with suggestions such as taking fingerprints or DNA evidence or blood samples, or catching and punishing the culprit – that is not the role of an accountant.

**Check your understanding**

Question: Which of the following would be a valid procedure in a forensic engagement to determine the amount of insurance to be claimed in respect of lost profits during a business interruption following a flood?

* Obtain a written confirmation from the insurance provider to verify the amount of the loss.
* Recalculate management’s assessment of the loss to verify mathematical accuracy.
* Obtain the profit forecast for the period covered by insurance, and cast for mathematical accuracy.

Answer: The assurance provider’s role is to independently quantify the loss in order to determine the amount to be claimed; therefore 1 and 2 are not relevant. They would review the profit forecast in comparison with the actual outturn to determine the amount of profit lost and the first step would be to ensure that it adds up correctly. (Answer 3) Question: Which of the following would be a valid statement to include in a witness statement from an expert witness, but not a professional witness?

* The company’s purchases daybook recorded 15 sales invoices made out in the name of the allegedly fictitious supplier.
* The majority of the transactions recorded in the sales day-book do not appear to be commercial in nature.
* 75% of customers breached the credit limits set by the company during the period.

Answer: 1 and 3 are a matter of fact, 2 is a matter of opinion. Only an expert witness can give their opinion. A professional witness is a witness of fact who can only comment on what they did, saw or heard. A professional accountancy witness could review a company’s records and comment on what they saw during that review. (Answer 2)

**Helen Barrett is a forensic accountant and a freelance lecturer**

* **AUDITOR LIABILITY**

Auditor liability: ‘fair and reasonable’ punishment?

/ Element: Page Intro Block: Text

The issue of auditor’s liability is included in the syllabus for Paper P7, *Advanced Audit and Assurance*. Candidates need to understand and apply the principles of establishing liability in a particular situation, as well as being able to discuss the ways in which liability may be limited. The specific learning outcomes can be found in the *Syllabus* and *Study Guide*.

This article focuses on the issue of auditor’s liability in the UK, and therefore contains references to the UK Companies Act 2006, as well as UK-specific legal cases. Candidates other than those attempting the UK adapted paper are not expected to have UK-specific knowledge. The concepts discussed in this article however are broadly relevant and will help candidates to understand why this is an important issue within the auditing profession.

Over the past two decades the bill for litigation settlements of Big Four audit firms alone has run into billions of dollars. Examples include Deloitte’s 2005 settlement of $250m regarding its audit of insurance company Fortress Re and PwC’s $229m settlement in the lawsuit brought by the shareholders of audit client Tyco in 2007.

Auditor liability is increasingly concerning, both in terms of audit quality and the reputation of the profession but also in terms of the cost to the industry and the barriers this creates to competition within the audit market.

This article considers the current legal position of auditors in the UK. It also discusses the impact on the competitiveness of the audit market and some of the methods available to limit exposure to expensive litigation.

**Types of liability**

Auditors are potentially liable for both criminal and civil offences. The former occur when individuals or organisations breach a government imposed law; in other words criminal law governs relationships between entities and the state. Civil law, in contrast, deals with disputes between individuals and/or organisations.

**Criminal offences** Like any individual or organisation auditors are bound by the laws in the countries in which they operate. So under current criminal law auditors could be prosecuted for acts such as fraud and insider trading.

Audit is also subject to legislation prescribed by the Companies Act 2006. This includes many sections governing who can be an auditor, how auditors are appointed and removed and the functions of auditors.

One noteworthy offence from the Companies Act is that of ‘knowingly, or recklessly causing a report under section 495 (auditor’s report on company’s annual accounts) to include any matter that is misleading, false or deceptive in a material particular’ (s.507).

This means that auditors could be prosecuted in a criminal court for either knowingly or recklessly issuing an inappropriate audit opinion.

**Civil offences**

There are two pieces of civil law of particular significance to the audit profession; contract law and the law of tort. These establish the principles for auditor liability to clients and to third parties, respectively.

Under contract law parties can seek remedy for a breach of contractual obligations. Therefore shareholders can seek remedy from an auditor if they fail to comply with the terms of an engagement letter. For example; an auditor could be sued by the shareholders, which was the case in the PwC settlement to Tyco shareholders referred to above.

Under the law of tort auditors can be sued for negligence if they breach a duty of care towards a third party who consequently suffers some form of loss.

**Case history**

The application of the law of tort in the auditing profession, and the way in which auditors seek to limit their exposure to the ensuing liabilities, has been shaped by a number of recent landmark cases. The most notable of these are Caparo Industries Plc (Caparo) v Dickman (1990) and Royal Bank of Scotland (RBS) vs Bannerman Johnstone MacLay (Bannerman) (2002).

In the first case Caparo pursued the firm Touche Ross (who later merged to form Deloitte & Touche) following a series of share purchases of a company called Fidelity plc. Caparo alleges that the purchase decisions were based upon inaccurate accounts that overvalued the company. They also claimed that, as auditors of Fidelity, Touche Ross owed potential investors a duty of care. The claim was unsuccessful; the House of Lords concluded that the accounts were prepared for the existing shareholders as a class for the purposes of exercising their class rights and that the auditor had no reasonable knowledge of the purpose that the accounts would be put to by Caparo.

It was this case that provided the current guidance for when duty of care between an auditor and a third party exists. Under the ruling this occurs when:

* the loss suffered is a reasonably foreseeable consequence of the defendant’s conduct
* there is sufficient ‘proximity’ of relationship between the defendant and the pursuer, and
* it is 'fair, just and reasonable' to impose a liability on the defendant.

In the second case RBS alleged to have lost over £13m in unpaid overdraft facilities to insolvent client APC Ltd. They claimed that Bannerman had been negligent in failing to detect a fraudulent and material misstatement in the accounts of APC. The banking facility was provided on the basis of receiving audited financial statements each year.

In contrast to Touche Ross, who had no knowledge of Caparo’s intention to rely upon the audited financial statements, Bannerman, through their audit of the banking facility letter of APC, would have been aware of RBS’s intention to use the audited accounts as a basis for lending decisions. For this reason it was upheld that they owed RBS a duty of care. The judge in the Bannerman case also, and crucially, concluded that the absence of any disclaimer of liability to third parties was a significant contributing factor to the duty of care owed to them.

**Joint and several liability**

The guidance for when an auditor may be liable, either under criminal or civil law, appears to be clear and largely uncontroversial. The same cannot be said of the nature of the fines and settlements, which remains a hotly debated issue.

Before discussing this, it is worth making the point that auditors are only found liable in cases where they have breached their responsibilities to perform work with professional competence and due care and to act independently of their clients. There is therefore little argument that they should face the penalties of their own failures and that parties that have suffered as a result should be able to seek adequate compensation.

The main criticism of the current system is that the penalties incurred by the audit profession are unfairly high. This arises from the civil law principle of ‘joint and several liability’ enforced in the UK (as well as the US). This means that even if there are multiple culpable parties in a negligence case the plaintiff may pursue any one of those parties individually for the entire damages sought.

So for example, if a director fraudulently misstates the financial statements, the company’s management fail to detect this because of poor controls and the auditor performs an inadequate audit leading to the wrong audit opinion, it would be fair to say all three parties are at fault. Shareholders seeking compensation for any consequent losses, however, could try and recover the full loss from only one of those three parties.

Given that many of the cases arise when companies are facing financial difficulties, as with the examples cited above, and that any individuals involved are unlikely to possess sufficient assets to settle the liabilities, the audit firm, who may be asset rich and possess professional indemnity insurance, is often the sole target for financial compensation.

Regardless of the perceived fairness, this situation does create a number of challenges for the profession, namely:

* The increasing cost to the industry, firstly from defending and settling claims but also from spiralling insurance premiums.
* The potential for consequent increases in audit fees to cover these rising costs.
* The overall lack of sufficient insurance cover in the sector in comparison to the size of some of the claims.(Reference 1)
* The lack of competition in the audit market for large (listed) entities.

With regard to the final point, auditor liability is not the sole reason for the lack of competition in the audit of listed entities but it is a significant barrier to entering that market. Currently only the Big Four firms have adequate insurance and asset cover to be able to audit an extensive range of listed clients. It may simply be too risky for smaller firms to take on such clients. Given that settlements against the Big Four have topped $300m, one large negligence case could easily bankrupt a mid-tier firm.

**Managing exposure to liability**

**Audit quality**

There are a number of ways in which audit firms can manage their exposure to claims of negligence. Perhaps the most obvious is not being negligent in the first place. In practical terms this means rigorously applying International Standards on Auditing and the Code of Ethics for Professional Accountants and paying close attention to the terms and conditions agreed upon in the engagement letter.

Of course, improvements in quality controls in comparison to current levels would not happen without investment from the audit firms. With pressure to reduce audit fees it is unlikely that firms will want to commit to further increases in cost unless it is perceived that such action will lead to long-term reductions in legal and insurance costs.

**Disclaimers of liability**

One of the outcomes of the Bannerman case was the potential exposure of auditors to litigation from third parties to whom they have not disclaimed liability. As a result it became common to include a disclaimer of liability to third parties in the wording of the audit report.

Disclaimers may not entirely eliminate liability to third parties but they do reduce the scope for courts to assume liability to them. It should be noted that whilst this should reduce the threat of litigation in the UK, this protection may not extend overseas because the disclaimer is based on a ruling from a UK court case. It also provides no protection from the threat of litigation from clients under contract law.

There are also critics of the ‘Bannerman Paragraph,’ who believe that its presence devalues the audit report. They argue that the disclaimer acts as a barrier to litigation, which reduces the pressure to perform good quality audits in the first place. It is plausible that this reduces the credibility of the audit report in the eyes of the reader.

**Liability Limitation Agreements**

Since 2008 auditors have been permitted, under the terms of the Companies Act, to use Liability Limitation Agreements (LLAs) to reduce the threat of litigation from clients. LLAs are clauses built into the terms of an engagement that impose a cap on the amount of compensation that can be sought from the auditor. These must be approved by shareholders annually and be upheld by judges as ‘fair and reasonable’ when cases arise.

Whilst this may sound straightforward it has created problems, including how to define the cap (ie as a fixed monetary amount, a multiple of the fee, proportionate liability on a case by case basis). It is also difficult to decide what is fair and reasonable when setting the terms of the engagement because this is done before any potential litigation, or the scale of potential litigation, is known to the auditor and the client. This is therefore open to the interpretation of the courts. At which point the level of compensation may as well lie at the discretion of the courts in the first place.

Another problem lies with the shareholders; what motivation do they have for agreeing to terms that could potentially reduce their ability to recover any losses they incur due to the negligence of other parties? Once again this may be perceived as a barrier to litigation that audit firms can hide behind, reducing the pressure to perform good quality audits.

**Current position**

All the methods described contribute to the management of auditor liability but it seems none of them have provided the protection the profession needs to become truly competitive. Remember, the profession is not asking for exemption from litigation, rather that it does not shoulder the entire burden of litigation where others may also be to blame.

In June 2008, the European Commission recommended that member states find a way to limit auditor liability to try and encourage competition in the audit of listed companies and to protect EU capital markets. Given the different legal systems involved the recommendation leaves it to member states to determine an appropriate method but suggests that the solution:

* should not apply in cases of misconduct
* would be ineffective if it did not extend to third parties, and
* should ensure fair compensation of damaged parties.

Whilst no firm decision has been reached in the UK there are an increasing number of advocates for a ‘proportional’ system of liability replacing the current ‘joint and several’ one. Under this proposal the audit firm would accept their proportion of the blame in a negligence case and would pay that proportion of the compensation. This system, as introduced in Australia in 2004, would ensure a fair outcome for the plaintiff without placing the entire financial burden upon the audit profession. It would also meet the EC recommendations listed above.

At the time of writing no solution has been agreed upon in the UK and the debate continues.

**Conclusions**

There is an increasing trend of litigation that is costing the audit profession billions of pounds. The potential costs and risks of auditing large, listed businesses may now be prohibitive for any firm of willing auditors outside of the Big Four.

Auditors can reduce their exposure to litigation but there is a rising groundswell of opinion that the audit profession has, for too long, borne the brunt of penalties for misdemeanours shared by other culpable parties. These penalties are prohibitive to competition, which may be damaging to capital markets.

There is widespread agreement that this situation must change. Unfortunately, any decision on the nature and timing of such a change appears to be a long way off. Until such time the audit profession will simply have to bear the burden of liability. **Simon Finley is a teaching fellow at the Aston University Accounting Group** Reference 1 *Auditing: Commission Issues Recommendation on Limiting Audit Firms’ Liability*, European Commission, 6 June 2008

* **THE CONTROL ENVIRONMENT OF A COMPANY**

**The purpose of this article is to provide candidates with a more detailed appreciation of matters pertinent to an auditor, focusing on the need for the auditor of a large limited liability company (in the UK – a limited company) to evaluate the effectiveness of the company’s control environment**

ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*,sets out the auditor’s responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment including the entity’s internal control. One of the five components of internal control is the control environment and it is recognised that the control environment within small entities is likely to differ from larger entities. Many candidates have not yet had the opportunity of working in larger entities, or have chosen not to, so have not been exposed to working within the type of strong control environment often referred to in auditing texts. Consequently, they often have limited experience on which to draw when answering exam questions that require anything other than superficial knowledge of an entity’s control environment.

This article aims to provide common examples of matters the auditor needs to consider when assessing an entity’s control environment, and in making an assessment as to their impact on the risk of material misstatement in the financial statements. Reflecting the general trend of exam questions testing knowledge of this area, the article focuses on the need for the auditor of a large limited liability company (in the UK – a limited company) to evaluate the effectiveness of the company’s control environment.

A company’s control environment comprises seven elements each requiring careful consideration by the company’s auditor, recognising that some elements may be more pertinent than others – depending on the subject company. Each one of these elements is identified below, along with an explanation of specific practical aspects that may be considered by the auditor when evaluating its effectiveness. Candidates should be aware that this process forms part of the auditor’s assessment of the overall effectiveness of the company’s internal control, relevant to the audit.

**1 Communication and enforcement of integrity and ethical values** Many companies have high values and seek to promote honesty and integrity among their employees on a day-to-day basis. Clearly, if it is evident that such values do exist and are communicated effectively to employees and enforced, this will have the effect of increasing confidence in the design, administration and monitoring of controls – leading to a reduced risk of material misstatement in a company’s financial statements. For example, where a company adopts comprehensive anti-bribery and corruption policies and procedures with regard to contract tendering, and has formal employee notification and checking practices in this regard, it follows that there is reduced risk of material misstatement due to the omission of provisions for fines for the non-compliance with relevant laws and regulations. Alternatively, the existence in a company of comprehensive and ethical procedures with regard to the granting of credit facilities to customers and the pursuance of payment of for goods and services supplied, together with regular supervisory control in this respect, is likely to lead to increased audit confidence in the trade receivables area. This is because the existence of a system allowing goods and services to be a supplied on credit to customers provides the opportunity for fraud to be perpetrated against the company by employees and customers, particularly if controls are deficient in terms of their design or implementation.

**2 Commitment to competence** Competence is the knowledge and skills necessary to accomplish tasks that define the individual’s job. It is self-evident that if individual employees are tasked with carrying out duties that are beyond their competence levels, then desired objectives are unlikely to be met. For example, there is an increased probability that the objective of avoiding material misstatement in a set of complex financial statements will not be met if prepared by an inexperienced company accountant. This is simply due to the inexperience (translating to a lower competence level) of the accountant. From this, it follows that the auditor will have increased confidence in internal control relevant to the audit, where management have taken measures to ensure employees who participate in internal control are competent to carry out relevant tasks effectively. Measures taken by management in this regard can cover a range of activity including for example, rigorous technical and aptitude testing at the employee recruitment stage and in-house or external training courses and mentoring from more senior colleagues

**3 Participation by those charged with governance** The directors of a limited liability/limited company are charged with the company’s governance. As such, they are responsible for overseeing the strategic direction of the company and its obligations related to its accountability – for example, to governments, shareholders and to society in general. In particular, in most jurisdictions the company’s directors are responsible for the preparation of its financial statements. Given the influence that the actions of directors have on a company’s internal control, the extent of their day-to-day active involvement in the company’s operations has a pervasive effect on the internal control of the company.

The extent to which directors do get involved will, to some extent, depend on legislation or codes of practice setting out guidance for best practice in given jurisdictions. For example, the UK Corporate Governance Code (with which companies listed on the London Stock Exchange should comply) sets out standards of good practice, including those pertaining to board leadership and effectiveness. Notwithstanding legislation and codes of practice, the extent of each director’s participation is largely influenced by the nature of their professional discipline and their individual perspective about how they should carry out their respective roles. Some may see themselves as micromanagers, while others will trust subordinates to carry out defined duties with minimal interference. Frequently, directors will be very experienced and adopt an arms-length approach to getting involved in operational tasks. However, they may insist on monitoring activity by way of receipt of formal narrative reports. Other directors may adopt a more casual (but equally thorough!) ‘working alongside subordinates’ approach as a method of monitoring activities.

All of the variables mentioned above with regard to director involvement, should be important considerations of an auditor as part of the process of ascertaining the extent of internal control in the company and in assessing its effectiveness.

**4 Management’s philosophy and operating style** A company’s board of directors will comprise of individuals each with a different mind – set as to philosophy and operating style, manifested in characteristics such as their:

* approach to taking and managing business risk
* attitudes and actions toward financial reporting
* attitudes toward information processing and accounting and functions personnel.

Each of the above characteristics underlie a company’s control environment and it is crucial for an auditor to have an understanding of them. Dealing with each in turn:

*Approach to taking and managing business risk.* Business risk is the risk inherent in a company as a consequence of its day-to-day operations and it comprises several components. The first of these is financial risk – for example, the risk that the company may have insufficient cash flow to continue in operation. The second component is operational risk – for example, the risk that the company’s product lines may decline in popularity leading to a sharp decline in sales and profitability. The final component of business risk is compliance risk – for example, the risk that the company may be in breach of health and safety regulations, leading to the possibility of hefty fines or even the closedown of operational activity.

Candidates should be aware that a risk-based approach to an audit requires the identification and assessment of inherent risk factors and then of the control risk pertaining to these, in order to determine the risk of material misstatement, prior to carrying out substantive procedures. By adopting a top-down approach to the audit and first identifying business risks, auditors should be able to identify the associated inherent risks arising. They can then progress through the audit using the audit risk model (audit risk = the risk of material misstatement x detection risk) to determine the amount of detailed testing required in each area of the financial statements. To illustrate this approach, referring to the compliance risk example above, an inherent risk arising from the risk of a breach of health and safety regulations. As a consequence, there is a risk that the company’s liabilities may be understated due to the omission of a provision required in the financial statements, in respect of a fine for a non-compliance.

The directors’ approach to taking and managing business risk has obvious ramifications on a company’s financial statements, and the auditor should be aware of the various factors that influence directors in this area, and of applicable controls in place. It is often the case that a newly established company with young entrepreneurial directors and a flat management structure will have a more liberal approach to taking and managing business risk than a well-established company with more experienced directors, and a steep hierarchical management structure. Consequently, it is likely that there would be a lower level of a risk of material misstatement in the financial statements of the latter company.

*Attitude and actions toward financial reporting.* Financial Reporting Standards exist to help facilitate fairness, consistency and transparency of financial reporting. However, some determinants of profitability such as the measure of depreciation, the valuation of inventory or the amount of a provision remain open to the subjective judgment of management. Consequently, the auditor needs to gain an understanding of directors’ attitudes and actions to financial reporting issues and then make a judgment as to the extent of reliance that can be placed upon these. It may be that a company that is struggling in a faltering economy, and in another driven by a culture to report increasing profits, there is a tendency to adopt aggressive (as opposed to conservative) accounting principles, in order to meet profit expectations. Clearly, on such audit engagements it is important for the auditor to remain resolute in exercising appropriate levels of professional scepticism throughout.

*Attitude towards information processing and accounting functions and personnel.* Properly financed and resourced with sufficient numbers of appropriately qualified staff and contemporary information and communications technology, the financial reporting (accounting) and information processing functions of a company are vital to a company’s ongoing existence. They are key to the facilitation of compliance with laws and regulations, transactions with third parties, administration and control systems and in the provision of information for decision making. In most very large companies many aspects of the accounting function are inextricably intertwined with specific aspects of the company’s information processing systems, and there is an ongoing programme of investment in these, to ensure that the accounting and information processing systems are contemporary and fit for purpose. This is reflective of a situation where directors recognise that business risk will be significantly reduced, if the company has effective information processing and accounting functions. However, this situation does not apply to all companies. In some, both functions may be seen by the directors merely as necessary functional overhead areas of the business and, as such, they become under-funded and inadequately resourced in terms of staffing and equipment. An auditor engaged on an audit in such a company should be aware that there is an increased risk of material misstatement in the financial statements.

**5 Organisational structure** ISA 315 describes a company’s organisational structure as being ‘the framework within which an entity’s activities for achieving its objectives are planned, executed, controlled and reviewed’. The appendix to the ISA then explains ‘that the appropriateness of an entity’s organisational structure depends, in part, on its size and the nature of its activities’. It follows from this that an international consulting company with offices and operations in several countries has different priorities in terms of organisational structure to a national car sales company with several offices and a number of sales branches in a single country. Similarly, the organisational structure deemed suitable for such a car sales company would not be appropriate for a single site manufacturing company. Generally, an auditor may reasonably expect there to be a positive correlation between the level of inherent risk and the size and complexity of a company’s operations. In assessing, the level of the risk of material misstatement the auditor should consider as to whether the company’s organisational structure in terms of authority, responsibility and lines of reporting meet desired objectives.

**6 Assignment of authority and responsibility***Normally, the* larger a company’s scale of operations, then the larger the size of the workforce and, inevitably, the larger the amount of assignment of authority and responsibility that is required. Consequently, companies need to deal not only with ensuring that appropriate levels of authority and responsibility are assigned to appropriately qualified and experienced individuals. They also need to ensure that adequate reporting relationships and authorisation hierarchies are in place. Additionally, individuals need to be properly resourced and made fully aware of their responsibilities and of how their actions interrelate with the actions of others and contribute to the objectives of the company. If a company is not successful in meeting each of these needs, then there is an increased probability of ineffective decisions, errors and oversights by employees leading to an increased risk of material misstatement in its financial statements. For example, where a wages clerk is authorised to process the wages payroll and is then assigned the (inappropriate!) authority to enter new employee details into the wages master file.

**7 Human resources policies and practices**As explained in ISA 315, ‘human resource policies and practices demonstrate important matters in relation to the control consciousness of an entity’. This implies that if human resources policies and practices are considered to be sound both in design and in implementation over a range of matters, then the risk of material misstatement will be reduced.

Examples of these matters include:

* Recruitment policies and procedures. These should ensure that only competent individuals with integrity are employed by the company. Interview procedures should ensure that only candidates meeting the company’s criteria for recruitment are engaged.
* There should be adequate induction procedures for new employees, such that they can carry out their assigned responsibilities effectively and efficiently soon after being engaged by the company.
* Employees should be provided with ongoing training, support and mentoring as appropriate, such that they can continue to carry out their assigned responsibilities effectively and efficiently.
* There should be regular formal appraisal, at least annually of an employee’s performance. Performance should be measured against standardised criteria authorised by senior management of the company, and there should be ongoing monitoring and feedback to employees about their performance and development needs.
* The company should employ comprehensive and transparent employment grievance procedures, such that employees can be confident that grievances will be dealt with openly and impartially.
* There should be open, transparent and equitable employee disciplinary procedures, such that employees can be confident they will not be treated unfairly by the company in the event that an action triggers its disciplinary process.
* Employment termination procedures should incorporate provision for an exit interview so that the reason for the termination can be confirmed or clarified, all emoluments due to the employee can be settled and arrangements can be made for the return of all company assets prior to the termination date.

While each of the above measures will have a positive impact on the internal control of a company, to some extent they all have the effect of reducing the risk of material misstatement in the financial statements. For example, the existence of fair and robust grievance and disciplinary procedures reduce the possibility of a successful claim against the company for constructive or unfair dismissal, and the absence of a material provision in this respect. Significantly, the existence of human resources policies and practices that are the same or similar to those above should leave a favourable impression with the auditor, as to the directors’ attitude toward their company’s workforce. It is likely that such an attitude would foster good working relationships with employees, leading to an increased likelihood that individuals would reciprocate by carrying out their tasks diligently with integrity in the best interests of the company – resulting in a reduced risk of material misstatement.

**Summary** As indicated at the beginning of this article, the purpose of it is to provide candidates with a more detailed appreciation of matters pertinent to an auditor, when evaluating the control environment of a limited liability/limited company. When asked to explain what is meant by the term ‘control environment’, they typically comment that it is a component of a company’s internal control and that it centres around how a company is operated by its management, reflecting such matters as their philosophy and operating style. While there is some merit in this answer, having now read the above commentary, candidates should be aware that the term has much more meaning than that.

**Written by a member of the audit examining team**

* **CONTINUE TO BE REST ASSURED**

**This article looks at the topic of assurance in the context of Paper P7, *Advanced Audit and Assurance*, describing a framework for the classification of assurance and non-assurance engagements, and giving guidance on the practical approach required when undertaking assurance assignments**

*Note: ISAE 3000, ISAE 3400, ISRS 4400, ISRS 4410 and ISRE 2400 are not examinable documents for Paper P7 UK and Ireland.*

**Assurance engagements**

The glossary of terms published by the International Auditing and Assurance Standards Board (IAASB) describes an assurance engagement as:

‘An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.’

**IAASB and the assurance framework**

The IAASB has developed the International Framework for Assurance Engagements in which it gives detailed guidance on assurance and non-assurance engagements. The structure and hierarchy of pronouncements are summarised at [www.ifac.org](https://www.ifac.org/) in the IAASB handbook, which is freely available online. For Paper P7 purposes, a summary of the developing framework for assurance and non-assurance engagements is shown below:

**Assurance engagements on historic financial information**

The first distinction to be made is to distinguish between the two types of assurance engagements on historic financial information that can be provided. The difference is the level of assurance provided on the historical information.

**Reasonable assurance engagement** This is a statutory audit, where the approach required will need to be consistent with local legislative requirements, such as the Companies Act 2006 in the UK, and audit work will need to be carried out in accordance with International Standards on Auditing (ISAs). The auditor will express a conclusion designed to enhance the degree of confidence of the intended users of the financial statements, and moderate to high assurance would normally be given.

**Limited assurance engagement** A limited assurance engagement is increasingly being seen as an alternative to the statutory audit. A good example of this type of engagement is represented by recent initiatives in the UK, which have proposed the introduction of ‘mini’ audits for companies below the audit exemption threshold. There currently exists no UK statutory requirement for a ‘mini’ audit, although an increasing number of companies are requesting, on a voluntary basis, limited assurance engagements. Such engagements do not give the same level of assurance as a statutory audit, but instead give ‘negative assurance’ based on more limited procedures than are required with a statutory audit. Negative assurance will typically be worded as follows:

‘Based on our review, nothing has come to our attention to indicate that the accompanying financial statements contain material misstatement.’

With a negative assurance statement, effectively no opinion is given on the information, but at least some assurance is provided that the information ‘appears reasonable’.

