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3RD EDITION

Auditing
A PRACTICAL APPROACH

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Auditing: A Practical Approach

3RD EDITION

Robyn Moroney

Fiona Campbell

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WILEY

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CONTENTS

About the authors viii
Preface ix

CHAPTER 1

Introduction and overview of audit and assurance 1

Audit process in focus 4
1.1 Auditing and assurance defined 5
1.2 Different assurance services 5
1.2.1 Financial report audits 5
1.2.2 Compliance audits 7
1.2.3 Performance audits 7
1.2.4 Comprehensive audits 8
1.2.5 Internal audits 8
1.2.6 Corporate social responsibility (CSR) assurance 8
1.3 Different levels of assurance 13
1.3.1 Reasonable assurance 13
1.3.2 Limited assurance 16
1.3.3 No assurance 18
1.4 Different audit opinions 21
1.5 Preparers and auditors 22
1.5.1 Preparer responsibility 22
1.5.2 Auditor responsibility 23
1.5.3 Assurance providers 24
1.6 Demand for audit and assurance services 25
1.6.1 Financial report users 25
1.6.2 Sources of demand for audit and assurance services 26
1.6.3 Theoretical frameworks 27
1.6.4 Demand in a voluntary setting 28
1.7 The role of regulators and regulations 29
1.7.1 Regulators 29
1.7.2 Regulation 31
1.8 The audit expectation gap 34
Summary 36
Key terms 37
Multiple-choice questions 37
Review questions 39
Professional application questions 39
Research question 43
Further reading 43
Solutions to multiple-choice questions 43
Notes 43
Acknowledgements 44

CHAPTER 2

Ethics, legal liability and client acceptance 45

Audit process in focus 47
2.1 The fundamental principles of professional ethics 47
2.1.1 Integrity 48
2.1.2 Objectivity 48
2.1.3 Professional competence and due care 48
2.1.4 Confidentiality 48
2.1.5 Professional behaviour 49
2.2 Independence 50
2.2.1 Threats to independence 51
2.2.2 Safeguards to independence 53
2.3 The auditor's relationships with others 56
2.3.1 Auditors and shareholders 56
2.3.2 Auditors and the board of directors 57
2.3.3 Auditors and the audit committee 57
2.3.4 Auditors and internal auditors 59
2.4 Legal liability 60
2.4.1 Legal liability to clients 60
2.4.2 Contributory negligence 62
2.4.3 Legal liability to third parties 63
2.4.4 Avoidance of litigation 64
2.5 Client acceptance and continuance decisions 65
Summary 70
Key terms 71
Multiple-choice questions 72
Review questions 73
Professional application questions 73
Research question 79
Further reading 79
Solutions to multiple-choice questions 79
Notes 79
Acknowledgements 80

CHAPTER 3

Risk assessment I 81

Audit process in focus 83
3.1 Phases of an audit 84
3.1.1 Risk assessment phase 84
3.1.2 Risk response phase 86
3.1.3 Concluding and reporting on an audit 86
3.2 Gaining an understanding of the client 86
3.2.1 Entity level 87

3.2.2 Industry level 89
3.2.3 Economy level 90
3.3 Fraud risk 90
3.3.1 Incentives and pressures to commit a fraud 91
3.3.2 Opportunities to perpetrate a fraud 92
3.3.3 Attitudes and rationalisation to justify a fraud 92
3.4 Going concern 93
3.4.1 Going concern risk — indicators 93
3.4.2 Going concern risk — mitigating factors 94
3.5 Corporate governance 95
3.6 Information technology 100
3.7 Closing procedures 101
Summary 104
Key terms 104
Multiple-choice questions 105
Review questions 106
Professional application questions 107
Research question 114
Further reading 114
Solutions to multiple-choice questions 114
Notes 114
Acknowledgements 115

CHAPTER 4
Risk assessment II 116
Audit process in focus 118
4.1 Audit risk 118
4.1.1 The audit risk model and its components 120
4.2 Materiality 123
4.2.1 Qualitative and quantitative materiality 123
4.2.2 Setting materiality 124
4.3 Audit strategy 125
4.4 Client approaches to measuring performance 129
4.4.1 Profitability 129
4.4.2 Liquidity 130
4.5 Analytical procedures 131
4.5.1 Comparisons 132
4.5.2 Trend analysis 132
4.5.3 Common-size analysis 133
4.5.4 Ratio analysis 133
4.5.5 Other analytical procedures 136
4.5.6 Factors to consider when conducting analytical procedures 137
Summary 139
Key terms 139
Multiple-choice questions 140
Review questions 141
Professional application questions 142
Research question 149
Solutions to multiple-choice questions 150
Notes 150

CHAPTER 5
Audit evidence 151
Audit process in focus 153
5.1 Assertions 154
5.2 Types of audit evidence 156
5.2.1 Sufficient appropriate audit evidence 157
5.2.2 External confirmations 158
5.2.3 Documentary evidence 160
5.2.4 Representations 161
5.2.5 Verbal evidence 168
5.2.6 Computational evidence 168
5.2.7 Physical evidence 169
5.2.8 Electronic evidence 170
5.3 Persuasiveness of audit evidence 170
5.3.1 Internally generated evidence 170
5.3.2 Externally generated evidence held by the client 171
5.3.3 Externally generated evidence sent directly to the auditor 171
5.4 Using the work of an expert 171
5.4.1 Assessing the need to use an expert 172
5.4.2 Determining the scope of the work to be carried out 172
5.4.3 Assessing the capability of the expert 172
5.4.4 Assessing the objectivity of the expert 172
5.4.5 Assessing the expert's report 173
5.4.6 Responsibility for the conclusion 173
5.5 Using the work of another auditor 174
5.6 Evidence gathering procedures 176
Summary 178
Key terms 179
Multiple-choice questions 180
Review questions 181
Professional application questions 182
Research question 188
Solutions to multiple-choice questions 188
Notes 188
Acknowledgements 188

CHAPTER 6
Gaining an understanding of the client's system of internal controls 189
Audit process in focus 191
6.1 Internal control defined 191
6.2 Objectives of internal controls 192

6.3 Entity-level internal controls 194
6.3.1 The control environment 194
6.3.2 The entity's risk assessment process 197
6.3.3 Information systems and communication 198
6.3.4 Control activities 199
6.3.5 Monitoring of controls 201
6.3.6 Internal control in small entities 202
6.4 Transaction-level internal controls 203
6.4.1 Example transaction flows — sales process 203
6.4.2 Example transaction flows — cost of sales process 203
6.5 Documenting internal controls 207
6.6 Identifying strengths and weaknesses in a system of internal controls 210
6.7 Management letters 211
Summary 216
Key terms 216
Multiple-choice questions 217
Review questions 218
Professional application questions 219
Research question 224
Solutions to multiple-choice questions 225
Notes 225
Acknowledgements 225

CHAPTER 7
Sampling and overview of the risk response phase of the audit 226
Audit process in focus 228
7.1 Audit sampling 229
7.2 Sampling and non-sampling risk 229
7.2.1 Sampling risk and tests of controls 229
7.2.2 Sampling risk and substantive procedures 231
7.2.3 Non-sampling risk 231
7.3 Statistical and non-statistical sampling 232
7.4 Sampling methods 233
7.4.1 Random selection 233
7.4.2 Systematic selection 233
7.4.3 Haphazard selection 234
7.4.4 Block selection 234
7.4.5 Judgemental selection 234
7.4.6 Factors to consider when selecting a sample 235
7.5 Factors that influence the sample size — testing controls 236
7.6 Factors that influence the sample size — substantive testing 238
7.7 Evaluating sample test results 239
7.8 Tests of controls and substantive procedures 241
7.8.1 Tests of controls 242
7.8.2 Substantive procedures 243
7.9 Nature, timing and extent of audit testing 245
7.9.1 Nature of audit testing 245
7.9.2 Timing of audit testing 246
7.9.3 Extent of audit testing 247
7.10 Drawing conclusions 247
7.11 Documentation — audit working papers 248
7.11.1 Permanent file 249
7.11.2 Current file 249
Summary 256
Key terms 257
Multiple-choice questions 258
Review questions 260
Professional application questions 260
Research question 266
Solutions to multiple-choice questions 266
Notes 266
Acknowledgements 266

CHAPTER 8
Execution of the audit — testing of controls 267
Audit process in focus 269
8.1 Types of controls 270
8.1.1 Prevent and detect controls 270
8.1.2 Manual and automated controls 275
8.2 Techniques for testing controls 277
8.2.1 Enquiry 277
8.2.2 Observation 277
8.2.3 Inspection of physical evidence 277
8.2.4 Re-performance 277
8.3 Selecting and designing tests of controls 278
8.3.1 Which controls should be selected for testing? 278
8.3.2 How much testing does the auditor need to do? 278
8.4 Results of the auditor's testing 283
8.5 Documenting conclusions 285
Summary 289
Key terms 289
Multiple-choice questions 290
Review questions 291
Professional application questions 292
Research question 299
Solutions to multiple-choice questions 299
Notes 299

CHAPTER 9

Execution of the audit — performing substantive procedures 300

Audit process in focus 302
9.1 Overview of substantive procedures 302
9.1.1 Substantive procedures and assertions 302
9.1.2 Definition of substantive procedures 305
9.2 Relationship between risk assessment and the nature, timing and extent of substantive procedures 307
9.2.1 Timing of substantive procedures 307
9.3 Substantive audit procedures 309
9.3.1 Tests of details 309
9.3.2 Key item testing 310
9.3.3 Analytical procedures 311
9.3.4 Types of analytical procedures 312
9.3.5 Performing substantive testing using computers 313
9.4 Levels of evidence 314
9.4.1 Persuasive 314
9.4.2 Corroborative 315
9.4.3 Minimal 316
9.4.4 General 317
9.5 Evaluating and documenting substantive analytical procedures results 317
9.5.1 Evaluating errors identified in testing 319
9.5.2 Concluding and documenting the results of substantive procedures 319
Summary 321
Key terms 321
Multiple-choice questions 322
Review questions 323
Professional application questions 324
Research question 329
Solutions to multiple-choice questions 329
Notes 329

CHAPTER 10

Substantive testing and balance sheet accounts 330

Audit process in focus 332
10.1 Relationship between risk assessment and substantive procedures 332
10.1.1 Extent of substantive procedures 332
10.1.2 Timing of substantive procedures 333
10.1.3 Matters to consider when designing substantive procedures 335
10.2 Substantive testing of cash 336
10.2.1 Principal objectives in auditing cash 337
10.2.2 Processes affecting cash 337
10.2.3 Illustrative procedures for auditing cash 339
10.3 Substantive testing of trade receivables 340
10.3.1 Principal objectives in auditing trade receivables 341
10.3.2 Processes affecting trade receivables 341
10.3.3 Illustrative procedures for auditing trade receivables 343
10.4 Substantive testing of inventory 346
10.4.1 Principal objectives in auditing inventory 347
10.4.2 Processes affecting inventory 347
10.4.3 Illustrative procedures for auditing inventory 349
10.5 Substantive testing of property, plant and equipment 353
10.5.1 Principal objectives in auditing property, plant and equipment 354
10.5.2 Processes affecting property, plant and equipment 354
10.5.3 Illustrative procedures for auditing property, plant and equipment 355
10.6 Substantive testing of payables 357
10.6.1 Principal objectives in auditing payables 358
10.6.2 Processes affecting payables 358
10.6.3 Illustrative procedures for auditing payables 359
10.7 Special considerations for auditing other balance sheet accounts 361
10.8 Assessing the results of substantive procedures 362
Summary 363
Key terms 364
Multiple-choice questions 364
Review questions 365
Professional application questions 366
Research question 376
Solutions to multiple-choice questions 376
Notes 376
Acknowledgements 376

CHAPTER 11

Substantive testing and income statement accounts 377

Audit process in focus 379
11.1 Relationship between risk assessment and substantive procedures 379
11.1.1 Differences between auditing income statement and balance sheet accounts 379

11.1.2 Extent of substantive procedures 380
11.1.3 Timing of substantive procedures 380
11.2 Substantive testing of revenue 381
11.2.1 Principal objectives in auditing revenue 382
11.2.2 Processes affecting sales revenue 383
11.2.3 Illustrative procedures for auditing revenue 384
11.3 Substantive testing of cost of sales and other significant expenses 387
11.3.1 Principal objectives in auditing costs and expenses 388
11.3.2 Processes affecting costs and expenses 388
11.3.3 Illustrative procedures for auditing costs and expenses 389
11.4 Assessing the results of substantive procedures 392
Summary 394
Key terms 394
Multiple-choice questions 395
Review questions 396
Professional application questions 397
Solutions to multiple-choice questions 405
Notes 405
Acknowledgements 405

CHAPTER 12

Completing and reporting on the audit 406

Audit process in focus 409
12.1 Engagement wrap-up 409
12.1.1 Sufficient appropriate audit evidence 411
12.1.2 Evaluating audit evidence 412
12.2 Going concern 413
12.3 Subsequent events 414
12.3.1 Type 1 subsequent events — adjusting events 415
12.3.2 Type 2 subsequent events — non-adjusting events 415
12.3.3 Procedures used when conducting a subsequent events review 416
12.4 Misstatements 418
12.4.1 Current-year misstatements 419
12.4.2 Prior-year misstatements 419
12.4.3 Qualitative considerations 420
12.5 Evaluating the conclusions and forming an opinion 421
12.6 Components of the audit report 421
12.7 Modifications to the audit report 424
12.7.1 Emphasis of matter 424
12.7.2 Limitation of scope 425
12.7.3 Disagreement with those charged with governance 425
12.8 *Corporations Act 2001* breaches 426
12.9 Management representation and communication with those charged with governance 426
12.9.1 Audit matters of governance interest to be communicated 427
12.9.2 Documentation considerations 428
Summary 429
Key terms 430
Multiple-choice questions 430
Review questions 431
Professional application questions 432
Research question 437
Solutions to multiple-choice questions 438
Notes 438

Appendix 439

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PREFACE

Welcome to the third edition of *Auditing: A Practical Approach*. This is not just another auditing text. As the title suggests, the resource focuses on how audits are conducted in practice. As authors, we bring our diverse experiences to this book to provide a very different approach to teaching and studying auditing. In addition to covering essential auditing topics, the text provides insights into how an audit is conducted and the issues that are of greatest concern to practising auditors.

As each chapter unfolds, students are introduced to the various stages of an audit. Key auditing concepts are addressed in a succinct manner making them understandable to all. To underpin this approach, each chapter begins with a diagrammatic depiction of the stages of an audit, with the current stage highlighted as we progress. The diagram provides a useful reference point to ground the discussion in each chapter to the relevant stage in the audit process.

To underpin our discussion of how an audit is conducted, we use a case study of a hypothetical client, Cloud 9. The discussion in each chapter is kept general, with our case study providing an example of how the general principles behind each audit may be applied in practice. By using this approach, students are provided a continuing example of how the concepts discussed may apply in practice.

The Cloud 9 case study provides a flexible learning tool to be used within an auditing and assurance course. Details about Cloud 9 and its audit are provided in each chapter. These details provide an insight into how an audit is conducted, the issues that auditors face at each stage of an audit, and the processes used to gather evidence and arrive at conclusions. The Cloud 9 case materials can form the basis for class discussions, student role plays or online exchanges between students. At the end of each chapter, a case-study problem is set using Cloud 9 as a base. These problems can be used as part of the weekly tutorial program, or as an assignment for students to work on individually or in groups (or some combination of the two).

Overview of the text

Chapter 1: Introduction and overview of audit and assurance. This chapter begins with a definition of assurance engagements, an explanation of how they can differ, and the different levels of assurance and opinions that can be provided by auditors. The role of the financial report preparer is contrasted with that of the auditor, which leads into a discussion of the source for the historical and ongoing demand for audit services. The regulations surrounding the provision of assurance services are outlined and the expectation gap explained. This chapter provides the background that underpins the remainder of the text.

Chapter 2: Ethics, legal liability and client acceptance. This chapter provides an overview of the fundamental principles of professional ethics that apply to all accountants. Particular attention is given to auditor independence, including threats and safeguards. The auditor's legal liability to their client and third parties is explained, together with the concept of contributory negligence. This chapter ends with a discussion of the factors to consider in the client acceptance or continuance decision, which marks the commencement of our discussion of how an audit is conducted.

Chapter 3: Risk assessment I. The first stage of every audit involves risk assessment. This important topic is covered in two chapters. Chapter 3 begins with a discussion of the different phases of an audit. The key components of the risk assessment phase are: gaining an understanding of the client, identifying the risk of fraud, evaluating the client's going concern assumption, gaining an understanding of the client's corporate governance structure and evaluating how a client's information technology (IT) can impact risk. These components of risk assessment are described in detail in this chapter, along with a discussion of how client closing procedures can impact reported results.

Chapter 4: Risk assessment II. This chapter continues our discussion of risk assessment. Specifically, this chapter includes a definition of audit risk and describes its components (inherent risk, control risk and detection risk). The concept of materiality, the development of planning materiality and how it is used when conducting an audit is then described. The process used by auditors in arriving at their audit strategy, which provides a blueprint for the remainder of the audit, is explained. The chapter concludes with an overview of the use of analytical procedures during the risk assessment phase of an audit.