**Assurance engagements other than audits or reviews of historical financial information**

The International Standard on Assurance Engagements (ISAE) 3000 gives guidance to practitioners (defined by ISAE 3000 as ‘professional accountants in public practice’) for the performance of assurance engagements other than audits or reviews of historical financial information. A summary of the key requirements of ISAE 3000 is shown in the following table.

|  |  |
| --- | --- |
| 1 | Ethical requirements – practitioners should comply with ethical requirements (ie IESBA’s Code of Ethics for Professional Accountants and ACCA’s Code of Ethics and Conduct). |
| 2 | Quality control – the practitioner should implement quality control procedures that are applicable to the individual engagement. |
| 3 | Engagement – the terms of the engagement should be recorded in an engagement letter, and the practitioner should agree on the terms of the engagement with the engaging party. |
| 4 | Planning and obtaining evidence – the practitioner should plan the engagement so that it will be performed effectively, and should consider materiality and assurance engagement risk, and sufficient appropriate evidence should be obtained on which to base the conclusion. |
| 5 | Reporting – the assurance report should be in writing and should contain a clear expression of the practitioner’s conclusion about the subject matter information. |

Block: Text

The approach required by ISAE 3000, and the work undertaken with an assurance engagement, may be similar in many respects to an audit engagement, although the context is different. For each of the assurance engagements on other information, the guidance from ISAE 3000 will apply, with the exception of Prospective Financial Information (PFI) work, where separate guidance is given in ISAE 3400, which is summarised later in this article.

Listed below are the most relevant areas where assurance engagements on other information will typically arise:

* Internal controls and systems reviews
* Due diligence reviews
* Prospective financial information.

**Internal control and systems reviews** The type of assurance work arising here is very similar to the work that auditors have been doing for a long time as part of the audit approach required when evaluating the effectiveness of internal control systems. Control and systems review work is tested in Paper F8 and, as such, needs little further coverage in this article.

**Key performance indicators** Developments in performance measurement have led to many companies publishing a selection of key performance indicators (KPIs) in the annual financial statements. KPIs represent a set of measures focusing on those aspects of performance that are most crucial for the continued success of an organisation. Many companies are increasingly opting for voluntary disclosure of KPIs, which can be financial (such as ratios based on the financial statements) or non-financial (such as targets on social and environmental matters). The increased tendency to disclose such data is often in response to shareholder expectations. The assurance approach towards KPIs requires careful consideration of how the KPI has been defined, the KPI calculation method, and the purpose of reporting the KPI, and the nature of evidence that would be available on the source of the underlying data.

Problems facing assurance providers in relation to KPI assessment may include the lack of precise definitions of KPI targets, lack of developed systems to capture KPI data, and the potential for KPIs, as disclosed, to be manipulated to achieve a desired result. However, an assurance report provided on the KPIs should add credibility to the published data if sufficient evidence is available to the assurance provider.

**Due diligence reviews** There is little specific guidance on due diligence reviews, despite this being an increasingly common form of assurance. Normally, the assurance provider is engaged by the potential acquirer of a company, who seeks to discover information about the target organisation. The assurance provider will attempt to verify any representations made by the management of the target company, and may also offer practical recommendations regarding the acquisition process.

**Prospective financial information** Procedures by assurance firms on prospective financial information (PFI) are well established, and separate guidance is given by the IAASB in ISAE 3400, *The Examination of Prospective Financial Information*, which again is very practical in nature. The standard defines PFI as ‘financial information based about events that may occur in the future and possible actions by an entity’.

The standard recognises that, because PFI relates to events and actions that have not yet occurred and may not occur, PFI work is highly subjective in its nature, and its preparation requires the exercise of considerable judgment.

ISAE 3400 requires that before accepting a PFI engagement, the terms of the engagement should be agreed on and sufficient knowledge of the business should be obtained. The period of time covered by the PFI should be clarified, which could be a forecast (usually a period of up to 12 months) and/or a projection (usually up to five years).

ISAE 3400 also requires that written representations should be requested from management regarding the intended use of the PFI, the completeness of significant management assumptions, and also management’s acceptance of its responsibility for the PFI. The assurance report should make it clear that management is responsible for the PFI and also the assumptions on which it is based. Given the subjective and speculative nature of the PFI, an opinion cannot be given on whether the results shown in the report will be achieved, so only negative assurance can be given.

**Non-assurance engagements**

Non-assurance engagements are more likely to arise with small companies, and only a general awareness will be required of the guidance given by the IAASB for each of these three areas. Each of the three so-called non-assurance areas is briefly summarised below.

**Review engagements** The objective of a review of financial statements is to enable an auditor to state whether, on the basis of procedures that do not provide all the evidence required in an audit, anything has come to the auditor’s attention that causes the auditor to believe that the financial statements are not prepared in accordance with the applicable financial reporting framework (ie negative assurance). Guidance to practitioners taking on this type of assignment is given by the IAASB in International Standard on Review Engagements (ISRE) 2400, *Engagements to Review Historical Financial Statements*.

Another type of review engagement is the review of interim financial information, covered by ISRE 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*.

There are many similarities between review engagements and the limited assurance engagements (these were discussed earlier, in the context of so-called ‘mini’ or voluntary audits). The best approach to adopt, however, is to consider the work required for the engagement itself, rather than to dwell on how the engagement is classified.

**Agreed upon procedures** The objective is for the auditor to carry out procedures of an audit nature to which the auditor, the entity, and any appropriate third parties have agreed, and for the auditor to report on factual findings. Guidance to practitioners taking on this type of assignment is given by the IAASB in International Standard on Related Services (ISRS) 4400, *Engagements to Perform Agreed Upon Procedures Regarding Financial Information*. Examples of this type of engagement could include the quantification of an insurance claim, or of the loss suffered due to a fraud. The specialist area of forensic accounting and auditing could be viewed as a specific type of agreed upon procedure engagement.

**Compilation engagements** The objective of a compilation engagement is for the practitioner to apply accounting and financial reporting expertise to assist management in the preparation and presentation of financial information in accordance with an applicable financial reporting framework based on information provided by management – and report in accordance with the requirements of ISRS 4410, *Compilation Engagements*. Thus, the practitioner’s report is not a vehicle to express an opinion or conclusion on the financial information in any form.

**Conclusion**

Students should expect to see assurance assignments other than reasonable assurance engagements appearing frequently in the Paper P7 exam. In other words, a question that is not based around a ‘traditional audit’, but is presented in the context – for example, of a due diligence engagement, a review of PFI, a review of KPIs, or a limited assurance engagement on historical information. Such a question could appear in Section A or B of the exam.

It is important that candidates appreciate the practical nature of these questions, which will require application of knowledge to the scenario. The requirement may ask the candidate to consider, for example:

* whether or not to accept the engagement
* matters to be discussed with the client post-acceptance
* methods of gathering sufficient and appropriate evidence
* the report to be provided.

**Written by a member of the Paper P7 examining team**

* **SA 315 (REVISED), IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT**

**One of the major revisions of ISA 315 relates to the inquiries made by external auditors of the internal audit function since internal auditors have better knowledge and understanding of the organisation and its internal control. This article addresses and highlights the components of internal control**

The International Auditing and Assurance Standards Board (IAASB) issues International Standard on Auditing (ISA) for international use. From time to time, ISAs are revised to provide updated standards to auditors. In order to enhance the overall quality of audit, IAASB published a consultation draft on a proposed revision to ISA 315. The objective in revising ISA 315 is to enhance the performance of external auditors by applying the knowledge and findings of an entity’s internal audit function in the risk assessment process, and to strengthen the framework for evaluating the use of internal auditors work to obtain audit evidence.

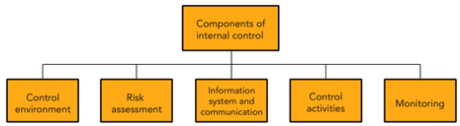
In March 2012, ISA 315 (Revised) was approved and released. One of the major revisions of ISA 315 relates to the inquiries made by external auditors of the internal audit function since internal auditors have better knowledge and understanding of the organisation and its internal control. This article addresses and highlights the components of internal control.

**Objectives in establishing internal controls**

Generally speaking, internal control systems are designed, implemented and maintained by the management and personnel in order to provide reasonable assurance to fulfil the objectives – that is, reliability of financial reporting, efficiency and effectiveness of operations, compliance with laws and regulations and risk assessment of material misstatement. The manner in which the internal control system is designed, implemented and maintained may vary with the entity’s business nature, size and complexity, etc. Auditors focus on both the audit of financial statements and internal controls that relates to the three objectives that may materially affect financial reporting.

In order to identify the types of potential misstatements and to determine the nature, timing and extent of audit testing, auditors should obtain an understanding of relevant internal controls, evaluate the design of the controls, and ascertain whether the controls are implemented and maintained properly.

The major components of internal control include control environment, entity’s risk assessment process, information system (including the related business processes, control activities relevant to the audit, relevant to financial reporting, and communication) and monitoring of controls.



Block: Text

**Control environment**

The control environment consists of the governance and management functions and the attitudes, awareness and actions of the management about the internal control. Auditors may obtain an understanding of the control environments through the following elements.

1. *Communication and enforcement of integrity and ethical values* It is important for the management to create and maintain honest, legal and ethical culture, and to communicate the entity’s ethical and behavioural standards to its employees through policy statements and codes of conduct, etc.

2. *Commitment to competence* It is important that the management recruits competent staff who possess the required knowledge and skills at competent level to accomplish tasks.

3. *Participation by those charged with governance* An entity’s control consciousness is influenced significantly by those charged with governance; therefore, their independence from management, experience and stature, extent of their involvement, as well as the appropriateness of their actions are extremely important.

4. *Management’s philosophy and operating style* Management’s philosophy and operating style consists of a broad range of characteristics, such as management’s attitude to response to business risks, financial reporting, information processing, and accounting functions and personnel, etc. For example, does the targeted earning realistic? Does the management apply aggressive approach where alternative accounting principles or estimates are available?  These management’s philosophy and operating style provide a picture to auditors about the management’s attitude about the internal control.

5. *Organisational structure* The organisational structure provides the framework on how the entity’s activities are planned, implemented, controlled and reviewed.

6. *Assignment of authority and responsibility* With the established organisational structure or framework, key areas of authority and reporting lines should then be defined. The assignment of authority and responsibility include the personnel that make appropriate policies and assign resources to staff to carry out the duties. Auditors may perceive the implementation of internal controls through the understanding of the organisational structure and the reporting relationships.

7. *Human resources policies and practices* Human resources policies and practices generally refer to recruitment, orientation, training, evaluation, counselling, promotion, compensation and remedial actions. For example, an entity should establish policies to recruit individuals based on their educational background, previous work experience, and other relevant attributes. Next, classroom and on-the-job training should be provided to the newly recruited staff. Appropriate training is also available to existing staff to keep themselves updated.  Performance evaluation should be conducted periodically to review the staff performance and provide comments and feedback to staff on how to improve themselves and further develop their potential and promote to the next level by accepting more responsibilities and, in turn, receiving competitive compensation and benefits.

With the ISA 315 (Revised), external auditors are now required to make inquiries of the internal audit function to identify and assess risks of material misstatement. Auditors may refer to the management’s responses of the identified deficiencies of the internal controls and determine whether the management has taken appropriate actions to tackle the problems properly.  Besides inquiries of the internal audit function, auditors may collect audit evidence of the control environment through observation on how the employees perform their duties, inspection of the documents, and analytical procedures.  After obtaining the audit evidence of the control environment, auditors may then assess the risks of material misstatement.

**Entity’s risk assessment process**

Auditors should assess whether the entity has a process to identify the business risks relevant to financial reporting objectives, estimate the significance of them, assess the likelihood of the risks occurrence, and decide actions to address the risks. If auditors have identified such risks, then auditors should evaluate the reasons why the risk assessment process failed to identify the risks, determine whether there is significant deficiency in internal controls in identifying the risks, and discuss with the management.

**The Information system, including the relevant business processes, relevant to financial reporting and communication**

Auditors should also obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

* The classes of transactions in the entity’s operations that are significant to the financial statements. The procedures that transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements.
* How the information system captures events and conditions that are significant to the financial statements.
* The financial reporting process used to prepare the entity’s financial statements.
* Controls surrounding journal entries.
* Understand how the entity communicates financial reporting roles, responsibilities and significant matters to those charged with governance and external – regulatory authorities.

**Control activities relevant to the audit**

Auditors should obtain a sufficient understanding of control activities relevant to the audit in order to assess the risks of material misstatement at the assertion level, and to design further audit procedures to respond to those risks. Control activities, such as proper authorisation of transactions and activities, performance reviews, information processing, physical control over assets and records, and segregation of duties, are policies and procedures that address the risks to achieve the management directives are carried out.

**Monitoring of controls**

In addition, auditors should obtain an understanding of major types of activities that the entity uses to monitor internal controls relevant to financial reporting and how the entity initiates corrective actions to its controls. For instance, auditors should obtain an understanding of the sources and reliability of the information that the entity used in monitoring the activities. Sources of information include internal auditor report, and report from regulators.

**Limitations of internal control systems**

Effective internal control systems can only provide reasonable, not absolute, assurance to achieve the entity’s financial reporting objective due to the inherent limitations of internal control – for example, management override of internal controls. Therefore, auditors should identify and assess the risks of material misstatement at the financial statement level and assertion level for classes of transactions, account balances and disclosures.

**Conclusion**

As internal auditors have better understanding of the organisation and expertise in its risk and control, the proposed requirement for the external auditors to make enquiries of internal audit function in ISA 315 (Revised) will enhance the effectiveness and efficiency of audit engagements. External auditors should pay attention to the components of internal control mentioned above in order to make effective and efficient enquiries. An increase in the work of internal audit functions is also expected because of such proposed requirement.

**Raymond Wong, School of Accountancy, The Chinese University of Hong Kong, and Dr Helen Wong, Hong Kong Community College, Hong Kong Polytechnic University**

**Reference** ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*

* **PLANNING AN AUDIT OF FINANCIAL STATEMENTS**

*Relevant to ACCA Qualification Paper P7* Paper P7, *Advanced Audit and Assurance*, regularly features questions set in the planning phase of an audit. Effective planning will focus the auditor’s attention on key areas of the audit and ensure that sufficient resources are allocated to the engagement. Planning should result in an audit that is well directed and supervised and ultimately good planning will reduce audit risk. Candidates will benefit from understanding the wider aspects of audit planning, and so this article summarises the main requirements and guidance contained in ISA 300, *Planning an Audit of Financial Statements*. **When does audit planning take place?** Naturally, it is reasonable to assume that planning occurs towards the start of an audit engagement. However, according to ISA 300, planning should not be seen as a discrete and separate part of the overall audit. Planning often begins shortly after, or in connection with, the completion of the previous audit, for example, with a review of issues that were discussed with management, such as control deficiencies or unadjusted errors. Such matters are relevant to the next year’s audit and need to be considered when planning. Similarly, the audit plan may be revised as the audit progresses, and should not be viewed as being fixed in place once the main planning phase has ended. For example, a significant event may take place as the audit is in progress, meaning that the audit plan needs to be changed. The nature and extent of planning activities depends on the size and complexity of the audit client, previous experience of the audit firm with the client, and any changes in circumstance that may occur during the audit. **Preliminary activities** ISA 300 contains a requirement that the auditor shall undertake the following activities at the beginning of the current audit engagement:

* Performing procedures regarding the continuance of the client relationship and the specific audit engagement.
* Evaluating compliance with relevant ethical requirements, including independence.
* Establishing an understanding of the terms of the engagement.

These requirements are also contained in and ISA 220, *Quality Control for an Audit of Financial Statements* and ISA 210, *Agreeing the Terms of Audit Engagements* and remind us that planning is a wider activity than just obtaining understanding of the business and performing risk assessment. **Audit strategy and audit plan** ISA 300 states that audit planning activities should:

* establish the overall audit strategy for the engagement
* develop an audit plan.

**Audit strategy** The audit strategy sets out in general terms how the audit is to be conducted and sets the scope, timing and direction of the audit. The audit strategy then guides the development of the audit plan, which contains the detailed responses to the auditor’s risk assessment. An underpinning principle of audit planning under the Clarified ISAs is that the audit plan should contain detailed responses to the specific risks identified from obtaining an understanding of the audited entity. ISA 300 requires the auditor to consider specific matters when establishing the audit strategy, and provides a list of typical matters to be considered in its appendix. These matters are discussed below. ***Identify the characteristics o f the engagement that define its scope*** Some audit engagements have specific characteristics that mean the audit has a wider scope than the audit of other entities. For example, a group audit engagement or the audit of a multinational company will both have wider scopes than an audit of a small, owner-managed entity. Matters such as the ability to use the work of internal auditors, the need to liaise with external service organisations, and the effect of IT on audit procedures are also relevant. The scope is also affected by the applicable financial reporting framework, the nature of the audited entity’s business and whether it operates business segments, the business activities conducted, and the availability of client personnel and data. ***Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required*** Reporting requirements will vary from audit to audit. For example, some entities have additional reporting requirements to comply with corporate governance regulations or industry requirements, and the auditor must understand these requirements from the start of the audit. The nature of other communications that may be necessary during the audit should be considered, such as liaison with component auditors, and communications to management and to those charged with governance. ***Consider the factors that are significant in directing the audit team’s efforts in the auditor’s professional judgment*** The strategy must consider issues to do with quality control, such as how resources are managed, directed and supervised, when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews. ***Consider the results of preliminary engagement activities and knowledge gained on other engagements*** This includes the initial assessments of materiality, risks identified from preliminary activities such as fraud risks, significant events that have occurred at the entity or in the industry in which it operates since the last audit, and the results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them. The audit firm may also have performed other services for the client that may be relevant in determining the audit strategy, for example, reviews of business plans or cash flow forecasts. ***Ascertain the nature, timing and extent of resources necessary to perform the engagement*** One of the main objectives of developing the audit strategy is to effectively allocate resources to the audit team, for example, the use of specialists on particular areas of the audit, or building a team of highly experienced auditors for a potentially high-risk audit engagement. If the audit is time pressured due a tight deadline, then more resources will need to be allocated to ensure that all necessary audit work is completed, and can be reviewed in time to meet the deadline. **Audit plan** ISA 300 states that once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking in to account the need to achieve the audit objectives through the efficient use of the auditor’s resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely interrelated since changes in one may result in consequential changes to the other. Therefore it is not necessarily the case that the audit strategy is prepared and completed before the audit plan is devised, and in practice it is typical for the two to be developed together. The audit plan is a detailed programme giving instructions as to how each area of the audit will be conducted. In other words, the audit plan details the specific procedures to be carried out to implement the strategy and complete the audit. ISA 300 provides guidance on what should be included in the audit plan, stating that the audit plan should describe:

* the nature, timing and extent of planned risk assessment procedures
* the nature, timing and extent of planned further audit procedures at the assertion level
* other planned audit procedures that are required to be carried out so that the engagement complies with ISAs.

Typically an audit plan will include sections dealing with business understanding, risk assessment procedures, planned audit procedures ie the responses to the risks identified and other mandatory audit procedures. **Changes to the audit strategy and audit plan** The audit strategy and audit plan are not fixed once the planning stage of the audit is complete. It is important that both are updated and changed as necessary as the audit progresses. For example, as a result of unexpected events, or changes in conditions, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor’s attention that differs significantly from the information available when the auditor planned the audit procedures, for example, an event may take place after audit planning has been initially completed which creates doubt over going concern. Or, as a result of performing planned audit procedures additional information may come to light which may lead the auditor to amend initial risk assessment, or level of performance materiality, for all, or part, of the audit. **Documentation** ISA 300 requires that as well as the audit strategy and audit plan being thoroughly documented, a record of significant changes made to the audit strategy and audit plan is needed. Documentation is crucial, because key decisions about how the audit will be performed are contained in the audit strategy and audit plan. The documentation should therefore include the response made by the auditor to any significant changes that occur during the audit, as discussed above. The audit strategy and audit plan do not need to be documented in a particular way. Some audit firms use memoranda, others checklists. Some use standardised documentation such as standardised audit programmes while others tailor the specific form of the documentation to each audit engagement. The form of the documentation does not matter as long as it provides a clear record of how the audit was planned. **Direction, supervision and review** ISA 300 requires that the auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. It is crucial that the audit plan includes the detail as to how supervision and review should be conducted during the audit, in order to perform a high quality audit. Inadequate supervision and review can lead to the audit team making errors, for example, selecting inappropriate items for sampling, or failing to properly conclude on audit procedures performed. The amount of detail included in the audit plan in relation to supervision and review will depend on factors such as the size and complexity of the entity being audited, the assessed risk of material misstatement, and the capabilities and competence of the audit team members. **Additional considerations in initial audit engagements** The final section of ISA 300 relates to initial audit engagements, and requires the auditor to perform client and engagement acceptance procedures (as also required by ISA 220), and also to communicate with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. The ISA recognises that for an initial audit engagement, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. **Conclusion** Planning an audit involves more than just obtaining business understanding and performing risk assessment. Planning is a dynamic process that may evolve during the audit, and should always respond to changes in the circumstances of the audited entity. Adherence to the requirements of ISA 300 should result in a well-focused audit, staffed by appropriate personnel, performing relevant and appropriate audit procedures. **Written by a member of the Paper P7 examining team**

* **COMPLETING THE AUDIT**

*Relevant to ACCA Qualification Paper P7 and Performance Objectives 17 and 18* The completion stage of the audit is of crucial importance. It is during the completion stage that the auditor reviews the evidence obtained during the audit together with the final version of the financial statements with the objective of forming the auditor’s opinion. This article explores some of the key requirements of International Standards on Auditing (ISA) that are relevant at the completion stage, and discusses the practical implications of those requirements.

**Review of audit files and evaluation of misstatements**

All audit work should be subject to review. This is a basic quality control requirement of ISA 220, *Quality Control for an Audit of Financial Statements*, and serves to ensure that sufficient appropriate audit evidence has been obtained in respect of transactions and balances included in the financial statements. From an exam point of view, candidates who have reviewed past Paper P7 exams will be familiar with exam requirements that ask candidates ‘the matters to consider and the evidence they expect to find’ when conducting an audit file review in relation to various matters, and such a requirement is clearly set in the completion stage of an audit. In performing a file review, the reviewer should consider the sufficiency of evidence obtained and may need to propose further audit procedures if evidence is found to be insufficient or contradictory. ISA 230, *Audit Documentation* requires that documentation of the review process includes who reviewed the audit work completed and the date and extent of such review. ISA 450, *Evaluation of Misstatements Identified during the Audit* is relevant during an audit file review. The objective of the auditor when following the requirements of this ISA are to evaluate both the effect of identified misstatements on the audit, and the effect of uncorrected misstatements, if any, on the financial statements. ISA 450 requires that all misstatements identified (other than those that are clearly trivial) shall be accumulated during the audit. The auditor may need to perform further audit procedures in response to an identified misstatement – for example, to determine whether further misstatements exist – and it is required that all misstatements are communicated to management on a timely basis, along with a request to amend the misstatement identified. Typically, the auditor will present the client with a list of misstatements (often referred to as the ‘audit error schedule’), quantifying the amount of each misstatement, and proposing the necessary adjustment to the financial statements. The proposed adjustment may be in the form of a journal entry, an amendment to the presentation of the financial statements, or a correction to a disclosure note. When management makes the necessary adjustments to the financial statements, the auditor should confirm that the adjustments have been made correctly. When misstatements remain uncorrected by management, the auditor is required to reassess the level of materiality to confirm that it remains appropriate, and should then determine if the uncorrected misstatements are material individually or in aggregate. The uncorrected misstatements must be communicated to those charged with governance, and the potential implications for the auditor’s report must also be communicated. The auditor must also obtain an understanding of management’s reasons for not making the necessary corrections to the financial statements. ISA 450 also requires that the auditor must request that management provides a written representation as to whether management believes the effects of uncorrected misstatements are immaterial, both individually and in aggregate, to the financial statements taken as a whole. A summary of uncorrected misstatements should also be included within, or attached to, the written representation.

**Final analytical procedures**

During the completion stage of the audit, the client should prepare the final version of the financial statements, which, as discussed above, should incorporate any adjustments of misstatements proposed by the auditor. The financial statements should be reviewed according to the requirements of ISA 520, Analytical Procedures. One of the objectives of the auditor in complying with ISA 520 is to design and perform analytical procedures near the end of the audit that assist in forming an overall conclusion as to whether the financial statements are consistent with the auditor’s understanding of the entity. The analytical procedures performed at this stage of the audit are not different to those performed at the planning stage – the auditor will perform ratio analysis, comparisons with prior period financial statements and other techniques to confirm that trends are as expected, and to highlight unusual transactions and balances that may indicate a risk of misstatement. The key issue is that, near the end of the audit, the auditor should have sufficient audit evidence to explain the issues highlighted by analytical procedures, and should therefore be able to conclude as to the overall reasonableness of the financial statements. When the analytical procedures performed near the end of the audit reveal further previously unrecognised risk of material misstatement, the auditor is required to revise the previously assessed risk of material misstatement and modify the planned audit procedures accordingly. This means potentially performing further audit procedures in relation to matters that are identified as high risk. As well as reviewing the main elements of the financial statements, the auditor must at this stage carefully review the notes to the financial statements for completeness and compliance with the applicable financial reporting framework. In many situations, this will be the first opportunity for the auditor to review this information, as clients often prepare the notes to the financial statements towards the end of the audit process. At this stage, the auditor should also read the other information to be issued with the financial statements for consistency with the financial statements. This is important as inconsistencies may have implications for the auditor’s report. Specific items of other information are subject to specific regulation in some jurisdictions – for example, in the UK and Ireland the auditor’s report must state whether the Directors’ Report is consistent with the financial statements.

**Subsequent events and going concern procedures**

There are two ISAs that are particularly relevant near the end of the audit. The first is ISA 560, *Subsequent Events*, which requires the auditor to perform audit procedures to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the auditor’s report that require adjustment of, or disclosure in, the financial statements have been identified. Typically, the auditor will follow a specific work programme dealing with subsequent events, including procedures such as reviewing internal accounting records and minutes of management meetings since the year-end and discussing subsequent events with management – particularly the extent to which management has established procedures adequate to identify relevant subsequent events. It is important that procedures dealing with subsequent events are performed up to the date of the auditor’s report. If they are performed too early and not updated close to the date of the auditor’s report, then a significant event may not be identified by the auditor. Secondly, ISA 570, *Going Concern* states that the auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast doubt on the entity’s ability to continue as a going concern. Therefore, the auditor will conclude on going concern matters near the end of the audit having reviewed all evidence obtained and after reviewing the final version of the financial statements.

**Written representations and communication with those charged with governance**

Towards the end of the audit, the auditor must consider the matters to be included in management’s written representation, according to ISA 580, *Written Representations* . This is a matter to be de alt with towards the conclusion of the audit because it is a requirement of ISA 580 that the date of the written representation shall be as near as possible to, but not after, the date of the auditor’s report. Written representations are necessary audit evidence, and therefore the auditor’s opinion cannot be expressed and the auditor’s report cannot be dated before the date of the written representations. Significant subsequent events may come to light very late in the audit, and therefore the written representations should cover all of the subsequent events period, right up to the date at which the audit report is dated. Important outputs of the audit are the matters to be communicated in accordance with ISA 260, *Communication with Those Charged with Governance*. The matters to be communicated include significant findings from the audit and matters relating to auditor’s independence. In addition, the auditor must also consider whether the two-way communication between the auditor and those charged with governance has been adequate for an effective audit, and have taken appropriate action if not.

**Audit clearance meeting**

At the conclusion of the audit, a meeting will usually be held between the auditor and management and/or those charged with governance of the client. At this clearance meeting the audit or will explain the various matters that have been discussed in this article, and any other matters to be discussed in respect of the financial statements and the audit. Typically, at the clearance meeting the following matters may be discussed:

* The adequacy of the entity’s internal controls and process of preparing the financial statements,
* any proposed adjustments to the financial statements
* any difficulties encountered during the audit process
* the details of ethical matters that may need to be clarified with the client
* confirmation of the matters to be included in management’s written representations
* an update on changes in financial reporting or other regulations that may impact the client’s financial statements, and
* confirmation that the client’s accounting policies are appropriate.

The audit clearance meeting is not a requirement of ISAs, but is often used as a means to ensure that there are no misunderstandings regarding the financial statements, the auditor’s report and any of the other matters discussed.

**Conclusion**

The completion stage of the audit must be carefully planned to ensure that the requirements of the many relevant ISAs are adhered to. If the completion stage is not adequately performed, there is a risk that an inappropriate opinion is given on the financial statements.