Chapter 5: Audit evidence. This chapter contains an overview of the different types of audit evidence and the processes used by auditors to gather that evidence throughout the audit. The audit assertions, which aid in risk identification and the design of audit procedures, are defined. The concept of sufficient appropriate audit evidence is explained. The relative persuasiveness of audit evidence is explained. The procedures used when using the work of an expert or another auditor are described. This chapter concludes with a discussion of the evidence gathering procedures most often used by auditors.

Chapter 6: Gaining an understanding of the client's system of internal controls. This chapter provides an introduction and overview to internal controls and a background to understanding how they are tested. In this chapter, internal control is defined and the seven generally accepted objectives of internal control activities are outlined. Internal control at the entity level and transaction level are explained and contrasted. A description is provided of how an auditor documents their understanding of their client's system of internal controls. Based upon that understanding an auditor will then identify strengths and weaknesses in their client's system of internal controls and communicate their findings to those charged with governance in the organisation being audited.

Chapter 7: Sampling and overview of the risk response phase of the audit. This chapter provides the backdrop for chapters 8 to 11, where tests of controls and substantive procedures are described in detail. This chapter commences with a description of audit sampling. Sampling and non-sampling risk are explained and contrasted, which are followed by a discussion of the difference between statistical and non-statistical sampling. Various sampling methods used in practise are then described. The factors that impact sample sizes when testing controls and conducting substantive tests are then outlined. The discussion around sampling is concluded with an explanation of how to evaluate the results of tests conducted on a sample. The difference between tests of controls and substantive procedures and the factors that impact the nature, timing and extent of audit testing are then explained. Once testing is completed an auditor must interpret the results of their testing and the implications of the findings on the remainder of the audit. A description is provided of how an auditor does this along with how they document the details of evidence gathered in their working papers.

Chapter 8: Execution of the audit — testing of controls. This chapter provides a description of how an auditor conducts their tests of their client's internal controls. The description includes a discussion of the different types of controls, the different techniques for testing controls, how an auditor selects and designs tests of controls, a comparison and contrast of the results of testing of controls and finally a discussion of how to document tests of controls.

Chapter 9: Execution of the audit — performing substantive procedures. This chapter provides an overview of the substantive procedures used by auditors when testing the details of their client's transactions and account balances. This chapter provides a backdrop to the detailed discussion in chapters 10 and 11. This chapter includes a discussion of the link between audit risk and the nature, timing and extent of substantive procedures conducted by the auditor. An overview is provided of common substantive audit procedures used in practice and the level of audit evidence obtained when conducting different tests. This chapter concludes with a description of the documentation of the conclusions reached by auditors as a result of their substantive procedures.

Chapter 10: Substantive testing and balance sheet accounts. This chapter provides an overview of the types of substantive procedures commonly used in practice when testing the contents of a client's balance sheet. The relationship between risk for a significant account and the extent and timing of substantive procedures for that account is described. The procedures commonly used by auditors when testing balance sheet accounts are then explained. Specifically, the procedures used by auditors when testing cash; trade (accounts) receivables; inventory; property, plant and equipment; and payables are described in detail in this chapter. An overview is then provided of how substantive testing is used for other balance sheet accounts before an explanation is provided of the processes used by auditors when assessing the results of their substantive procedures to determine whether additional substantive tests are necessary.

Chapter 11: Substantive testing and income statement accounts. This chapter provides an overview of the types of substantive procedures commonly used in practice when testing the contents of a client's income statement. The relationship between an auditor's overall risk assessment for a client and the consequent extent and timing of substantive procedures when testing income statement accounts is explained. These procedures are compared and contrasted to the procedures outlined in chapter 10 when testing balance sheet accounts. The procedures commonly used by auditors when testing income statement accounts are then explained. Specifically, the procedures used by auditors when testing revenue, cost of sales and significant expense accounts are described in detail in this chapter. Finally, an overview is provided of how the results of these substantive procedures are used by auditors to determine whether additional substantive tests are necessary.

Chapter 12: Completing and reporting on the audit. This final chapter of the text marks the conclusion of the audit. An explanation of the procedures performed by an auditor as part of their wrap-up, including gathering and evaluating audit evidence, is provided. The going concern concept is revisited in the context of finalising the audit. Subsequent event testing is explained. The procedures used by auditors when evaluating material misstatements uncovered during their audit are outlined. A description is provided of how auditors evaluate the conclusions drawn throughout the audit in relation to evidence gathered and their impact on the overall opinion formed on the financial report. The form and content of the audit report is outlined and possible *Corporations Act 2001* breaches are described. Finally, a description is provided of the reports an auditor will provide to their client's management and those charged with governance at the conclusion of the audit.

Structure of each chapter

Each chapter commences with an overview of the *learning objectives* addressed in the chapter. These learning objectives are highlighted throughout the chapter as the discussion unfolds. After each learning objective is covered in the text, three *before you go on* questions are set for students to confirm they recall the main issues covered. As these questions come directly from the text, it is straightforward for students to check their understanding of the key concepts covered before progressing to the next learning objective (section) in the chapter. Specific learning objectives are also linked to end-of-chapter professional application questions. This approach means that tutorial questions can be set to ensure coverage of the learning objectives considered most important.

Following the learning objectives listed at the beginning of each chapter is a summary of the *Australian and international assurance standards* discussed in each chapter. The listed standards are incorporated in the discussion within each chapter. Pronouncements and guidance statements are listed with the standards and discussed where applicable.

The summary of standards is followed by a diagram of the *overview of the audit*. This figure aids in understanding the structure of the textbook, which mirrors the process generally used when conducting an audit. The diagram highlights the stage to be covered in the current chapter, which aids in understanding what has come before and what is still to come.

Following the overview diagram is an *audit process in focus* section, which includes a brief overview and outline of each chapter. Key terms are highlighted throughout the chapter and their definitions appear at the end of chapter, which aids studying and revision.

The Cloud 9 case study appears throughout each chapter. Students can choose to incorporate Cloud 9 in their reading of each chapter or to go back and read through the case study after reading the main text. As Cloud 9 is easily distinguishable from the main text, either approach can be adopted when studying a chapter.

Descriptions of the *professional environment* in which auditors operate appear in each chapter. These vignettes provide some details of the auditing profession and various challenges faced by auditors.

Each chapter concludes with a summary, list of key terms used and end-of-chapter questions. The summary provides a brief recap of each learning objective covered in a chapter. The end-of-chapter questions include multiple-choice questions, review questions, professional application questions, a Cloud 9 case study question and a research question. Solutions to multiple-choice questions appear at the very end of each chapter, so students can use these as part of their independent study. The review questions test student understanding of the key concepts covered in the chapter. The professional application questions are problems designed around the learning objectives set for the chapter. Each question is graded as basic, moderate or challenging and indicates the learning objective(s) covered. A selection of the professional application questions are based upon problems set by Chartered Accountants Australia and New Zealand as part of their chartered accountants program. The Cloud 9 case study builds from one chapter to the next and is based on the information provided in each chapter, in the case study at the end of each chapter and in the appendix. The use of a case study in this text aids in the appreciation of how each topic covered fits into the context of an audit as a whole. Together with the practical approach used in the body of the text, this allows a deeper understanding of how audits are conducted in practice. Research questions provide an opportunity for students to gain a deeper appreciation for the role of academic research in providing greater insights into audit practice.

Robyn Moroney, Fiona Campbell, Jane Hamilton
May 2016

CHAPTER 1

Introduction and overview of audit and assurance

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1.1 describe an assurance engagement

1.2 discriminate between different types of assurance services

1.3 discriminate between different levels of assurance

1.4 categorise different audit opinions

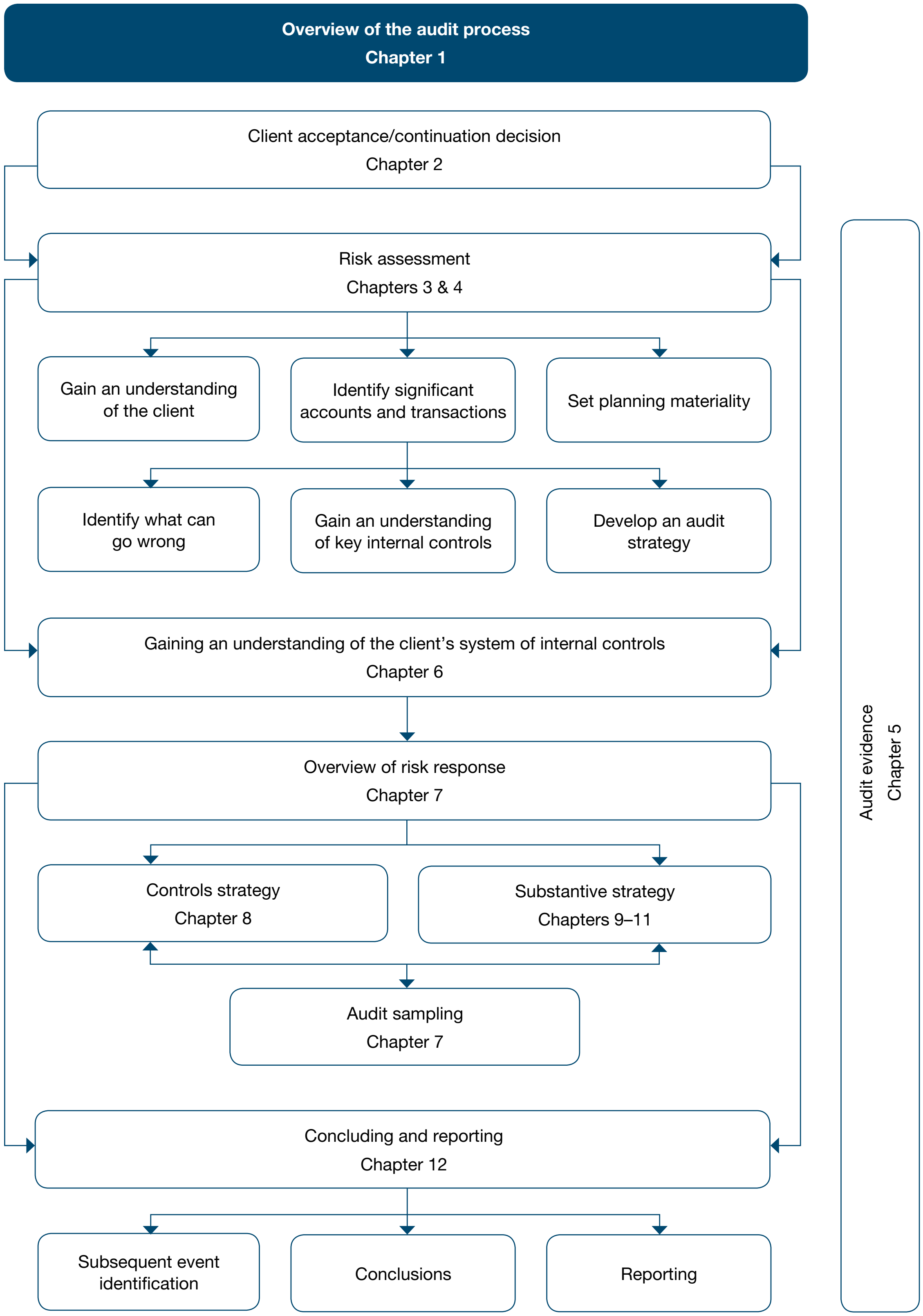
1.5 discriminate between the different role of the preparer and the auditor, and discuss the different firms that provide assurance services

1.6 justify the demand for audit and assurance services

1.7 compare the different regulators and regulations surrounding the assurance process

1.8 categorise the audit expectation gap.

AUDITING AND ASSURANCE STANDARDS	
AUSTRALIAN	**INTERNATIONAL**
Framework for Assurance Engagements	*International Framework for Assurance Engagements*
APES 110 *Code of Ethics for Professional Accountants*	*Code of Ethics for Professional Accountants*
APES 210 *Conformity with Auditing and Assurance Standards*	
ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*	ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*
ASA 210 *Agreeing the Terms of Audit Engagements*	ISA 210 *Agreeing the Terms of Audit Engagements*
ASA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*	ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*
ASA 610 *Using the Work of Internal Auditors*	ISA 610 *Using the Work of Internal Auditors*
ASA 700 (Revised) *Forming an Opinion and Reporting on a Financial Report*	ISA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*
ASA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*	ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*
ASA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*	ISA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*
ASA 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*	ISA 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
ASRE 2410 *Review of a Financial Report Performed by the Independent Auditor of the Entity*	ISRE 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*
ASAE 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*	ISAE 3000 *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*
ASAE 3410 *Assurance Engagements on Greenhouse Gas Statements*	ISAE 3410 *Assurance Engagements on Greenhouse Gas Statements*
ASAE 3500 *Performance Engagements*	
ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports, Other Financial Information, and Other Assurance Engagements*	ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*
Regulatory Guide 230 Disclosing non-IFRS financial information	


Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client's system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

This text is designed to provide students with the opportunity to learn about auditing by using a practical, problem-based approach. Each chapter begins with some information about an audit client — Cloud 9 Pty Ltd (Cloud 9). The chapter then provides the underlying concepts and background information needed to deal with this client's situation and the problems facing its auditor. As students work through the chapters, they gradually build up their knowledge of auditing by studying how the contents of each chapter are applied to Cloud 9. The end-of-chapter exercises and problems also provide students with the opportunity to study other aspects of Cloud 9's audit, in addition to applying the knowledge gained in the chapter to other practical examples.

Cloud 9 Inc., a listed company in the United States (US), is looking to expand. McLellan's Shoes was seen as a potential target.

In 1980, Ron McLellan starts a business in Sydney manufacturing and retailing customised basketball shoes. Ron calls his business McLellan's Shoes. Ron borrows from the bank to start the business, using his house as security, and over the years he works very hard to establish a profitable niche in the highly competitive sport shoe market. Ron is able to repay the bank in 1993, just before the recession. As he watches interest rates soar above 20 per cent, he vows to never borrow again.

As the business grows, Ron's wife and three adult children start to work for him, with responsibility for administration, marketing and sales, production and distribution. By the early 1990s, Ron's business employs 20 people full time, most of whom work in production. There are also several casual employees and part-time staff in the retail outlet, particularly during busy periods.

In February 1995, Ron receives a call from Chip Masters, the senior vice-president of Cloud 9 Inc. Chip expresses an interest in buying McLellan's Shoes. Ron is getting tired, and his children are starting to fight amongst themselves about who is going to take over from their father. Ron has had enough, but he does not want Chip to know that. He asks if Chip is ready to talk about the price. Chip said he is, but first he needs to see the audited financial reports for McLellan's Shoes.

Ron asks for some time. He tells Chip that he needs to talk to his family and will get back to him. When Ron puts the phone down he immediately rings his friend from the golf club, Ernie Black, who is a chartered accountant. For years, Ernie has been quietly suggesting to Ron that his business affairs need attention. Ron is good at making deals and working hard, but he has never bothered with sophisticated financial arrangements. He is still running his business as a sole trader (not a company), and his wife does all the tax returns. Ron is in a panic — he wants to sell McLellan's Shoes, but what is he going to do about Chip's request for audited financial reports?

Audit process in focus

The purpose of this chapter is to provide an overview of audit and assurance services. While the focus of this text is the audit of financial reports, in this chapter we define assurance engagements and differentiate between different types of assurance engagements. The assurance engagements explained in this chapter include financial report audits, compliance audits, performance audits, comprehensive audits, internal audits and assurance of corporate social responsibility disclosures. We also provide an overview of the different levels of assurance that can be provided when conducting assurance procedures. The levels of assurance discussed in this chapter include reasonable, limited and no assurance engagements.

Next we provide a brief overview of the different audit reports that an auditor can issue after completing their audit. Auditors can issue either an unmodified or a modified audit report. Four modifications to an audit report are: the inclusion of an emphasis of matter paragraph, a qualified opinion, an adverse opinion or a disclaimer of opinion. These concepts are explained further in this chapter.

The roles of the financial report preparer and auditor are explained and contrasted. An overview is then provided of the different firms that provide assurance services. That section contains details of both accounting and consulting firms and the different services that they provide. The factors that explain why there is a demand for audit and assurance services are then described before an overview is provided of assurance regulators and their regulations. The audit expectation gap is explained in the last section of this chapter.

1.1 Auditing and assurance defined

LEARNING OBJECTIVE 1.1 Describe an assurance engagement.

CLOUD 9

Chip Masters has asked Ron McLellan for audited financial reports of McLellan's Shoes. Ron has never had an audit and is not sure what it involves. He has heard about tax audits, environmental audits, efficiency audits, as well as financial report audits. Are they all the same thing? Ernie explains to Ron that there are several services that people call 'audits' that are different to financial report audits. However, all these services, including financial report audits, can be defined as assurance engagements.

An **assurance engagement** (or service) is defined as 'an engagement in which an assurance practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the measurement or evaluation of an underlying subject matter against criteria' (*Framework for Assurance Engagements*, para. 10; *International Framework for Assurance Engagements*, para. 7).

An assurance practitioner may be, for example, an auditor working in public practice providing assurance on financial reports of publicly listed companies or a consultant providing assurance about environmental disclosures. Intended users are the people for whom the assurance provider prepares their report (for example, the shareholders). The responsible party is the person or organisation (for example, a company) responsible for the preparation of the subject matter (for example, the financial reports). While the audit of a company's financial reports is the most common assurance engagement and the focus of much of this text, it is not the only type of assurance. The next section of this chapter provides a description of different types of assurance services.

BEFORE YOU GO ON

- What are two examples of assurance providers?
- What might an assurance provider express a conclusion about?
- What is a responsible party?

1.2 Different assurance services

LEARNING OBJECTIVE 1.2 Discriminate between different types of assurance services.

In this section we provide an overview of the different types of assurance services that an assurance practitioner can provide. The most common types of assurance engagements are financial report audits, compliance audits, performance audits, comprehensive audits, internal audits and assurance on corporate social responsibility (CSR) disclosures. Each will now be explained in turn.

1.2.1 Financial report audits

According to ASA 200 (ISA 200) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*, the objective of a **financial report audit** is for the auditor to express an opinion about whether the financial report is prepared in all material respects in accordance with a financial reporting framework (ASA 200, para. 11; ISA 200, para. 11). Within an Australian context, this means that the financial report has been prepared in accordance with Australian Accounting Standards and interpretations and any relevant legislation such as the *Corporations Act 2001*. Where a fair presentation framework is applicable, which is generally the case for financial reports, the opinion required by the Australian Auditing Standards is on whether the financial report is presented fairly, in all material respects, or gives a true and fair view (ASA 200, para. A13; ISA 200, para. A13).

CLOUD 9

Ron is not running a company; he operates his customised basketball shoe business as a sole trader. He is aware that big companies have to be audited, but because he is not affected by the Corporations Act he does not believe that he has to have an audit. Ernie agrees that Ron does not have to follow the same rules, but also tells him that Australian Auditing Standards apply to an audit of a financial report for any purpose. This means that although all the attention is usually on companies, sole traders can have their financial reports audited too.

A financial report and a directors' report must be prepared annually by disclosing entities, public companies, large proprietary companies and registered schemes (s. 292 of the Corporations Act). Under sections 295(4)(c) and 295A of the Act, directors of the reporting entity must declare whether the reporting entity will be able to pay its debts as and when they become due, whether the financial records have been properly maintained, whether the financial report and notes comply with Australian Accounting Standards including interpretations, and whether the financial report and notes give a **true and fair view** (this concept is discussed in more detail in section 1.5 of this chapter). A true and fair view refers to the consistent and faithful application of accounting standards in accordance with the financial reporting framework when preparing the financial report (ASA 200, para. 13; ISA 200, para.13). Australian companies must prepare their financial report in compliance with accounting standards (s. 296 of the Corporations Act). If compliance with accounting standards does not give a true and fair view, a company should provide additional information in the notes to the financial report (s. 295(3)(c) of the Corporations Act). Regulatory Guide 230 (ASIC, 2011) provides information for company directors and financial report preparers regarding the disclosure of information other than in accordance with accounting standards. Section 301 of the Act requires that the financial report be audited. It is part of the auditor's responsibility to form an opinion on the truth and fairness of the financial report. In fulfilling their role, the auditor must be independent of the company they audit, exercise due professional care, and comply with Auditing and Assurance Standards (APES 210, para. 1.2).

CLOUD 9

Ron believes that his business has good, reliable financial records. Ron's wife helps him keep tight control of the cash and other assets, and together they prepare some simple reports on a regular basis. Ron believes he knows exactly what is happening in the business and monitors the business's cash flow and profit very closely. However, he has not prepared financial reports that comply with Australian Accounting Standards. Is this a problem? Ernie explains to Ron that some businesses must apply the accounting standards, even if they are not companies. It all depends on whether it is reasonable to expect the existence of users dependent on the reports for information that will be useful to them in making and evaluating decisions about the allocation of scarce resources (Statement of Accounting Concepts 1 (SAC1) *Definition of the Reporting Entity*, para. 40). Ron is a bit worried now — how does he know if he has these 'users'?

Limitations of an audit

A financial report audit is conducted to enhance the reliability and credibility of the information included in a financial report. Yet it is not a guarantee that the financial report is free from error or fraud.

The limitations of an audit stem from the nature of financial reporting, the nature of audit procedures and the need for the audit to be conducted within a reasonable period of time and at a reasonable cost (ASA 200, ISA 200).

The nature of financial reporting refers to the use of judgement when preparing financial reports due to the subjectivity required when arriving at accounting estimates. Judgement is also required when selecting and applying accounting methods.

The nature of audit procedures refers to the reliance on evidence provided by the client and its management. If an auditor does not have access to all the information relevant to the audit there is a limitation in the scope of their audit. If the auditor is unaware of this situation, they may arrive at an inappropriate conclusion based on incomplete facts. Evidence may be withheld or modified by perpetrators of fraud. It can be difficult for an auditor to determine whether a fraud has occurred and documents altered as those committing a fraud generally hide evidence. Sampling is used when testing transactions and account balances. If a sample is not representative of all items available for testing, an auditor may arrive at an invalid conclusion.

The timeliness and cost of a financial report audit refers to the pressure an auditor faces to complete their audit within a certain time frame at a reasonable cost. While it is important that an auditor does not omit procedures in an effort to meet time and cost constraints, they may be under some pressure to do so. This pressure will come from clients wanting to issue their financial reports by a certain date, from clients refusing to pay additional fees for additional audit effort, and from within the audit firm where there are pressures to complete all audits on a timely basis to avoid incurring costs that may not be recovered. By taking the time to plan the audit properly, an auditor can ensure that adequate time is spent where the risks of a significant error or fraud are greatest.

1.2.2 Compliance audits

A **compliance audit** involves gathering evidence to ascertain whether the person or entity under review has followed the rules, policies, procedures, laws and regulations with which they must conform. There are a number of examples of compliance audits. A tax audit is used to determine whether an individual or company has completed their tax return in accordance with the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997*. Within an organisation, management may specify that certain processes be followed when completing a function. For example, a company may have policies and procedures for the hiring of new staff. In that case the organisation's internal auditors may be called upon to check whether employees are following the specified processes appropriately.

1.2.3 Performance audits

Performance audits are concerned with the economy, efficiency and effectiveness of an organisation's activities (ASAE 3500 *Performance Engagements*, para. 12). Economy refers to the cost of inputs, including wages and materials. Efficiency refers to the relationship between inputs and outputs. Specifically, efficiency refers to the use of the minimum amount of inputs to achieve a given output. Finally, effectiveness refers to the achievement of certain goals or the production of a certain level of outputs. From an organisation's perspective it is important to perform well across all three dimensions and not allow one to dominate. For example, if buying cheap inputs results in an inefficient production process, efficiency may be seen to be sacrificed to achieve economic goals.

Performance audits are generally conducted by an organisation's internal auditors or they may be outsourced to an external audit firm. Performance audits are sometimes referred to as value for money audits, operational audits or efficiency audits.

1.2.4 Comprehensive audits

A **comprehensive audit** may encompass elements of a financial report audit, a compliance audit and a performance audit. For example, an auditor may report on whether an entity has met its efficiency targets. Comprehensive audits most commonly occur in the public sector where compliance with various regulations is examined when completing a financial report audit.

1.2.5 Internal audits

Internal audits are conducted to provide assurance about various aspects of an organisation's activities. The internal audit function is typically conducted by employees of the organisation being audited, but can be outsourced to an external audit firm. As such, the function of internal audit is determined by **those charged with governance** and management within the organisation. While the functions of internal audits vary widely from one organisation to another, they are often concerned with evaluating and improving risk management, internal control procedures and elements of the governance process. The internal audit function often conducts performance audits, compliance audits, internal control assessments and reviews. Many internal auditors are members of the Institute of Internal Auditors (IIA). The IIA is an international organisation, with more than 180 000 members, that provides guidance and standards to aid internal auditors in their work. When conducting the financial report audit, the external auditor will consider and often rely on the work done by the internal auditors (ASA 610 (ISA 610) *Using the Work of Internal Auditors*).

1.2.6 Corporate social responsibility (CSR) assurance

Corporate social responsibility (CSR) reporting is voluntary and is becoming more widespread (see section 1.6.4 of this chapter for a discussion of the demand for assurance in a voluntary setting). CSR disclosures include environmental, employee and social reporting. Some organisations choose to have their CSR disclosures assured by an independent assurance provider. The assurance of CSR disclosures is currently carried out by either auditors or specialist **consulting firms**. As these disclosures include non-financial as well as financial information, the skill set required to conduct these assurance services is quite broad. Whether a company chooses to provide additional voluntary environmental disclosures or not, an auditor must consider the impact of environmental issues on their clients' financial report when conducting the financial report audit.

ASAE 3000 (ISAE 3000) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* provides some guidance for auditors when assuring CSR and similar reports. ASAE 3000 (ISAE 3000) provides guidance on the client acceptance decision, quality control, the role of professional scepticism and professional judgement, planning and performing the assurance engagement, steps in evidence gathering, and forming an opinion based on conclusions drawn from the evidence gathered. An example of an assurance report relating to a CSR report is provided in figure 1.1.

CLOUD 9

Ron is not concerned about internal audits — his business is too small for a separate internal audit function. He is also not worried about CSR reporting or compliance and performance audits. His priority at the moment is to close the deal with Chip Masters, and he still does not know what he has to do about the audit.

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Independent Limited Assurance Report in relation to Telstra Group's 2014 Corporate Responsibility Reporting

To the Management and Directors of Telstra Group

We have carried out a limited assurance engagement in order to state whether anything has come to our attention to suggest that the agreed environmental, human resource and community data as reported in the Telstra Group's ('Telstra') 2014 Annual Report and Bigger Picture Sustainability Report (collectively referred to as 'the Report') has not been presented in accordance with the criteria listed below.

Subject Matter

The Subject Matter for our limited assurance engagement for the year ending 30 June 2014 is the 31 metrics and related performance disclosures included in the Report (refer to Attachment A for a list of the 31 metrics) and an assessment of Telstra's sustainability materiality assessment process.

Criteria

The following Criteria have been applied to the Subject Matter described above:

- The principle of materiality in the context of the Global Reporting Initiative ('GRI') framework
- *National Greenhouse and Energy Reporting Act 2007*
- *National Greenhouse and Energy Reporting Regulations 2008*
- *National Greenhouse and Energy (Measurement) Determination 2008*, including the *National Greenhouse and Energy Reporting (Measurement) Amendment Determination 2013 (No. 1)* (the 'Measurement Determination')
- National Greenhouse Accounts Factors, July 2013 for scope 1, 2 and 3 greenhouse gas emissions (the 'NGA Factors')
- UK Department for Environment Food and Rural Affairs (DEFRA) – 2013 greenhouse gas conversion factors for company reporting
- Telstra's reported criteria as detailed in the Glossary document at www.telstra.com/sustainability/report for:
  - Certain scope 3 greenhouse gas emissions
  - Carbon emissions intensity (CO_2-e/TB)
  - Network related emissions
  - Energy and emission savings
  - Air travel
  - Waste recycled
  - MobileMuster (mobility device recycling)
  - Paper consumption
  - Water consumption
  - Sensis – Yellow and White Pages metrics
  - Human resources and community metrics

The Responsibility of Management

The management of Telstra is responsible for the preparation and presentation of the Subject Matter in the Report in accordance with the above Criteria, and is also responsible for the selection of methods included in the Criteria. No conclusion is expressed as to whether the selected methods used are appropriate for the purpose described above. Further, Telstra's management is responsible for establishing and maintaining internal controls relevant to the preparation and presentation of the Subject Matter that is free from material misstatement, whether due to fraud or error; selecting and applying appropriate criteria; maintaining adequate records and making estimates that are reasonable in the circumstances.

FIGURE 1.1 Example of an assurance report

FIGURE 1.1 (*continued*)

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Assurance Practitioner's Responsibility

Our responsibility is to express a limited assurance conclusion on the Subject Matter based on our assurance engagement in accordance with the Criteria. We conducted our limited assurance engagement in accordance with:

- *National Greenhouse and Energy Reporting (Audit) Determination 2009*
- *ISAE 3000 International Standards on Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*
- *ASAE 3410 Assurance Engagements on Greenhouse Gas Statements*
- *The terms of reference for this engagement as agreed with Telstra*

Our procedures were designed to obtain a limited level of assurance on which to base our conclusion and, as such, do not provide all the evidence that would be required to provide a reasonable level of assurance. The procedures performed depend on the assurance practitioner's judgement including the risk of material misstatement of the Subject Matter, whether due to fraud or error. While we considered the effectiveness of management's internal controls when determining the nature and extent of our procedures, our assurance engagement was not designed to provide assurance on internal controls.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our limited assurance conclusions.

Work Performed

Our assurance procedures included, but were not limited to:

- Gaining an understanding of the environmental, human resource and community reporting processes supporting the business activities
- Conducting site visits at three sample sites to identify material sources of energy and diesel consumption, and sources of greenhouse gas emissions, and understand the basis for measurement and preparation of the metrics and the Report
- Conducting interviews and collation of evidence to understand processes and controls supporting the data
- Checking that methodologies have been correctly applied as per the Measurement Determination, NGA Factors and methodologies outlined in the Glossary document at www.telstra.com/sustainability/report
- Undertaking analytical procedures to support the reasonableness of the data and disclosures
- Identifying and testing assumptions supporting the calculations
- Testing on a limited sample basis documentation supporting calculations to underlying source information
- Testing on a limited sample basis the effectiveness of the controls performed by Telstra
- Checking the appropriateness of the presentation of the information in the Report
- Checking Telstra's self-assessment of its sustainability material issues against GRI's principle of materiality

Use of our Report

Our limited assurance report has been prepared for distribution to the management and directors of Telstra. We disclaim any assumption of responsibility for any reliance on this assurance statement or on the Subject Matter to which it relates, to any person other than management and directors of Telstra, or for any purpose other than that for which it was prepared.

Independence, Competence and Experience

In conducting our assurance engagement we have met the independence requirements of the APES 110 Code of Ethics for Professional Accountants. We have the required competencies and experience to conduct this assurance engagement.

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Limitations

The Subject Matter of our work did not include any comparisons made against FY13 human resource and community data.

Matters Relating to Electronic Presentation of Information

Our limited assurance engagement included web-based information that was available via web links as of the date of this statement. We provide no assurance over changes to the content of this web-based information after the date of this assurance statement.

Conclusion

Based on our limited assurance procedures, nothing has come to our attention that causes us to believe that the Subject Matter as detailed above, and as presented in the Report is not presented fairly, in all material respects, in accordance with the Criteria as presented above.

Ernst & Young

Ernst & Young
Melbourne, Australia
12 August 2014

FIGURE 1.1 (*continued*)

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Attachment A

List of metrics assured as part of our limited assurance engagement:

Area	Metric
Environment	Total carbon emissions (scope 1, scope 2 and scope 3) (tCO_2-e)
	Emissions by source (tCO_2-e)
	Total energy use – stationary and transport (GJ)
	Stationary and transport energy by source (%)
	Emissions intensity (tCO_2-e/TB)
	Network related emissions (percentage of total emissions)
	Annualised emissions savings resulting from project initiatives in FY14 (tCO_2-e/year)
	Annualised network energy savings resulting from project initiatives (GJ)
	Annualised commercial energy savings resulting from project initiatives (GJ)
	Air travel (km)
	Total waste (t)
	Mobile Muster contribution (t)
	Total paper consumption (t)
	Water consumption (kL)
	Directory paper use for Yellow and White pages (t)
	Directory paper use for Yellow Pages in the Car (t)
	Cumulative customer opt-outs of Yellow and White Page directories (#)
	National directory recycling and reuse rate (%)
	Paper properties (grade and recycle content)
Human resource	Number of employees by geographic locations (%) (Telstra Group)
	Number of employees by age (%) (Telstra Corporation)
	Number of employees by employment level (%) (Telstra Corporation)
	Number of employees by type (%) (Telstra Corporation)
	Number of Telstra employees by contract type and coverage over bargaining agreements (%) (Telstra Corporation)
	Representation of women by employment level (# and %) (Telstra Corporation)
Community	Employee volunteering days on Telstra time (days)
	Employee matched payroll giving participation rates (%) and dollars donated ($)
	Number of pre-paid mobile phone recharge cards distributed and dollar value of program (# and $)
	Number of rebates provided on Telstra bills to financial hardship customers and dollar value of program (# and $)
	Number of people receiving discounts via our pensioner discount program and dollar value of program (# and $)
	Dollar value of our InContact program ($)

PROFESSIONAL ENVIRONMENT

Assurance engagements on carbon emissions information

Many companies now present CSR information in their annual reports or in separate corporate sustainability reports. In some cases, the reports include information about carbon emissions. However, the reporting and assurance of these reports is voluntary and largely unregulated, raising concerns about the quality of the information. One of these concerns is that the information being provided in CSR reports is not sufficiently reliable, particularly with respect to carbon emissions data.