**Written by a member of the Paper P7 examining team**

* **AUDIT AND INSOLVENCY**
* *Relevant to ACCA Qualification Paper P7 (UK) and (IRL)* From June 2011, the syllabus for Paper P7 (UK) and (IRL) includes specific learning outcomes relevant to auditing aspects of insolvency (syllabus reference E7). This topic has been added to the syllabus on the recommendation of the Financial Reporting Council’s Professional Oversight Board in order to comply with the requirements of the Statutory Audit Directive, as the topic is considered required knowledge for those wishing to obtain the audit qualification and practice as an auditor. Why should auditors need to understand aspects of insolvency? The simple answer is that, unfortunately, many auditors’ clients will face financial distress at so me point in their business life cycle. The global economic recession of the past few years has caused many companies to face insolvency, and in times of crisis the directors of such companies may turn to their auditor for information and advice. Therefore, auditors must be in a position to determine the level of financial difficulty being faced by a client, explain and recommend the various options available to management, and explain the consequences of liquidation or administration. This article highlights some of the issues that auditors may have to deal with in respect of insolvency. Of course, it is important to study this topic in its entirety using an up-to-date study text to gain full knowledge and understanding of this new syllabus area.

**The meaning of insolvency**

It is important to understand what is actually meant by a company being ‘insolvent’, and to distinguish insolvency from general, less severe financial difficulties. A company is insolvent if the value of its assets is less than its liabilities – in other words, the statement of financial position shows a position of net liabilities. If all of the company’s assets were sold at book value, the existing liabilities could not be paid. This is a more fundamental problem than simply being short of cash. Company directors are charged with monitoring financial position and performance. This is especially important when the company is experiencing financial difficulties, as a company experiencing cash flow problems can quickly turn insolvent. When a company is facing insolvency, the directors must consider the interests of creditors (payables), shareholders and other stakeholders, which is impossible to do without up-to-date financial information. Directors must, therefore, prepare and monitor financial statements and cash flow and profit forecasts on a regular basis in order to deter mine the financial position of the company. Auditors may be asked to advise on whether a company is insolvent, or to review historic or projected financial information. Having up-to-date financial information and taking professional advice may also help to protect directors from legal claims such as wrongful trading or misfeasance.

**Options available**

The directors of an insolvent company face a difficult decision. Should they continue to trade, in the hope that the company’s performance and position will improve, or should they cut their losses and wind up the company? This is a dilemma that the auditor may be asked to help resolve by evaluating the advantages and disadvantages of the options available, and considering the impact of each on the relevant par ties, including creditors, shareholders, management and employees. The auditor may also be asked to explain the procedures involved in placing a company into administration or liquidation, as directors will usually have limited knowledge in this area.

**Administration**

If the directors decide to try to save the company, it can be placed into administration, which offers some breathing space and legal protections while a rescue plan is formulated to try to preserve the company’s going concern status. The main advantage of administration is that once an administrator is appointed, a moratorium over the company’s debts commences meaning that it is not possible for a winding up petition to be presented at court by the company’s creditors (payables) – thus allowing time for the rescue plan to be designed and initiated. A company in administration is under the control of the appointed administrator who is given a short period of time (usually eight weeks) to set out a proposal for achieving the aim of the administration, or to decide that it is not reasonable that the company can be rescued. A creditors’ meeting is called, at which the proposals are accepted or rejected. The administrator takes over management of the company and has the power to appoint and remove directors. The process for appointment of an administrator varies, and may or may not involve a court order. A company, its directors or one or more creditors (payables) can apply to the court for the appointment of an administrator. The court will grant an administration order only if it is satisfied that the company is – or is likely to become insolvent, and that the administration process is likely to achieve its purpose of rescuing the company as a going concern. It is also possible for an administrator to be appointed without a court order, either by a floating chargeholder, or by the company or its directors. Administration usually lasts for 12 months, after which time the administrator automatically vacates office, though the period of administration can – in some cases – be extended subject to approval from creditors (payables). On the other hand, administration may not last for the full 12-month period, and may end early if the administration has been successful.

**Liquidation**

If the company cannot be saved, then liquidation or ‘winding up’ is likely to be initiated. The company will cease to trade, assets are sold, liabilities are paid (to the extent allowed by the proceeds from the sale of assets and by applying the rules for allocation of assets described below), and eventually the company will be dissolved. Once liquidation proceedings are under way share dealings must stop, and the directors lose their power to manage the company. The procedures involved in placing a company into liquidation are complicated by the fact that there are different ways that the process is initiated – compulsory liquidation, members’ voluntary liquidation, and creditors’ voluntary liquidation. Compulsory liquidation is usually initiated by one or more creditors, who apply to the court and must demonstrate that the company is unable to pay its debts. A creditor who is owed more than £750, and who has served the company with a written demand for payment that has not been settled, has grounds to apply to the court for compulsory liquidation. In less common circumstances, a member (shareholder) who is dissatisfied with the directors’ management of the company may petition the court for the company to be wound up on the just and equitable ground. For this to be successful, the member had to demonstrate to the court that winding up is the only remedy available. Voluntary liquidation can occur through two different routes – a member’s voluntary liquidation, or a creditors’ voluntary liquidation. The former is used where the company is solvent, and can only take place when the directors have made a declaration of solvency. Creditors have no involvement with this type of liquidation, as the declaration of solvency means that they will be paid in full and therefore have no risk exposure. Shareholders pass a resolution to wind up the company and appoint a liquidator, who is responsible for closing down the company. In contrast, in a creditors’ voluntary liquidation the creditors are heavily involved with proceedings, as in this case the company is not solvent, and therefore creditors face the risk that they will not be paid the full amount owing to them. The process is started by a shareholders’ meeting where a resolution is passed to agree that the company should be wound up, but subsequently, the creditors’ wishes over the appointment of the liquidator and the process of winding up will override the wishes of the shareholders.

**Allocating company assets**

An important issue arising on liquidation is the order of priority for allocating company assets. This is especially important for creditors and shareholders because, by definition, an insolvent company cannot pay everything that is owed. The amounts that will be paid on liquidation depend on matters such as whether debts are secured or unsecured, whether charges over assets are fixed or floating in nature, whether shareholders own preference or equity shares, the costs suffered by the liquidator (which are generally paid first) and the amount of preferential creditors (including employees’ salaries and other benefits in arrears). In most liquidations equity shareholders receive very little, and usually nothing, as they rank last in the order of priority in allocating company assets. The auditor of an insolvent or potentially insolvent company may be asked to advise on the allocation of company assets.

**Advantages of administration**

In many cases, it may be preferable to place a company into administration, rather than go through the process of liquidation. The obvious advantage is that if the administration is successful, the company will continue as a going concern, allowing shareholders to continue to hold their shares and, hopefully, eventually receive a return on that investment. In contrast, as mentioned above, shareholders usually receive nothing when a company is wound up. For creditors, the continued existence of the company may also prove beneficial, as its improved cash flows should allow debts to be repaid, and trading relationships can be maintained. Administration may also be beneficial to employees, as there will continue to be employment of some staff in the continued business (though, of course, the administrator may make some redundancies as part of the company’s rescue plan). In contrast, in a compulsory liquidation the employees are automatically dismissed.

**Conclusion**

Auditors have a part to play in advising directors of companies that are in financial distress or, indeed, are insolvent. Candidates attempting Paper P7 (UK) or (IRL) must be prepared to identify the issues relating to insolvency in a given scenario and to provide appropriate explanations and recommendations. Auditing aspects of insolvency will not be examined at each sitting, but will feature fairly regularly in case study type questions. Studying from an up-to-date study text is essential. **Written by a member of the Paper P7 examining team**

* **GROUP AUDITING**

**This article reviews the most significant elements of group audits and changes to ISA 600 that were introduced as a result of the recent Clarity project**

In March 2008, the Paper P7 examiner wrote an article about auditing groups and joint audits.

This article is a reminder of some of the most significant elements of group audits, which feature frequently in the Paper P7 exam. The significant changes to ISA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* that were introduced as a result of the recent Clarity project are likely to make group auditing even more examinable. Exam questions may focus on the audit of group financial statements, or on the requirements of the group auditor to report to management on matters all around the group.

**Similarities within the ISA 600 series of auditing standards**

Group auditing often necessitates that the group auditor places considerable reliance on other audit firms. However, ISA 600 doesn’t allow the group auditor to wholly outsource responsibility for parts of the audit to another auditor.

**To begin at the beginning: acceptance of the assignment**

ISA 600 requires the group engagement partner each year formally to assess whether it is appropriate to act as group auditor. If at any point the group engagement partner concludes that they lack the professional skills necessary to form a group audit opinion, they should resign. ISA 600 requires that the group engagement partner resign immediately if there is any significant restriction placed by the parent company management on information made available from within the group (or disclaim opinion if resignation is not legally possible).

ISA 600 (revised and redrafted) extends this responsibility to require that the auditor relying on the third party’s work has obtained their own understanding of the specialist area in question, or business of each subsidiary or associate (referred to as ‘components’ in ISA 600, with that company’s auditor referred to as the ‘component auditor’). **The group auditor must form their own concurring opinion on any judgmental areas.** This does not require having the same depth of knowledge as the expert/other auditor, but they would need to be able to review the third party’s files and have sufficient independent knowledge to understand the work done, the reason for the work and the conclusions from that evidence.

**Group audit opinion**

The parent company of a group will normally publish its financial statements as an individual company and the group financial statements in the same document, so, the audit opinion will normally be expressed on ‘the financial statements of the company and of the group as at...’ Although presented as one opinion, it logically contains two separate opinions; one on the entity financial statements of the parent itself and another on the financial statements of the group. ISA prohibits the group auditor from making any reference to the work of any other experts or auditors, as doing so would diminish the credibility of the audit opinion and allow the group auditor to ‘pass the buck’ for responsibility for part of the audit. You should be prepared to explain this point in the exam. This is an example of where ISA differs from US audit standards, where reference to other auditors conducting some of the work on components is permissible.

**Planning work required**

Groups often have a number of subsidiaries that are either dormant or immaterial. At a minimum, the group engagement team must develop an understanding of each component of the group and review the financial statements of each subsidiary.

Where a component is judged to be material or a significant contributor of inherent risk at the group level, further work will be required to be satisfied that the financial statements of each component, in order to be satisfied that the component is unlikely to introduce errors that could be material at the group level. This work might include:

* discussing with the component auditor, and/or the management of the component, the business activities that are significant to the group
* reviewing the more significant parts of the component auditor’s working papers
* discussing with the component auditor the susceptibility of the company’s financial statements to material error or deliberate misstatement
* reviewing the component auditor’s documentation of identified significant risks, and the conclusions reached on these risks
* observing final clearance meetings between the component auditor and the management of the company.

**The group auditor as the repository of information**

The group engagement team’s role brings information flowing to them that is useful to disseminate around the group. This includes materiality (see below) and matters such as related party relationships, which may be unknown at the component level, because two subsidiaries may be unaware of each other’s existence. The group auditor asks each component auditor for known related party relationships and then communicates a collated list of all related party relationships to each component auditor.

**Materiality**

At the planning stage, the group engagement partner must determine several figures for materiality for each component part of the group (ISA 600:21).

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Group** | **Parent** | **Each component** |
| Financial statements materiality | Group auditor | Group auditor | Component auditor |
| Materiality for the consolidation package as a whole | Group auditor | Group auditor | Group auditor |
| Level of reduced materiality for sensitive figures | Group auditor | Group auditor | Group auditor |
| Performance materiality | Group auditor | Group auditor | Group auditor |

Block: Text

Performance materiality is the figure below that any errors in the financial statements may be considered trivial. The component auditor will be required to communicate to the group auditor a summary of all unadjusted errors in the consolidation package.

It is common in larger group audits for the financial statements to be prepared using a consolidation package of information that is sent to the parent company by each component company. This will omit many of the disclosures that will be in the eventual entity financial statements. The component auditor may, therefore, be required to issue a special audit opinion on the truth and fairness of the consolidation package. This opinion is likely to be addressed to the directors of the component company, or may be addressed to the group auditor directly.

In order to minimise the risk of several accidental or deliberate errors in the financial statements together exceeding group materiality, component materiality figures will normally be significantly lower than the group materiality figure, even for the largest component companies.

**Example 1**

Imagine that financial statements materiality is taken to be 10% of profit or loss for each entity within a group and performance materiality is set at 0.5% of profit. Imagine that a group has a parent company and two components, one of which is profit making and one of which is loss making:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **$'000s** | **Parent** | **Subsidiary 1** | **Subsidiary 2** | **Group** |
| Proft | 2,000 | 12,000 | (8,000) | 6,000 |
| Component materiality @ 10% | 200 | 1,200 | 800 | 600 |
| Performance materiality @ 0.5% | 10 | 60 | 40 | 30 |

Block: Text

If subsidiary 1 were audited by another firm using the same materiality calculation method as the parent, an unadjusted error of $10m would correctly result in issuance of an unmodified audit opinion on the financial statements of that individual company. However, the effect of losses elsewhere in the group would mean that although this error would not be material at the component level, it would be material at the group level. Since it is only likely to be the parent auditor who has this overview of the group, the group engagement team must communicate materiality figures to component auditors in advance of audit work commencing. In this example, the maximum component materiality figure that the group auditor could communicate to the component auditors would be 600, but it would be wise to select a lower figure than this, in order to reduce to a tolerable level the risk of errors in both component companies together exceeding 600.

In the exam, if you are given extracts from draft financial statements, it’s often a good start to recommend and briefly explain a figure for materiality.

**Communication between auditors**

ISA 600 in its revised form contains extensive new requirements on the communication between parent and component auditor. In addition to practical matters such as materiality, the required format of the consolidation package, deadlines and contact details, the group auditor must communicate a number of matters at the planning to the component auditor, including:

* related party relationships known anywhere around the group
* identified significant risks, whether due to error or fraud
* methodology to be used for impairment testing of goodwill. Audit of estimates is subjective and so it’s essential that the group auditor’s preferred method is used throughout the group. Be prepared to explain this in Paper P7.

Matters that the component auditor must communicate to the group auditor will include:

* any known related party relationships and related party transactions
* any indications of management bias
* any significant risks to the truth and fairness of the component financial statements, work done on these risks and the conclusions reached
* all intra-group transactions, period end balances and allowances for unrealised profit
* any observed non-trivial failure to observe relevant laws and regulations
* all observed control weaknesses, flagging significant weaknesses separately
* any known events after the reporting date.

**Audit of the consolidation process**

Once the group engagement partner is satisfied that the individual financial statements within the group are free from material misstatement, attention can now shift to audit of the consolidation process.

The good news for exam purposes is that this stage of the audit is very similar regardless of the specific company, so good marks can be obtained largely by memorising the risks and responses below.

Principal risks arising in the consolidation process include errors or omissions arising during:

* transcription of figures from individual financial statements to consolidation workings
* classification of components (eg associate, subsidiary)
* cancellation of intra-group trading, cancellation of intra-group balances and allowance for unrealised profit on intra-group transfers
* recognition of impairment of purchased positive goodwill
* determination of fair values being used on acquisition
* arithmetical inaccuracy in the consolidation process
* identification and disclosure of related party relationships and transactions
* foreign currency translation from functional currency of components to reporting currency of the group.

The most reliable evidence on completeness and accuracy of consolidation adjustments in a large group is likely to be determining whether the client’s accounting systems adequately flags transactions with fellow group companies. The process is still likely to be highly substantive in nature and will probably include these tests of detail:

* line-by-line agreement of all items from audited component financial statements (or consolidation packages submitted to head office) to the consolidation schedules
* detailed discussion with management on the reason for classification of each component
* sample testing of known intra-group transactions to ensure that they have been eliminated in the client’s consolidation
* recalculation of all significant workings, such as goodwill, non-controlling interests and foreign currency translation.

**Final review of financial statements**

The group audit opinion may be signed on some date on or after the audit opinions on material components are signed. Once the component auditor has issued their opinion, their responsibility for reporting on the impact on events after the reporting date is greatly diminished, yet there may be material events that could be material in the group financial statements. The group engagement team will normally agree in advance with the auditor of significant components that an update on events is given by the component auditor to the group engagement partner immediately before the group audit opinion is signed. It is the responsibility of the group engagement team to ensure that material events are reported.

**Reporting to management and the board**

In addition to the usual requirements for reporting to those charged with governance (the ‘management letter’), ISA 600:49 requires the group engagement partner also to report to management on any concerns that they had about possible fraud anywhere in the group, any restrictions on information made available by component management and any concerns that they had about the quality of work performed by any component auditor.

In addition to the audit report to shareholders, the group auditor is required by ISA 600 to report on a group-wide basis to group management and separately to those charged with governance at a group level, such as the audit committee of the board. This split communication echoes the requirements of ISA 260 Communication with Those Charged with Governance to produce different letters to different levels of management.

The report to management will include details of all observed instances of non‑trivial fraud and all non-trivial deficiencies in internal controls around the group.

The report to those charged with governance, most probably the audit committee, will include:

* an overview of the audit approach insofar as it affects component auditors
* any doubts that the group auditor may have about the quality of work performed by the component auditor, giving the group auditor a potentially awkward need to publicly question the skills of a fellow professional.
* any limitations on audit scope anywhere within the group
* any suspected fraud where management is suspected of involvement.

**Summary**

ISA 600 represents a significant extension of the responsibilities of both group auditor and component auditor compared with the previous ISA. It is likely to be a controversial standard in practice, and it is therefore likely to be in many Paper P7 exams.

Understanding and memorising the key points of the standard is a very good use of study time when preparing for the Paper P7 exam.

**Graham Fairclough is group technical director at the ExP Group**

* **ACCEPTANCE DECISIONS FOR AUDIT AND ASSURANCE ENGAGEMENTS**

*Relevant to ACCA Qualification Paper P7* The syllabus for Paper P7, *Advanced Audit and Assurance* includes Professional Appointments (syllabus reference C4). The learning outcomes include the explanation of matters that should be considered and procedures that should be followed by a firm before accepting a new client, a new engagement for an existing client, or agreeing the terms of any new engagement. The engagement may be an audit, or it may be a non-audit or assurance engagement. Acceptance decisions are crucially important, because new clients and/or engagements can pose threats to objectivity, or create risk exposure to the firm, which must be carefully evaluated. One of the current issues being debated in the profession is whether there should be an outright ban on the provision of non-audit services to audit clients. In addition, new International Standard on Auditing (ISA) requirements compel the firm to establish whether preconditions for an audit are present when faced with a potential new audit engagement. All of these factors mean that acceptance decisions must be taken with care.

**Accepting new audit clients**

IFAC’s Code of Ethics for Professional Accountants states: ‘Before accepting a new client relationship, a professional accountant in public practice shall determine whether acceptance would create any threats to compliance with the fundamental principles. Potential threats to integrity or professional behaviour may be created from, for example, questionable issues associated with the client (its owners, management or activities).’ This means that when approached to take on a new client, the firm should investigate the potential client, its owners and business activities in order to evaluate whether there are any questions over the integrity of the potential client which create unacceptable risk. These investigative actions are usually performed as ‘know your client/customer’ or ‘customer due diligence’ procedures, which are also carried out in order to comply with anti-money laundering regulations. Once a client has been accepted, the firm should consider the suitability of the specific engagement it has been asked to perform. In particular there may be ethical threats which mean that the engagement should not be accepted, in particular whether there are any threats to objectivity. Potential threats could arise for example, if members of the audit firm hold shares in the client or there are family relationships. If threats are discovered, it may not mean that the client must be turned down, as safeguards could potentially reduce the threats to an acceptable level. There may be other ethical matters to evaluate in relation to a potential new engagement, for example, whether any conflict of interest or confidentiality issues could arise, and if so, whether appropriate safeguards can be put in place. Also, the firm’s competence to perform the potential work should be evaluated, especially if the potential client operates in a specialised industry, or if the client has a complex structure. A self-interest threat to professional competence and due care is created if the engagement team does not possess, or cannot acquire, the competencies necessary to properly carry out the engagement. Practical matters such as the resources needed to perform the work, the deadline for completion, and logistics like locations and geographical spread will have to be looked into as well. Obviously, these matters need to be evaluated in the specific context of the potential engagement, and should be fully documented. Different types of potential engagement will give rise to different matters that should be evaluated. For example, if the firm is asked to perform the audit of a large group of companies with operations in many countries, then resourcing the audit may be the most significant issue. The fee may be large, leading to a self-interest threat of fee dependence. On the other hand, if asked to perform the audit of a small owner-managed company, fee dependence is less likely to be an issue, but threats potentially created by the auditor appearing to make management decisions could be significant. In answering requirements on client and engagement acceptance, candidates are warned that their comments must be made specific to the scenario presented to them in order to pass the requirement. Commercially, an engagement should be profitable to make it worthwhile for the firm. But the firm must take care that commercial considerations do not outweigh other matters to be considered. IFAC’s Code makes it clear that acceptance decisions are not to be treated as a one-off matter. The Code states: ‘It is recommended that a professional accountant in public practice periodically review acceptance decisions for recurring client engagements.’ Changes in the circumstances of either the client, or the audit firm may mean that an engagement ceases to be ethically or professionally acceptable or creates a heightened level of risk exposure. Therefore, client continuance assessments are important and should be fully documented.

**Preconditions for an audit**

Once a firm has decided to go ahead with an audit engagement, it must comply with the requirements of ISA 210, *Agreeing the Terms of Audit Engagements*. ISA 210 was revised as part of the International Auditing and Assurance Standards Board’s Clarity Project, with new requirements to perform specific procedures in order to establish whether the preconditions for an audit are present. ISA 210 defines preconditions for an audit as follows: ‘The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted’. This means that the auditor must do two things. First, the auditor must determine the acceptability of the financial reporting framework to be applied in the preparation of the financial statements. This includes evaluating whether law or regulation prescribes the applicable financial reporting framework, considering the purpose of the financial statements, and the nature of the reporting entity (for example, whether a listed company or a public sector entity). In most cases this will simply be a matter of confirming with the client that the financial statements will be prepared under International Financial Reporting Standards, or other national reporting framework. Second, the auditor must obtain the agreement of management that it acknowledges and understands its responsibility:

* For the preparation of the financial statements in accordance with the applicable financial reporting framework.
* For internal controls to enable the preparation of financial statements which are free from material misstatement, whether due to fraud or error.
* To provide the auditor with access to all information necessary for the purpose of the audit.

In relation to the final bullet point, if management impose a limitation on the scope of the auditor’s work in the terms of a proposed audit engagement, the auditor should decline the audit engagement if the limitation could result in the auditor having to disclaim the opinion on the financial statements. The engagement should also be declined if the financial reporting framework is unacceptable, or if management fail to provide the agreement outlined above. (ISA 580, *Written Representations* also requires that management provide written representations regarding its responsibilities in relation to the preparation of financial statements.)

**Accepting non-audit assignments**

It is very common for audit clients to approach their auditor for the provision of additional services, ranging from audit related services such as tax planning and bookkeeping, to other engagements such as due diligence and forensic investigations. The audit firm must again carefully consider whether it is ethically and professionally acceptable to take on the additional service. The main ethical threat created by the provision of non-audit services is the threat to objectivity. The threats created are most often self-review, self-interest and advocacy threats and if a threat is created that cannot be reduced to an acceptable level by the application of safeguards, the non-audit service shall not be provided. The UK Auditing Practices Board’s (APB) Ethical Standard 5, *Non-audit services provided to audit clients* contains similar principles, and emphasises the ‘management threat’ which exists when the audit firm makes decisions and judgments that are properly the responsibility of management. Both the Code and ES 5 outline a principles-based approach to determining the acceptability of a non-audit service to an audit client. With a few exceptions, if safeguards can reduce threats to an acceptable level then the service may be provided. Safeguards could include using separate teams to provide the various services to the client, and the use of second partner review or Engagement Quality Control Review. ES 5 specifies that it is the audit engagement partner who should evaluate the level of threat, the effectiveness of safeguards, and is ultimately responsible for the documentation of the acceptance decision. The provision of non-audit services to audit clients continues to be debated by the profession. Many argue in favour of outright prohibition as being the only measure which can totally safeguard auditor’s objectivity. However, it is accepted that audit firms are best placed to provide audit clients with additional services due to the knowledge of the business which they already possess, leading to a lower cost and higher quality service than that would be provided by a different firm. In 2010 the APB issued a feedback and consultation paper The provision of non-audit services by auditors , which prompted continued discussion of these issues and recommended a number of measures to:

* Increase the rigour with which auditors assess threats to their independence
* Introduce a new non-audit services disclosure regime and
* Increase the role of Audit Committees in overseeing the retention of a company’s auditors to undertake non-audit services.

The final bullet point is important as it links to corporate governance. Under many codes of corporate governance, including the UK Corporate Governance Code , the client’s audit committee should be involved with any decision as to whether the audit firm can be engaged to provide a non-audit service. Therefore, when approached to provide a non-audit service to an audit client, there should be full discussion with those charged with governance, including the audit committee, with a view to seeking approval for the engagement to go ahead. As well as considering independence and objectivity, audit firms should remember that the fundamental ethical principles apply to non-audit services, just as they apply to audits. Therefore, when considering whether to provide a non-audit service, the firm should evaluate its competency to perform the work, whether confidentiality is an issue, and that it is able to comply with all relevant laws and regulations. As discussed above, in answering requirements to do with non-audit services, candidates’ answers must apply knowledge to the specific scenario provided in order to score well.

**Conclusion**

The evaluation of new engagements is a crucial part of successful practice management. The current debate over the acceptability of auditors providing non-audit services to their audit clients indicates that ethical matters will continue to play an important part in acceptance decisions. **Written by a member of the Paper P7 examining team**

* **AUDITING IN A COMPUTER-BASED ENVIRONMENT**

**Specific aspects of auditing in a computer-based environment**

Information technology (IT) is integral to modern accounting and management information systems. It is, therefore, imperative that auditors should be fully aware of the impact of IT on the audit of a client’s financial statements, both in the context of how it is used by a client to gather, process and report financial information in its financial statements, and how the auditor can use IT in the process of auditing the financial statements.

The purpose of this article is to provide guidance on following aspects of auditing in a computer-based accounting environment:

* Application controls, comprising input, processing, output and master file controls established by an audit client, over its computer-based accounting system and
* Computer-assisted audit techniques (CAATs) that may be employed by auditors to test and conclude on the integrity of a client’s computer-based accounting system.

Exam questions on each of the aspects identified above are often answered to an inadequate standard by a significant number of students – hence the reason for this article.

Dealing with application controls and CAATs in turn:

**Application controls**

Application controls are those controls (manual and computerised) that relate to the transaction and standing data pertaining to a computer-based accounting system. They are specific to a given application and their objectives are to ensure the completeness and accuracy of the accounting records and the validity of entries made in those records. An effective computer-based system will ensure that there are adequate controls existing at the point of input, processing and output stages of the computer processing cycle and over standing data contained in master files. Application controls need to be ascertained, recorded and evaluated by the auditor as part of the process of determining the risk of material misstatement in the audit client’s financial statements.

**Input controls**

Control activities designed to ensure that input is authorised, complete, accurate and timely are referred to as input controls. Dependent on the complexity of the application program in question, such controls will vary in terms of quantity and sophistication. Factors to be considered in determining these variables include cost considerations, and confidentiality requirements with regard to the data input. Input controls common to most effective application programs include on-screen prompt facilities (for example, a request for an authorised user to ‘log-in’) and a facility to produce an audit trail allowing a user to trace a transaction from its origin to disposition in the system.

Specific input validation checks may include:

*Format checks* These ensure that information is input in the correct form. For example, the requirement that the date of a sales in voice be input in numeric format only – not numeric and alphanumeric.

*Range checks* These ensure that information input is reasonable in line with expectations. For example, where an entity rarely, if ever, makes bulk-buy purchases with a value in excess of $50,000, a purchase invoice with an input value in excess of $50,000 is rejected for review and follow-up.