The IAASB added a project to its agenda in February 2008 to develop a new International Standard on Assurance Engagements (ISAE) for assurance engagements on carbon emissions information. The rationale for the project is related to the growth in carbon trading, or emissions trading, schemes around the world, and the need for reliable information and a global approach for their efficient and effective operation. In addition, a new standard will likely be of assistance to financial statement auditors when considering the carrying value of emission trading rights in a financial statement audit.[1] Steps along the way to a new standard included: participant roundtables; the publication of an Issues Paper; and the establishment of the IAASB Emissions Task Force to develop a preliminary working draft of an ISAE. After the March 2012 meeting, the IAASB approved ISAE 3410 *Assurance Engagements on Greenhouse Gas Statements*. The new standard is effective for assurance reports covering periods ending on or after 30 September 2013. The equivalent Australian Standard (ASAE 3410) is effective for assurance periods commencing on or after 1 January 2015.

One of the most significant issues in the development of ISAE 3410 was the need to deal with both limited assurance and reasonable assurance greenhouse gas (GHG) engagements. The IAASB concluded that an explicit risk assessment of the engagement was required to determine which audit procedures are appropriate. Unlike in financial statement audits, the standard does not mandate certain types of procedures (such as inquiry and analytical procedures) as the primary means of obtaining evidence. This requirement recognises that GHG information is not capable of being subject to the rigor of a double entry bookkeeping system and is susceptible to different risks than historical financial information. In addition, the nature of assurance engagements on GHG statements can vary greatly. Auditing carbon emissions information creates new challenges for auditors and has the potential to change what it means to be an 'auditor' in the twenty-first century.

BEFORE YOU GO ON

- What are the three elements of a performance audit?
- What is the objective of a financial report audit?
- What are the most common functions of the internal audit function?

1.3 Different levels of assurance

LEARNING OBJECTIVE 1.3 Discriminate between different levels of assurance.

In this section we describe the different levels of assurance that a practitioner can provide when conducting assurance procedures. An assurance practitioner can provide reasonable assurance, limited assurance or no assurance. When providing reasonable and limited assurance, the practitioner's report is addressed to the party requesting assurance (for example, a company's shareholders). When an assurance practitioner performs a non-assurance engagement, a report on their findings is sent to the responsible party (that is, the organisation that prepared the information under consideration). The differences between reasonable, limited and no assurance are now explained.

1.3.1 Reasonable assurance

The objective of a **reasonable assurance** engagement is to gather sufficient evidence upon which to form a positive expression of an opinion regarding the truth and fairness of the information being assured. This means that the auditor has done adequate work to report with reasonable certainty that the information being assured is, or is not, reliable (ASA 200, para. 5; ISA 200, para. 5). This means that the auditor will conduct detailed testing of a client's control procedures and/or transactions and accounts to satisfy themselves that the information being assured is fairly presented. For example, an auditor is in the position to say whether in their opinion a financial report is in accordance with relevant law and accounting standards, and gives a true and fair view of the financial position of the reporting entity. Auditors can make such a positive statement only if they are reasonably sure that the evidence gathered is sufficient. The audit of a company's financial report is one example of a reasonable assurance engagement. ASA 700 (ISA 700) (Revised) *Forming an Opinion and Reporting on a Financial Report* provides guidance on the form and elements of the audit report.

The audit opinion will depend upon the auditor's findings while conducting the audit. A brief overview of the different opinions that an auditor may form when conducting a financial report audit are provided in the next section of this chapter. Reasonable assurance is the highest level of assurance provided; it is high but not absolute assurance.

Following public consultations in 2011, 2012 and 2013 the International Auditing and Assurance Standards Board (IAASB) decided to change the format of the audit report. The intention was to increase confidence in the audit and financial reports. The IAASB have indicated that the new format will increase the transparency and informational value of the audit, enhancing auditor communication with investors, increasing management attention to the disclosures in the financial reports referred to in the audit report and renewing the auditor focus with a view to enhancing professional scepticism.

The Auditing and Assurance Standards Board (AUASB) have adopted the new audit report format, and issued new auditing standards in 2015. Changes include moving the opinion section from the end of the report to the beginning of the report, the inclusion of a 'Key audit matters' section, where auditors communicate issues that were important in the current audit, and enhanced disclosures around the auditor's responsibilities when conducting the audit. According to ASA 701, key audit matters include areas of higher assessed risk of material misstatement, areas that involve significant judgement where there is high uncertainty around estimations and the effect of significant events on the audit (para. 9). The new audit report format is to be used for audits of financial reports for periods ending on or after 15 December 2016. An example of an audit report in the new format is provided in figure 1.2.

PROFESSIONAL ENVIRONMENT

Enhancing the value of auditor reporting

Are audit reports 'wholly uninformative'? The UK Financial Reporting Council believes that audit reports are an uninformative result of an opaque audit process.[2] The IAASB also believes that the 'current audit report provides little information about the procedures performed and the judgments exercised by the auditor in forming an audit opinion'.[3]

In May 2011, the IAASB released a consultation paper, 'Enhancing the value of auditor reporting: exploring options for change'. The consultation paper was an early step in a larger project investigating ways to increase the communication value of the standard audit report during a time of changing financial reporting regimes in several countries around the world. The final part of the project is a revised set of standards on audit reporting. The changes in financial reporting are, in part, a response to the global financial crisis in the first decade of the twenty-first century. Auditors generally survived the crisis without serious accusations of blame, but there were questions raised about the existing audit framework. Other significant publications in this period relating to the future role of audit include the European Commission (EC) green paper on audit policy issued in October 2010, and the International Organization of Securities Commissions (IOSCO) consultation report in September 2009 on audit communications.[4]

The IAASB believes that the 'expectation gap' is really an 'information gap'. The audit report system is like a traffic light system. The audit report either says 'go' or 'stop' (if there is an audit qualification), but does not provide an insight into the company's governance structures, financial health or risks within the company.[5] Audit firms, such as Grant Thornton, agree changes are necessary. However, although Grant Thornton agrees that 'auditors should provide better communication to investors' and that there should be more transparency about how audit opinions are reached, they believe that the company's audit committee should be responsible for enhanced reporting on the oversight of the financial reporting process and the external audit.[6]

The UK FRC agrees that audit committees have a vital role to play. A key recommendation in the FRC's proposals is that audit committees should make fuller reports to explain how they discharged their responsibilities for the integrity of the annual report and other duties.[7] Auditors will be wary of any change to their responsibilities that allows directors to retreat from theirs. The appropriate sharing of responsibilities between the auditors and company management for better financial and audit reporting is part of the process leading towards a revised set of audit reporting standards.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Audit of the Financial Report

Opinion

We have audited the financial report of ABC Company Ltd. (the Company), which comprises the statement of financial position as at 30 June 20X1, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial report, including a summary of significant accounting policies, and the directors' declaration.

In our opinion:

the accompanying financial report of ABC Company Ltd, is in accordance with the *Corporations Act 2001*, including:

(a) giving a true and fair view of the company's financial position as at 30 June 20X1 and of its performance for the year ended on that date; and

(b) complying with Australian Accounting Standards and the *Corporations Regulations 2001*.

Basis for Opinion

We conducted our audit in accordance with Australian Auditing Standards. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Report* section of our report. We are independent of the Company in accordance with the Corporations Act and the ethical requirements of the Accounting Professional and Ethical Standards Board's APES 110 *Code of Ethics for Professional Accountants* (the Code) that are relevant to our audit of the financial report in Australia. We have also fulfilled our other ethical responsibilities in accordance with the Code.

We confirm that the independence declaration required by the Corporations Act, which has been given to the directors of ABC Company Ltd, would be in the same terms if given to the directors as at the time of this auditor's report.

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

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial report of the current period. These matters were addressed in the context of our audit of the financial report as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[*Description of each key audit matter in accordance with ASA 701*]

Other Information

The directors are responsible for the other information. The other information comprises the information in the Company's annual report for the year ended 30 June 20X1, but does not include the financial report and the auditor's report thereon.

Our opinion on the financial report does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial report, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial report or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Directors' Responsibilities for the Financial Report

The directors of the Company are responsible for the preparation of the financial report that gives a true and fair view in accordance with Australian Accounting Standards and the Corporations Act and for such internal control as the directors determine is necessary to enable the preparation of the financial report that gives a true and fair view and is free from material misstatement, whether due to fraud or error.

In preparing the financial report, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

Auditor's Responsibilities for the Audit of the Financial Report

Our objectives are to obtain reasonable assurance about whether the financial report as a whole is free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the Australian Auditing Standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or

FIGURE 1.2 Example of an audit report in the new format

FIGURE 1.2 (*continued*)

error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of this financial report.

Report on the Remuneration Report

We have audited the Remuneration Report included in [paragraphs a to b or pages x to y] of the directors' report for the year ended 30 June 20X1. The directors of the Company are responsible for the preparation and presentation of the Remuneration Report in accordance with section 300A of the Corporations Act. Our responsibility is to express an opinion on the Remuneration Report, based on our audit conducted in accordance with Australian Auditing Standards.

Opinion on the Remuneration Report

In our opinion, the Remuneration Report of ABC Company Ltd., for the year [period] ended 30 June 20X1, complies with section 300A of the Corporations Act.
[*Auditor's name and signature*]

[*Date of the auditor's report*]

[*Auditor's address*]

Source: Auditing and Assurance Standards Board 2015, ASA 700 (Revised) *Forming an Opinion and Reporting on a Financial Report,* Appendix.

1.3.2 Limited assurance

The objective of a **limited assurance** engagement is to gather sufficient evidence upon which to form a negative expression of an opinion regarding the reliability of the information being assured. This means that the auditor has done adequate work to report whether or not anything came to their attention that would lead them to believe that the information being assured is *not* true and fair. The auditor will not conduct detailed testing when undertaking a limited assurance engagement and so they are not in a position to say that in their opinion the financial report *is* in accordance with the relevant law and accounting standards, and/or *does* give a true and fair view of the financial position and performance of the reporting entity. The auditor is only able to say that nothing makes them believe otherwise. To make a negative statement, auditors do not need to be *as* sure about the evidence as they must be to make a positive statement.

The review of a company's half-year financial report is an example of a limited assurance engagement (**review engagement**). ASRE 2410 (ISRE 2410) *Review of a Financial Report Performed by the Independent Auditor of the Entity* provides guidance on the form and elements of the review report. An example of a review report is provided in figure 1.3. The review report highlights the responsibilities of the directors for the preparation and fair presentation of the half-year report and the responsibility of the auditor to comply with ASRE 2410 when conducting their review. An explanation is provided of the procedures used in conducting the review. The report confirms the independence of the audit firm from their client. Finally, the review report includes the conclusion (opinion) of the auditor that they were not aware of any matter that made them believe that the half-year report was not true and fair (negative assurance).

In conducting a review an auditor will obtain an understanding of the entity under review including its internal controls; identify potential material misstatements where effort should be concentrated; and conduct analytical procedures, enquiries of entity personnel and other tasks to aid in the formulation of their opinion. The work done when conducting a review is a subset of the work done when conducting an audit. Specifically, an auditor will make enquiries of key personnel, apply analytical procedures and observe client staff. That is why an auditor can provide only limited (moderate) assurance after completing a review.

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Report on the Half-Year Financial Report

We have reviewed the accompanying half-year financial report of Telstra Corporation Limited, which comprises the statement of financial position as at 31 December 2014, the income statement, statement of comprehensive income, statement of changes in equity and statement of cash flows for the half-year ended on that date, notes comprising a summary of significant accounting policies and other explanatory information, and the directors' declaration of the consolidated entity comprising the company and the entities it controlled at the half-year end or from time to time during the half-year.

Directors' Responsibility for the Half-Year Financial Report

The directors of the company are responsible for the preparation of the half-year financial report that gives a true and fair view in accordance with Australian Accounting Standards and the *Corporations Act 2001* and for such internal controls as the directors determine are necessary to enable the preparation of the half-year financial report that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express a conclusion on the half-year financial report based on our review. We conducted our review in accordance with Auditing Standard on Review Engagements ASRE 2410 *Review of a Financial Report Performed by the Independent Auditor of the Entity*, in order to state whether, on the basis of the procedures described, we have become aware of any matter that makes us believe that the financial report is not in accordance with the *Corporations Act 2001* including: giving a true and fair view of the consolidated entity's financial position as at 31 December 2014 and its performance for the half-year ended on that date; and complying with Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*. As the auditor of Telstra Corporation Limited and the entities it controlled during the half-year, ASRE 2410 requires that we comply with the ethical requirements relevant to the audit of the annual financial report.

A review of a half-year financial report consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Australian Auditing Standards and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Independence

In conducting our review, we have complied with the independence requirements of the *Corporations Act 2001*. We have given to the directors of the company a written Auditor's Independence Declaration, a copy of which is included in the Directors' Report.

Conclusion

Based on our review, which is not an audit, we have not become aware of any matter that makes us believe that the half-year financial report of Telstra Corporation Limited is not in accordance with the *Corporations Act 2001*, including:

(a) giving a true and fair view of the consolidated entity's financial position as at 31 December 2014 and of its performance for the half-year ended on that date; and

(b) complying with Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*.

Ernst & Young

Ernst & Young

SJ Ferguson
Partner
Sydney, Australia
12 February 2015

FIGURE 1.3 Example of a review report

Source: Telstra, Financial results for the half-year ended 31 December 2014, p. 40.

1.3.3 No assurance

An assurance provider may perform other services for clients for which no assurance is provided. In such circumstances an assurance provider must ensure when reporting their findings that they make clear that they are merely reporting the facts of their findings and are not providing assurance (*Framework for Assurance Engagements*, paras 20–21; *International Framework for Assurance Engagements,* paras 15–16). An example of an engagement where **no assurance** is provided is an **agreed upon procedures engagement** where an auditor completes a set of tasks requested by their client and reports on their findings to the client. The client, not the auditor, determines the nature, timing and extent of evidence gathered, and draws their own conclusions based upon the outcomes of the work conducted by the auditor. As no conclusion is arrived at by the auditor, no assurance is provided by the auditor. An example of an agreed upon procedures report is provided in figure 1.4.

CLOUD 9

As Ernie explains the differences between reasonable and limited assurance, Ron wonders if Chip will accept a review, rather than an audit, of the financial reports. If he will, it will be much easier and cheaper for Ron. However, Ron also realises that Chip would not get as much assurance from a review as he would get from an audit. Ron thinks Chip would know the difference between an audit and a review; because he asked for an audit Chip must need the additional assurance it provides.

BEFORE YOU GO ON

- What are the main differences between reasonable and limited assurance engagements?
- What is the level of assurance required for an annual financial report?
- What does negative assurance mean?

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REPORT OF FACTUAL FINDINGS

To Directors, Fishpond Airways Pty Ltd

Report of Factual Findings

We have performed the procedures agreed with you to report factual findings for the purpose of assisting you in assessing, in combination with other information obtained by you, the accuracy of accounts payable as at 30 July 2015. The procedures performed are detailed in the terms of the engagement of 2 August 2015 and described below with respect to the accounts payable of Fishpond Airways Pty Ltd as of 30 July 2015.

Management's Responsibility for the Procedures Agreed

Management are responsible for the adequacy or otherwise of the procedures agreed to be performed by us. You are responsible for determining whether the factual findings provided by us, in combination with any other information obtained, provide a reasonable basis for any conclusions which you or other intended users wish to draw on the subject matter.

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Assurance Practitioner's Responsibility
Our responsibility is to report factual findings obtained from conducting the procedures agreed. We conducted the engagement in accordance with Standard on Related Services ASRS 4400 *Agreed-Upon Procedures Engagements to Report Factual Findings*.

Because the agreed-upon procedures do not constitute either a reasonable or limited assurance engagement in accordance with Standards issued by the Auditing and Assurance Standards Board, we do not express any conclusion and provide no assurance on the accounts payable of Fishpond Airways Pty Ltd as of 30 July 2015. Had we performed additional procedures or had we performed an audit or a review of the accounts payable in accordance with Standards issued by the Auditing and Assurance Standards Board, other matters might have come to our attention that would have been reported to you.

Independence
We have complied with ethical requirements equivalent to those applicable to Other Assurance Engagements, including independence.

Factual Findings

The procedures were performed solely to assist you in evaluating the accuracy of the accounts payable. The procedures performed and the factual findings obtained are as follows:

Procedures Performed	Factual Findings	Errors or Exceptions Identified
1. We obtained and checked the addition of the trial balance of accounts payable as at 30 July 2015 prepared by Fishpond Airways Pty Ltd, and we compared the total to the balance in the related general ledger account.	We found the addition to be correct and the total amount to be in agreement.	None
2. We compared the attached schedule provided by Fishpond Airways Pty Ltd of major suppliers and the amounts owing at 30 July 2015 to each of the related names and amounts in the trial balance.	We found the amounts compared to be in agreement, except for the exception noted.	The amount included in the trial balance as owing to Hancy Aeronautical Parts Pty Ltd was $107,894. The amount included in the attached schedule as owing to Hancy Aeronautical Parts Pty Ltd was $57,894.
3. For 7 suppliers haphazardly selected from the attached schedule we obtained suppliers' statements or requested suppliers to confirm balances owing at 30 July 2015.	We found there were suppliers' statements for all such suppliers.	None

FIGURE 1.4 Example of an agreed upon procedures report

FIGURE 1.4 (*continued*)

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4. We compared such statements or confirmations to the amounts referred to in 2. For amounts which did not agree, we obtained reconciliations from Fishpond Airways Pty Ltd. For reconciliations obtained, we identified and listed outstanding invoices, credit notes and payments, each of which was greater than $10,000. We agreed outstanding invoices over $10,000 for suppliers selected to accounts payable for the subsequent period, invoices subsequently received and either credit notes or payment made.	We found the amounts agreed, or with respect to amounts which did not agree, we found Fishpond Airways Pty Ltd had prepared reconciliations and that the credit notes, invoices and payments over $10,000 as agreed to reconciling items.	None

Restriction on Distribution and Use of Report

This report is intended solely for the use of Fishpond Airways Pty Ltd for the purpose set out above. As the intended user of our report, it is for you to assess both the procedures and our factual findings to determine whether they provide, in combination with any other information you have obtained, a reasonable basis for any conclusions which you wish to draw on the subject matter. As required by ASRS 4400 *Agreed-Upon Procedures Engagements to Report Factual Findings* , distribution of this report is restricted to those parties that have agreed the procedures to be performed with us and other intended users identified in the terms of the engagement (since others, unaware of the reasons for the procedures, may misinterpret the results).

Our report may be relied upon by Fishpond Airways Pty Ltd for the purpose set out above only pursuant to the terms of our engagement letter dated 2 August 2015.

We disclaim all responsibility to any other party for any loss or liability that the other party may suffer or incur arising from or relating to or in any way connected with the contents of our report, the provision of our report to the other party or the reliance upon our report by the other party.

EY

EY
Melbourne

23 September 2015

Source: EY 2015.

1.4 Different audit opinions

LEARNING OBJECTIVE 1.4 Categorise different audit opinions.

Chapter 12 contains a detailed discussion of the different types of audit opinion at which an auditor can arrive when completing their audit. The purpose of this section is to present a very brief overview of those opinions to show where we are heading.

The most common audit report includes an **unmodified opinion**. This type of opinion is arrived at when the auditor believes that the financial report is true and fair, it presents fairly the financial position of the company, and the information provided is in accordance with Australian Accounting Standards and interpretations and the Corporations Act.

An audit report may be modified with the inclusion of an 'emphasis of matter' paragraph (ASA 706 (ISA 706) (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*). An emphasis of matter paragraph does not affect the auditor's opinion that the financial report is true and fair. It draws the attention of the reader to an issue that the auditor believes has been adequately and accurately explained in a note to the financial report. The purpose of the emphasis of matter paragraph is to ensure that the reader pays appropriate attention to the issue when reading the financial report.

Finally, an audit report may be **modified** with a qualified, adverse or disclaimer opinion (ASA 705 (ISA 705) (Revised) *Modifications to the Opinion in the Independent Auditor's Report*). These types of modifications do affect the auditor's opinion. A **qualified opinion** is issued when the auditor believes that 'except for' the effects of a matter that is explained in the audit report, the financial report can be relied upon by the reader. A qualified opinion is used when the matter of concern can be identified, quantified and explained in the audit report. In this case the matter of concern is material but not pervasive to the financial report. In this context 'pervasive' refers to misstatements that are not confined to individual accounts or elements of a financial report, or, if confined, the misstatements affect an extensive portion of a financial report or are disclosures that are vital to a user's understanding of the financial report. More serious matters require an adverse opinion or disclaimer of opinion. An adverse opinion is appropriate if the auditor has evidence that identified misstatements, individually or in aggregate, are material and pervasive to the financial report. A disclaimer of opinion is used when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and concludes that the possible effects on the financial report could be material and pervasive. Although these opinions are used in different circumstances, in both instances the matter or matters of concern are so material and pervasive to the financial report that the auditor cannot issue a qualified, 'except for' opinion.

The different audit opinions are illustrated in table 1.1.

TABLE 1.1 **Different audit opinions**

Nature of matter giving rise to the modification	Auditor's judgement about the pervasiveness of the effects or possible effects on the financial report	
	Material but not pervasive	**Material and pervasive**
The financial report is materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Source: Auditing and Assurance Standards Board 2015, ASA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*, para A1.

CLOUD 9

Ron worries that an auditor might not be able to give an unmodified opinion on his business's financial reports. The whole point of getting an audit would be to give Chip sufficient assurance that the financial reports give a true and fair view of his business's financial position and performance, and thus agree to pay a good price for the business. If the auditor gives a disclaimer of opinion or an adverse opinion, Chip could either change his mind about the business, or offer only a very low price because he can't be sure that the business is as profitable and as solvent as Ron claims. Even getting a qualified opinion would be serious. Ernie assures Ron that disclaimers are extremely rare; in fact, he has never seen one. Adverse opinions are also rare, and if Ron's belief about his good financial records and tight control over assets is well founded, then there should not be any major problems.

BEFORE YOU GO ON

- When will an unmodified opinion be issued?
- What are the different types of modified audit opinions?
- What is the purpose of an emphasis of matter paragraph?

1.5 Preparers and auditors

LEARNING OBJECTIVE 1.5 Discriminate between the different role of the preparer and the auditor, and discuss the different firms that provide assurance services.

In this section we explain and contrast the different responsibilities of financial report preparers and auditors. We provide details of the role that each group plays in ensuring that the financial report is an accurate representation of the company in question. Following this discussion is an overview of the different firms that provide assurance services.

A financial report includes the balance sheet (statement of financial position), income statement (statement of comprehensive income), statement of cash flows, statement of changes in equity and accompanying notes. It is the responsibility of those charged with governance (generally the board of directors and management of an entity) to prepare the financial report. They must ensure that the information included in the financial report is true and fair and complies with Australian Accounting Standards and interpretations and the Corporations Act. According to paragraph A2 of ASA 200 (ISA 200), it is the responsibility of those charged with governance to identify the financial reporting framework to be used in the preparation and presentation of their financial report, establish and maintain internal controls that are effective in preventing and detecting material misstatements finding their way into the financial report, selecting and applying appropriate accounting policies and making reasonable accounting estimates.

1.5.1 Preparer responsibility

It is the responsibility of those charged with governance to ensure that the information contained in their financial report is relevant, reliable, comparable, understandable and true and fair. Each of these concepts is now discussed.

Relevant

The information included in the financial report should be relevant to the users of that report. Information is relevant if it has an impact on the decisions made by users regarding the performance of the entity. Users require information that helps them evaluate past, present and future events relating to the entity. They are interested in evaluating past decisions made by management and predicting whether the entity will remain viable (that is, a going concern) into the future. Users can use current information to estimate future share price movements, likely dividend payments and the ability of the entity to meet its immediate obligations.

Reliable

The information included in the financial report should be reliable to the users of that report. Information is reliable when it is free from material misstatements (errors or fraud). If users perceive that the information presented is unreliable, for whatever reason, the financial report cannot be used to make the types of decisions outlined above. The information must be unbiased; it must not be presented in such a way as to influence the decision-making process of the user. An independent audit of the financial report is one method of improving the reliability of the financial report.

Comparable

The information included in the financial report should be comparable through time. Users need to be able to trace an entity's performance to identify any trends that may influence their perception of how well the entity is doing. Users also need to be able to benchmark the performance of the entity against other similar organisations to assess its relative performance. To enable such comparisons, information must be presented consistently across time and across entities. Any changes in accounting policies must be clearly disclosed so that appropriate adjustments can be made. Consistent application of Australian Accounting Standards by all entities over time aids these comparisons.

Understandable

The information included in the financial report should be understandable. Users need to understand the information presented in order to make appropriate decisions. The notes to the financial report are used to provide additional details to aid in the interpretation of the accounting information provided. The details included in the notes must be phrased in such a way as to impartially inform users to aid their decision making.

True and fair

The information included in the financial report should be true and fair. 'Truth and fairness' or 'presented fairly' refers to the consistent and faithful application of accounting standards or an applicable framework when preparing the financial report.

It is the responsibility of the auditor to form an opinion on the truth and fairness or fair presentation of the financial report. In doing so, the auditor will assess the accounting policies selected by those charged with governance of the entity. Specifically, the auditor will evaluate whether those accounting policies are consistent with the financial reporting framework used by the entity. The auditor will also consider the accounting estimates made by those charged with governance and management to determine whether the estimates are reasonable. The auditor will assess the relevance, reliability, comparability and understandability of the information presented in the financial report.

1.5.2 Auditor responsibility

When undertaking an audit, the auditor should use professional scepticism, professional judgement and due care. Each of these concepts is now defined and explained.

Professional scepticism

Professional scepticism is an attitude adopted by the auditor when conducting the audit. It means that the auditor remains independent of the entity, its management and its staff when completing the audit work. In a practical sense, it means that the auditor maintains a questioning mind and thoroughly investigates all evidence presented by their client. The auditor must seek independent evidence to corroborate information provided by their client; they must be suspicious when evidence contradicts documents held by their client or enquiries made of client personnel (including management and those charged with governance).

Professional judgement

Professional judgement relates to the level of expertise, knowledge and training that an auditor uses while conducting an audit. An auditor must utilise their judgement throughout the audit. For example, an auditor must determine the reliability of an information source, and decide on the sufficiency and appropriateness of evidence gathered, the procedures to be used in testing and an appropriate sample size.

Due care

Due care refers to being diligent while conducting an audit, applying technical and statute-backed standards, and documenting each stage in the audit process.

1.5.3 Assurance providers

Assurance services are provided by accounting and other consulting firms. The largest accounting firms in Australia are known collectively as the 'Big-4' or the first-tier. The firms that comprise the Big-4 are Deloitte, EY, KPMG and PwC. These four firms operate internationally and dominate the assurance market throughout the world. The first-tier once comprised eight firms, but after a series of mergers and the collapse of Arthur Andersen, the Big-8 became the Big-4. These four firms dominate the audits of Australia's largest companies.

The next tier of accounting firms is known as the mid-tier or second-tier. The firms that comprise the mid-tier have a significant presence nationally and most have international affiliations. The firms that make up the mid-tier in Australia include, among others, Crowe Horwath, BDO, PKF Australia, Grant Thornton, Pitcher Partners, Moore Stephens, Nexia and RSM Bird Cameron. These firms service medium-sized and smaller clients.

The next tier of accounting firms is made up of regional and local accounting firms. These firms service clients in their local areas and range in size from single-partner firms to several-partner firms with professionally qualified and trained staff.

All of these accounting firms provide non-assurance (or non-audit) services as well as assurance (or audit) services. These non-assurance services include management consulting, mergers and acquisitions, insolvency, tax and accounting services. The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9) specifies a number of requirements when an accounting firm provides non-audit services to their audit clients. These rules were established to increase the transparency of the extent of services being provided by an accounting firm to their audit clients following the collapse of several high-profile companies including Enron (in the United States) and HIH (in Australia). The collapse of Arthur Andersen (previously a first-tier accounting firm) raised concerns that the provision of non-audit services to an audit client may affect the independence and objectivity of the auditor.

A company's annual report (which contains their financial report) includes the directors' report. CLERP 9 requires that the directors' report must include a section headed 'non-audit services' or similar. That section must include:

- details of the amount paid or payable to the company's auditor for non-audit services (each non-audit service must be listed separately along with the amount paid or payable for that service)
- a statement of whether the directors are satisfied that the provision of non-audit services by the auditor does not affect the auditor's independence
- if the directors are satisfied that auditor independence has not been impacted by the provision of non-audit services, a statement of the directors' reasons for being satisfied.

Accounting firms are not the only providers of assurance services. A number of consulting firms provide assurance services primarily of corporate social responsibility disclosures, including some combination of environmental disclosures, carbon emissions, community engagement, charitable activities and employee welfare. Consulting firms employ staff with a variety of expertise including, for example, engineers, accountants, sociologists, scientists and economists.

CLOUD 9

Ernie stresses to Ron that any financial reports prepared for McLellan's Shoes are Ron's responsibility, even if they are audited. The auditor has to be sceptical about the claims made by Ron in the financial reports. These claims include, for example, that the assets shown on the balance sheet exist and are valued correctly, and that the balance sheet contains a complete list of the business's liabilities. In other words, the auditor is not just going to believe whatever Ron tells them. Auditors must gather evidence about the financial reports before they can give an audit opinion. Ernie also explains to Ron that because his business is relatively small, he has a choice between large and small audit firms. Very large companies must choose a Big-4 auditor because often the other auditors are too small to do the work and still maintain their independence. If a small audit firm audits a large company it is open to the criticism that it will not be sufficiently sceptical because it does not want to lose the fees from that client. A large audit firm has many other clients, so the fees from any one client are a relatively small part of its revenue. Ron likes the idea that the smaller audit firms are generally less expensive.

BEFORE YOU GO ON

- A financial report must be relevant and reliable. What do these terms mean in this context?
- What three characteristics should an auditor have when conducting an audit?
- What are non-audit services?

1.6 Demand for audit and assurance services

LEARNING OBJECTIVE 1.6 Justify the demand for audit and assurance services.

In this section we will firstly provide an overview of the key financial report users and their requirements. This is followed by a description of why these users may demand an audit of the financial report. Three theoretical frameworks that have been used to encapsulate these sources of demand are next described. Finally, the demand for assurance services in a voluntary setting is explored.

1.6.1 Financial report users

Financial report users include current and potential investors (shareholders if the entity is a company), suppliers, customers, lenders, employees, governments and the general public. Each of these groups will read the financial report for a slightly different reason. Each group of users and their reasons for reading a company's financial report is described below.

Investors

Investors generally read a financial report to determine whether they should invest in, or buy, hold or sell shares in the case of a company, the entity being reported on. They are interested in the return on their investment and are concerned that the entity will remain a going concern into the foreseeable future. Investors may also be interested in the capacity of the entity to pay a dividend. Prospective investors read financial reports to determine whether they should buy shares in the entity.

Suppliers

Suppliers may read a financial report to determine whether the entity can pay them for goods supplied. They are also interested in whether the entity is likely to remain a going concern (that is, is likely to continue to be a customer of the supplier), and continue to be able to pay its debts as and when they fall due.

Customers

Customers may read a financial report to determine whether the entity is likely to remain a going concern if the customer relies on the entity for their business.

Lenders

Lenders may read a financial report to determine whether the entity can pay the interest and principal on their loans as and when they fall due.

Employees

Employees may read a financial report to determine whether the entity can pay their wages or salaries and other entitlements (for example, holiday pay). They may also be interested in assessing the future stability and profitability of the entity, as this affects their job security.

Governments

Governments may read a financial report to determine whether the entity is complying with regulations, is paying a fair amount of taxation given its reported earnings and to gain a better understanding of the entity's activities. An entity in receipt of government grants may provide a copy of their financial report when applying for a grant and when reporting on how grant funds have been spent.

The general public

The general public may read a financial report to determine whether they should associate with the entity (for example, as a future employee, customer or supplier), and to gain a better understanding of the entity, what it does and its plans for the future.

1.6.2 Sources of demand for audit and assurance services

Financial report users and their needs, as outlined in the previous section, are many and varied. There are a number of reasons why some or all of these users would demand an audit of a financial report. These include remoteness, complexity, competing incentives and reliability. Each of these concepts is now explained.

Remoteness

Most financial report users do not have access to the entity under review. This makes it difficult to determine whether the information contained in the report is a fair presentation of the entity and its activities for the relevant period.

Complexity

Most financial report users do not have the accounting and legal knowledge to enable them to assess the reasonableness of complex accounting and disclosure choices being made by the entity.

Competing incentives

Management has an incentive to disclose the information contained in the financial report in a way that helps them achieve their own objectives; for example, to present their performance in the best possible light. Users may find it difficult to identify when management is presenting biased information.

Reliability

Financial report users are concerned with the reliability of the information contained in the financial report. As they use that information to make decisions that have real consequences (financial and otherwise, such as assessing the future viability of the company) it is very important that users are able to rely on the facts contained in the financial report.

An independent third-party review of the information contained in the financial report by a team of auditors, who have the knowledge and expertise to assess the truth and fairness of the information being presented by the preparers, aids users across all of these issues. Auditors have access to entity records, so they are not remote. They are trained accountants and so have detailed knowledge about the complex technical accounting and disclosure issues required to assess the choices made by the financial report preparers. Independent auditors have no incentives to aid the entity in presenting their results in the best possible light. They are concerned with ensuring that the information contained in the financial report is reliable and free from any significant (material) misstatements (error or fraud).

CLOUD 9

Ron tells Ernie that he has no remote users, such as shareholders or lenders, and his business is not very complex. He is the owner and the manager of McLellan's Shoes and therefore has no competing incentives. For all these reasons, he has never felt the need to purchase an audit to assure users of the reliability of his business's financial information. Ernie agrees, but points out that there is now a user who is very interested in the reliability of the financial information — Chip Masters.