*Compatibility checks* These ensure that data input from two or more fields is compatible. For example, a sales invoice value should be compatible with the amount of sales tax charged on the invoice.

*Validity checks* These ensure that the data input is valid. For example, where an entity operates a job costing system – costs input to a previously completed job should be rejected as invalid.

*Exception checks* These ensure that an exception report is produced highlighting unusual situations that have arisen following the input of a specific item. For example, the carry forward of a negative value for inventory held.

*Sequence checks* These facilitate completeness of processing by ensuring that documents processed out of sequence are reject ed. For example, where pre-numbered goods received notes are issued to ac knowledge the receipt of goods into physical inventory, any input of notes out of sequence should be rejected.

*Control totals* These also facilitate completeness of processing by ensure that pre-input, manually prepared control totals are compared to control totals input. For example, non-matching totals of a ‘batch’ of purchase invoices should result in an on-screen user prompt, or the production of an exception report for follow-up. The use of control totals in this way are also commonly referred to as output controls (see below).

*Check digit verification* This process uses algorithms to ensure that data input is accurate. For example, internally generated valid supplier numerical reference codes, should be formatted in such a way that any purchase invoices input with an incorrect code will be automatically rejected.

**Processing controls**

Processing controls exist to ensure that all data input is processed correctly and that data files are appropriately updated accurately in a timely manner. The processing controls for a specified application program should be designed and then tested prior to ‘live’ running with real data. These may typically include the use of run-to-run controls, which ensure the integrity of cumulative totals contained in the accounting records is maintained from one data processing run to the next. For example, the balance carried forward on the bank account in a company’s general (nominal) ledger. Other processing controls should include the subsequent processing of data rejected at the point of input, for example:

* A computer produced print-out of rejected items.
* Formal written instructions notifying data processing personnel of the procedures to follow with regard to rejected items.
* Appropriate investigation/follow up with regard to rejected items.
* Evidence that rejected errors have been corrected and re-input.

**Output controls**

Output controls exist to en sure that all data is processed and that output is distributed only to prescribed authorised users. While the degree of output controls will vary from one organisation to another (dependent on the confidentiality of the information and size of the organisation), common controls comprise:

* Use of batch control totals, as described above (see ‘input controls’).
* Appropriate review and follow up of exception report information to ensure that there are no permanently outstanding exception items.
* Careful scheduling of the processing of data to help facilitate the distribution of information to end users on a timely basis.
* Formal written instructions notifying data processing personnel of prescribed distribution procedures.
* Ongoing monitoring by a responsible official, of the distribution of output, to ensure it is distributed in accordance with authorised policy.

**Master file controls**

The purpose of master file controls is to ensure the ongoing integrity of the standing data contained in the master files. It is vitally important that stringent ‘security’ controls should be exercised over all master files.

These include:

* appropriate use of passwords, to restrict access to master file data
* the establishment of adequate procedures over the amendment of data, comprising appropriate segregation of duties, and authority to amend being restricted to appropriate responsible individuals
* regular checking of master file data to authorised data, by an independent responsible official
* processing controls over the updating of master files, including the use of record counts and control totals.

**Computer Assisted Audit Techniques (CAATs)**

The nature of computer-based accounting systems is such that auditors may use the audit client company’s computer, or their own, as an audit tool, to assist them in their audit procedures. The extent to which an auditor may choose between using CAATs and manual techniques on a specific audit engagement depends on the following factors:

* the practicality of carrying out manual testing
* the cost effectiveness of using CAATs
* the availability of audit time
* the availability of the audit client’s computer facility
* the level of audit experience and expertise in using a specified CAAT
* the level of CAATs carried out by the audit client’s internal audit function and the extent to which the extern al auditor can rely on this work.

There are three classifications of CAATs – namely:

* Audit software
* Test data
* Other techniques

Dealing with each of the above in turn:

**Audit software**

Audit software is a generic term used to describe computer programs designed to carry out tests of control and/or substantive procedures. Such programs may be classified as:

*Packaged programs* These consist of pre-prepared generalised programs used by auditors and are not ‘client specific’. They may be used to carry out numerous audit tasks, for example, to select a sample, either statistically or judgementally, during arithmetic calculations and checking for gaps in the processing of sequences.

*Purpose written programs* These programs are usually ‘client specific ’ and may be used to carry out tests of control or substantive procedures. Audit software may be bought or developed, but in any event the audit firm’s audit plan should ensure that provision is made to ensure that specified programs are appropriate for a client’s system and the needs of the audit. Typically, they may be used to re-perform computerised control procedures (for example, cost of sales calculations) or perhaps to carry out an aged analysis of trade receivable (debtor) balances.

*Enquiry programs* These programs are integral to the client’s accounting system; however they may be adapted for audit purposes. For example, where a system provides for the routine reporting on a ‘monthly’ basis of employee starters and leavers, this facility may be utilised by the auditor when auditing salaries and wages in the client’s financial statements. Similarly, a facility to report trade payable (creditor) long outstanding balances could be used by an auditor when verifying the reported value of creditors.

**Test data**

*Audit test data* Audit test data is used to test the existence and effectiveness of controls built into an application program used by an audit client. As such, dummy transactions are processed through the client’s computerised system. The results of processing are then compared to the auditor’s expected results to determine whether controls are operating efficiently and systems’ objectiveness are being achieved. For example, two dummy bank payment transactions (one inside and one outside authorised parameters) may be processed with the expectation that only the transaction processed within the parameters is ‘accepted’ by the system. Clearly, if dummy transactions processed do not produce the expected results in output, the auditor will need to consider the need for increased substantive procedures in the area being reviewed.

*Integrated test facilities* To avoid the risk of corrupting a client’s account system, by processing test data with the client’s other ‘live’ data, auditors may instigate special ‘test data only’ processing runs for audit test data. The major disadvantage of this is that the auditor does not have total assurance that the test data is being processed in a similar fashion to the client’s live data. To address this issue, the auditor may therefore seek permission from the client to establish an integrated test facility within the accounting system. This entails the establishment of a dummy unit, for example, a dummy supplier account against which the auditor’s test data is processed during normal processing runs.

**Other techniques** This section contains useful background information to enhance your overall understanding.

Other CAATs include:

*Embedded audit facilities (EAFs)* This technique requires the auditor’s own program code to be embedded (incorporated) into the client’s application software, such that verification procedures can be carried out as required on data being processed. For example, tests of control may include the reperformance of specific input validation checks (see input controls above) – selected transactions may be ‘tagged’ and followed through the system to ascertain whether stated controls and processes have been applied to those transactions by the computer system. The EAFs should ensure that the results of testing are recorded in a special secure file for subsequent review by the auditor, who should be able to conclude on the integrity of the processing controls generally, from the results of testing. A further EAF, of ten overlooked by students, is that of an analytical review program enabling concurrent performance of analytical review procedures on client data as it is being processed through the automated system.

*Application program examination* When determining the extent to which they may rely on application controls, auditors need to consider the extent to which specified controls have been implemented correctly. For example, where system amendments have occurred during an accounting period, the auditor would need assurance as to the existence of necessary controls both before and after the amendment. The auditor may seek to obtain such assurance by using a software program to compare the controls in place prior to, and subsequent to, the amendment date.

**Summary**

The key objectives of an audit do not change irrespective of whether the audit engagement is carried out in a manual or a computer-based environment. The audit approach, planning considerations and techniques used to obtain sufficient appropriate audit evidence do of course change. Students are encouraged to read further to augment their knowledge of auditing in a computer-based environment and to practise their ability to answer exam questions on the topic by attempting questions set in previous ACCA exam papers.

**Written by a member of the audit exam team**

* **AUDIT OF ESTIMATES AND FAIR VALUES**

**Relevant to ACCA Qualification Paper P7** Making estimates is an inevitable part of preparing financial statements. Management will need to make estimates about many of the assets and some of the liabilities in order to show them at a reliable value. These estimates will include some routine matters such as the expected life of property, plant and equipment, estimating appropriate allowances for receivables and some more challenging matters, such as valuation of pension liabilities for a newly acquired subsidiary. Estimates share one characteristic above all others – they are an attempt to look into the future and are consequently subject to a high degree of uncertainty and so inherent risk of misstatement. ISA 700 requires that an auditor expresses an opinion in terms of reasonable assurance. This requires us to state an opinion that we believe a set of financial statements present a true and fair view (or are fairly presented). The assertive nature of this opinion requires a substantial amount of robust evidence to support it. It is rather too easy to drop into auditing estimates to a degree where conclusions become that management’s estimates are ‘reasonable’ or even ‘plausible’. Neither of these conclusions mirror the wording used in our actual audit report and so are insufficient to comply with the requirement of ISA 700 and ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. Obtaining certainty about the future is impossible, but obtaining evidence to support a reasonable conclusion on likely future outcomes is not.

**How can estimates be wrong?**

It is logically impossible to say that an estimate about the future is certain to be right. It’s much easier, however, to identify when an estimate is likely to be wrong. So it is perhaps easiest to start off identifying some common situations when an estimate looks likely to be materially misstated. This list isn’t exhaustive, but it includes some of the biggest potential errors and you should be sure that you’re comfortable with all of them before taking the Paper P7 exam. *Misunderstanding the stated system of GAAP*. In the audit report, we define true and fair, or fair presentation, by referring to full compliance with a stated system of GAAP. It is, therefore, essential to have an in-depth knowledge of the GAAP system being used to define truth and fairness before it’s possible to express an audit opinion that is built on that system. This is why you can expect a reasonable amount of accounting knowledge to be needed to pass Paper P7. Unfortunately, there is not one unifying method of deciding what constitutes a true and fair estimate. For example, inventory will be defined as being fairly estimated in value if it is valued at the lower of cost and net realisable value. Contingent liabilities are fairly estimated if they are shown with a value of zero, unless they are being valued as part of an acquirer’s initial consolidation of a new subsidiary (see later). The definition of fair value given in the IASB glossary is: The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction. In practice, this definition is stretched somewhat depending on the asset or liability in question and so it is necessary to know the specific rules for each material asset or liability. *Management bias*. Bias is not necessarily deliberate, but is almost certain to exist in most estimates. Bias may be exacerbated during a takeover situation, when management are likely to wish to convince sellers of a business that net assets have a lower fair value than they really have, in order to obtain a lower price for the acquired business. Innate optimism and human nature may deter management from wishing to accept that less will be received from receivables than management wish. Familiarity with preparing estimates in an established way may also build in long-standing bias. *Poor data, poor controls*. If information systems are poor, even neutral management will produce estimates that are unreliable. For example, if a loan provider has poor data collection on overdue repayments, estimates of impairments of financial assets are likely to be unreliable.

**Fair values – acquisition of new subsidiaries**

When a parent company acquires a new subsidiary, it will pay the fair value of the acquired company as a whole. This is because the previous owners tend to be unwilling to sell their company for less than its fair value. In order to bring in a fair estimate of the initial value of goodwill, IFRS 3, *Business Combinations* requires that the individual net assets of the acquired company be valued at their fair value at the date of the acquisition. Fair value still means the amount that would be transferred between knowledgeable parties in an arm’s length transaction. Often, the acquirer will have investigated their assessment of value of material assets, liabilities and contingent liabilities of the target company as part of a pre-acquisition due diligence investigation. In these circumstances, the values ascribed to individual assets and liabilities in this due diligence will be an appropriate value to use for the initial recognition of each asset and liability. This means that fair value often becomes fair value through the eyes of the acquirer. This is not always the most appropriate valuation basis, however, since the value given by the acquirer may include some degree of the acquirer’s intentions. For example, it is common for a new acquirer to plan to restructure an acquired business shortly after the acquisition. This might include an intention to pay off any litigation in progress at the date of acquisition in order to fee management time for integration of the subsidiary into its new group. This could result in incorrect recognition of provisions that are higher than the true value of the obligation. IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* normally prohibits recognition of contingent liabilities. This rule is overturned on the acquisition of a new subsidiary, since the existence of contingent liabilities (eg individual lawsuits against the company) will reduce the value that the acquirer is willing to pay for control of the company. To ensure a fair value of initial goodwill, contingent liabilities must be valued within the statement of financial position; with the most appropriate valuation probably being the amount that the acquirer would be willing to pay an independent third party to assume the risk on their behalf. IFRS 3 also requires recognition of any contingent consideration payable to the sellers of the new subsidiary. These are common in ‘earn out’ arrangements where the amount that the seller eventually pays is adjusted for post-acquisition profit of the business. The determination of a fair value of this contingent consideration is subject to elevated estimation uncertainty.

**What is the auditor to do?**

ISA 540 states that the auditor’s objective is to obtain sufficient, appropriate evidence on whether:

* Accounting estimates are reasonable, and
* Related disclosures in the financial statements are adequate.

A critical first step for the auditor in planning the work needed on estimates is to understand the client’s business and identify where the greatest scope for accidental or deliberate bias in production of estimates exists. This assessment will include a formal and documented assessment of:

* How the client identifies items subject to estimates and how satisfactory these procedures appear to be.
* How the client identifies and assesses estimation uncertainty . Estimation uncertainty is ‘The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement’. The greater the estimation uncertainty, the more the client will need to explore the effect of different models and assumptions to make an appropriate estimate. For example, if long-term receivables are judged to be subject to high estimation uncertainty, the client will need to test how sensitive the estimates are to changes in discount rates or assumed default rates. If estimation uncertainty is lower, less work will be required by the client in determining the estimate and also less corroborative evidence needs to be obtained by the auditor.
* How the client has identified new items that are subject to estimates and any existing items subject to estimation but where there may now be a more reliable method of establishing an estimate.
* The source data used by the client upon which to base an estimate, together with how relevant and reliable that source data appears to be.

Historically, estimates have arguably mostly been audited by assessing the client’s schedules and determining if they are reasonable. ISA 540 requires a more forensic approach than this.

**Sufficient, appropriate evidence**

The greater the potential materiality of an item and the greater its estimation uncertainty, the greater the evidence will need to be in order to be sufficient and appropriate to base a conclusion. The core evidence is likely to be:

* The auditor must assess and document their own independent assessment of estimation uncertainty for each material, subjectively valued item in the financial statements.
* Assessment of adequacy of controls over determining estimates and whether the controls have worked as specified. For example, if a risk management committee is tasked with approval of all material estimates, is there evidence that this has happened, that its members were properly briefed and competent?
* Inspection of accounting policies used by management to ensure that they comply with the appropriate rules of the GAAP system used.
* Investigation of outcomes of the uncertainties after the year-end but before the audit opinion is issued. If the uncertainty has been settled before the audit opinion has been issued, the uncertainty has effectively been disposed of.
* Comparison of historical accuracy of management estimates compared with actual outcomes. The greater the variance between estimates and eventual outcomes, the greater the risk of error; either by high estimation uncertainty or weak control by management of the process of determining estimates.
* Verification of any underlying data used by management (eg debt default rates by age of debt) to external evidence.
* The auditor’s response is graded depending on whether a risk identified is a normal risk or a significant risk. A significant risk is one that the auditor judges to have high estimation uncertainty. The size of the item in the draft financial statements may give a misleading view of its potential significance. If an item is estimated to have a low value, but is subject to high estimation uncertainty then that figure may well be significantly understated when compared with the eventual outcome of the estimate. Hence ISA 540 directs the auditor’s work from a starting point of uncertainty rather than the materiality of the draft figure in the financial statements. The greater the estimation uncertainty, rather than the size of the draft figure, the greater the amount of evidence that the auditor will need to obtain.
* The auditor must develop their own point estimate, or range of estimates if a point estimate is not achievable. A point estimate is the auditor’s own assessment of the single most likely value. A range of estimates is the range over which the auditor believes an estimate would be reasonable.
* For significant risks, the auditor must assess if management considered alternative means for determining estimates.
* Significant risks may arise as a result of valuation being largely linked to management intentions (eg the intended future use of an asset may affect its recoverable value and so impairment loss under IAS 36, *Impairment of Assets*). ISA 540 requires the auditor to document an assessment of viability of management’s intentions wherever these intentions are part of the estimated fair value of an item subject to significant risks.
* The auditor must assess for signs of management bias. The existence of management bias does not necessarily mean that management is incapable of producing a neutral estimate, but the chances of an estimate not being neutral are increased.
* A change in method of estimation by management should be treated with scepticism. Changing the methodology used to make an estimate has much the same effect on the financial statements as changing an accounting policy, so the auditor should require evidence that a change in methodology as necessary to produce more reliable estimates.
* Sceptically review assumptions used by management for internal consistency and ensure in accordance with observable market data. For example, if inflation has been built into growth in expected income streams, ensure that all future costs are also estimated allowing for expected inflation. There is a high inherent risk of cost estimates being based on today’s costs; thus overestimating net income.
* Ranges of estimates are normally adequate if their range of values (other than remotely possible values) is within performance materiality. Performance materiality is the figure below which errors noted on audit tests of detail are not cumulatively recorded in the audit files. If their range of values other than remote possibilities falls outside the limit of performance materiality, they represent significant estimation risks and more evidence is required; normally including estimation of a point estimate.
* Should consider need for specialist advice.
* Obtain written management representations to confirm the auditor’s understanding of management’s intentions. Note that management representations alone do not provide sufficient, appropriate evidence. The representation letter should be viewed as a necessary, but insufficient component of the audit evidence.

**Summary**

Audit of estimates is subject to a high degree of uncertainty. The degree of audit risk is somewhat reduced by GAAP systems accepting that more than one estimate of the same uncertainty may give a true and fair view. This is why GAAP systems often require substantial disclosure of the circumstances giving rise to the uncertainty; so that readers can make up their own mind. Audit of estimates is likely to be a common feature in the Paper P7 exam, as well as in practice. Auditor’s judgment is often difficult to challenge. Failure to follow the prescribed steps that lead to the use of auditor’s judgment however is much easier to attack in any negligence action. Both Paper P7 students and auditors in practice will do well to be familiar with the enhanced requirements of ISA 540.

**Graham Fairclough is group technical director at the ExP Group**

* **ANALYTICAL PROCEDURES**

**To obtain audit evidence, the auditor performs one – or a combination – of the following procedures:**

* inspection
* observation
* external confirmation
* inquiry
* reperformance
* recalculation
* analytical procedures.

It is mandatory that the auditor should perform risk assessment for the identification and assessment of risks of material misstatement at the financial statement and assertion level, and the risk assessment procedures should include analytical procedures (ISA 315). It is also mandatory that the auditor should perform analytical procedures near the end of the audit that assess whether the financial statements are consistent with the auditor’s understanding of the entity (ISA 520). Analytical procedures are also commonly used in non-audit and assurance engagements, such as reviews of prospective financial information, and non-audit reviews of historical financial information. While the use of analytical procedures in such engagements is not covered in the ISAs, the principals regarding their use are relevant.

**Definition of analytical procedures**

Analytical procedures consist of ‘evaluations of financial information through analysis of plausible relationships among both financial and non-financial data’. They also encompass ‘such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount’ (ISA 520). A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of conditions to the contrary.

**Purposes of analytical procedures**

Analytical procedures are used throughout the audit process and are conducted for three primary purposes:

* Preliminary analytical review – risk assessment (required by ISA 315) Preliminary analytical reviews are performed to obtain an understanding of the business and its environment (eg financial performance relative to prior years and relevant industry and comparison groups), to help assess the risk of material misstatement in order to determine the nature, timing and extent of audit procedures, ie to help the auditor develop the audit strategy and programme.
* Substantive analytical procedures Analytical procedures are used as substantive procedures when the auditor considers that the use of analytical procedures can be more effective or efficient than tests of details in reducing the risk of material misstatements at the assertion level to an acceptably low level.
* Final analytical review (required by ISA 520) Analytical procedures are performed as an overall review of the financial statements at the end of the audit to assess whether they are consistent with the auditor’s understanding of the entity. Final analytical procedures are not conducted to obtain additional substantive assurance. If irregularities are found, risk assessment should be performed again to consider any additional audit procedures are necessary.

**Use of substantive analytical procedures**

One of the objectives of ISA 520 is that relevant and reliable audit evidence is obtained when using substantive analytical procedures. The primary purpose of substantive analytical procedures is to obtain assurance, in combination with other audit testing (such as tests of controls and substantive tests of details), with respect to financial statement assertions for one or more audit areas. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be more predictable over time. The application of substantive analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and occurrence of transactions. Due to their nature, substantive analytical procedures can often provide evidence for multiple assertions, identify audit issues that may not be apparent from more detailed work, and direct the auditor’s attention to areas requiring further investigation. Furthermore, the auditor may identify risks or deficiencies in internal control that had not previously been identified, which may cause the auditor to re-evaluate his planned audit approach and require the auditor to obtain more assurance from other substantive testing than originally planned. To derive the most benefit from substantive analytical procedures, the auditor should perform substantive analytical procedures before other substantive tests because results of substantive analytical procedures often impact the nature and extent of detailed testing. Substantive analytical procedures might direct attention to areas of increased risk, and the assurance obtained from effective substantive analytical procedures will reduce the amount of assurance needed from other tests. There are four elements that comprise distinct steps that are inherent in the process to using substantial analytical procedures: **STEP 1: Develop an independent expectation** The development of an appropriately precise, objective expectation is the most important step in effectively using substantive analytical procedures. An expectation is a prediction of a recorded amount or ratio. The prediction can be a specific number, a percentage, a direction or an approximation, depending on the desired precision. The auditor should have an independent expectation whenever s/he uses substantive analytical procedures (ISA 520). The auditor develops expectations by identifying plausible relationships (eg between store square footage and retail sales, market trends and client revenues) that are reasonably expected to exist based on his knowledge of the business, industry, trends, or other accounts. **STEP 2: Define a significant difference (or threshold)** While designing and performing substantive analytical procedures the auditor should consider the amount of difference from the expectation that can be accepted without further investigation (ISA 520). The maximum acceptable difference is commonly called the ‘threshold’. Thresholds may be defined either as numerical values or as percentages of the items being tested. Establishing an appropriate threshold is particularly critical to the effective use of substantive analytical procedures. To prevent bias in judgment, the auditor should determine the threshold while planning the substantive analytical procedures, ie before Step 3, in which the difference between the expectation and the recorded amount are computed. The threshold is the acceptable amount of potential misstatement and therefore should not exceed planning materiality and must be sufficiently small to enable the auditor to identify misstatements that could be material either individually or when aggregated with misstatements in other disaggregated portions of the account balance or in other account balances. **STEP 3: Compute difference** The third step is the comparison of the expected value with the recorded amounts and the identification of significant differences, if any. This should be simply a mechanical calculation. It is important to note that the computation of differences should be done after the consideration of an expectation and threshold. In applying substantive analytical procedures, it is not appropriate to first compute differences from prior-period balances and then let the results influence the ‘expected’ difference and the acceptable threshold. **STEP 4: Investigate significant differences and draw conclusions** The fourth step is the investigation of significant differences and formation of conclusions (ISA 520). Differences indicate an increased likelihood of misstatements; the greater the degree of precision, the greater the likelihood that the difference is a misstatement. Explanations should be sought for the full amount of the difference, not just the part that exceeds the threshold. There is a chance that the unexplained difference may indicate an increased risk of material misstatement. The auditor should consider whether the differences were caused by factors previously overlooked when developing the expectation in Step 1, such as unexpected changes in the business or changes in accounting treatments. If the difference is caused by factors previously overlooked, it is important to verify the new data, to show what impact this would have on the original expectations as if this data had been considered in the first place, and to understand any accounting or auditing ramifications of the new data.

**Key factors affecting the precision of analytical procedures**

There are four key factors that affect the precision of analytical procedures:

**1 Disaggregation** The more detailed the level at which analytical procedures are performed, the greater the potential precision of the procedures. Analytical procedures performed at a high level may mask significant, but offsetting, differences that are more likely to come to the auditor’s attention when procedures are performed on disaggregated data. The objective of the audit procedure will determine whether data for an analytical procedure should be disaggregated and to what degree it should be disaggregated. Disaggregated analytical procedures can be best thought of as looking at the composition of a balance(s) based on time (eg by month or by week) and the source(s) (eg by geographic region or by product) of the underlying data elements. The reliability of the data is also influenced by the comparability of the information available and the relevance of the information available. **2 Data reliability** The more reliable the data is, the more precise the expectation. The data used to form an expectation in an analytical procedure may consist of external industry and economic data gathered through independent research. The source of the information available is particularly important. Internal data produced from systems and records that are covered by the audit, or that are not subject to manipulation by persons in a position to influence accounting activities, are generally considered more reliable. **3 Predictability** There is a direct correlation between the predictability of the data and the quality of the expectation derived from the data. Generally, the more precise an expectation is for an analytical procedure, the greater will be the potential reliability of that procedure. The use of non-financial data (eg number of employees, occupancy rates, units produced) in developing an expectation may increase the auditor’s ability to predict account relationships. However, the information is subject to data reliability considerations mentioned above. **4 Type of analytical procedures** There are several types of analytical procedures commonly used as substantive procedures and will influence the precision of the expectation. The auditor chooses among these procedures based on his objectives for the procedures (ie purpose of the test, desired level of assurance).

* Trend analysis – the analysis of changes in an account over time.
* Ratio analysis – the comparison, across time or to a benchmark, of relationships between financial statement accounts and between an account and non-financial data.
* Reasonableness testing – the analysis of accounts, or changes in accounts between accounting periods, that involves the development of a model to form an expectation based on financial data, non - financial data, or both.

Each of the types uses a different method to form an expectation. They are ranked from lowest to highest in order of their inherent precision. Scanning analytics are different from the other types of analytical procedures in that scanning analytics search within accounts or other entity data to identify anomalous individual items, while the other types use aggregated financial information. If the auditor needs a high level of assurance from a substantive analytical procedure, s/he should develop a relatively precise expectation by selecting an appropriate analytical procedure (eg a reasonableness test instead of a simple trend or ‘flux’ analysis). Thus, determining which type of substantive analytical procedure to use is a matter of professional judgment. In summary, there is a direct correlation between the type of analytical procedure selected and the precision it can provide. Generally, the more precision inherent in an analytical procedure used, the greater the potential reliability of that procedure. **Key messages:**

* Substantive analytical procedures play an important part in a risk-based audit approach.
* Properly designed and executed analytical procedures can allow the auditor to achieve audit objectives more efficiently by reducing or replacing other detailed audit testing.
* The effectiveness of analytical procedures depends on the auditor’s understanding of the entity and its environment and the use of professional judgment; therefore, analytical procedures should be performed or reviewed by senior members of the engagement team.

It is vital that the analytical procedures be sufficiently documented to enable an experienced auditor, having no previous connection with the audit, to understand the work done (ISA 230).

* **GOING CONCERN**

**The Paper P7 examiner describes the additional guidance given for ISA 570, *Going Concern***

The recent global economic crisis, commonly referred to as the credit crunch, has provided many challenges for both the preparers and the auditors of published financial statements.

For auditors, ISA 570, *Going Concern* is a well-established source of guidance, and additional direction has been provided by the IAASB's Practice Alert *Audit Considerations in Respect of Going Concern in the Current Economic Environment*, issued in January 2009. In the UK, the APB issued the Bulletin *Going Concern Issues During the Current Economic Conditions* in December 2008. Both of these are examinable documents for the Paper P7 exams in 2010.

**The auditor's objectives in relation to going concern**

ISA 570 contains well-established guidance on going concern, including the following objectives for the auditor:

* to obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements
* to conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, and
* to determine the implications for the auditor's report.

All audits should involve an assessment of the appropriateness of the going concern assumption, and it is obvious to say that the auditor may well have to perform additional procedures when there are heightened risks relating to going concern, caused by difficult economic and market conditions. But going concern should be considered at all stages of the audit, not just in terms of specific procedures. It is important to remember that going concern is not just something considered at a particular stage in the audit cycle, but should be an issue that permeates the whole performance and review of an audit.