1.6.3 Theoretical frameworks

The reasons for demanding audit and assurance services outlined in the previous section have led to the development of three theoretical frameworks that have been used to explain why audits occurred prior to regulations requiring that they be done, why users may demand an audit from a certain type of firm (for example, a first-tier or an industry specialist firm) and why users may demand assurance of voluntarily disclosed information (for example, environmental reports). The three theories are agency theory, the information hypothesis and the insurance hypothesis. Each is described in turn.

Agency theory

When an individual is an owner-manager of their own business there are no competing incentives. The owner (principal) and manager (agent) are one. When an owner hires a manager to run the business on their behalf, potential conflicts arise. The manager has an incentive to provide favourable results. If there is one owner, they can more easily monitor the activities of their manager. When there are several owners (such as shareholders of a large company) it is difficult for the owners to monitor the activities of the management. Agency theory tells us that due to the remoteness of the owners from the entity, the complexity of items included in the financial report and competing incentives between the owners and managers, the owners (principals) have an incentive to hire an auditor (incur a monitoring cost) to assess the truth and fairness of the information contained in the financial report prepared by their managers (agents). Managers also have an incentive to hire an auditor to demonstrate to their shareholders that they have prepared true and fair financial reports free of fraud and error.

Information hypothesis

Financial report users require access to high-quality information to make a variety of decisions. That information is used to determine whether to hold or sell shares in the entity, whether to lend money to the entity, what rate of interest to charge the entity on money lent and so on. The greater the perceived quality of the information contained in the financial report, the more likely it is relied upon by the users of that information. The information hypothesis tells us that due to the demand for reliable, high-quality information, various user groups including shareholders, banks and other lenders will demand that financial reports be audited to aid their decision making.

Insurance hypothesis

Investors take on a risk when buying shares. If the entity fails, investors could lose the money invested. According to the insurance hypothesis, an audit is one way for investors to insure against at least part of their loss should the company they invest in fail. As auditors are required to take out professional indemnity insurance policies they are seen as having 'deep pockets' (that is, access to money), should an investor be able to prove that audit negligence was to blame, at least in part, for their loss. The insurance hypothesis tells us that investors will demand that financial reports be audited as a way of insuring against some of their loss should their investment fail. In chapter 2, we discuss the legal liability of the auditor and provide details of cases where investors have sued auditors seeking compensation after they have suffered a loss.

CLOUD 9

Cloud 9 is considering buying McLellan's Shoes from Ron. In effect, it is considering investing in the business. If the business fails, the shareholders of Cloud 9 will lose their money. The new investors have competing incentives to Ron. If Ron purchases an audit, he is providing assurance to the potential new investors about the truth and fairness of the financial reports. The audit also increases the perceived reliability of the information in the financial reports. For example, the outsiders know that Ron will have to convince an auditor of the appropriateness of the reporting decisions he is making.

Purchasing an audit is also a way of taking insurance against any possible loss by creating the opportunity for investors to recover their investment from the auditor. In reality, the auditor is not guaranteeing the success of the business, only providing reasonable assurance that the financial report complies with the relevant laws and standards and gives a true and fair view of the business's financial position and performance. There is little chance of a successful legal action against an auditor unless it can be established that the auditor failed to perform to a reasonable standard.

1.6.4 Demand in a voluntary setting

While the main focus of this text is the audit of company financial reports, assurance providers (including auditors and consultants) provide other assurance services (as outlined in section 1.2). The theories outlined above are now being used to understand more about the demand for assurance of CSR disclosures including environmental, sustainability and carbon emissions reports.

It is becoming more common for companies to voluntarily disclose CSR information in their annual reports, on their websites and in separate stand-alone reports. This trend of increased disclosures has been in response to stakeholder (shareholder, lender, employee, customer, supplier and public) demand that companies be more accountable for their impact on the environment and on society. Stakeholders are concerned about more than just profits and returns on shareholder funds. They want to know what impact companies are having on our environment and what actions are being taken by those companies to reduce that impact.

Stakeholders are concerned about the reliability of environmental and other CSR disclosures. Just as the provision of these disclosures is voluntary, so is the assurance. Companies are not required to have their environmental and other CSR disclosures assured. Yet, a number of companies do. Assurance is provided to meet user demands for high-quality, reliable information, and to also demonstrate a high level of corporate responsibility.

BEFORE YOU GO ON

- Who are the main users of company financial reports?
- Why might financial report users demand an audit?
- What are the three most common theories used to explain the origins of the demand for audit and assurance services?

1.7 The role of regulators and regulations

LEARNING OBJECTIVE 1.7 Compare the different regulators and regulations surrounding the assurance process.

In this section we discuss the regulators and regulations that affect the audit process.

1.7.1 Regulators

A number of regulators have an impact on the audit process, either directly or indirectly. They include the Financial Reporting Council (FRC), the Auditing and Assurance Standards Board (AUASB), the Accounting Professional and Ethical Standards Board (APESB), the Australian Securities and Investments Commission (ASIC), the Australian Securities Exchange (ASX), the Companies Auditors and Liquidators Disciplinary Board (CALDB), Chartered Accountants Australia and New Zealand (CAANZ), CPA Australia and the Institute of Public Accountants (IPA). Each regulator will now be discussed in turn.

Financial Reporting Council (FRC)

The FRC is a statutory body. Its activities are determined by the *Australian Securities and Investments Commission (ASIC) Act 2001* amended by the CLERP Act. The FRC oversees the process used for setting accounting standards (by the Australian Accounting Standards Board (AASB)) and auditing standards (by the AUASB). The FRC also monitors and reports regularly on matters concerning auditor independence. To ensure standard-setter independence, the ASIC Act specifically prohibits the FRC from becoming involved in technical issues around the standard-setting process.

Auditing and Assurance Standards Board (AUASB)

In accordance with section 336 of the Corporations Act, the AUASB is responsible for the formulation of auditing and assurance standards. Auditing standards include mandatory requirements, which are legally enforceable under the Corporations Act. Members of the AUASB are appointed by the FRC. The chair of the board is appointed by the Minister for Superannuation and Corporate Law. The AUASB significantly revised and redrafted the Australian Auditing Standards (ASAs) to bring them in line with International Standards on Auditing (ISAs), which are issued by the International Auditing and Assurance Standards Board (IAASB). The IAASB undertook a redrafting of the ISAs, placing them in a 'clarity' format to improve the consistent application of International Auditing Standards worldwide. As well as issuing ASAs, the AUASB is responsible for issuing Auditing Standards on Review Engagements (ASREs), Standards on Assurance Engagements (ASAEs) and Guidance Statements (GSs).

Accounting Professional and Ethical Standards Board (APESB)

The APESB was established in 2006 by CPA Australia and the Institute of Chartered Accountants (now CAANZ). The Institute of Public Accountants (IPA) is now also a member of the APESB. The APESB was established as an independent body to issue professional and ethical standards and to actively advocate the professional and ethical behaviour of accountants. Accountants who are members of the professional accounting bodies (CAANZ, CPA Australia and the IPA) are required as a condition of their membership to comply with the ethical and professional standards approved by the APESB. APES 110 *Code of Ethics for Professional Accountants* and other APESB professional standards and guidance notes are binding on all members of the professional accounting bodies. Broadly, these standards aim to regulate members' ethical conduct and the performance of professional services across various types of professional and business engagements. The APESB follows pronouncements issued by the International Ethics Standards Board for Accountants (IESBA) as a base for its proposed professional and ethical standards, and in doing so seeks to maintain conformity of its standards with those of the IESBA. As ASA 210 (ISA 210) *Agreeing the Terms of Audit Engagements* requires compliance with ethical standards, they too are legally enforceable under the Corporations Act.

Australian Securities and Investments Commission (ASIC)

ASIC is an independent Commonwealth Government body. ASIC was established by the ASIC Act. ASIC administers the ASIC Act and conducts much of the work required by the Corporations Act. ASIC regulates Australia's corporate, markets and financial services sectors. The ASIC Act requires that ASIC:

- maintain, facilitate and improve the performance of the financial system
- promote confident and informed participation by investors and consumers in the financial system
- administer the law effectively and with minimal procedural requirements
- enforce and give effect to the law
- receive, process and store, efficiently and quickly, information provided by others
- make information about companies and other bodies available to the public as soon as practicable.

ASIC also plays a role in overseeing the audit function. ASIC registers auditors, processes annual statements from registered auditors, enforces independence requirements and provides a whistleblowing facility for the reporting of contraventions of the Corporations Act. CLERP 9 requires that ASIC conducts an audit inspection program to report on audit quality and make recommendations for continued improvement. In response to this requirement, ASIC visits a selection of audit firms annually to gain an understanding of their policies and procedures in relation to their independence, audit quality, methodologies and training programs.

Australian Securities Exchange (ASX)

The ASX was formed in 1987 by the merging of six independent stock exchanges that operated in the state capital cities. Each of those exchanges had a history of share trading dating back to the nineteenth century. The ASX aims to help listed companies raise funds, provide opportunities for investors to build wealth and enable buyers and sellers to transact with confidence. The ASX reports that about half of Australians own shares either directly or indirectly through managed funds or self-managed superannuation funds. The detail contained in published audited financial reports is one important source of information for investors in companies that trade on the ASX. The ASX has published guidelines and recommendations for good corporate governance. These recommendations aim to improve, among other things, the reliability of published financial reports. These guidelines are discussed in detail in chapter 3.

Companies Auditors and Liquidators Disciplinary Board (CALDB)

The CALDB was established in 1990 to replace state-based boards by the Corporations Act and the ASIC Act. The CALDB can respond only to applications made by ASIC (regarding an auditor) or the Australian Prudential Regulation Authority (regarding a liquidator) stating that the individual concerned has breached the Corporations Actor the ASIC Act. In particular, the CALDB is involved when it is believed an auditor or liquidator has not carried out their duties properly, is not a fit and proper person, is subject to disqualification or should not remain registered for some other reason. In response, the CALDB may cancel or suspend the individual's registration, give the individual a warning or ask them to make an undertaking to improve their conduct.

Chartered Accountants Australia and New Zealand (CAANZ)

CAANZ is a professional body with more than 100 000 members working in public practice (including the Big-4 and mid-tier chartered accounting firms), industry, academia and government. CAANZ was formed in 2014 following the amalgamation of the Institute of Chartered Accountants Australia (ICAA) and the New Zealand Institute of Chartered Accountants (NZICA). Its members work in Australia, New Zealand and more than 100 other countries. To become a chartered accountant it is necessary to undertake the Chartered Accountants (CA) Program, which combines study and mentored work experience. After completing an accounting course accredited by CAANZ and work experience supervised by a chartered accountant mentor, it is possible to commence the CA program. After completing the CA

Program and three years of work experience supervised by a chartered accountant mentor, it is possible to apply for membership of CAANZ.

The CA Program

The CA Program includes five modules and a practical experience component. The first four modules can be taken in any order but the fifth must be done last:
1. audit and assurance
2. financial accounting and reporting
3. management accounting and applied finance
4. taxation
5. capstone.[8]

The practical experience component comprises three years full-time experience in a relevant accounting role at an accredited organisation continuously mentored by a member of CAANZ or a member of an overseas accounting body recognised by CAANZ.

CPA Australia

CPA Australia is a professional body with more than 150 000 members working as finance, accounting and business professionals, academics and public servants in Australia and around the world. A number of professional bodies, dating back to the late 1880s, merged to create a combined body in the early 1900s. Various versions of that professional body operated under a variety of names, before becoming CPA Australia in 2000. To become a CPA it is necessary to undertake the CPA Program and have three years of work experience mentored by a member of CPA Australia.

The CPA Program

The CPA Program comprises six segments; four compulsory and two electives. The four compulsory segments are:
1. ethics and governance
2. strategic management accounting
3. financial reporting
4. global strategy and leadership (must be done last).

The two electives can be chosen from:
1. advanced audit and assurance
2. advanced taxation
3. contemporary business issues
4. financial risk management.[9]

The CPA Program also requires that candidates complete three years full time mentored relevant practical experience.

Institute of Public Accountants (IPA)

The IPA is a professional body with more than 26 000 members working in industry, commerce, government, academia and public practice. The IPA was formed in the early twentieth century as the Institute of Factory and Cost Accountants.

To become a member of the IPA, a graduate with an approved degree needs to complete four units and three years of mentored work experience. The four units include two electives and:
1. strategic planning and management
2. professional ethics.[10]

1.7.2 Regulation

In this section we provide a broad overview of some of the key regulations that impact the audit process. Auditing standards and pronouncements, the Corporations Act and CLERP 9 are discussed in turn.

Auditing standards and pronouncements

Auditing standards are issued by the AUASB in Australia. These standards provide minimum requirements and guidance for auditing and assurance services. The standards comprise Australian Auditing Standards (ASAs), Standards on Review Engagements (ASREs), Standards on Assurance Engagements (ASAEs) and Standards on Related Services (ASRSs). ASAs were developed and are regularly updated to guide financial report audits and apply to all audits of historical financial information where reasonable assurance is provided. ASREs apply to the review of a financial report and other historical financial information where limited assurance is provided. ASAEs apply to assurance engagements dealing with subject matter other than historical financial information, such as the effectiveness of internal controls, where either reasonable or limited assurance is provided. ASRSs apply to engagements involving agreed upon procedures where no assurance is provided. The AUASB also issues a standard on quality control for firms that perform audits and reviews (ASQC1) and Guidance Statements on audit, review, assurance and related services matters.[11] Figure 1.5 provides an overview of the pronouncements issued by the AUASB.

Corporations Act

The Corporations Act provides guidance on the audit of a company's financial report. Section 301 requires that certain financial reports be audited. Section 307 specifies that the audit report must state whether the financial report is in accordance with accounting standards and whether it provides a true and fair view. Section 307A stipulates that auditing standards must be followed when conducting an audit. Section 307B requires the retention of audit working papers for seven years and section 307C requires that the auditor declare their independence from the company being audited. The Act empowers the auditor to gain access to information required as part of their audit and requires that the auditor must report to ASIC when they believe that the company being audited has not complied with the Corporations Act or has somehow attempted to interfere with the audit.

CLERP 9

The CLERP 9 Act came into effect on 1 July 2004. CLERP 9 delivered significant changes to a number of Acts, including the Corporations Act and the ASIC Act. It contains a number of amendments affecting the audit profession. Establishing the Auditing and Assurance Standards Board was part of this change giving auditing standards the force of law for the purposes of the Corporations Act.

Some of the other changes brought about by CLERP 9 include:

- financial report disclosure of non-audit services provided by a company's auditors
- additional disclosure in the directors' report regarding the auditor
- enhanced auditor independence requirements
- restrictions on an auditor becoming an officer of their client within two years of ceasing employment with their audit firm
- auditor rotation for those that play a significant role in the audit of a client in five out of seven years.

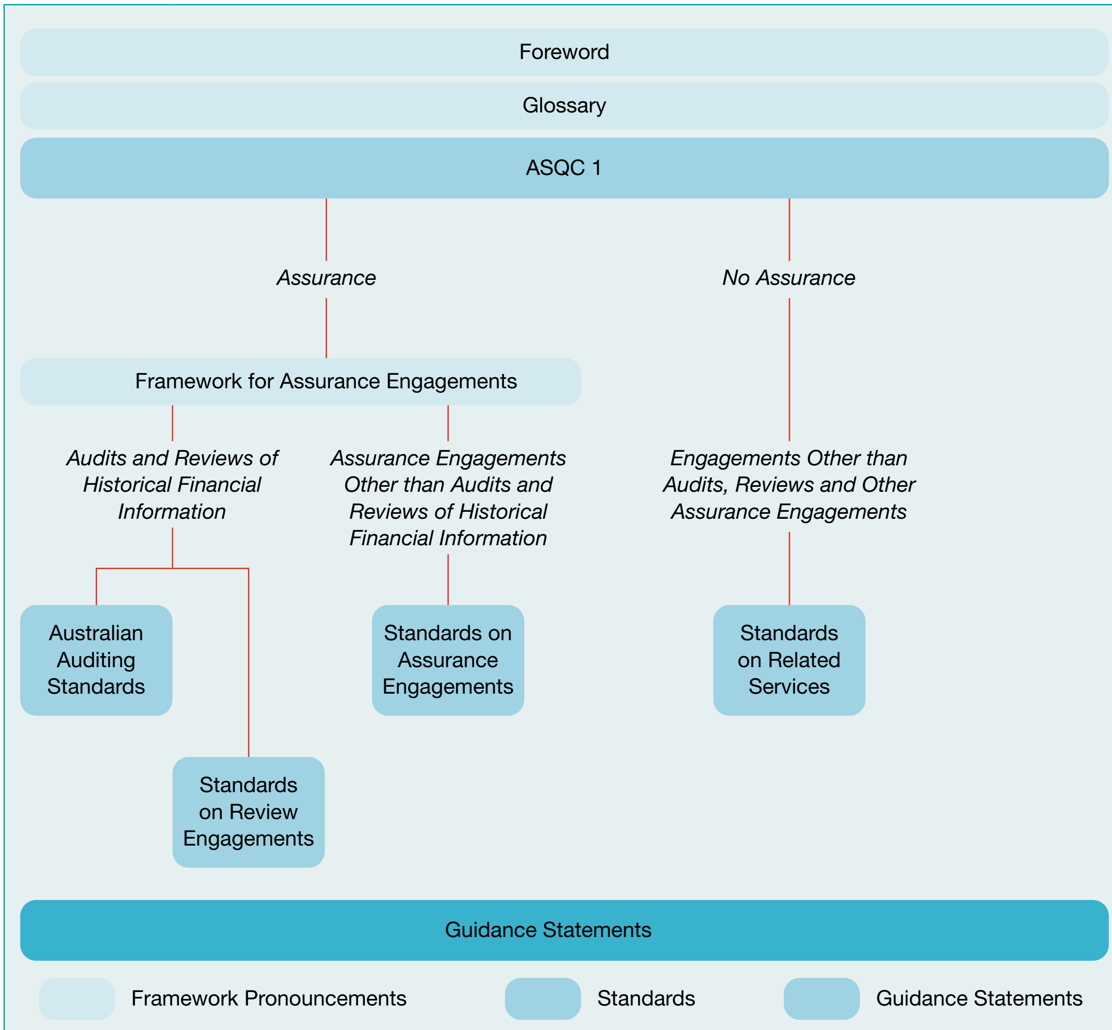

FIGURE 1.5 Structure of pronouncements issued by the AUASB

Source: Auditing and Assurance Standards Board 2014, *Framework for Assurance Engagements*, 'Appendix 1', p. 25.

CLOUD 9

Ernie explains that, in general, the regulators and regulations that apply to companies are not relevant to McLellan's Shoes because it is not incorporated. However, any auditor Ron engages would be also performing company audits and would be a member of at least one of the professional accounting bodies. The auditor would apply the auditing and accounting standards that are relevant to an audit engagement when auditing a small business. The auditor would apply strict professional standards to Ron's audit and should perform the audit to a reasonable standard.

BEFORE YOU GO ON

- Name the three professional accounting bodies in Australia.
- What is the FRC and what is its role?
- What are the main functions of the CALDB?

1.8 The audit expectation gap

LEARNING OBJECTIVE 1.8 Categorise the audit expectation gap.

The audit expectation gap occurs when there is a difference between the expectations of assurance providers and financial report users. The gap occurs when user beliefs do not align with what an auditor has actually done. In particular, the gap is caused by unrealistic user expectations such as:
- the auditor is providing complete assurance
- the auditor is guaranteeing the future viability of the entity
- an unmodified audit opinion is an indicator of complete accuracy
- the auditor will definitely find any fraud
- the auditor has checked all transactions.

The reality is that:
- an auditor provides reasonable assurance
- the audit does not guarantee the future viability of the entity
- an unmodified opinion indicates that the auditor believes that there are no material (significant) misstatements (errors or fraud) in the financial report
- the auditor will assess the risk of fraud and conduct tests to try to uncover any fraud, but there is no guarantee that they will find a fraud, should one have occurred
- the auditor tests a sample of transactions.

The audit expectation gap is represented graphically in figure 1.6.

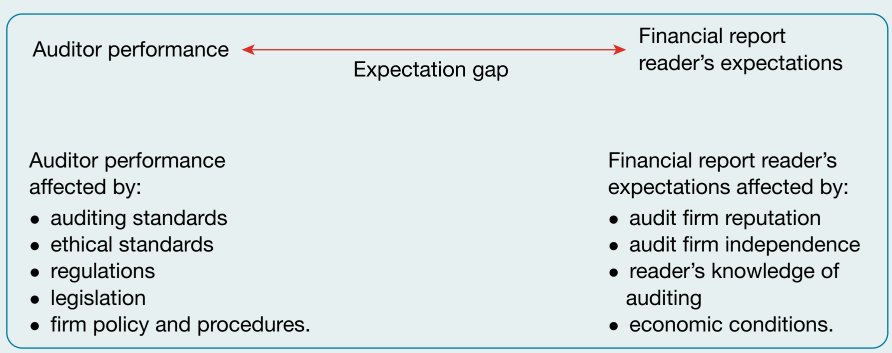

FIGURE 1.6 Audit expectation gap

The audit expectation gap can be reduced by:
- auditors performing their duties appropriately, complying with auditing standards and meeting the minimum standards of performance that should be expected of all auditors
- peer reviews of audits to ensure that auditing standards have been applied correctly
- auditing standards being reviewed and updated on a regular basis to enhance the work being done by auditors
- education of the public
- enhanced reporting to explain what processes have been followed in arriving at an audit (reasonable assurance) or a review (limited assurance) opinion (significant improvements have been introduced by standard setters improving assurance reporting)
- assurance providers reporting accurately the level of assurance being provided (reasonable, limited or none).

It is anticipated that the new audit report format will reduce the expectation gap.

As described in this chapter, financial report users rely on an audited financial report to make a variety of decisions. They use the report to assess the performance of the company, the appropriateness of the remuneration paid to management, the adequacy of dividends declared and the likely future viability of the company. Following the corporate collapses of the early 2000s (for example, Enron and HIH) user confidence in auditors and audited financial reports hit a low. The Australian federal government responded by asking Professor Ian Ramsay to write a report on the state of auditor independence in Australia. At that time the government also announced that a Royal Commission would inquire into the circumstances surrounding the failure of the HIH Insurance Group. The results of the HIH Royal Commission and Ramsay's report (2001) have been incorporated in CLERP 9, as described in this chapter.

The standard setters have also responded to public demands that auditors pay greater attention to the risk that a material fraud may occur. ASA 240 (ISA 240) *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report* requires that auditors consider the risk of material fraud on every audit. The auditor must assess the risk that a material fraud could occur and gauge the adequacy of the client's system of internal control to prevent or detect such a fraud. If the auditor is not satisfied with the client's system of internal control, their audit procedures must be designed to aid in the detection of any material suspected frauds.

While highlighting the importance of considering fraud in every audit, standard setters also highlight that the primary responsibility for fraud prevention and detection remains with those charged with governance (generally the client's management) (ASA 240, para. 4; ISA 240, para. 4). They also emphasise the inherent limitation of any audit, making fraud detection less than certain (ASA 240, para. 5; ISA 240, para. 5).

CLOUD 9

Ron believes that Chip Masters would know what an audit can provide, and what it cannot, because Chip is an experienced vice-president of a large international company. He would deal with auditors on a regular basis. However, would a US businessperson have different expectations from those of an Australian businessperson? Ernie does not think so. The large audit firms operate in both the United States and Australia, and although there are differences in the laws, the basic principles are the same. The large audit firms use the same fundamental methodology, or approach, for all their clients around the world, and the audit reports are similar.

Ron thanks Ernie for his time. Ernie has helped him to understand that preparing more detailed financial reports and engaging an auditor to perform a financial report audit would not be as bad as he first thought. Ron now understands why Ernie thinks audits are valuable, and not just another business expense. If Chip Masters thinks that Ron's financial reports are more credible with an audit, then it is likely that he will be prepared to pay a higher price for Ron's business.

BEFORE YOU GO ON

- Define the audit expectation gap.
- What has caused the audit expectation gap?
- What can be done to reduce the audit expectation gap?

SUMMARY

1.1 Describe an assurance engagement.

An assurance engagement involves an assurance provider arriving at an opinion about some information being provided by their client to a third party. A financial report audit is one type of assurance engagement. This engagement involves an auditor arriving at an opinion about the truth and fairness of the financial report. Their audit report is addressed to the shareholders of the company being audited, but other users may read the financial report.

1.2 Discriminate between different types of assurance services.

Assurance services include financial report audits, compliance audits, performance audits, comprehensive audits, internal audits, and assurance on corporate social responsibility (CSR) disclosures.

1.3 Discriminate between different levels of assurance.

The different levels of assurance include reasonable assurance, which is the highest level of assurance, limited assurance or no assurance. Reasonable assurance is provided on an audit of a company financial report. Limited assurance is provided on a review of a company's half-year financial report. No assurance is provided on an agreed upon procedures engagement.

1.4 Categorise different audit opinions.

An auditor can issue an unmodified report; a modified report that does not affect the auditor's opinion, known as an emphasis of matter opinion; or a modified report that does affect the auditor's opinion and contains a qualified opinion, an adverse opinion or a disclaimer of opinion.

1.5 Discriminate between the different role of the preparer and the auditor, and discuss the different firms that provide assurance services.

It is the responsibility of a company's governing body to ensure that their financial report is relevant, reliable, comparable, understandable, and true and fair. It is the responsibility of the auditor to form an opinion on the truth and fairness or fair presentation of the financial report. In doing so the auditor must maintain their professional scepticism, and utilise professional judgement and due care.

The different firms that provide assurance services include the Big-4 international firms, the mid-tier national firms (with international links), local and regional firms, and consulting firms that tend to specialise in assurance of CSR and environmental disclosures.

1.6 Justify the demand for audit and assurance services.

Financial report users include investors (shareholders), suppliers, customers, lenders, employees, governments and the general public. These groups of users demand audited financial reports due to their remoteness from the entity, accounting complexity, competing incentives between them and the entity's managers, and their need for reliable information on which to base decisions. The theories used to describe the demand for audit and assurance services are agency theory, the information hypothesis and the insurance hypothesis.

1.7 Compare the different regulators and regulations surrounding the assurance process.

Regulators of the assurance process include the Financial Reporting Council (FRC), the Auditing and Assurance Standards Board (AUASB), the Accounting Professional and Ethical Standards Board (APESB), the Australian Securities and Investments Commission (ASIC), the Australian Securities Exchange (ASX), the Companies Auditors and Liquidators Disciplinary Board (CALDB), Chartered Accountants Australia and New Zealand (CAANZ), CPA Australia and the Institute of Public Accountants (IPA). Regulations of the assurance process include auditing standards and pronouncements, Corporations Law and CLERP 9.

1.8 Categorise the audit expectation gap.

The audit expectation gap occurs when there is a difference between the expectations of assurance providers and financial report or other users. The gap occurs when user beliefs do not align with what an auditor has actually done.

KEY TERMS

Agreed upon procedures engagement An auditor completes a set of tasks from which no conclusion is drawn and no assurance is provided to users.

Assurance engagement An engagement performed by an auditor or consultant to enhance the reliability of the subject matter.

Compliance audit An audit to determine whether the entity has conformed with regulations, rules or processes.

Comprehensive audit An audit that encompasses a range of audit and audit-related activities, such as a financial report audit, performance audit and compliance audit.

Consulting firms Non-audit firms that provide assurance services on information such as corporate social responsibility and environmental disclosures.

Corporate social responsibility (CSR) Includes a range of activities undertaken voluntarily by a corporation. CSR disclosures include environmental, employee and social reporting.

Financial report audit Provides reasonable assurance about whether the financial report is prepared in all material respects in accordance with a financial reporting framework.

Internal audit A semi-independent service within an entity which generally evaluates and improves risk management, internal control procedures and elements of the governance process.

Limited assurance Moderate assurance on the reliability of the subject matter.

Modified report When an auditor includes an emphasis of matter paragraph in their report or issues a qualified opinion, an adverse opinion or a disclaimer of opinion.

No assurance When an auditor completes a set of tasks requested by their client and they report factually on the results of that work.

Performance audit An assessment of the economy, efficiency and effectiveness of an organisation's operations.

Qualified opinion Provided when the author concludes that the financial report contains a material (significant) misstatement.

Reasonable assurance High but not absolute assurance on the reliability of the subject matter.

Review engagement The auditor does adequate work to report whether or not anything came to their attention, which would lead them to believe that the information being assured is not true and fair.

Those charged with governance Generally the board of directors and management of an entity.

True and fair view Refers to the consistent and faithful application of accounting standards in accordance with the financial reporting framework, where applicable, when preparing the financial report.

Unmodified opinion When the auditor concludes that the financial report is prepared, in all material respects, in accordance with the applicable financial reporting framework.

MULTIPLE-CHOICE QUESTIONS

1.1 The parties or matters relevant to an assurance engagement are: **LO5**

(a) users, responsible party, subject matter.
(b) assurance practitioner, responsible party.
(c) responsible party, users, subject matter, criteria.
(d) assurance practitioner, users, responsible party.

1.2 When performing an audit required under section 301 of the Corporations Act the auditor has a responsibility to: **LO5**

(a) form an opinion on the subject criteria.
(b) form an opinion on the independence of the directors.
(c) form an opinion on the truth and fairness of the financial report.
(d) all of the above.

1.3 Performance audits are useful because they: **LO2**
(a) include a comprehensive audit.
(b) allow the auditor to demonstrate how well they are performing.
(c) are concerned with the economy, efficiency, and effectiveness of an organisation's activities.
(d) involve gathering evidence to ascertain whether the entity under review has followed the rules, policies, procedures, laws or regulations with which they must conform.

1.4 The function of internal audit is determined by: **LO2**
(a) the IIA.
(b) the government.
(c) the external auditor.
(d) those charged with governance and management.

1.5 Negative assurance means: **LO3**
(a) the auditor has conducted an audit and provides an opinion that the financial reports are true and fair.
(b) the auditor has conducted sufficient work to conclude that the appropriate outcome is an adverse audit report.
(c) the auditor has done adequate work and nothing came to their attention which would lead them to believe that the information being assured is not true and fair.
(d) the auditor disclaims responsibility for the audit opinion because they are unable to do sufficient work to conclude that the information being assured is true and fair.

1.6 An auditor disclaims responsibility when: **LO4**
(a) the users cannot rely on the financial report.
(b) the audit opinion is unqualified and unmodified.
(c) the auditor is unable to obtain sufficient evidence about a potentially material and pervasive matter.
(d) the audit opinion is unqualified and the auditor includes a paragraph in the audit report to emphasise something important.

1.7 Those charged with governance have a responsibility to ensure that the information in financial report is: **LO5**
(a) true and fair.
(b) relevant and reliable.
(c) comparable and understandable.
(d) all of the above.

1.8 Agency theory explains that audits are demanded because conflicts can arise between: **LO6**
(a) auditors and owners.
(b) owners and principals.
(c) agents and managers.
(d) managers and owners.

1.9 The insurance hypothesis means: **LO6**
(a) an audit acts as insurance.
(b) owners must take insurance.
(c) managers must take insurance.
(d) none of the above.

1.10 The audit expectation gap occurs when: **LO8**
(a) the public is well educated about auditing.
(b) user beliefs do not align with what an auditor has actually done.
(c) auditors perform their duties appropriately and satisfy users' demands.
(d) peer reviews of audits ensure that auditing standards have been applied correctly and the standards are at the level that satisfy users' demands.

REVIEW QUESTIONS

1.11 What does 'assurance' mean in the financial reporting context? **LO1**

1.12 Explain the difference between a financial report audit and an assurance engagement. **LO2, 3**

1.13 Who are the three parties relevant to an assurance engagement in the financial reporting context? Explain why each party is interested in the result of an audit. **LO5**

1.14 An assurance engagement involves evaluation or measurement of subject matter against criteria. What criteria are used in a financial report audit? **LO2, 3**

1.15 Who would request a performance audit? Why? **LO2**

1.16 What steps can an organisation take to increase the independence of its internal auditors? **LO2**

1.17 What is an 'emphasis of matter' paragraph? When do you think an auditor would use it? **LO4**

1.18 Compare the financial report users and their needs for a large listed public company with those of a sporting club (for example, a football club). Are the users' needs the same in each case? Explain. **LO6**

1.19 What international standards or guidelines are relevant to the assurance of corporate social responsibility disclosures? **LO2**

1.20 Explain the system of reviewing the quality of audits performed by registered company auditors. **LO7**

1.21 Explain the difference between the IAASB and the AUASB. **LO7**

1.22 Explain the 'audit expectation gap'. What causes the gap? **LO8**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

1.23 AUDIT REPORTS ★ **LO2, 3, 4, 5, 8**

Find a copy of a recent audit report and a review report for an Australian company listed on the ASX.

Required

(a) Explain the relevance of the paragraphs 'Directors' responsibility for the financial report' and 'Auditor's responsibility' in the audit report to the audit expectation gap.
(b) Find the lines in the audit report that express the auditor's opinion. What sort of opinion is it?
(c) Find the lines in the review report that express the auditor's conclusion. Is it an audit opinion? Is it a positive or negative statement?
(d) Make a list of the other differences between the audit report and the review report.

1.24 NON-ASSURANCE SERVICES ★ **LO5**

All companies are required to disclose in their annual reports the amounts paid to their auditors for both the financial report audit and any other services performed for the company.

Required

Obtain a copy of a recent annual report (most companies make their annual reports available on the company's website) and find the disclosures explaining the amounts paid to auditors. How much was the auditor paid for the audit and non-assurance, or other, services?

1.25 TYPES OF ASSURANCE ENGAGEMENTS ★ **LO1**

Find an example of a financial report review report issued by an auditor for a publicly listed company.