Auditors should consider the current economic circumstances and their impact on a particular audit when:

* assessing risk at the planning stage of the audit, and when re-assessing risk as the audit progresses
* designing and performing audit procedures to respond to the assessed risks
* evaluating and concluding on the results of audit procedure, and
* forming an audit opinion.

**Assessing risk at the planning stage of the audit**

Auditors are required by ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, to gain an understanding of the audit client's business and the economic environment in which it operates. This understanding should then lead to the identification of business risks, which are then evaluated in terms of any risks of material misstatement in the financial statements.

Business risks include risks that could reduce the company's profit and/or cash inflows, and could ultimately mean that either a company is not a going concern, or that there are significant doubts over its ability to continue as a going concern. Identification of this heightened risk at this initial stage in the audit cycle means that additional audit procedures can be planned as a response to the specific risks identified.

All of this means that the auditor must gain a detailed understanding of the economic environment in which a company is operating, and more specifically, an understanding of the particular market conditions affecting its operations. Risks can arise from many factors, including reduced demand for goods and services, customers' inability to pay for goods and services already provided, and an inability to raise necessary finance. Such factors must be assessed for their specific impact on a company's operations. It is important to remember that difficult economic or market conditions do not necessarily mean that a material uncertainty exists about a company's ability to continue as a going concern.

The evaluation of business risks should lead to the assessment of specific financial statement risks. For a company facing going concern difficulties, the fundamental financial statement risk is whether the financial statements have been prepared under the correct assumption, or whether any significant uncertainties have been disclosed in the financial statements. However, there are more specific financial statement risks including:

* potential overstatement of non-current assets if impairments caused by reduced market value or value in use have not been recognised
* potential overstatement of inventory if net realisable value has fallen due to reduced demand
* potential overstatement of receivables if bad debts not provided for
* incorrect measurement and recognition of gains or losses on financial instruments due to inactive markets
* incorrect measurement and disclosure of assets held for sale or discontinued operations
* incorrect measurement or disclosure of provisions or contingent liabilities caused by restructuring of operations.

**Designing, performing and evaluating audit procedures**

Where risks, such as the ones mentioned above, have been identified, the auditor must respond to the risks by designing and performing appropriate audit procedures. Clearly the procedures should address the specific risks identified, and so extra procedures may be needed on many balances and transactions such as the ones outlined above.

More generally, audit procedures are necessary in order to evaluate how the key management personnel have satisfied themselves that it is appropriate to adopt the going concern basis in preparing the financial statements. Procedures should include:

* analysing and discussing cash flow, profit and other relevant forecasts with management
* reviewing the terms of loan agreements and determining whether they have been breached
* reading minutes of board meetings and relevant committees for any discussion of financing difficulties
* reviewing events after the year end to identify factors relevant to the going concern assumption as a basis for the preparation of the financial statements.

Paragraph A15 of ISA 570 contains examples of additional procedures that may be used.

Analysis of cash flow is usually a key feature of any going concern evaluation. In this evaluation the auditor should pay particular attention to the reliability of the company's systems for generating the cash flow information, and whether the assumptions underlying the cash flow appear reasonable.

In evaluating going concern, the auditor will consider whether necessary borrowing facilities are in place and in doing so will attempt to obtain confirmations from the company's bankers. However, the bankers may be reluctant to confirm whether the borrowing facilities will be available, in which case the auditor should consider the significance of this to the entity's ability to continue as a going concern, and also consider, through discussion with management, whether there are other strategies or sources of finance available.

**Forming an audit opinion**

In forming the audit opinion, the auditor should consider two issues: have the financial statements been prepared using the appropriate going concern assumption, and is there adequate disclosure of any material uncertainty regarding the going concern status.

First, the auditor may conclude that management's use of the going concern assumption is inappropriate. This means that the financial statements are effectively rendered meaningless, and ISA 570 requires the auditor to express an adverse opinion on the financial statements.

In rare circumstances, where the financial statements have not been prepared under the going concern assumption (for example, using a liquidation basis), and the auditor agrees with the use of this alternative basis for the preparation of the financial statements, the audit report will not be qualified, as there is no basis for a disagreement, but the auditor may consider it necessary to include an Emphasis of Matter paragraph in the audit report to highlight the unusual circumstances to the users of the financial statements.

It is much more likely that the auditor disagrees with the level of disclosure of material uncertainties, rather than disagreeing with the use of the going concern assumption. ISA 570 contains detailed guidance in this area, which is briefly summarised below:

* Where the disclosure of material uncertainty is considered adequate, the auditor includes an Emphasis of Matter paragraph within the audit report to highlight the uncertainty to the users of the financial statements.
* Where there are multiple significant uncertainties that relate to the financial statements as a whole, a disclaimer of opinion may be considered more appropriate than an Emphasis of Matter paragraph. ISA 570 comments that this is in extremely rare cases only.
* Where the disclosure of material uncertainty is not considered adequate, the audit opinion should be either qualified due to disagreement, or an adverse opinion should be given, depending on the level of significance of the lack of disclosure.

**Ethical matters**

In the current economic climate, with severe restrictions on borrowing facilities in many jurisdictions, auditors are likely to be asked by audit clients to perform non-audit services which may create self review, advocacy or management threats to objectivity and independence. For example, the audit firm may be asked to perform:

* a review of the business including advising on restructuring options
* a review of prospective financial information, possibly for presentation to potential providers of finance
* advising on corporate finance options, or negotiating such options.

The problem created is that the audit firm may not be able to objectively assess going concern factors when in addition becoming involved with non-audit services pertaining to the going concern status of the company. The audit firm should carefully consider the appropriateness of providing such non-audit services in these circumstances.

Safeguards may be able to reduce the threats to objectivity and independence to an acceptable level. Safeguards may include:

* a review of the going concern assessment and conclusion reached by a partner who is not a member of the audit team
* additional procedures as part of an Engagement Quality Control Review
* confirmation from the audit client that they remain responsible for any decisions or actions taken as a result of the non-audit service provided.

**Conclusion**

In the current economic climate, auditors must be extra vigilant in relation to the audit of going concern matters, and should also remember the possible ethical implications of being involved in non-audit services relevant to going concern. Even though the global economy may now be showing signs of recovery, the effects in some markets and for many companies are likely to be seen for some time, so auditors should not approach the assessment of going concern in difficult times as a one-off exercise, but as an issue to be continually addressed.

**Written by a member of the Paper P7 examining team**

* **AUDIT RISK**

**This article outlines and explains the concept of audit risk, making reference to the key auditing standards which give guidance to auditors about risk assessment**

Identifying and assessing audit risk is a key part of the audit process, and ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*, gives extensive guidance to auditors about audit risk assessment. The purpose of this article is to give summary guidance to FAU, F8 and P7 students about the concept of audit risk. All subsequent references in this article to the standard will be stated simply as ISA 315, although ISA 315 is a ‘redrafted’ standard, in accordance with the International Auditing and Assurance Standards Board (IAASB) Clarity Project. For further details on the IAASB Clarity Project, read the article 'The IAASB Clarity Project' (see 'Related links').

**What is audit risk?**

According to the IAASB Glossary of Terms (1), audit risk is defined as follows:

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

**Why is audit risk so important to auditors?**

Audit risk is fundamental to the audit process because auditors cannot and do not attempt to check all transactions. Students should refer to any published accounts of large companies and think about the vast number of transactions in a statement of comprehensive income and a statement of financial position. It would be impossible to check all of these transactions, and no one would be prepared to pay for the auditors to do so, hence the importance of the risk‑based approach toward auditing. Traditionally, auditors have used a risk-based approach in order to minimise the chance of giving an inappropriate audit opinion, and audits conducted in accordance with ISAs must follow the risk‑based approach, which should also help to ensure that audit work is carried out efficiently, using the most effective tests based on the audit risk assessment. Auditors should direct audit work to the key risks (sometimes also described as significant risks), where it is more likely that errors in transactions and balances will lead to a material misstatement in the financial statements. It would be inefficient to address insignificant risks in a high level of detail, and whether a risk is classified as a key risk or not is a matter of judgment for the auditor.

**Relevant ISAs**

There are many references throughout the ISAs to audit risk, but perhaps the two most important audit risk-related ISAs are as follows:

**ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs*** ISA 200 sets out the overall objectives of the auditor, and the standard explains the nature and scope of an audit designed to enable an auditor to meet those objectives. References to audit risk are frequently made by ISA 200, and the standard also requires that the auditor shall plan and perform an audit with professional scepticism, recognising that circumstances might exist that may cause the financial statements to be materially misstated. Professional scepticism is defined as an attitude that includes a questioning mind and a critical assessment of evidence.

**ISA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*** ISA 315 deals with the auditor’s responsibility to identify and assess the risks of material misstatement in the financial statements through an understanding of the entity and its environment, including the entity’s internal controls and risk assessment process. The first version of ISA 315 was originally published in 2003 after a joint audit risk project had been carried out between the IAASB, and the United States Auditing Standards Board. Changes in the audit risk standards have arguably been the single biggest change in auditing standards in recent years, so the significance of ISA 315, and the topic of audit risk, should not be underestimated by auditing students.

The requirements of ISA 315 are summarised in the following table.

|  |  |
| --- | --- |
| **(1)**. The auditor shall perform risk assessment procedures in order to provide a basis for the identification and assessment of the risks of material misstatement.  **(2)**. The auditor is required to obtain an understanding of the entity and its environment, including the entity’s internal control systems.  **(3)**. The auditor shall identify and assess the risks of material misstatement, and determine whether any of the risks identified are, in the auditor’s judgement, significant risks. This is in order to provide a basis for designing and performing further audit procedures.  **(4)**. ISA 330 then deals with the required responses to assessed risks. |  |

Block: Text

Let us consider each of these four stages in more detail.

**1. Risk assessment procedures** ISA 315 gives an overview of the procedures that the auditor should follow in order to obtain an understanding sufficient to assess audit risks, and these risks must then be considered when designing the audit plan. ISA 315 goes on to require that the auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. ISA 315 goes on to identify the following three risk assessment procedures:

***Making inquiries of management and others within the entity*** Auditors must have discussions with the client’s management about its objectives and expectations, and its plans for achieving those goals.

***Analytical procedures*** Analytical procedures performed as risk assessment procedures should help the auditor in identifying unusual transactions or positions. They may identify aspects of the entity of which the auditor was unaware, and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.

***Observation and inspection*** Observation and inspection may also provide information about the entity and its environment. Examples of such audit procedures can potentially cover a very broad area, including observation or inspection of the entity’s operations, documents, and reports prepared by management, and also of the entity’s premises and plant facilities.

ISA 315 requires that risk assessment procedures should, at a minimum, comprise a combination of the above three procedures, and the standard also requires that the engagement partner and other key engagement team members should discuss the susceptibility of the entity’s financial statements to material misstatement. Key risks can be identified at any stage of the audit process, and ISA 315 requires that the engagement partner should also determine which matters are to be communicated to those engagement team members not involved in the discussion.

**2. Understanding an entity** ISA 315 gives detailed guidance about the understanding required of the entity and its environment by auditors, including the entity’s internal control systems. Understanding of the entity and its environment is important for the auditor in order to help identify the risks of material misstatement, to provide a basis for designing and implementing responses to assessed risk (see reference below to ISA 330, *The Auditor’s Responses to Assessed Risks*), and to ensure that sufficient appropriate audit evidence is collected. Given that the focus of this article is audit risk, however, students should ensure that they also make themselves familiar with the concept of internal control, and the components of internal control systems.

**3. Identification and assessment of significant risks and the risks of material misstatement** In exercising judgement as to which risks are significant risks, the auditor is required to consider the following:

* Whether the risk is a risk of fraud.
* Whether the risk is related to recent significant economic, accounting or other developments, and therefore requires specific attention.
* The complexity of transactions.
* Whether the risk involves significant transactions with related parties.
* The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.
* Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

**4. ISA 330 and responses to assessed risks** The requirements of ISA 330, *The Auditor’s Responses to Assessed Risks*, will be covered in a future article, but essentially ISA 330 gives guidance about the nature and extent of the testing required, based on the risk assessment findings.

**Audit risk and business risk**

For the purposes of the F8 exam, it is important to make a distinction between audit risk and business risk (which is not examinable in F8), even though ISA 315 itself does not make such a distinction clear. ISA 315(2) defines business risk as follows:

*‘A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity’s ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.’*

Hence, business risk is a much broader concept than audit risk. Students are reminded that business risk is excluded from the FAU and F8 syllabus, although it is examinable in P7.

**The audit risk model**

Finally, it is important to make reference to the so called traditional audit risk model, which pre-dates ISA 315, but continues to remain important to the audit process. The audit risk model breaks audit risk down into the following three components:

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

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

***Detection risk*** This is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. The interrelationship of the three components of audit risk is outside the scope of this current article. F8 students, however, will typically be expected to have a good understanding of the concept of audit risk, and to be able to apply this understanding to questions in order to identify and describe appropriate risk assessment procedures.

**The UK and Ireland perspective**

The UK Auditing Practices Board announced in March 2009 that it would update its auditing standards according to the clarified ISAs, and that these standards would apply for audits of accounting periods ending on or after 15 December 2010. UK and Irish students should note that there are no significant differences on audit risk between ISA 315 and the UK and Ireland version of the standard.

**Conclusions**

The concept of audit risk is of key importance to the audit process and F8 students are required to have a good understanding of what audit risk is, and why it is so important. For the purposes of the F8 exam, it is important to understand that audit risk is a very practical topic and is therefore examined in a very practical context. Any definition or explanation of the audit risk model itself will usually only be allocated a small number of marks, but many students still include such definitions in answers to case study and scenario questions which require a practical application of audit risk assessment procedures. Students must also be prepared to apply their understanding of audit risk to questions and come up with appropriate risk assessment procedures.

**Written by a member of the F8 examining team**

**References**

* **AUDITING IN A COMPUTER-BASED ENVIRONMENT (2)**

*Relevant to Foundation level Paper FAU and ACCA Qualification Papers F8 and P7 (Int and UK)* **The accounting systems of many companies, large and small, are computer-based; questions in all ACCA audit papers reflect this situation.** Students need to ensure they have a complete understanding of the controls in a computer-based environment, how these impact on the auditor’s assessment of risk, and the subsequent audit procedures. These procedures will often involve the use of computer-assisted audit techniques (CAATs). The aim of this article is to help students improve their understanding of this topic by giving practical illustrations of computer-based controls and computer-assisted techniques and the way they may feature in exam questions. **Relevant auditing standards** References will be made throughout this article to the most recent guidance in standards:

* ISA 300 (Redrafted) Planning an Audit of Financial Statements
* ISA 315 (Redrafted) Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment
* ISA 330 (Redrafted) The Auditor’s Responses to Assessed Risks.

**Internal controls in a computer environment** The two main categories are application controls and general controls. **Application controls** These are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorised and are completely and accurately recorded and processed (ISA 315 (Redrafted)). Application controls apply to data processing tasks such as sales, purchases and wages procedures and are normally divided into the following categories: *(i) Input controls* Examples include batch control totals and document counts, as well as manual scrutiny of documents to ensure they have been authorised. An example of the operation of batch controls using accounting software would be the checking of a manually produced figure for the total gross value of purchase invoices against that produced on screen when the batch-processing option is used to input the invoices. This total could also be printed out to confirm the totals agree. The most common example of programmed controls over the accuracy and completeness of input are edit (data validation) checks when the software checks that data fields included on transactions by performing:

* reasonableness check, eg net wage to gross wage
* existence check, eg that a supplier account exists
* character check, eg that there are no alphabetical characters in a sales invoice number field
* range check, eg no employee’s weekly wage is more than $2,000
* check digit, eg an extra character added to the account reference field on a purchase invoice to detect mistakes such as transposition errors during input.

When data is input via a keyboard, the software will often display a screen message if any of the above checks reveal an anomaly, eg ‘Supplier account number does not exist’. (ii) Processing controls An example of a programmed control over processing is a run-to-run control. The totals from one processing run, plus the input totals from the second processing, should equal the result from the second processing run. For instance, the beginning balances on the receivables ledger plus the sales invoices (processing run 1) less the cheques received (processing run 2) should equal the closing balances on the receivable ledger. (iii) Output controls Batch processing matches input to output, and is therefore also a control over processing and output. Other examples of output controls include the controlled resubmission of rejected transactions, or the review of exception reports (eg the wages exception report showing employees being paid more than $1,000). (iv) Master files and standing data controls Examples include one-for-one checking of changes to master files, eg customer price changes are checked to an authorised list. A regular printout of master files such as the wages master file could be forwarded monthly to the personnel department to ensure employees listed have personnel records. **General controls** These are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, mini-frame and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

* data centre and network operations
* system software acquisition, change and maintenance
* program change
* access security
* application system acquisition, development, and maintenance (ISA 315 (Redrafted))

‘End-user environment’ refers to the situation in which the users of the computer systems are involved in all stages of the development of the system.

*(i) Administrative controls* Controls over ‘data centre and network operations’ and ‘access security’ include those that:

* prevent or detect errors during program execution, eg procedure manuals, job scheduling, training and supervision; all these prevent errors such as using wrong data files or wrong versions of production programs
* prevent unauthorised amendments to data files, eg authorisation of jobs prior to processing, back up and physical protection of files and access controls such as passwords
* ensure the continuity of operations, eg testing of back - up procedures, protection against fire and floods.

*(ii) System development controls* The other general controls referred to in ISA 315 cover the areas of system software acquisition development and maintenance; program change; and application system acquisition, development and maintenance. ‘System software’ refers to the operating system, database management systems and other software that increases the efficiency of processing. Application software refers to particular applications such as sales or wages. The controls over the development and maintenance of both types of software are similar and include:

* Controls over application development, such as good standards over the system design and program writing, good documentation, testing procedures (eg use of test data to identify program code errors, pilot running and parallel running of old and new systems), as well as segregation of duties so that operators are not involved in program development
* Controls over program changes – to ensure no unauthorised amendments and that changes are adequately tested, eg password protection of programs, comparison of production programs to controlled copies and approval of changes by users
* Controls over installation and maintenance of system software – many of the controls mentioned above are relevant, eg authorisation of changes, good documentation, access controls and segregation of duties.

*Exam focus* Students often confuse application controls and general controls. In the June 2008 CAT Paper 8 exam, Question 2 asked candidates to provide examples of application controls over the input and processing of data. Many answers referred to passwords and physical access controls – which are examples of general controls – and thus failed to gain marks. **Computer-assisted audit techniques** Computer-assisted audit techniques (CAATs) are those featuring the ‘application of auditing procedures using the computer as an audit tool’ ( Glossary of Terms ). CAATs are normally placed in three main categories:

*(i) Audit software* Computer programs used by the auditor to interrogate a client’s computer files; used mainly for substantive testing. They can be further categorised into:

* Package programs (generalised audit software) – pre-prepared programs for which the auditor will specify detailed requirements; written to be used on different types of computer systems
* Purpose-written programs – perform specific functions of the auditor’s choosing; the auditor may have no option but to have this software developed, since package programs cannot be adapted to the client’s system (however, this can be costly)
* Enquiry programs – those that are part of the client’s system, often used to sort and print data, and which can be adapted for audit purposes, eg accounting software may have search facilities on some modules, that could be used for audit purposes to search for all customers with credit balances (on the customers’ module) or all inventory items exceeding a specified value (on the inventory module).

Using audit software, the auditor can scrutinise large volumes of data and present results that can then be investigated further. The software consists of program logic needed to perform most of the functions required by the auditor, such as:

* select a sample
* report exceptional items
* compare files
* analyse, summarise and stratify data.

The auditor needs to determine which of these functions they wish to use, and the selection criteria. *Exam focus* Sometimes, questions will present students with a scenario and ask how CAATs might be employed by the auditor. Question 4 in the December 2007 Paper F8 exam required students to explain how audit software could be used to audit receivables balances. To answer this type of question, you need to link the functions listed above to the normal audit work on receivables. Students should refer to the model answer to this question. The following is an example of how this could be applied to the audit of wages:

* Select a random sample of employees from the payroll master file; the auditor could then trace the sample back to contracts of employment in the HR department to confirm existence
* Report all employees earning more than $1,000 per week
* Compare the wages master file at the start and end of the year to identify starters and leavers during the year; the auditor would then trace the items identified back to evidence, such as starters’ and leavers’ forms (in the HR department) to ensure they were valid employees and had been added or deleted from the payroll at the appropriate time (the auditor would need to request that the client retain a copy of the master file at the start of the year to perform this test)
* Check that the total of gross wages minus deductions equates to net pay.

*(ii) Test data* Test data consists of data submitted by the auditor for processing by the client’s computer system. The principle objective is to test the operation of application controls. For this reason, the auditor will arrange for dummy data to be processed that includes many error conditions, to ensure that the client’s application controls can identify particular problems. Examples of errors that might be included:

* supplier account codes that do not exist
* employees earning in excess of a certain limit
* sales invoices that contain addition errors
* submitting data with incorrect batch control totals.

Data without errors will also be included to ensure ‘correct’ transactions are processed properly. Test data can be used ‘live’, ie during the client’s normal production run. The obvious disadvantage with this choice is the danger of corrupting the client’s master files. To avoid this, an integrated test facility will be used (see other techniques below). The alternative (dead test data) is to perform a special run outside normal processing, using copies of the client’s master files. In this case, the danger of corrupting the client’s files is avoided – but there is less assurance that the normal production programs have been used. *(iii)    Other techniques* There are increasing numbers of other techniques that can be used; the main two are:

* Integrated test facility – used when test data is run live; involves the establishment of dummy records, such as departments or customer accounts to which the dummy data can be processed. They can then be ignored when client records are printed out, and reversed out later.
* Embedded audit facilities (embedded audit monitor) – also known as resident audit software; requires the auditor’s own program code to be embedded into the client’s application software. The embedded code is designed to perform audit functions and can be switched on at selected times or activated each time the application program is used. Embedded facilities can be used to: –  Gather and store information relating to transactions at the time of processing for subsequent audit review; the selected transactions are written to audit files for subsequent examination, often called system control and review file (SCARF) –  Spot and record (for subsequent audit attention) any items that are unusual; the transactions are marked by the audit code when selection conditions (specified by the auditor) are satisfied. This technique is also referred to as tagging.

The attraction of embedded audit facilities is obvious, as it equates to having a perpetual audit of transactions. However, the set-up is costly and may require the auditor to have an input at the system development stage. Embedded audit facilities are often used in real time and database environments. **Impact of computer-based systems on the audit approach** The fact that systems are computer-based does not alter the key stages of the audit process; this explains why references to the audit of computer-based systems have been subsumed into ISAs 300, 315 and 330. *(i) Planning* The Appendix to ISA 300 (Redrafted) states ‘the effect of information technology on the audit procedures, including the availability of data and the expected use of computer - assisted audit techniques’ as one of the characteristics of the audit that needs to be considered in developing the overall audit strategy. *(ii) Risk assessment* 'The auditor shall obtain an understanding of the internal control relevant to the audit.’ (ISA 315 (Redrafted)) The application notes to ISA 315 identify the information system as one of the five components of internal control. It requires the auditor to obtain an understanding of the information system, including the procedures within both IT and manual systems. In other words, if the auditor relies on internal control in assessing risk at an assertion level, s/he needs to understand and test the controls, whether they are manual or automated. Auditors often use internal control evaluation (ICE) questions to identify strengths and weaknesses in internal control. These questions remain the same – but in answering them, the auditor considers both manual and automated controls. For instance, when answering the ICE question, ‘Can liabilities be incurred but not recorded?’, the auditor needs to consider manual controls, such as matching goods received notes to purchase invoices – but will also consider application controls, such as programmed sequence checks on purchase invoices. The operation of batch control totals, whether programmed or performed manually, would also be relevant to this question. *(iii) Testing* ‘The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level.’ (ISA 330 (Redrafted)) This statement holds true irrespective of the accounting system, and the auditor will design compliance and substantive tests that reflect the strengths and weaknesses of the system. When testing a computer information system, the auditor is likely to use a mix of manual and computer-assisted audit tests. **‘Round the machine (computer)’ v ‘through the machine (computer)’ approaches to testing** Many students will have no experience of the use of CAATs, as auditors of clients using small computer systems will often audit ‘round the machine’. This means that the auditor reconciles input to output and hopes that the processing of transactions was error-free. The reason for the popularity of this approach used to be the lack of audit software that was suitable for use on smaller computers. However, this is no longer true, and audit software is available that enables the auditor to interrogate copies of client files that have been downloaded on to a PC or laptop. However, cost considerations still appear to be a stumbling block. In the ‘through the machine’ approach, the auditor uses CAATs to ensure that computer - based application controls are operating satisfactorily. **Conclusion** The key objectives of an audit do not change in a computer environment. The auditor still needs to obtain an understanding of the system in order to assess control risk and plan audit work to minimise detection risk. The level of audit testing will depend on the assessment of key controls. If these are programmed controls, the auditor will need to ‘audit through the computer’ and use CAATs to ensure controls are operating effectively. In small computer-based systems, ‘auditing round the computer’ may suffice if sufficient audit evidence can be obtained by testing input and output. **Written by a member of the Paper F8 examining team**

* **MASSAGING THE FIGURES**

**A survey of audit committee members attending the 4th Annual Audit Committee Issues Conference, published by KPMG in 2008(1), identified the increased risk of earnings management as a top concern. For auditors, it is certainly the case that there is an increased risk of earnings management or even fraudulent financial reporting in the financial statements of those companies affected by the global economic downturn.**

**What is ‘earnings management’?**

Earnings management occurs when companies deliberately manipulate their revenues and/or expenses in order to inflate (or deflate) figures relating to profits and earnings per share. In other words, it is when companies use ‘creative accounting’ to construct reported figures that show the position and performance that management want to show. Unfortunately, earnings management is not uncommon. Preparers of financial information (the finance director or financial controller, for example) are often under pressure from other members of the senior management team to present a certain level of profitability. This is especially the case in today’s economic climate, when a company’s revenue may have reduced significantly due to market factors, or if profit is being eroded by significant expenses arising from asset impairments or other exceptional losses.

Earnings management does not always mean that the applicable financial reporting framework has not been followed. Earnings management is often described as ‘bending the rules’. It may be that the manipulation of published figures is the result of selecting an accounting policy which is allowed under the financial reporting framework, but which does not reflect economic reality. For example, changing the estimated life of a non-current asset is allowed under financial reporting standards, but if it is done purely to manipulate the depreciation charge (and therefore earnings), then it becomes an example of earnings management.

The problem for the auditor is that financial reporting standards allow a degree of flexibility in application, and all financial statements will include balances and disclosures that are subject to judgment and estimations. This means that it is sometimes difficult to decide if an accounting treatment is within accepted accounting principles, or whether the treatment is in breach of the rules – in which case it represents fraudulent financial reporting.

**When does earnings management become fraud?**

Fraudulent financial reporting is a deliberate misstatement in the financial statements. It can include the deliberate falsification of underlying accounting records, intentionally breaching an accounting standard, or knowingly omitting transactions or required disclosures in the financial statements. For example, deliberately not disclosing a contingent liability, or significant going concern problems, in the notes to the financial statements means that the disclosures required (under IAS 37 and IAS 1 respectively) have intentionally not been made. According to ISA 240 (Redrafted), *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, this is an example of fraudulent financial reporting.

ISA 240 (Redrafted) states that ‘incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to reach financial goals can be significant’. It can therefore be seen that in times of financial difficulty, such as the current economic downturn, management may feel pressurised into the non‑disclosure of items that may detract from the company’s performance during the year, or into the use of accounting policies which produce deliberately misstated results for the year.

Earnings management and fraudulent financial reporting are discussed more fully in an article in *Student Accountant*(2), which can be found on the ACCA website.

**What are the implications to the auditor?**

**Professional scepticism** ISA 240 (Redrafted) stresses the importance of approaching the audit with a degree of professional scepticism, an attitude which should be heightened if there is a suspicion of fraudulent financial reporting.

**Discussion among the audit team** In accordance with ISA 315, *(Redrafted) Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*, ISA 240 (Redrafted) re-emphasises the fact that the audit team should have a discussion about those factors that indicate that the financial statements may be susceptible to misstatement due to fraud.

**Evaluation of accounting policies** When assessing the risk of fraudulent financial reporting, particular attention should be paid to the selection and application of accounting policies. Particular attention should focus on those policies relating to complex transactions, and to subjective matters. All accounting policies and estimates should be carefully reviewed for potential bias. The circumstances resulting in any bias may represent a risk of misstatement due to a fraudulent financial reporting.

**Completeness of disclosures** In difficult economic times, management may be tempted to hide information which may raise concerns about the company’s performance. The auditor must therefore consider whether all relevant information has been disclosed in the financial statements in compliance with accounting standards.

**Audit report** In cases where financial statements appear to have been misstated due to earnings management or fraudulent financial reporting, the auditor should carefully consider the implications for the audit report. The problem for the auditor will be to decide whether any earnings management is within generally accepted accounting principles (and so, therefore, the financial statements are fairly presented), or whether it is so aggressive that it is in breach of accepted accounting practice and therefore fraudulent. A breach of financial reporting principles resulting from the misapplication of accounting standards will result in a disagreement and thus a potential qualification of the audit opinion.

**Reporting to those charged with governance** Instances of fraudulent financial reporting should be communicated to those charged with governance on a timely basis. The relevant audit procedures necessary to complete the audit should also be discussed.

**Other reporting responsibilities** ISA 240 (Redrafted) indicates that where fraud has occurred, the auditor should consider other reporting responsibilities, such as communications with regulatory and enforcement authorities. In many jurisdictions, it would also be appropriate to communicate with shareholders, for example at a general meeting of members.

**Conclusion**

Current global economic circumstances mean that auditors face increased audit risk. Preparers of financial statements have the motive to make the published accounts appear as good as possible, and the means to do this is earnings management or fraudulent financial reporting. Auditors therefore need to conduct risk assessment and audit procedures carefully, in order to fully identify indicators of manipulation, and to gather sufficient evidence to decide whether any manipulation is the result of bending or breaking financial reporting rules, for which the ultimate consequence may be a qualified audit opinion. Auditors, as well as shareholders, may need to approach all companies’ financial statements with an increased degree of scepticism in the current climate.

**Written by a member of the P7 examining team**

**References**

* Recession-Related Risks, a Top Concern for Audit Committees, KPMG Audit Committee Institute Survey, 2008.

Namasiku L, Earnings Management, *Student Accountant*, April 2004.

* **ISA 240 (REDRAFTED) - AUDITORS AND FRAUD**

**Relevant to ACCA Qualification papers F8 and P7**

**This article examines the definitions given by International Standard on Auditing (ISA) 240 (Redrafted) of fraud and error, and the historical expectations of the audit role. It also defines the extent of auditor responsibilities for the prevention and detection of fraud, including the need for professional scepticism and discussion among the engagement team. The article then summarises the key risk assessment procedures required of auditors by ISA 240 (Redrafted), and concludes that the traditional ‘watchdog not bloodhound’ philosophy regarding the extent of auditor responsibilities for fraud detection is no longer valid in the context of the requirements of the redrafted ISA.**

Fraud is a highly controversial area, and the extent of auditor responsibility for the prevention and detection of fraud has generated considerable discussion in recent years. This article aims to summarise the current extent of auditor responsibilities for fraud, as per the requirements of ISA 240 (Redrafted), *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*. ISA 240 (Redrafted) was issued in December 2006 and is effective for audits of financial statements for periods beginning on or after 15 December 2008. The International Auditing and Assurance Standards Board (IAASB) Clarity Project was launched in 2004 in order to encourage greater use of its standards and to facilitate the process of translation of standards into other languages. ISA 240 is described by the IAASB Handbook (reference 1) as ‘redrafted’ because it has been revised in the past few years and is not in need of further revision by the Clarity Project. As a result, the ‘clarified’ version of ISA 240 is the same as the redrafted version. See the IAASB Handbook, and the section ‘Background Information on the Clarity Project of the IAASB’ for further details (reference 2).

**Background**

The traditional ‘passive philosophy’ towards auditor responsibility for fraud detection is well summarised by the Lord Justice Lopes’ ruling, in the UK, given in the 1896 Kingston Cotton Mill case (re Kingston Cotton Mill Company (No.2)): *‘An auditor is not bound to be a detective, or … to approach his work with suspicion, or with a foregone conclusion that there is something wrong. He is a watchdog, not a bloodhound.’* (Reference 3). **Watchdogs and Bloodhounds** (below) gives formal definitions of a ‘watchdog’ and a ‘bloodhound’.

Clearly, auditing has changed considerably since 1896, although auditor responsibility for fraud detection has remained a low priority. We now consider the requirements of the recently revised audit standard regarding the role of the auditor and fraud detection, and then form a conclusion about the current extent of auditor responsibility for fraud detection.

**The difference between fraud and error**

The key distinguishing factor between fraud and error is whether the underlying action that results in a misstatement of the financial statements is intentional or unintentional. The term ‘fraud’ is a broad legal concept, but the auditor is concerned with fraud that causes a material misstatement in the financial statements. ISA 240 (Redrafted) defines fraud as: *‘An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.’* ISA 240 (Redrafted), paragraph 11.

The two types of fraud most relevant to the auditor, according to ISA 240 (Redrafted), are misstatements arising from fraudulent financial reporting, and misstatements arising from the misappropriation of assets. By way of contrast to fraud, the term ‘error’ refers to an unintentional misstatement in financial statements, including the omission of an amount or a disclosure. ISA 240 (Redrafted) says: *‘The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.’* ISA 240 (Redrafted), paragraph 2.

The emphasis of this article is on fraud, because fraud responsibilities are more controversial than error. Fraud may involve sophisticated and carefully organised schemes, designed to conceal fraudulent activity, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. However, in order to better understand error, more consideration of internal control effectiveness is required.

**ISA 240 (redrafted) and responsibilities for fraud**

ISA 240 (Redrafted) makes it clear who has the main responsibility for the prevention and detection of fraud: *‘The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.’* ISA 240 (Redrafted) paragraph 4.

ISA 240 (Redrafted) also goes on to state, however, that: *‘An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.’* ISA 240 (Redrafted), paragraph 5.

Hence, both the entity itself and the auditors have responsibilities for fraud and error. It could be said that management, and those charged with governance, have the **primary responsibility** for fraud and error, whereas the auditor has a **secondary responsibility**. It is important, however, to ensure that the extent of these secondary responsibilities are clearly understood, which is the area discussed in the rest of this article.

**Professional scepticism**

ISA 200 (Revised and Redrafted), *Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs*, requires the auditor to maintain an attitude of professional scepticism: *‘The auditor shall plan and perform an audit with professional scepticism, recognising that circumstances may exist that cause the financial statements to be materially misstated.’* ISA 200 (Revised and Redrafted), paragraph 15.

ISA 200 (Revised and Redrafted) describes professional scepticism as: *‘An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.’* ISA 200 (Revised and Redrafted), paragraph 13 (l).

ISA 240 (Redrafted) further requires that: *‘The auditor is responsible for maintaining an attitude of professional scepticism throughout the audit.’* ISA 240 (Redrafted), paragraph 8.

Professional scepticism is of key importance to the audit, for example requiring auditors to be alert to:

* audit evidence contradicting other  evidence
* information questioning evidence reliability
* conditions that may indicate possible fraud
* circumstances that suggest the need for audit procedures in addition to those required by the ISAs.

**Discussion among the engagement team**

ISA 240 (Redrafted) refers to the requirement in ISA 315 (Redrafted), *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment*, that members of the engagement team discuss the susceptibility of the entity’s financial statements to material misstatement due to fraud. ISA 240 (Redrafted) requires that: *‘This discussion shall place particular emphasis on how and where the entity’s financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.’* ISA 240 (Redrafted), paragraph 15.

Ordinarily, the key members of the engagement team should be involved in the discussion, and the engagement partner should then consider which matters are to be communicated to those in the team not involved in the discussion. Discussion is expected to occur with a questioning mind, setting aside any beliefs held by the engagement team members that the management and those charged with governance are honest and have integrity. Interestingly, this discussion is also expected to include a consideration of how an element of unpredictability will be incorporated into the nature, timing, and extent of the audit procedures to be performed.

**ISA 240 (redrafted) risk assessment procedures**

ISA 240 (Redrafted) requires that the auditor performs risk assessment procedures to obtain information for use in identifying the risks of material misstatement due to fraud. Paragraphs 17 to 24 of ISA 240 (Redrafted) outline the required risk assessment procedures, which are summarised in the **Risk Assessment Procedures** box below.

**Conclusion**

The redrafting of ISA 240 has allowed for a timely review of audit responsibilities relating to fraud. It should be noted, however, that there are minor differences of emphasis between the requirements of ISA 240 (Redrafted) and the current requirements of ISA (UK and Ireland) 240 The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements, which became effective for periods commencing on or after 15 December 2004. According to ISA 240 (Redrafted) the difference between fraud and error depends upon whether deception has been used, and the distinction between the responsibilities of those charged with governance and auditors for fraud prevention can be described respectively as **primary** and **secondary** responsibilities. Auditors are required, however, to maintain an attitude of professional scepticism throughout the audit, and members of the audit engagement team are required to discuss the susceptibility of the entity’s financial statements to material misstatement due to fraud.

ISA 240 (Redrafted) requires auditors to perform risk assessment procedures to obtain information for use in identifying the risks of material misstatement due to fraud.

Finally, it can be concluded that to describe the audit role as that of a ‘watchdog, not a bloodhound‘ is no longer valid in the context of the requirements of the redrafted and revised ISAs; these negate the traditional ‘passive philosophy’ towards auditor responsibility for fraud detection, marking a significant shift away from a ‘monitoring’ role and towards the requirement for a very keen ‘sense of smell’.

**Written by a Paper F8 exam panel member**

**References**

* *Handbook of International Auditing, Assurance, and Ethics Pronouncements,* Part II, IAASB, 2008 Edition.
* *Background Information on the Clarity Project of the International Auditing and Assurance Standard Board, 2008 Edition*, pages 1 to 4, in Part II of *Handbook of International Auditing, Assurance, and Ethics Pronouncements*, IAASB, 2008 Edition.
* Lord Justice Lopes, *The Law Times*, Volume LXXIV, Court of Appeal, 11 July 1896, quoted in Sarup D, *Watchdog or Bloodhound? The Push and Pull Towards a New Audit Model*, Information Systems Control Journal, Volume 1, 2004.

*Oxford English Dictionary*, [www.askoxford.com](https://www.askoxford.com/)

* **THE IMPORTANCE OF FINANCIAL REPORTING STANDARDS TO AUDITORS**

*Relevant to ACCA Qualification Paper P7* **The *Study Guide* for Paper P7 contains (in Section D1 (iii) (j) Evaluation and review) a list of financial reporting matters which are examinable from the auditor’s point of view. Candidates can expect to be faced with at least one requirement, and most likely several requirements each sitting dealing with such matters. This article provides extra guidance in this area.** The significance of financial reporting standards In an audit of historical financial information, the significance of financial reporting standards cannot be over-emphasised. The opinion ultimately provided at the end of the engagement will state whether, in the auditor’s opinion, the financial statements are fairly presented (or show a true and fair view). A fundamental issue that must be considered in order to reach this opinion is whether the financial statements have been prepared in compliance with the relevant financial reporting framework. In other words, have the relevant financial reporting standards been followed by the management of the entity when preparing the financial statements? The technical correctness of the financial statements is implicit in an unmodified audit opinion. Clearly, the auditor must fully understand the relevant financial reporting standards to be able to reach an opinion as to whether they have been complied with. This is why the Paper P7 exam will test, on a regular basis, the matters which an auditor must consider with regard to a variety of financial reporting issues. **How much knowledge needs to be retained from previous papers?** There are a large number of financial reporting standards examinable for this paper. Because Paper P7 follows on from Paper P2, *Corporate Reporting*, all examinable financial reporting standards for Paper P2 are eligible for testing in Paper P7 questions. However, exposure drafts and discussion papers examinable in Paper P2 will not be tested in Paper P7. There is therefore a lot of assumed knowledge with regard to financial reporting standards. Candidates should be aware that in the context of Paper P7 questions they will be expected to retain a basic understanding of the key principles of financial reporting standards. This means that candidates should remember key definitions, recognition criteria, measurement rules and disclosure requirements, in sufficient detail to be able to discuss the financial reporting treatment of an item from the auditor’s point of view. Candidates will be aware of the large number of financial reporting standards, and it is fair to say that some of the standards are more examinable in Paper P7 than others. The first two Paper P7 exams have examined fairly straightforward financial reporting issues, as the transition from the old to the new syllabus meant that candidates attempting Paper P7 in the first two sittings would not necessarily have knowledge of the full range of standards examined in Paper P2. Financial reporting issues tested so far include: research and development, revenue recognition, provisions, inventory valuation, related party transactions, discontinued operations, impairment of assets, investment cost, and consolidation issues. All of these have associated financial reporting standards. Now that the transitional phase is over, more challenging financial reporting matters are likely to be examined (as well as the type of matters already seen in the exam). The financial reporting issues which pose particular problems for the auditor are those that call for complex or subjective accounting treatments, and which create an inherent risk that the financial statements are prone to contain a material misstatement. It is helpful to categorise financial reporting issues into those which require a more detailed level of knowledge, and those for which less detailed knowledge will be expected. **Likely to be examined in detail**

* Recognition and valuation of tangible and intangible non-current assets including initial and subsequent measurement, revaluations, impairments, and investment properties.
* Leasing transactions including sale and leaseback arrangements.
* Financial instruments – particularly classification and subsequent measurement.
* Share-based payment arrangements, including equity-settled and cash-settled schemes.
* Deferred tax balances – recognition of deferred tax assets and liabilities, and their measurement.
* Employee benefits – defined contribution and defined benefit plans, including the basic principles of measurement, and the treatment of actuarial gains and losses.
* Discontinued operations and held for sale assets.
* Provisions (including decommissioning provisions and provisions associated with restructuring) and contingent liabilities and assets.
* Revenue recognition.
* Related party transactions.
* Events after the reporting date.
* Business combinations – particularly the cost of investment and calculation of goodwill, and determination of the status of an investment.

**Likely to be examined in less detail**

* Inventory and receivables valuations.
* Cash flow statements.
* Reporting operating (segmental) information.
* Earnings per share.
* Financial instruments – hedging and derivatives.
* Changes in accounting policy.
* Government grants and assistance.
* Construction contracts.

Marks will be available on the marking scheme for reference to relevant financial reporting standards, though the amount of marks for simply referring to the name and number of relevant standard will be restricted. Most marks will be for demonstrating an understanding of a financial reporting issue, and its relevance to the audit. **What are the impacts of financial reporting issues for the auditor?** The auditor should consider financial reporting issues throughout an audit. Therefore, question scenarios involving these matters could be based in the planning phase, the evidence gathering period, or during the completion stage when the audit opinion is being evaluated. Each of these stages of the audit is discussed in turn below. ***The planning phase*** At this initial stage of the audit, the auditor will use risk assessment techniques to assess the client’s business and financial statements for potential problem areas. One type of risk that the auditor will assess is financial statement risk. Financial statement risk is the risk that components of the financial statements could be misstated, through inaccurate or incomplete recording of transactions or disclosure. Financial statement risks, therefore, represent potential errors or deliberate misstatements in the published accounts of a business. Financial statement risks could lead to a balance being over or understated in value, or could result in an item being recognised when it should not be, or vice versa, the non-recognition of an item which should be recognised. In addition, financial statement risk could lead to an item being recognised at an inappropriate time, or in incorrect presentation or disclosure of a matter. Clearly, the auditor must understand financial reporting standard requirements in order to assess the risk of an item being recognised, measured, or disclosed incorrectly. For an example of how this issue could be tested see Paper P7 June 2008 Q1 (bii) which requires an assessment of financial statement risks in relation to potential litigation and demolition of property, plant and equipment. ***Gathering evidence*** The second type of question that could feature financial reporting standards deals with the stage of the audit when the auditor is gathering evidence. Auditors need to gather sufficient, appropriate evidence regarding financial reporting issues. Of course, one of the matters for which the auditor needs to gather evidence is in relation to compliance with financial reporting standards. A common question requirement here will ask the candidate to ‘comment on the matters to be considered’ in relation to a financial reporting issue. Usually, a second, related requirement will ask the candidate to suggest relevant audit procedures. For an example of this type of question requirement, see Paper P7 June 2008 Q3 (b). Some financial reporting matters are considered to be relatively hard to audit, and, in some cases, a particular International Standard on Auditing (ISA) has been issued to provide guidance to the auditor on such matters. An example is ISA 550, *Related Parties*, which provides guidance for the auditor on the subject of auditing related party transactions. These are the kind of matters which are likely to feature regularly in the exam, so candidates should pay particular attention to financial reporting matters which are the subject of specific ISAs (see ISAs 540–570). An example of a question featuring this type of financial reporting matter can be seen in Paper P7 June 2008 Q3 (a). Candidates must pay close attention to the wording of question requirements. Questions which ask candidates to ‘comment on the matters which should be considered’ will feature regularly in the exam. Typical matters which should be considered by the auditor in the context of a financial reporting issue may include, for example: whether the financial reporting issue is relatively complex, or whether the financial reporting issue is subjective, necessitating the use of significant judgement. The existence of either increases the inherent risk that a balance or transaction will be materially misstated the specific requirements of any relevant financial reporting standard, in terms of the recognition, measurement, or presentation or disclosure of the item, and whether, in the context of the scenario, it appears that the requirements have been followed or not the materiality of the item in question, bearing in mind that materiality should be assessed from a quantitative and a qualitative viewpoint the wider impact of an issue on the financial statements, for example, consider the implication of a matter to all of the primary financial statements, and disclosure needed in the notes to the financial statements. Candidates may also be required to consider only one aspect of a financial reporting matter, so care must be taken to restrict the answer to the specific requirement. For example, Paper P7 December 2007 Q2 (bii) required candidates to ‘describe the evidence you would seek to support the assertion that development costs are technically feasible’. It is important to follow the instructions being given, in other words, to only discuss matters relevant to technical feasibility, and not to deviate into discussions of other, irrelevant matters. (Many candidates in answering this question discussed, for example, the commercial viability of the product in question, and whether the entity intended to use or sell the product, neither comment answered the question as set.) Similarly, candidates should make an effort to discuss only the specific balance or transaction required. As an example, Paper P7 June 2008 Q2 (bi) required the explanation of audit procedures appropriate for the carrying value of an investment. Many answers, however, incorrectly focused on the audit of the goodwill arising on consolidation, which was irrelevant to the question requirement. ***Reaching an audit opinion*** The ultimate impact of financial reporting issues is in arriving at the audit opinion. The auditor must decide whether the financial statements prepared by management comply with relevant standards, and if they do not, the auditor needs to consider the impact on the audit opinion. A non-compliance with standards leading to a material misstatement in the financial statements will result in an opinion modified due to disagreement, which could be an ‘except for’ qualification, or an adverse opinion. For an example of a question in this area, see Paper P7 December 2007 Q5 (a). On discovering a material breach of financial reporting standards, the auditor should bring the matter to the attention of those charged with governance. This is to highlight the seriousness of the issue, and to ensure that those charged with governance have full awareness of the technical issues involved, and can therefore make an informed decision with regard to amending the financial statements. **CONCLUSION** There is a wide range of financial reporting standards which are potentially examinable, and candidates should be aware that a lack of knowledge of these standards, which is assumed from previous exams, will put their performance in Paper P7 at a disadvantage. Candidates should be conversant with the key aspects of all examinable financial reporting standards, but should focus their attention on the key financial reporting matters outlined above. Ultimately, an auditor of historical financial information cannot hope to perform a quality audit in the absence of a detailed knowledge and understanding of financial reporting standards, which is why such matters will regularly feature in the exam. Well-prepared candidates can score very highly in such questions by demonstrating their knowledge of a financial reporting matter, but more importantly, applying that knowledge to the issue faced by the auditor in the question scenario provided. **Written by a member of the Paper P7 examining team**

* **FORENSIC AUDITING**

*Relevant to ACCA Qualification Paper P7* **This article explores some of the issues relevant to forensic investigations.** ‘Forensic auditing’ covers a broad spectrum of activities, with terminology not strictly defined in regulatory guidance. Generally, the term ‘forensic accounting’ is used to describe the wide range of investigative work which accountants in practice could be asked to perform. The work would normally involve an investigation into the financial affairs of an entity and is often associated with investigations into alleged fraudulent activity. Forensic accounting refers to the whole process of investigating a financial matter, including potentially acting as an expert witness if the fraud comes to trial. Although this article focuses on investigations into alleged frauds, it is important to be aware that forensic accountants could be asked to look into non-fraud situations, such as the settling of monetary disputes in relation to a business closure or matrimonial disputes under insurance claims. The process of forensic accounting as described above includes the ‘forensic investigation’ itself, which refers to the practical steps that the forensic accountant takes in order to gather evidence relevant to the alleged fraudulent activity. The investigation is likely to be similar in many ways to an audit of financial information, in that it will include a planning stage, a period when evidence is gathered, a review process, and a report to the client. The purpose of the investigation, in the case of an alleged fraud, would be to discover if a fraud had actually taken place, to identify those involved, to quantify the monetary amount of the fraud (ie the financial loss suffered by the client), and to ultimately present findings to the client and potentially to court. Finally, ‘forensic auditing’ refers to the specific procedures carried out in order to produce evidence. Audit techniques are used to identify and to gather evidence to prove, for example, how long the fraud has been carried out, and how it was conducted and concealed by the perpetrators. Evidence may also be gathered to support other issues which would be relevant in the event of a court case. Such issues could include:

* the suspect’s motive and opportunity to commit fraud
* whether the fraud involved collusion between several suspects any physical evidence at the scene of the crime or contained in documents
* comments made by the suspect during interviews and/or at the time of arrest
* attempts to destroy evidence.

**TYPES OF INVESTIGATION** The forensic accountant could be asked to investigate many different types of fraud. It is useful to categorise these types into three groups to provide an overview of the wide range of investigations that could be carried out. The three categories of frauds are corruption, asset misappropriation and financial statement fraud. **Corruption** There are three types of corruption fraud: conflicts of interest, bribery, and extortion. Research shows that corruption is involved in around one third of all frauds.

* In a conflict of interest fraud, the fraudster exerts their influence to achieve a personal gain which detrimentally affects the company. The fraudster may not benefit financially, but rather receives an undisclosed personal benefit as a result of the situation. For example, a manager may approve the expenses of an employee who is also a personal friend in order to maintain that friendship, even if the expenses are inaccurate.
* Bribery is when money (or something else of value) is offered in order to influence a situation.
* Extortion is the opposite of bribery, and happens when money is demanded (rather than offered) in order to secure a particular outcome.

**Asset misappropriation** By far the most common frauds are those involving asset misappropriation, and there are many different types of fraud which fall into this category. The common feature is the theft of cash or other assets from the company, for example:

* Cash theft – the stealing of physical cash, for example petty cash, from the premises of a company.
* Fraudulent disbursements – company funds being used to make fraudulent payments. Common examples include billing schemes, where payments are made to a fictitious supplier, and payroll schemes, where payments are made to fictitious employees (often known as ‘ghost employees’).
* Inventory frauds – the theft of inventory from the company.
* Misuse of assets – employees using company assets for their own personal interest.

**Financial statement fraud** This is also known as fraudulent financial reporting, and is a type of fraud that causes a material misstatement in the financial statements. It can include deliberate falsification of accounting records; omission of transactions, balances or disclosures from the financial statements; or the misapplication of financial reporting standards. This is often carried out with the intention of presenting the financial statements with a particular bias, for example concealing liabilities in order to improve any analysis of liquidity and gearing. **CONDUCTING AN INVESTIGATION** The process of conducting a forensic investigation is, in many ways, similar to the process of conducting an audit, but with some additional considerations. The various stages are briefly described below. **Accepting the investigation** The forensic accountant must initially consider whether their firm has the necessary skills and experience to accept the work. Forensic investigations are specialist in nature, and the work requires detailed knowledge of fraud investigation techniques and the legal framework. Investigators must also have received training in interview and interrogation techniques, and in how to maintain the safe custody of evidence gathered. Additional considerations include whether or not the investigation is being requested by an audit client. If it is, this poses extra ethical questions, as the investigating firm would be potentially exposed to self-review, advocacy and management threats to objectivity. Unless robust safeguards are put in place, the firm should not provide audit and forensic investigation services to the same client. Commercial considerations are also important, and a high fee level should be negotiated to compensate for the specialist nature of the work, and the likely involvement of senior and experienced members of the firm in the investigation. **Planning the investigation** The investigating team must carefully consider what they have been asked to achieve and plan their work accordingly. The objectives of the investigation will include:

* identifying the type of fraud that has been operating, how long it has been operating for, and how the fraud has been concealed
* identifying the fraudster(s) involved
* quantifying the financial loss suffered by the client
* gathering evidence to be used in court proceedings
* providing advice to prevent the reoccurrence of the fraud.

The investigators should also consider the best way to gather evidence – the use of computer assisted audit techniques, for example, is very common in fraud investigations. **Gathering evidence** In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed. The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered. It is important that the investigating team is skilled in collecting evidence that can be used in a court case, and in keeping a clear chain of custody until the evidence is presented in court. If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s). Evidence can be gathered using various techniques, such as:

* testing controls to gather evidence which identifies the weaknesses, which allowed the fraud to be perpetrated
* using analytical procedures to compare trends over time or to provide comparatives between different segments of the business
* applying computer assisted audit techniques, for example to identify the timing and location of relevant details being altered in the computer system
* discussions and interviews with employees
* substantive techniques such as reconciliations, cash counts and reviews of documentation.

The ultimate goal of the forensic investigation team is to obtain a confession by the fraudster, if a fraud did actually occur. For this reason, the investigators are likely to avoid deliberately confronting the alleged fraudster(s) until they have gathered sufficient evidence to extract a confession. The interview with the suspect is a crucial part of evidence gathered during the investigation. **Reporting** The client will expect a report containing the findings of the investigation, including a summary of evidence and a conclusion as to the amount of loss suffered as a result of the fraud. The report will also discuss how the fraudster set up the fraud scheme, and which controls, if any, were circumvented. It is also likely that the investigative team will recommend improvements to controls within the organisation to prevent any similar frauds occurring in the future. **Court proceedings** The investigation is likely to lead to legal proceedings against the suspect, and members of the investigative team will probably be involved in any resultant court case. The evidence gathered during the investigation will be presented at court, and team members may be called to court to describe the evidence they have gathered and to explain how the suspect was identified. It is imperative that the members of the investigative team called to court can present their evidence clearly and professionally, as they may have to simplify complex accounting issues so that non-accountants involved in the court case can understand the evidence and its implications. **CONCLUSION** In summary, a forensic investigation is a very specialist type of engagement, which requires highly skilled team members who have experience not only of accounting and auditing techniques, but also of the relevant legal framework. There are numerous different types of fraud that a forensic accountant could be asked to investigate. The investigation is likely to ultimately lead to legal proceedings against one or several suspects, and members of the investigative team must be comfortable with appearing in court to explain how the investigation was conducted, and how the evidence has been gathered. Forensic accountants must therefore receive specialist training in such matters to ensure that their credibility and professionalism cannot be undermined during the legal process.

**Written by a member of the Paper P7 examining team**

* **AUDITORS' REPORTS TO THOSE CHARGED WITH GOVERNANCE**

*Relevant to ACCA Qualification Paper P7*

When considering the reporting ‘outputs’ of an audit of historical financial information, attention is usually focused on the report issued by the auditors to shareholders, which contains the audit opinion. However, there is another important reporting ‘output’ produced as a result of the audit process – the auditor’s communication to those charged with governance. This short article outlines the main features of this communication and summarises the requirements of ISA 260, *Communication of Audit Matters With Those Charged With Governance*, and the UK equivalent, ISA 260 (UK and Ireland), *Communication of Audit Matters With Those Charged With Governance*.

Auditors are required by ISA 260 to communicate audit matters of governance interest to those charged with governance. It is important that those charged with governance have an understanding of all significant issues that have arisen from the audit process.

**Relevant persons**

The first step is to consider to whom the communication should be directed. ISA 260 does not specify this exactly, but states that ‘governance is the term used to describe the role of persons entrusted with the supervision, control and direction of an entity’. This implies that the communication should be with the highest level of management, including the executive and non-executive directors, and the audit committee, where relevant. The identity of the relevant person(s) to whom the communication will be addressed may be clarified in the engagement letter.

**Matters to be communicated** In the second step, the auditor should consider the type of issues that should be communicated. ISA 260 provides some guidance as to the matters which ordinarily could be incorporated in the communication, including:

* the overall approach and scope of the audit, including any limitations on the scope of the audit
* the accounting policies, and any changes to them, that could materially affect the financial statements
* adjustments arising as a result of audit procedures which could materially impact the financial statements
* material events or uncertainties which could jeopardise the going concern status, and which require disclosure within the financial statements
* disagreements with management over accounting treatments or disclosures
* any expected modifications to the audit report
* material weaknesses discovered in the internal systems and controls.

All of the above are referred to as ‘findings from the audit’ (also often called ‘management letter points’).

The reason for communicating such matters is to ensure that the auditors have brought them to the attention of the people responsible for the accounting and financial reporting function of the entity. Those responsible can then discuss the matters and decide any actions that need to be taken in respect of them. For example, if the management of the entity was totally unaware of the matters regarding control weaknesses, it then has the opportunity to implement corrective action. It could also be the case that the management lacks technical knowledge; for example, it may not be appreciated that a specific accounting policy is in breach of acceptable accounting practice. Again, armed with information from the auditor, management can then resolve the problem by deciding on a new accounting policy.

It is important that material errors found in the financial statements are highlighted to management; if they are left uncorrected, the audit opinion will be modified. Management must be made aware of this and given the opportunity to correct the financial statements if necessary, in order to avoid a modified audit report.

**Other relevant matters to be communicated** The communication to those charged with governance should not just contain findings from the audit, but should cover the range of issues related to the audit, which the auditor may want to raise with management. Such matters may include:

* details of any threats to independence and objectivity, and of any safeguards adopted
* explanations of the audit approach used (for example, the concept of materiality and its application to the audit process)
* a summary of business risks identified, including an assessment of the likelihood of the risks materialising
* a review of the contents of the management’s representation letter
* recommendations, where relevant, to help improve the entity’s internal systems and controls.

**The timing and form of communication** The auditor should communicate matters to those charged with governance on a timely basis, in order for management to react to the matters raised as soon as possible. Findings from the audit relevant to the accounting and financial reporting function should be communicated before the approval of the financial statements by management. This means that material errors can be corrected by management prior to the audit report being issued, thus avoiding a modification of the report.

ISA 260 discusses the various forms that the communication should take. In most cases, the communication will be in writing, and in the UK and Ireland this is a requirement of the standard. A communication should be issued even if there are no matters that the auditor wishes to bring to the attention of those charged with governance, stating that there are no significant findings from the audit to be communicated.

Outside the UK and Ireland, the communication could be made orally. In this situation, it is important that the auditor has a written record within the audit working papers of the discussion of significant matters with management.

Whichever method is used to formally communicate the matters, oral or written, the process should be seen as a two-way dialogue. Management should have the opportunity to respond to the auditor regarding the matters raised.

**Conclusion**

The communication with those charged with governance should be viewed as a crucial reporting ‘output’ of the audit. It allows management to be informed of significant matters arising from the audit process, and allows management the chance to respond to the auditor regarding these matters, and to take action to improve the accounting and financial reporting function of the entity.

**Written by a member of the Paper P7 examining team**

* **GROUP AUDIT ISSUES**

*Relevant to ACCA Qualification Paper P7*

In October 2007, the International Auditing and Assurance Standards Board issued International Standard on Auditing (ISA) 600 (Revised and Redrafted), Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors). As ISA 600 is a fairly lengthy document, this article summarises only some of its sections. In addition, it is important to appreciate that ISA 600 does not cover all of the issues relevant in a group audit situation, and that the auditor or assurance provider must consider a wide variety of issues, including detailed financial reporting standards, and issues currently being debated within the profession.

**ISA 600 (revised and redrafted), special considerations – audits of group financial statements (including the work of component auditors)**

**Definitions**

The group auditor is responsible for providing the audit opinion on the group financial statements. Components of the group financial statements can include subsidiaries, associates, joint ventures, and branches. The components may be audited by the group auditor, but may instead be audited by a different firm of auditors known as the ‘component auditors’, also known as the ‘other auditor’. The term component auditor is introduced by the revised and redrafted ISA 600. This article focuses on the objectives and responsibilities of the group auditor.

**Objectives**

The objective of the group auditor is twofold. First, the group auditor should establish that it is appropriate to act as group auditor. Second, the group auditor should gather sufficient and appropriate evidence in order to reach an opinion on the consolidated financial statements. This article focuses on the second of these two objectives.

It is useful to consider the process by which the group financial statements are produced before considering the group auditor’s objectives in relation to evidence. This three-stage process is summarised in Figure 1.

**Stage one – gathering evidence on the components**

**Planning and risk assessment**

It is imperative that the group auditor has a good understanding of the structure of the group, the significance (ie materiality) of each component of the group, the mechanics of the consolidation process, and the risk of material misstatement presented by each of the company’s financial statements. Materiality levels should be established for the group in aggregate, and for the individually significant components.

**Involvement in the work of component auditors**

In a group, it is likely that some companies will be audited by a different firm of auditors. The group auditor has two issues to resolve. First, the group auditor cannot simply rely on another auditor’s opinion on the financial statements of the company. In other words, if the other auditor has concluded that the financial statements of the component are free from material misstatement, the group auditor should not just rely on this opinion and assume that the figures taken from the company’s financial statements into the consolidated financial statements are correct. A material misstatement in the financial statements of a company could become a material misstatement in the financial statements of the group.

For all companies within the group, regardless of materiality, the group auditor should review a report of work done by the component auditor. This report of work done could be in the form of an executive summary, or a memorandum of audit issues arising from the audit of the company. Alternatively, the group auditor may issue a questionnaire, to be completed by the component auditor, which would highlight key issues arising from the audit of the component. Following this review, the group auditor will need to decide on the extent of any further actions which need to be taken, or any further work which needs to be carried out, in order to ensure that the financial statements are free from material misstatement. Such actions could include:

* a review of the component auditor’s overall audit strategy
* performing a risk assessment at the company level
* participating in closing meetings with the component auditor and the management of the company
* a review of relevant parts of the component auditor’s audit working papers.

Where a company is material to the group financial statements, the group auditor should carry out further actions, including:

* discussing with the component auditor, and/or the management of the company, the business activities that are significant to the group
* discussing with the component auditor the susceptibility of the company’s financial statements to material error or deliberate misstatement
* reviewing the component auditor’s documentation of identified significant risks, and the conclusions reached on these risks.

It may be the case that, having performed the actions outlined above, the group auditor concludes that further audit work is required on the financial statements of a company, or that a memorandum of audit issues arising from the audit of the company is needed. For example, the group auditor may consider that an element of the financial statements of the company could be materially misstated, and that further audit evidence is necessary. The group auditor should determine the nature of the work necessary, and whether the work should be carried out by the group auditor or the component auditor. Having taken the actions outlined above, the group auditor should now have obtained sufficient evidence to show that the individual company financial statements are free from material misstatement, and are a sound basis for the preparation of the consolidated financial statements.

**Stage two – auditing the consolidation**

**The consolidation process**

The group auditor must plan the audit procedures to be performed on the consolidation process. For some groups, the consolidation will be complex and is likely to involve some areas of judgement, and so there is a high degree of audit risk. Thorough planning will be essential to ensure that audit risk is minimised. The types of audit procedures that could be performed include:

* checking that figures taken into the consolidation have been accurately extracted from the financial statements of the components
* evaluating the classifications of the components of the group – for example, whether the components have been correctly identified and treated as subsidiaries, associates, or joint ventures
* reviewing the disclosures necessary in the group financial statements, such as related party transactions and minority interests
* investigating the treatment of any components which have a different financial year end from that of the rest of the group
* gathering evidence appropriate to the specific consolidation adjustments made necessary by financial reporting standards, including, for example: – the calculation of goodwill and its impairment review – cancellation of inter-company balances and transactions – provision for unrealised profits as a result of inter-company transactions – fair value adjustments needed for assets and liabilities held by the component – re-translation of financial statements of components denominated in a foreign currency.

Some of the evidence required to meet the above objectives will be gathered by the component auditor, and it is the group auditor’s responsibility to communicate to the component auditor the evidence that they are expected to gather. This communication ideally occurs at the audit planning stage. The group auditor must have a sound knowledge of the relevant financial reporting standards, which include:

* IFRS 3, *Business Combinations*
* IAS 28, *Investments in Associates*
* IAS 31, *Interests in Joint Ventures*
* IAS 32, *Financial Instruments: Presentation*
* IAS 39, *Financial Instruments: Recognition and Measurement*.

Candidates are advised that, for the purposes of study for Paper P7, they must be very familiar with the above financial reporting standards. Particularly important are the accounting regulations relating to subsidiaries regarding goodwill, inter-company transactions, and fair value adjustments, as well as the financial reporting implications on the acquisition and disposal of a subsidiary. Candidates must also be aware of the principles of accounting for associates, joint ventures, and foreign subsidiaries. It is also important to remember that the parent company’s individual financial statements will contain balances and transactions pertinent to the components of the group. The parent company’s statement of financial position (balance sheet) will carry the investments as non-current assets, and the statement of comprehensive income is likely to contain dividend receipts and other group transactions. The auditor expressing an opinion on the parent company’s individual financial statements must gather sufficient appropriate evidence regarding these items, paying particular attention to the carrying value of the investments. Candidates are reminded that IFRS 3 contains detailed guidance on the treatment of group investments, particularly on the calculation of the cost of investment.

**Stage three – issuing the group audit opinion**

The group auditor issues an opinion on the consolidated financial statements. This is done after a thorough review of all evidence gathered in the first and second stages.

**Other matters relevant to a group audit situation**

**Joint auditing**

A joint audit is when two audit firms are appointed to jointly provide an audit opinion on a set of financial statements. This is becoming increasingly common, especially in group audits, where a component may be audited by both the group auditor and another auditor. The main benefit of this type of arrangement is that when a new component is acquired by the group, for example the acquisition of a new subsidiary, it is advantageous to keep the subsidiary’s existing audit firm, which will have built up considerable knowledge and experience of the business of the component. However, the group auditor will also need to build up knowledge of the new subsidiary’s business, and also become familiar with the audit methods and procedures used by the other auditor. One way for this to happen is for the group auditor to be appointed, along with the other auditor, to jointly provide the audit opinion on the individual financial statements of the subsidiary. The two firms will work together to plan the audit, gather evidence, review the work done, and to finally provide the opinion.

Other benefits from a joint audit may include better availability of resources and the provision of a higher quality audit, as there will be access to staff from both firms of auditors. The inclusion of members of staff from the group audit firm within the audit team of the subsidiary should also improve the efficiency of the audit of the consolidation process.

However, it may be difficult for the two firms to work together if they use different audit methods and it may take time to develop a ‘joint audit’ approach. There will also be cost implications for the client, as it will presumably be more expensive to use two firms of auditors to provide an audit opinion instead of one.

Joint auditing has been the subject of some debate within the profession in recent times. This is largely because it is seen as a way for small and medium-sized audit firms to continue to be involved in the audit of their client once the client has been acquired by another company. Prior to the emergence of the joint audit, it would have been most likely for the existing auditor (especially if a small or medium-sized audit firm) to be replaced by the group auditor (likely to be a larger audit firm) as the provider of the audit opinion on the individual financial statements.

As more and more companies become acquisition targets, it can be seen that if this practice were to continue, the small and medium-sized audit firms would continue to lose audit clients to the larger audit firms, and would be left with few clients to provide a source of income. Therefore, in the interests of maintaining revenue streams for small and medium-sized audit firms, and in the interests of competition in the audit profession, joint auditing is an important current issue, and will continue to be debated for the foreseeable future.

**Conclusion**

Group audits raise a variety of issues. The group structure can be complex and the existence of numerous components within the group means that there may be several firms of auditors involved. The group auditor must ensure that the group audit is carefully planned and that communications with other auditors are made early in the audit process. The group auditor needs to gather two types of evidence. Evidence regarding individual components of the group may be gathered using a joint audit arrangement, though this is not without disadvantages. Evidence on the consolidation process must be thorough, and planned with regard to numerous complex financial reporting standards.

**Written by a member of the Paper P7 examining team**

**Reference**

ISA 600 (Revised and Redrafted), *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, IAASB, October 2007.

* **EXAMINING EVIDENCE**

*Relevant to Professional Scheme Papers 2.6 and 3.1 and new ACCA Qualification Papers F8 and P7* **Questions in auditing exams on audit procedures are very common. This article considers the difference between audit procedures and audit evidence and techniques for deciding on relevant audit evidence in a variety of circumstances.**

**Audit procedures versus audit evidence**

Audit procedures are actions that auditors carry out during the audit. Paper 2.6 questions typically ask candidates to describe audit procedures, also known as ‘audit tests’ or ‘audit work’.

Audit evidence is obtained by the auditor as a result of the audit procedure. For example, ‘performing a circularisation of receivables/debtors’ is an audit procedure, whereas ‘replies from customers’ is audit evidence. It is very important to be aware of the difference. If a question asks for audit evidence and candidates state audit procedures, then the question hasn’t been answered, and gains no marks.

**Which of the following are procedures and which are evidence?**

* Inspecting non-current/fixed assets for signs of obsolescence
* An item of inventory/stock that is present at the inventory/stock count
* A bank statement
* Counting petty cash
* A working paper showing a re-calculation of depreciation
* A sales invoice
* Attending a wages pay out.

**Answer**

Items 1, 4 and 7 are procedures (because procedures are actions, notice the use of verbs such as ‘inspecting’, ‘counting’, and ‘attending’). The other items are evidence, as they are the result of audit procedures.

However, note that the phrasing is ‘state the audit evidence that you should expect to find in undertaking your review of the audit working papers and financial statements’. Item 5 meets this criterion because it is a working paper, but items 3 and 6 are not necessarily included in audit working papers, so one would need to phrase the answer in such a way as to make this clear. For example, one could say ‘a copy sales invoice’ and ‘a copy bank statement with the balance cross-referenced to the bank reconciliation’.

Item 2 is definitely not evidence normally seen in working papers, since it is an item of physical inventory/stock. This could be rephrased as ‘a schedule showing items test-counted at the inventory/stock count’ to make it into a correct answer.

**Identifying appropriate audit evidence**

Substantive testing questions can be quite tricky, as they can cover a range of accounting standards, and therefore are more varied than questions on topics such as inventory/stock, receivables/debtors, payables/creditors, or non-current/fixed assets.

Candidates need to be able to think on their feet and develop a ‘sensible answer’ approach to a wide variety of questions, even if they have never considered the subject previously. One way to do this is to use the financial statement assertions as a starting point.

The financial statement assertions are those assertions that are implicit or implied when the directors make an explicit statement that the financial statements give a true and fair view. In other words, they are attributes of the financial statements that must be true if the financial statements are to give a true and fair view.

Assertions include completeness (all assets, liabilities, transactions, and events are included) and valuation (assets and liabilities are included at an appropriate carrying value). Auditors design their audit programmes to ensure – as far as possible – that each of these assertions are true, in order to gain evidence that proves that the financial statements give a true and fair view.

Using the assertions as a starting point to answer a question can be useful if the question is general – for example ‘describe how you would audit leases’. Candidates could consider what assertions are relevant to leases and then describe audit tests and/or evidence (depending on the question) to prove each of these assertions.

**Example**

You are the manager in charge of the audit of Yummy Mummy Co., a listed company with a European-wide chain of fashion stores for babies and expectant mothers. The audit for the year ended 30 September 2006 is nearing completion. The draft financial statements show a profit before tax of $50.6m (2005: $95.3m).

The audit senior has produced a schedule of ‘Points for the attention of the audit manager’ as follows:

**(a)** Due to the falling birth rate, the performance of the stores in Italy has been worse than expected. An impairment review was performed on 15 October 2006, treating the Italian stores as a single cash-generating unit, which indicated that the recoverable amount of the assets (based on value in use) was $23m lower than the carrying value. (6 marks)

**(b)** The company self-manufactures many of its clothing lines, and has a factory in Manchester, UK. Research has shown that the company could achieve substantial cost savings by outsourcing to south east Asia, and the factory in Manchester is to be closed. A provision of $3.2m to cover redundancy costs has been included in the 2006 draft financial statements. (7 marks)

**(c)** The company is planning to open 20 new stores in south east Asia in the next year. To assist in financing the expansion, the company sold a number of its properties on 28 September 2006 for $200m and leased them back under operating leases. (7 marks)

**Required:**

For each of the above points: **(i)**Comment on the matters that you should consider; and **(ii)** State the audit evidence that you should expect to find, in undertaking your review of the audit working papers and financial statements of Yummy Mummy Co. (20 marks)

The mark allocation is shown against each of the three points.

**Formulating an answer**

Note the format of the question. There are three mini-case studies, and for each the candidate has to (i) comment on the matters that should be considered and (ii) state audit evidence. As this article is about audit evidence, we will only consider Part (ii) of the question. However, the examiner has given guidance on how she wants candidates to answer Part (i), and has said that matters to consider will normally include risk, materiality, and accounting treatment. In many answers, there is also a requirement to comment on the type of audit report that would be needed if the company refuses to amend an erroneous treatment.

**Deciding on audit evidence**

For each scenario:

* Think about how the accountant would have calculated the numbers in the financial statements, the source documents used and the systems followed, and then write about the documents etc, that one would expect to see.
* Think about how to verify the other relevant facts in each case.
* Consider the accounting/disclosure requirements of each scenario, and say how one can check if they are being met.

Remember, as the question is about evidence, not procedures, I would advise candidates to begin their answers to each part with the words ‘I would expect to see’, and then list out the evidence as bullet points. This should stop candidates talking about procedures. Here is an example answer – the bracketed text in italics is not part of the answer, but simply explanation where required. *(a) (Accounting issues in this scenario are subsequent events (adjusting) and impairment.)* I would expect to see:

* extracts from the management accounts showing the performance of the Italian stores compared to budget, and the most recent budget for 2007
* a copy of the board minutes detailing management’s plans to improve performance or to sell the stores (if performance continues to be poor it could affect going concern, if stores are to be sold they may need to be re-categorised as assets held for sale)
* a schedule comparing the carrying value of the assets with the recoverable amount, annotated to show that carrying value has been agreed to the non-current/fixed assets register, and that any allocation of central assets and goodwill was reasonable
* a completed audit programme for non-current/fixed assets (as the appropriateness of the value of the assets has already been checked during the audit of non-current/fixed assets, there is no need to check it again)
* a calculation of value in use, annotated to show that the cash flows have been compared with budgets for 2007 and beyond, and with actual cash flows (to see if they are reasonable).

*(b) (The obvious accounting issue is provisions, but issues which are not mentioned – but which are potentially relevant – include assets held for sale and discontinued operations.)* I would expect to see:

* a copy of the announcement of the restructuring (has to be before the year end in order for a provision to be made)
* a working paper detailing whether redundancy payments are being made in accordance with contractual, statutory, or constructive obligations, and how the constructive obligations, if any, have been derived (in some countries, companies are required under statute to pay certain levels of compensation to redundant employees)
* a schedule detailing the amount to be paid to each redundant employee. This schedule should be annotated to show that all relevant employees have been included and that the calculations have been checked for a sample of employees, including agreement of their pay/service to their contracts where relevant
* a point in the management representation letter as to any other costs to be provided for in closing the factory (eg penalties for cancellation of leases) a point in the management representation letter detailing whether the factory is to be sold or abandoned (if a decision is made to sell, then assets are valued as assets held for sale, but not if it is to be abandoned)
* a copy of the invitation to tender for the outsourcing contract, and notes of discussions with management as to how the manufacturer was selected and how quality is to be assured.

*(c) (Candidates need to focus on checking whether the leaseback is really an operating lease rather than a finance lease.)* I would expect to see:

* a copy of the leasing contract
* a schedule comparing the present value of the minimum lease payments with the fair value of the leased assets
* a note comparing the length of the lease with the estimated useful life of the assets, and stating whether Yummy Mummy Co. is responsible for maintenance and insurance
* a schedule calculating the amounts that should appear in the financial statements, if the audit team believes this to be a finance lease
* an estimate of the carrying value of the assets at the date of sale, if the lease is an operating lease (if selling price is not fair value, it affects how profit on sale is recognised)
* a point in the management representation letter on the purchaser of these properties, and whether they are related to Yummy Mummy Co. and, if necessary, a draft of the related party disclosures that will appear in the financial statements.

This is just one possible answer – there are many other valid points that could be made. Notice that this sample answer reflects the three points mentioned above:

* Evidence to show that the accountant has worked out the figures correctly (eg the calculation of the redundancy payment, the calculation of value in use).
* Evidence to prove other relevant facts (eg performance in Italy, outsourcing contract, lease agreement).
* Evidence to prove that accounting standards have been complied with (eg date of closure announcement, comparison of payments, fair value of leased assets).

**Connie Richardson is a lecturer at FTC Kaplan in Singapore**

* **AUDIT WORKING PAPERS**

This article is about audit working papers. Auditors should prepare and organise their working papers in a manner that helps the auditor carry out an appropriate audit service. The auditor should avoid preparing or accumulating unnecessary working papers, and should therefore avoid making extensive copies of the client’s accounting records. It is worth noting at this stage that it is neither necessary nor practicable for the auditor to document every matter considered during the audit. Audit documentation needs to be understood for both *Audit and Assurance* (AA) and *Advanced Audit and Assurance* (AAA).

**The auditing standards**

ISA 230, *Audit Documentation* states that the objective (1) of the auditor is to prepare documentation that provides:

* A sufficient and appropriate record of the basis for the auditor’s report, and
* Evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.

The auditor should prepare the audit documentation on a timely basis and in such a way so as to enable an experienced auditor, having no previous connection with the audit, to understand:

* The nature, timing, and extent of the audit procedures performed to comply with ISAs and applicable legal and regulatory requirements
* The results of the audit procedures and the audit evidence obtained, and
* Significant matters arising during the audit, the conclusions reached and significant judgments made in reaching those conclusions.

In documenting the nature, timing, and extent of audit procedures performed, the auditor should record the identifying characteristics of the specific items or matters being tested. The auditor should document discussions of significant matters with management and others on a timely basis. If the auditor has identified information that contradicts or is inconsistent with the auditor’s final conclusion regarding a significant matter, the auditor should document how the auditor addressed the contradictions or inconsistency in forming the final conclusion. Where, in exceptional circumstances, the auditor judges it necessary to depart from a basic principle or an essential procedure that is relevant in the circumstances of the audit, the auditor should document how the alternative audit procedures performed achieve the objective of the audit, and, unless otherwise clear, the reasons for the departure. In documenting the nature, timing, and extent of audit procedures performed, the auditor must record:

* The identifying characteristics of the specific items or matters tested
* Who performed the audit work and the date such work was completed, and
* Who reviewed the audit work and the date and extent of such review (2).

The auditor should complete the assembly of the final audit file on a timely basis after the date of the auditor’s report. After the assembly of the final audit file has been completed, the auditor should not delete or discard audit documentation before the end of its retention period. When the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final file has been completed, the auditor should, regardless of the nature of the modifications or additions, document:

* The specific reasons for making them, and
* When and by whom they were made and reviewed.

When exceptional circumstances arise after the date of the auditor’s report that require the auditor to perform new or additional audit procedures, or that lead the auditor to reach new conclusions, the auditor should document:

* The circumstances encountered
* The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor’s report
* When and by whom the resulting changes to audit documentation were made, and (where applicable) reviewed.

The requirements of the ISA guide the auditor to produce audit documentation that is of an acceptable standard. Understanding and applying the requirements will protect the auditor from unwelcome and unnecessary litigation.

**Importance of working papers**

Working papers are important because they:

* are necessary for audit quality control purposes
* provide assurance that the work delegated by the audit partner has been properly completed
* provide evidence that an effective audit has been carried out
* increase the economy, efficiency, and effectiveness of the audit
* contain sufficiently detailed and
* up-to-date facts which justify the reasonableness of the auditor’s conclusions
* retain a record of matters of continuing significance to future audits.

**Avoiding unnecessary papers**

Before deciding to prepare a particular audit working paper, the auditor should be satisfied that it is:

* necessary either because it will serve an essential or useful purpose in support of the auditor’s report, or because it will provide information needed for tax or other client-related statutory/regulatory purposes
* not practicable for the client staff to prepare the working paper, or for the auditor to make copies of papers that the client staff (including internal auditors) have prepared as part of their normal regular duties.

**Content**

Typically each audit working paper must be headed with the following information:

* The name of the client
* The period covered by the audit
* The subject matter
* The file reference (3)
* The initials (signature) of the member of staff who prepared the working paper, and the date on which it was prepared
* In the case of audit papers prepared by client staff, the date the working papers were received, and the initials of the audit team member who carried out the audit work
* The initials of the member of staff who reviewed the working papers and the date on which the review was carried out
* Each audit paper should meet the characteristics of a good working paper, as detailed later in this article.

**Papers prepared by client**

Certain working papers required by the auditor may have already been prepared by client staff. The auditor should make arrangements, whenever possible, for copies of these to be made available to the audit team. If client staff prepare working papers which are to be retained by the auditor, the auditor should agree the form of the working papers with client staff at an early stage in the audit, and include this information in the audit timetable.

When arranging for working papers to be prepared, the auditor should take care to ensure that the working papers will give all the information required. All such working papers should normally be clearly identified as having been prepared by the client. The member of audit staff directly responsible for an audit area in which working papers prepared by client staff are included should sign those papers – this will show that they have been checked and that they can be reviewed by the manager and the partner, and by subsequent reviewers. The signature of the audit team member indicates that the working paper (prepared by client staff) has been ‘audited’.

**Some characteristics of a good working paper**

On the basis of the discussion above, a good working paper should meet the requirements of ISA 230 by displaying the following characteristics:

* It should state a clear audit objective, usually in terms of an audit assertion (for example, ‘to ensure the completeness of trade payables’).
* It should fully state the year/period end (eg 31 October 20X9), so that the working paper is not confused with documentation belonging to a different year/period.
* It should state the full extent of the test (ie how many items were tested and how this number was determined). This will enable the preparer, and any subsequent reviewers, to determine the sufficiency of the audit evidence provided by the working paper.
* Where there is necessary reference to another working paper, the full reference of that other working paper must be given. A statement that details of testing can be found on ‘another working paper’ is insufficient.
* The working paper should clearly and objectively state the results of the test, without bias, and based on the facts documented.
* The conclusions reached should be consistent with the results of the test and should be able to withstand independent scrutiny.
* The working paper should be clearly referenced so that it can be filed appropriately and found easily when required at a later date.
* It should be signed by the person who prepares it so that queries can be directed to the appropriate person.
* It should be signed and dated by any person who reviews it, in order to meet the quality control requirements of the review.

The reviewer of audit working papers should ensure that every paper has these characteristics. If any relevant characteristic is judged absent, then this should result in an audit review point (ie a comment by the reviewer directing the original preparer to rectify the fault on the working paper).

**Conclusion**

Working papers provide evidence that an effective, efficient, and economic audit has been carried out. They should therefore be prepared with care and skill. They should be sufficiently detailed and complete so that an auditor with no previous experience of that audit can understand the working papers in terms of the work completed, the conclusions reached, and the reasoning behind these conclusions.

**Notes**

* ISA 230 paragraph 5.
* Paragraph 17 of ISA 220 establishes the requirement for the engagement partner to be satisfied that sufficient appropriate audit evidence has been obtained through a review of the audit documentation (and discussion with the engagement team). This does not imply that each specific working paper must include evidence of review, however there must be documentation of what work was reviewed, who reviewed the work and when it was reviewed.

Each audit firm has its own file numbering and referencing system. Within each system, the best way of numbering working papers is to file them serially in each section and to cross-reference them. Where papers are intended to agree with or support items appearing in the financial statements, or in other working papers in the file, the auditor should normally prepare them so as to make such agreements obvious without the necessity of further investigation and reconciliation.

* **ADVANCED AUDIT AND ASSURANCE – EXAMINER’S APPROACH**

This article outlines the approach that will be used to examine *Advanced Audit and Assurance* (AAA), effective from the September 2018 exam session. The article should be read in conjunction with the relevant *Study Guide* and *Syllabus* and list of examinable documents.

**Format of the exam**

A new format is being introduced from September 2018. Please refer to the specimen paper for an example of the format. All questions in the exam will be compulsory from September 2018.

**Section A** Section A will consist of one compulsory Case Study question, for a total of 50 marks, broken down into several requirements. The question scenario will provide a range of detailed information in the form of “exhibits”, and could relate to one or more client companies. The information will come from a variety of sources, and may include, for example, background information about a client, notes of meetings or phone calls held with management of the client company, extracts from financial statements, and extracts from audit working papers.

While the question scenario will be set in the planning phase of an audit, requirements could cover a range of topics, for example relating to evidence, audit quality or ethics. The aim is to place candidates in a 'real world' situation where they would be faced with several very different issues in relation to the one or more clients.

Four professional marks will be available in Section A and will be awarded based on the level of professionalism with which a candidate’s answer is presented, including the structure and clarity of the answer provided.

**Section B** Section B will contain **two compulsory** questions of 25 marks each. Shorter scenarios will be provided as a basis for the Section B requirements. Candidates should ensure that they study the whole syllabus and practice as wide a range of past questions as possible in preparation for the exam, as questions and syllabus topics can no longer be avoided.

One of the Section B questions will always be set in the completion stage of an audit, and could focus on topics including the final review of audit evidence, including evaluation of matters and evidence to support the audit opinion, the audit of going concern and subsequent events, the auditor’s report, and reports to those charged with governance.

The other section B question could cover a range of topics – the only exclusion is that it will not be based on an audit completion scenario.

**Key objectives of the syllabus**

Audit planning and risk assessment will continue to be examined in every sitting, in Section A. Candidates should be aware that 'planning' covers a wide variety of topics, and does not just mean 'risk assessment'. For more clarity in this area it is essential to read the *Syllabus* and *Study Guide* in order to appreciate the breadth of the syllabus in relation to 'planning'. As explained above, planning questions will include wider issues, so candidates might be expected to deal with ethical matters which arise when planning an audit, or issues such as accepting a new audit client.

At each sitting, candidates should also be prepared to tackle requirements relating to obtaining audit evidence. Requirements are likely to focus on specific financial statement balances or transactions, for which candidates will be asked to design the relevant audit procedures. Candidates should ensure that when asked to ‘design’ procedures that they provide the source and purpose for each relevant procedure.

When asked to comment on the 'matters to consider' in the completion phase of an audit, candidates should be aware that one of the key matters to consider is whether the relevant accounting standard has been adhered to, as well as the materiality of the matter, and to consider and explain the audit evidence which should have been obtained in relation to the issue.

Auditor’s reports and reporting to those charged with governance are both important areas. There have been changes in the last few years in relation to auditor’s reports, and it is important that candidates familiarise themselves with the most up to date requirements. It is essential that candidates are confident answering questions on this topic as Syllabus section E will form one of the Section B questions every session.

Ethics and related professional issues are likely to feature in every session, either in Section A or Section B. It is important to appreciate that ethics is not just about independence but also covers ethical issues such as conflicts of interest and confidentiality, as well as fraud and error, and professional liability. Matters such as audit quality and professional scepticism are also important syllabus areas, and candidates should be prepared to evaluate whether an audit has been conducted suitably, including whether the auditor has applied an appropriate level of professional scepticism in a specific situation.

In respect of current issues, candidates should be ready to discuss a current issues topic in the context of the client scenario provided. As current issues can impact on any stage of an audit or assurance engagement, a current issues requirement could feature in either Section A or Section B of the exam.

Candidates should appreciate that they are expected to read around current issues and not rely on manuals from tuition providers. Good quality newspapers, professional journals, as well as ACCA's website, provide sources of information on current developments in audit and assurance. Candidates must not rote learn a provided piece of information on a current issue and then proceed to regurgitate this information verbatim as an answer to an exam requirement. By the time candidates have reached this stage in their professional studies they should take responsibility for developing their own opinion on a current issue, and be able to reach their own conclusion.

**Syllabus changes**

As part of the transition to AAA, the syllabus has been amended. However, no significant syllabus amendments or additions have been made; the syllabus has just been restructured to allow for the proposed coverage as discussed above. Some learning outcomes have been reworded streamline the study guide and make it more user-friendly.

In addition, some of the learning outcome verbs and other wordings have been changed, to better reflect the level of knowledge or application skill that is being tested. For example, candidates will be asked to evaluate audit risks, and to design audit procedures, requirements which better indicate the practical and applied nature of what is required.

**Specific competencies**

AAA is a challenging and mostly practical exam. Candidates must consider carefully whether they have the required competencies when deciding whether to take this option exam. The competencies necessary for a candidate to achieve a clear pass in AAA include:

* a thorough understanding of the relevant audit, assurance and financial reporting regulations that fall within the syllabus
* the ability to apply knowledge to specific client scenarios
* the ability to have an independent opinion, backed up by reasoned argument
* an appreciation of commercial factors which influence practice management
* an appreciation of the fast-moving developments in audit and assurance practices.

Candidates would be ill-advised to choose AAA as an Options exam if they:

* have little or no practical audit experience
* struggled with preceding audit exams
* are unwilling to take responsibility for their own opinions by reading around current issues
* are uncomfortable discussing arguments or reaching opinions.

**Information sources**

Candidates should ensure they are familiar with the wide range of materials available to help them with their studies. In addition to material provided by tuition providers, and ACCA's website, candidates are encouraged, as discussed above, to regularly read up on current issues.

Candidates are encouraged to practise past questions to ensure that that they have good knowledge of the syllabus, are familiar with question requirements and have strong exam technique.

*Student Accountant* will notify you via email from time to time when new technical articles for AAA have been published. Such articles should be considered essential reading, and will cover both exam approach and technical issues from the syllabus.  These articles are also available on the ACCA website and candidates are reminded to visit the site regularly to ensure they are aware of additional resources.

**Conclusion**

Candidates who have practised plenty of past exam questions, who have taken time to read around the syllabus, and who use sensible exam technique on the day of the exam are very likely to secure a pass. This exam should not be approached as a rote learning exercise, but as a chance to show the ability to think logically and practically, reach an opinion, and demonstrate the application of technical issues to a real-world scenario.

**Written by a member of the AAA examining team**

* **HOW TO TACKLE AUDIT AND ASSURANCE CASE STUDY QUESTIONS**

This article provides an insight into the recommended approach for Section A questions in Paper P7, *Advanced Audit and Assurance*. Paper P7 is one of the final options papers, and, as such, will be a demanding and challenging exam, aiming to test whether candidates have the necessary knowledge, application, skills, and judgement to complete their professional qualification. Using good exam technique and having a sensible approach to questions will do much to help secure a clear pass mark. This is the first of a two-part series on approaching Section A questions. The next article – which will be published in the September 2007 issue of student accountant – will include elements of a typical question and illustrate how these should be approached.

The exam will include two questions in Section A, with a combined mark allocation of between 50 and 70 marks. It is likely that the combined total of the two questions will be towards the higher end of this range.

Both Section A questions will be case studies. Detailed information will be provided about a business for which the candidate’s firm is providing an audit or assurance service. The aim of the case study question is to place the candidate in a real-world situation, facing the real-world requirements that an audit or assurance provider would have to deal with. The questions will therefore be practical in nature.

**Case study requirements**

Each case study question will include several separate requirements taken from separate syllabus areas. This mirrors what happens in the real world when, for example, an audit manager planning an assignment needs to consider not only how to plan the work, but also assess the implications of any ethical, practice management, quality control, or current professional issues raised from information provided by the client. At least one of the requirements could be to provide a response to a specific enquiry raised by the client or potential client in the scenario.

The first stage, when attempting a case study question, is to carefully read the requirements and understand exactly what is being asked for. By the time a candidate reaches this final stage in their professional studies it is hoped that they are familiar with the general style of question requirements. However, the wording used is such an important issue that it is worth repeating for the sake of clarity. At the Professional level, requirements are at the highest intellectual level and it is imperative that candidates understand exactly what is being asked.

Generally, requirements ask the candidate to perform an action, as follows:

|  |  |
| --- | --- |
| **Requirement** | **Meaning** |
| Identify | Pick out a relevant issue/point from the scenario |
| Comment on | Offer an opinion, debate a topic, express a reaction |
| Explain | Clarify and provide extra details on a subject matter |
| Evaluate/assess | Weigh up advantages and disadvantages and make a judgement |
| Critically discuss | Consider a subject in depth and come to an opinion |
| Justify | Come to a conclusion and provide a strong argument for a decision |

Block: Text

Candidates should familiarise themselves with exam terminology and tailor their answers accordingly. Taking time to consider the exact wording of the requirement will result in a focused answer which satisfies the question set.

Note that very few marks will be available in Paper P7 for rote-learning and the listing of facts, rules, or pieces of information. Instead, the application of knowledge to the specific scenario provided will score well. For example, a requirement may ask for the  identification and explanation of matters (such as business or financial statement risks). As a general rule, a maximum of one-third of the available marks would be available for identification; the remaining two-thirds would be for the explanation of the matter. It is therefore not possible to pass the question requirement without application to the question scenario.

**Professional marks**

The ACCA Qualification features a core theme of ‘ethics and professionalism’, and all Professional level exams will contain some marks on this topic. In Paper P7, the professional marks will be allocated between the two Section A questions, with a maximum of five marks being available across the two questions. The requirements will clearly state how many marks are available and which question requirement they relate to.

It is likely that Section A requirements containing professional marks will ask for the answer in a particular format, such as a report or briefing notes. The professional marks will be awarded for the following:

* structure and presentation
* clarity of explanation
* use of language appropriate to the addressee
* use of professional judgement
* discussion of both sides of a debate
* appreciation of relevant current professional issues.

**Case study information**

Having read the requirements and understood exactly what has been asked for, the next step is to carefully read through the information provided, all the time bearing in mind the specific instructions given in the requirements.

The information provided in the scenario is likely to be both numeric and narrative, and could come from many different sources, such as:

* extracts from financial statements
* information from management systems
* details taken from working papers
* verbal representations from the client or members of the audit/assurance team
* statements from third parties.

The information in the question will need to be carefully read and it is important that sufficient time is spent digesting and understanding the information provided. Candidates who skim read the information and do not take time to stop and think about the issues raised in the scenario are likely to produce a poorly focused answer which fails to identify the main points.

When reading the case study scenario it is important, therefore, to identify the following:

* What is your role? For example, are you the manager responsible for the audit, or responsible for company-wide matters such as ethics or quality control?
* What is the time scale? Are you planning an assignment prior to the client’s year end, or reviewing working papers at the conclusion of the audit?
* What does the company do? Is it involved in manufacturing, a service industry, or financial services? Does the company operate in a highly-regulated industry?
* What is the key relationship in the scenario? Is the company a long standing or potential client? Is this a one-off or a recurring engagement?

Understanding these basic facts will ensure that candidates approach the question requirements from the correct viewpoint.

When reading through the scenario it is useful to highlight or underline important pieces of information. A lot of time can be wasted by continually re-reading the scenario, so thoroughly reading and annotating the question paper should improve time management. Remember, with reading and planning time now being given at the start of the exam, there should be plenty of time to read the entire scenario carefully.

**Planning and time allocation**

The case study questions will contain at least three discrete requirements. Time must be allocated between the requirements to ensure that each is addressed in sufficient depth. Failing to deal with a requirement obviously reduces the overall mark available for a question, but it also detracts from the quality of the answer as a whole. Remember, within each requirement there will be some relatively easy marks to gain, so by not attempting a requirement these marks are lost.

Is it worthwhile planning the answer? The simple answer is yes, as long as the plan is not too detailed and is then followed. A brief plan of the main points to be covered will keep the focus on the key elements of the requirements, and should avoid digressions into irrelevant matters. A good plan should prioritise the most significant issues. This is important, because if time runs short, key issues will still have been covered. A good plan will also draw out links between different pieces of information provided in the scenario. However, a plan is only worth doing if it enhances the answer. Spending too long on a very detailed plan, resulting in a lack of time to deal with the question requirements in detail, is not a good use of time in the exam. Plans should be very brief, no more than bullet points, and clearly labelled so they can not be confused with the actual answer.

A general comment on time allocation: a common error is to spend too long on the first two questions, leaving very little time for the remaining questions. It is imperative that each question is properly attempted, and that sufficient time is left towards the end of the exam to attempt the final question. Candidates are advised that the quality of the overall script will be reviewed, and students are reminded to attempt the correct number of questions.

**Take time to think**

This may sound obvious, but it is important to take time to think about the requirements, the scenario, and how to answer the question. Rushing to put pen to paper without sitting back to think an answer through is a frequent mistake in exams. The following are common examples of errors caused by not thinking about the facts in the scenario or the question requirement.

Failing to properly read and understand the question requirements could result in:

* not thinking properly about the actual question requirement and then proceeding to answer the requirement inappropriately. Not answering the question set is a major reason for failure. Linked to this, it is apparent that a question requirement is often only read briefly, and that the candidate then goes on to assume that the requirement is identical to requirements from previous exam questions. This will mean failing to answer the specific question set.
* making comments that belong to a different question requirement is a mistake which comes from not looking at the question requirements in their entirety. It is important to look at how the requirements relate to each other to ensure that an answer is logical and comments made do not refer to the wrong answer requirement.

Failing to read the scenario carefully, or failing to think it through, could result in:

* making inappropriate suggestions, as a result of not thinking clearly and professionally about the relationship between the audit/assurance provider and the client. It is imperative that candidates appreciate that Paper P7 examines not just technical concepts, but also the ability to make commercial and professional comments and recommendations. This is one area where stopping and thinking about the relationships between individuals within the scenario is crucial. For example, if the candidate is given the role of an audit manager or partner, it is important not to defer to more junior members of the team. Equally, inappropriate comments to the client must be avoided. For example, the management of the client company should not be ‘asked if they are corrupt’ or ‘asked to prove their technical ability to prepare accounts’. Clearly, such comments detract heavily from the quality of any answer, but can be avoided by thinking carefully about relationships and how they should be managed.
* making wholly inappropriate practical suggestions. For example, asking, as part of audit evidence, to physically verify an asset that has been sold, or requesting sight of a purchase invoice for an item bought many years ago. Think carefully about requests or recommendations and ask whether the request could actually be carried out.
* seeing a word and assuming it means something, when really it means something entirely different – this is a common mistake and results purely from not thinking before writing an answer. For example, if a scenario includes information about fines or penalties, it is important to think about whether the amount has been paid before the year end, and not to automatically assume, without taking time to think about the facts from the scenario, that a provision would be necessary.
* when performing calculations, it is crucial to think about the figures provided in the scenario and to use the correct figure in the right way. For example, when calculating materiality, make sure that the correct benchmark is used. If calculating the materiality of an asset, the materiality calculation should be based on the balance sheet, rather than on revenue as this is totally inappropriate.

**Presenting the answer**

It should go without saying that answers should be clearly presented, as this makes marking much easier. In particular, the following points should be noted:

* Use headings and sub-headings to give the answer a logical flow.
* Bullet points are only appropriate when listing facts which require little explanation, which will be rare in Paper P7.
* Illegible handwriting is a major problem for markers. If handwriting is a particular area of concern, leave a blank line between each line of writing, and write more slowly.
* Start each answer on a new page of the answer booklet.

Remember that some requirements contain professional marks, as discussed earlier, and in these requirements the presentation and layout of the answer is particularly important.

**Conclusion**

This article has focused on the case study questions which will appear in Section A of the Paper P7 exam, but many of the points made could equally apply to the Section B questions. It is hoped that candidates will have already developed good exam technique in order to reach this final stage in their professional exams. However, in every sitting, many relatively easy marks are not gained because of a poor approach to answering questions. It is recommended that candidates practise as many questions as possible in preparation for the exam; bearing in mind the points made in this article while practising questions should improve performance significantly.

**Written by a member of the Paper P7 examining team**

* **AUDIT AND ASSURANCE CASE STUDY QUESTIONS**

The first article in this series of two on Paper P7 case study questions discussed question style, what to look for in the requirements, how higher-level skills are tested, and the meaning of professional marks within a question requirement. This second article goes through part of a typical Section A case study question, applying the recommended approach described in the previous article. This approach comprises four stages.

**Stage 1 – understanding the requirement**

The first thing to do is to read and fully understand the question requirement. Here is the requirement we will be looking at in this article:

*‘Prepare a report, to be used by a partner in your firm, in which you identify and evaluate the professional, ethical, and other issues raised in deciding whether to accept the appointment as provider of an assurance opinion as requested by Petsupply Co.’* (12 marks)

Note: this requirement includes two professional marks.

Having read the requirement, break it down. You are asked to do two things:

* identify, ie state from the information provided
* evaluate, ie discuss from a critical point of view.

The requirement asks you to consider ‘professional, ethical, and other issues’. This could cover a wide range of considerations, such as:

* ethics: independence, competence, conflicts of interest, confidentiality, assessing integrity
* professional issues: the risk profile of the work requested, the fee – and whether it is sufficient to compensate for high risk, availability of staff, managing client expectations, logistical matters such as timing, legal and regulatory matters – such as money laundering, and (in some cases) obtaining professional clearance
* other issues: whether the work ‘fits’ with the commercial strategy of the audit firm, the potential knock-on effect of taking on the work – such as the impact on other clients, or on other work performed for this client.

You are asked to produce a report, so remember that the professional marks available will be awarded for using the correct format, the use of professional business language, and for presenting your comments as a logical flow culminating in a conclusion.

From reading the requirement, you know that the question scenario will be based on a potential assurance assignment and will be broadly based around acceptance issues.

**Stage 2 – reading the scenario**

When reading through the detail of the scenario, you should now be alert to information relevant to this requirement. Highlight important points that you think are relevant to the scenario and remember to focus on issues that could affect your acceptance of a potential assurance assignment.

Now read the following extract from the scenario and highlight the salient points – remember to look out for any factors relevant to the ethical, professional, and other issues described above.

Extract: You are a senior manager in Dyke & Co, a small firm of Chartered Certified Accountants, which specialises in providing audits and financial statement reviews for small to medium-sized companies. You are responsible for evaluating potential assurance engagements, and for producing a brief report on each prospective piece of work to be used by the partners in your firm when deciding whether to accept or decline the engagement. Dyke & Co is keen to expand the assurance services offered, as a replacement for revenue lost from the many small‑company clients choosing not to have a statutory audit in recent years. It is currently May 2007.

Petsupply Co has been an audit client of Dyke & Co for the past three years. The company owns and operates a chain of retail outlets selling pet supplies. The finance director of Petsupply Co recently communicated with your firm to enquire about the provision of an assurance report on data provided in the Environmental Report published on the company’s website. The following is an extract from the e-mail sent to your firm from the finance director of Petsupply Co:

*‘At the last board meeting, my fellow directors discussed the content of the Environmental Report. They are keen to ensure that the data contained in the report is credible, and they have asked whether your firm would be willing to provide some kind of opinion verifying the disclosures made. Petsupply Co is strongly committed to disclosing environmental data, and information gathered from our website indicates that our customers are very interested in environmental matters. It is therefore important to us that Petsupply Co reports positive information which should help to retain existing customers, and to attract new customers. I am keen to hear your views on this matter at your earliest convenience. We would like verification of the data as soon as possible.’*

You have looked at Petsupply Co’s Environmental Report on the company website, and found a great deal of numerical data provided, some of which is shown below in Table 1.

**Table 1: Petsupply Co's environmental report – numerical data**

|  |  |  |  |
| --- | --- | --- | --- |
| **Petsupply Co: environmental key performance indicator (KPI)/target** | **Actual KPI year to 30 April 2007** | **Actual KPI year to 30 April 2006** | **Reason for variance/trend** |
| To spend $1m per annum on developing environmentally-friendly packaging and bags | $1.1m spent on relevant development | $0.75m spent on relevant development | Petsupply Co has more liquid funds available in the year to 2007 to spend on development projects |
| To increase the amount of waste recycled by 10% per annum | 50 tonnes of waste recycled | 25 tonnes of waste recycled | Petsupply Co has doubled the amount of waste recycled due to installation of recycling bins at all  stores |
| To ensure that at least 90% of our customers are ‘very happy’ with Petsupply Co’s environmental policies | 95% ‘very happy’ | 70% ‘very happy’ | Customers complete surveys in store to rate our policies; data shows that customers are extremely happy with our progress on environmental matters |

Block: Text

**Stage 3 – take time to think about the requirement and the scenario**

As discussed in the previous article, you must take time and not rush to answer. When evaluating this particular scenario try to think widely about the information provided. Your answer should cover a broad range of issues rather than concentrating on one or two. Your comments must be tailored to the scenario. It is pointless, for example, to write about a general acceptance issue which is not specifically related to Petsupply Co.

It is important to appreciate that few marks will be available for stating the issue. The higher-level skill marks in this question will be awarded for a discussion of why the issue is relevant to the decision about whether or not to provide the assurance service to Petsupply Co. The requirement is to evaluate the scenario and therefore it is crucial to demonstrate an appreciation that there may be two conflicting sides to the discussion.

Table 2 shows an example of a thought process which identifies the issues and explains why each issue is relevant to the requirement; the issues are shown in the order in which they appear in the question.

**Table 2: Example of a thought process which identifies issues and shows relevance to the requirement**

|  |  |
| --- | --- |
| **Issue from the scenario** | **Why relevant to the requirement** |
| Your firm is keen to provide more assurance services due to loss of income from audit services | The engagement will provide an extra source of revenue, and accepting the assignment fits the commercial strategy of Dyke & Co. But, the firm should not put the fact that it wants more revenue from providing assurance services above the more important consideration of ethical and professional issues, and the overall assessment of the risk attached to the assignment. It will also be important to consider whether the assignment is a one-off engagement or is likely to be an ongoing service. |
| Petsupply Co has been a client for three years | Your firm will already possess good business understanding, which will reduce the risk associated with the engagement, and should also cut down on planning time. However, Dyke & Co must consider various ethical matters, as Petsupply Co is already an audit client, including the appropriateness of providing a non-audit service, and the impact on the level of fees received from an existing client. It is irrelevant to discuss whether there are general threats, such as financial interests in Petsupply Co, as Dyke & Co already provides the audit service, and should therefore already have conducted general ethical clearance. |
| The assurance service requested is to provide an opinion on environmental key performance indicators | This appears to be a very specialist assignment and it is questionable whether a small firm of accountants would possess relevant skills and experience. However, the firm could either spend time and money training staff to perform the assignment, or bring in specialists to perform the work. This would enable Dyke & Co to build up experience in this area, enabling it to provide further services of this type, which fits in with the firm’s commercial strategy. However, whether the skills are developed in house, or bought in, there will be considerable expense involved; Dyke & Co would need to carefully consider the fee charged as the firm will want to recover as much cost as possible. |
| Petsupply Co is keen to disclose positive data in order to maintain customer satisfaction | There is a high inherent risk attached to the environmental data. Petsupply Co has a clear reason to manipulate the data in order to disclose that targets are being met. In deciding whether to accept the assignment, Dyke & Co must consider whether this risk can be reduced to an acceptable level. It may be difficult for Dyke & Co to challenge the directors with confidence about the data, given its lack of experience in this area. |
| Petsupply Co requires a ‘verification’ of the environmental data | The client appears to have an unrealistic expectation of what an assurance service can provide. Before any decision is made about acceptance, Dyke & Co must explain to the client that its report will not verify or certify the data, and is likely to provide at best ‘limited assurance’ over the data – the expectation of the client clearly needs to be managed. |
| Petsupply Co wants the work performed as quickly as possible | As discussed above, Dyke & Co will need to either develop or buy-in expertise in this area, and due to the high inherent risk identified above, the firm will want to spend plenty of time gathering evidence. The client again may have unrealistic expectations about the timeframe in which the opinion could be provided. |
| Some of the data shown in the environmental report is not well defined | It would be relatively easy to gather evidence on the amount spent on development, as this is similar to a substantive audit procedure but it may be hard for Dyke & Co to substantiate if the money has really been spent on environmentally-friendly packaging.  Quantifying how much waste has been recycled will depend on the strength of the system put in place by Petsupply Co to capture the data. Equally, it would be difficult to gather detailed evidence to reach an opinion on customer satisfaction as it is a very subjective measure, not suitable for quantification. All of the above points suggest that the engagement will involve testing some subjective issues, and possibly relying on the controls put in place by the client, both of which have an impact on the overall risk assessment of the work requested. |

Block: Text

Table 2 is not an answer, it is a thought process. This is what you should be thinking about after reading through the scenario. The previous article stressed the importance of thinking through the scenario. It may help to jot these ideas down in an answer plan before making a start on your written answer, as this will help you to prioritise the points and give the report a logical flow.

**Stage 4 – writing the report**

The requirement states that two professional marks are available. As discussed in the previous article, these marks are not for the technical content of the answer, but for the way the relevant points are communicated. The report will be evaluated on the following:

* Use of a report format – a brief introduction, clear separate sections each discussing a different point, and a final conclusion.
* Style of writing – the report is addressed to the partner and so language should be appropriate. You do not need to explain things that would be obvious to a partner, and you must be tactful.
* Clarity of explanation – make sure that each point is explained simply and precisely, and avoid ambiguity.
* Evaluation skills – demonstrate that each point may have a positive and a negative side.

Remember, when answering any question requirement it is quality not quantity that counts. You should make each point succinctly and remain focused on the specific requirement. Questions can be time pressured, but it is important to remember that you should be able to read the requirement, think about it, and write an answer in the time available. This means that there is only a limited amount of time available for actually writing the answer, so keep it short and to the point. Irrelevant waffle earns no marks and will detract from the professional skills evaluation. What follows is an outline report format for this requirement:

**Introduction**

* Report is internal, addressed to a partner, covering proposed assurance service for existing audit client

**Section 1 – ethical matters**

* Provision of non-audit service
* Impact on total fee from client
* Competence to perform work – specialised engagement

**Section 2 – risk-related matters**

* High inherent risk – figures prone to manipulation
* Data highly subjective
* Need to rely on systems put in place by client

**Section 3 – commercial matters**

* Fee will have to be high enough to compensate for high risk
* Fee may need to compensate for specialists if used
* Strategic fit – assignment in line with commercial goals of Dyke & Co
* Build up experience in non-audit service
* Ascertain whether assignment will be recurring

**Section 4 – other matters**

* Managing client expectation regarding type of opinion sought
* Managing client expectation regarding timeframe

**Conclusion**

* Summary of key issues and decision on acceptance

Note: not all of the above points are necessary to secure a pass mark; the marking scheme is also flexible enough to cater for comments that may not appear in the ‘model answer’.

**Summary**

This article shows how to approach one requirement from a typical Section A question in Paper P7. It is important to practise technique by attempting as many questions as possible, starting with the Pilot Paper for Paper P7.

**Written by a member of the Paper P7 examining team**