Required

(a) What level of assurance is provided by the financial report review?
(b) Why would a review be appropriate for a set of half-yearly financial reports?

1.26 CORPORATE SUSTAINABILITY REPORTING ASSURANCE ★ **LO2, 3, 5**

Find an example of a recent corporate sustainability assurance report for a large company and any audit or review of that report by an auditor.

Required

(a) Who wrote the assurance report?
(b) What level of assurance is provided?

1.27 BIG-4 VS NON-BIG-4 ASSURANCE PROVIDERS ★ LO5, 6

Most audit firms maintain a website that explains the services offered by the firm and provides resources to their clients and other interested parties. The services offered by most firms include both audit and non-audit services.

Required

Find the websites for:
(a) a Big-4 audit firm
(b) a mid-tier audit firm.

Compare them on the:
i. range of services provided
ii. geographic coverage (i.e. where their offices are located)
iii. number of staff and special skills offered
iv. industries in which they claim specialisation
v. publications and other materials provided to their clients or the general public
vi. marketing message.

1.28 NON-ASSURANCE SERVICES ★ LO5

Potter and Partners are a chartered accounting firm with offices in capital cities in most states. The head of the business development department is seeking to grow the firm's revenue from non-audit services.

Required

What non-audit services could a chartered accounting firm provide to its listed company clients? Explain why a company would buy these services from its audit firm instead of another consulting firm.

1.29 CORPORATE SUSTAINABILITY REPORTING ASSURANCE ★ LO2, 3, 5

Climate Balance Pty Ltd is a consulting firm specialising in sustainability and climate change issues. It offers sustainability report assurance services to a variety of organisations, including listed companies. It is not a registered company auditor and does not provide company audits.

Required

Why would a listed company obtain sustainability assurance services from a consulting firm and its company audits from a chartered accounting firm?

1.30 BIG-4 VS NON-BIG-4 ASSURANCE PROVIDERS ★★ LO5, 6

Section 301 of the Corporations Act requires companies to have their financial reports audited. Academic research suggests that Big-4 auditors charge higher fees than other auditors and their audit reports are more credible than those issued by other auditors.[12]

Required

In times of economic recession would you expect:
(a) the demand for audits to increase or decrease?
(b) clients to shift from large (Big-4) auditors to smaller auditors, or from smaller auditors to Big-4 auditors? Why or why not?

1.31 CORPORATE SUSTAINABILITY REPORTING ASSURANCE STANDARDS ★★ LO2, 3, 5

Providers of corporate sustainability assurance reports often state that the work was performed in accordance with ISAE 3000 and/or ASRE 2405. Obtain a copy of each of these documents.

Required

Explain why ISAE 3000 and ASRE 2405 would be useful in CSR assurance.

1.32 EXPECTATIONS GAP ★★ LO8

MaxSecurity Limited (MaxSecurity) has been an audit client of Smith & Associates (S&A) for the past 15 years. MaxSecurity is based in Wollongong, where it manufactures high-tech armour-plated personnel carriers. MaxSecurity often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialised and MaxSecurity does business only with nations that have a recognised, democratically elected government. MaxSecurity maintains a highly secure environment because of the sensitive and confidential nature of its vehicle designs and its clients.

Clarke Field has been the engagement partner on the MaxSecurity audit for the last five years. Clarke is a specialist in auditing clients in the defence industry and intends to remain as review partner when the audit is rotated next year to a new partner (Sally Woodrow, who is to be promoted to partner to enable her to sign-off on the audit).

The board of MaxSecurity is considering issuing half-yearly financial reports in addition to its full-year financial reports and has approached the audit partner, Clarke Field, to discuss the possibility of engaging the firm to discuss the audit implications. Clarke suggests that S&A could review the half-yearly financial reports.

MaxSecurity's end of financial year is 30 June.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

Required

Discuss the expectations gap that could exist for the audit of MaxSecurity. Consider the existence of any special interests of the users of MaxSecurity's financial reports.

1.33 BEING AN AUDITOR ★★ **LO3, 5, 8**

You have recently graduated from your university course and start work with an audit firm. You meet an old school friend, Nga, for dinner — you haven't seen each other for several years. Nga is surprised that you are now working as an auditor because your childhood dream was to be a ballet dancer. Unfortunately, your knees were damaged in a fall and you can no longer dance. The conversation turns to your work and Nga wants to know how you do your job. Nga cannot understand why an audit is not a guarantee the company will succeed. Nga also thinks that company managers will lie to you in order to protect themselves, and as an auditor you would have to assume that you cannot believe anything a company manager says to you.

Required

(a) Write a letter to Nga explaining the concept of reasonable assurance, and how reasonable assurance is determined. Explain why an auditor cannot offer absolute assurance.

(b) Explain in the letter to Nga the concept of 'professional scepticism' and how it is not the same as assuming that managers are always trying to deceive auditors.

1.34 COMPANY AUDITOR REGISTRATION ★★ **LO7**

Anyone wishing to become a registered company auditor has to comply with certain requirements, as outlined in section 1280 of the Corporations Act. The requirements were changed by the passage of the CLERP 9 legislation in 2004, potentially making it easier for auditors in regional or rural areas to meet the experience requirements. You have graduated from your accounting course and believe that although you have not had much experience working with auditors, you are capable of meeting all the requirements and being a good auditor.

Required

Visit the ASIC website (www.asic.gov.au) and locate the guidance for meeting the regulatory requirements for company auditor registration. Summarise those requirements and explain what is required for registration for anyone with a completed accounting degree.

1.35 ASIC AND THE CALDB ★★★ **LO7**

You are a trainee auditor working for a small audit firm. You completed your accounting degree at the end of last year and although you have not yet had much experience, you are concerned at some of the practices and procedures adopted at your audit firm. You overhear the two partners, Alex and Riley, discussing some problems they are facing with a particular client. Alex is advising Riley to 'get the paperwork right' on the audit, otherwise they will be in trouble if they get selected for the ASIC inspection program. Alex is also concerned that 'the CALDB will be after them'. After the conversation, Riley comes to you to ask if you, as a recent graduate, know anything about the ASIC inspection program and the CALDB. Riley confesses that he hasn't been keeping up to date.

Required

Write a report to Riley explaining (i) ASIC's audit inspection program and (ii) the CALDB and how it operates.

1.36 DEMAND FOR ASSURANCE ★★★ **LO6**

In 2002, the audit firm Arthur Andersen collapsed following charges brought against it in the United States relating to the failure of its client, Enron. Some other clients announced that they would be dismissing Arthur Andersen as their auditor even before it was clear that Arthur Andersen would not survive.

Required

Using the theories outlined in this chapter on the demand for audits, explain some reasons why these clients took this action.

1.37 PERFORMANCE AND COMPLIANCE AUDITS ★★★ **LO2**

Chan and Partners Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year, Chan and Partners gained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home
- Total Cancer Specialists Limited (TCSL), a private oncology clinic that specialises in the treatment of cancer.

Year end for all MSHG entities is 30 June.

TCSL owns two relatively old linear accelerators used in radiation therapy. Recently, radiographers using these linear accelerators have raised concerns that they have adverse radiation effects on patients.

TCSL also wishes to purchase a new, more technologically advanced linear accelerator. The Department of Health funded half the purchase price on the basis that TCSL followed the Department's 'Guidelines for procurement of medical equipment' when purchasing the accelerator. The Department of Health has engaged the Auditor-General to check that TCSL met the terms of the funding agreement.

The Auditor-General has also been asked to conduct a performance audit that examines how well hospitals manage waste. Hospitals generate significant amounts of waste, both general and clinical. General waste is not dangerous and can be disposed of more cheaply than clinical waste.

Five years ago, the federal government measured the amount of hospital waste produced in terms of quantity and cost of disposal. The government then set an objective for hospitals to improve how they manage waste and published a document titled 'Waste management guidelines'.

The aims of the Auditor-General's performance audit include assessing whether:

1. improvements have occurred
2. hospitals have reduced the amount of waste produced
3. hospitals have reduced the cost of waste disposal.

The Auditor-General's preliminary findings indicate that many hospitals do not have processes for segregating general and clinical waste. These hospitals treat all waste as clinical waste.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2008.

Required

(a) Discuss the relevant criteria against which the Auditor-General will check TCSL's compliance with the terms of the funding agreement.

(b) Identify two criteria the Auditor-General can use to examine how well hospitals manage waste.

CASE STUDY — CLOUD 9

Ron McLellan established his business, McLellan's Shoes, in 1980. Since then he has run his business as a sole trader. Ron keeps records and his wife helps him prepare basic accounting records. As McLellan's Shoes has no outside owners, Ron has never seen the need to have his accounts audited.

When Chip Masters from Cloud 9 Inc. expressed an interest in buying McLellan's Shoes in 1995, Ron was asked to provide audited financial reports. Ron discussed his concerns about having an audit with his friend Ernie Black. Ernie is concerned that Ron may forget their conversations and has asked you to prepare a summary of the issues listed below for Ron.

Required

(a) What are the main differences between a financial report audit, an environmental audit and an efficiency audit?
(b) What is the difference between reasonable assurance and limited assurance?
(c) Why would Chip ask that Ron have the financial report for McLellan's Shoes audited rather than reviewed?
(d) What factors should Ron consider when selecting an accounting firm to complete the McLellan's Shoes audit?

RESEARCH QUESTION

Chong and Pflugrath conducted a study of different audit report formats and their effects on the audit expectation gap. They investigated whether report length (long or short), the location of the audit opinion (at the start or the end) and plain language (instead of technical language) affect shareholders' and auditors' perceptions of the audit. They surveyed a sample of shareholders and auditors and concluded that the responses indicate there are only minor effects on the audit expectation gap from using different report formats.[13]

Required

(a) In your view, what should be contained in an audit report that conveys realistic explanations of the auditor's role and the assurance provided by the audit report?
(b) Do you believe that auditors are correct in dismissing users' expectations as 'unrealistic'? Should auditors be trying to meet these expectations by rethinking their role and changing their approach?

FURTHER READING

Ramsay, I 2001, *Independence of Australian company auditors*, Department of Treasury, Canberra.

Financial Reporting Council 2011, *Annual report 2010–2011,* Chapter 3 'Monitoring auditor independence', Commonwealth of Australia, www.frc.org.au.

European Commission 2010, *Audit Policy: Lessons from the crisis*, Brussels, http://ec.europa.eu.

Public Company Accounting Oversight Board (PCAOB) 2011, *Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011–006*, 16 August, http://pcaobus.org.

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. b, 2. c, 3. c, 4. d, 5. c, 6. c, 7. d, 8. d, 9. a, 10. a.

NOTES

1. IAASB 2012, *Assurance on a Greenhouse Gas Statement*, www.ifac.org/IAASB.
2. Financial Reporting Council 2011, *Effective company stewardship: Next steps*, September, www.frc.org.uk.

3. De Beer, L 2011, ‘A future predicted: Changing scope of the audit report’, *Accountancy*, August, www.accountancysa.org.za.
4. ibid.
5. ibid.
6. Thornton, G 2011, ‘Consultation paper — enhancing the value of auditor reporting: Exploring options for change’, *Submission to the Auditing and Assurance Standards Board*, 17 August, www.auasb.gov.au.
7. Financial Reporting Council, op cit., p. 6.
8. These details are correct at the time of writing. Visit the CAANZ website for current information on the CA Program (www.charteredaccountantsanz.com).
9. These details are correct at the time of writing. Visit the CPA Australia website for current information on the CPA Program (www.cpaaustralia.com.au).
10. These details are correct at the time of writing. Visit the IPA website for current information on the IPA Program (www.publicaccountants.org.au).
11. Ethical standards are also important regulations concerning auditors. These are discussed in detail in chapter 2 of this text.
12. Francis, JR 2004, ‘What do we know about audit quality?’ *The British Accounting Review*, 36, pp. 345–68.
13. Chong, KM & Pflugrath, G 2008, ‘Do different audit report formats affect shareholders’ and auditors’ perceptions?’ *International Journal of Auditing*, 12, pp. 221–41.

ACKNOWLEDGEMENTS

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CHAPTER 2

Ethics, legal liability and client acceptance

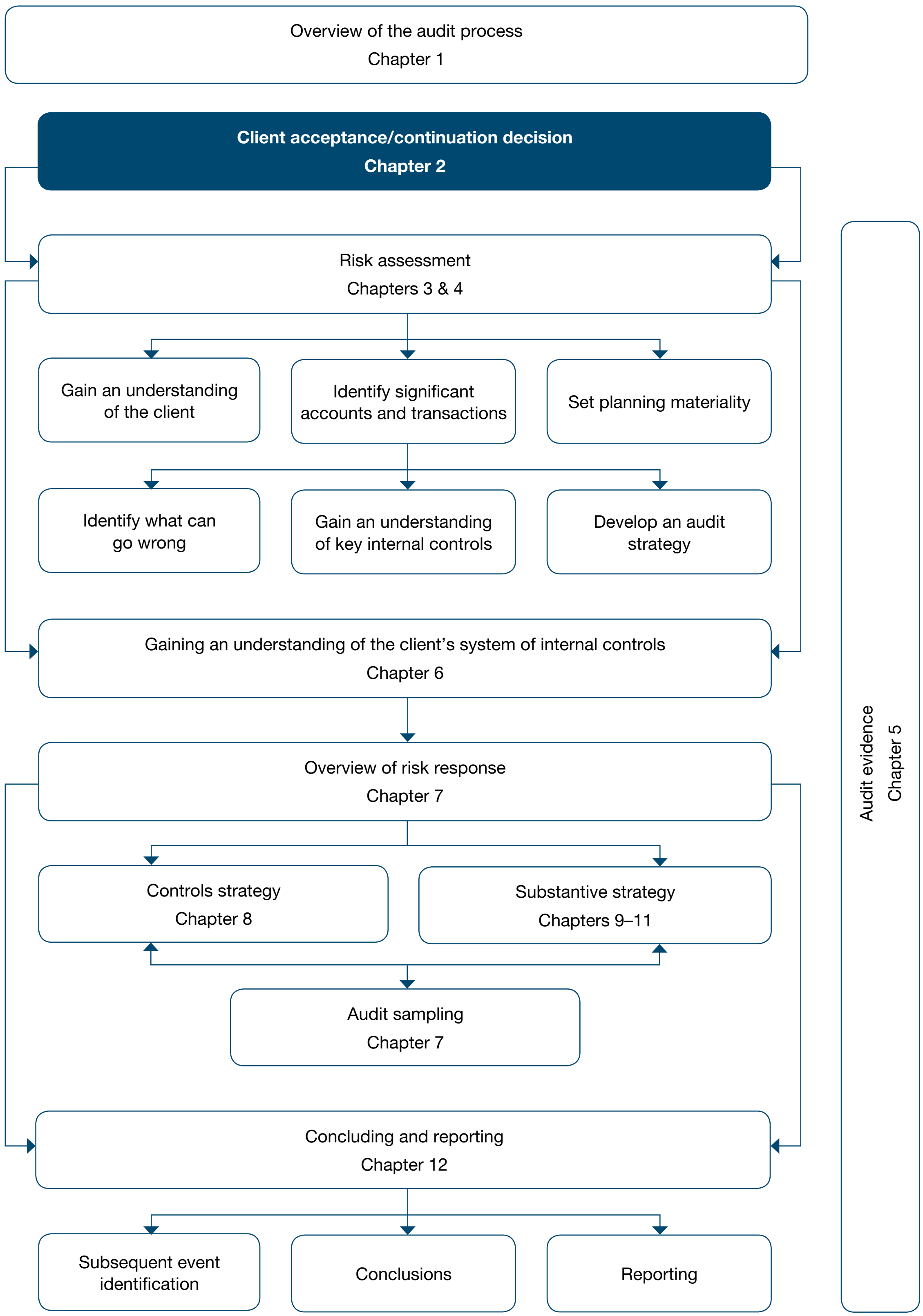
LEARNING OBJECTIVES

After studying this chapter you should be able to:

2.1 explain the fundamental principles of professional ethics
2.2 describe and assess auditor independence
2.3 describe the relationship between an auditor and key groups they have a professional link with during the audit engagement
2.4 illustrate the auditor's legal liability to their client, contributory negligence and the extent to which an auditor is liable to third parties
2.5 categorise the factors to consider in the client acceptance or continuance decision.

AUDITING AND ASSURANCE STANDARDS

AUSTRALIAN	**INTERNATIONAL**
ASA 210 *Agreeing the Terms of Audit Engagements*	ISA 210 *Agreeing the Terms of Audit Engagements*
ASA 610 *Using the Work of Internal Auditors*	ISA 610 *Using the Work of Internal Auditors*
APES 110 *Code of Ethics for Professional Accountants*	*Code of Ethics for Professional Accountants*
ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, Other Assurance Engagements and Related Services Engagements*	ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*



Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client's system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

Ron McLellan came to an arrangement with Chip Masters and sold McLellan's Shoes to Cloud 9 Inc. in 1996. The new business is named Cloud 9 Pty Ltd (Cloud 9). As part of the sale agreement, Ron McLellan was appointed to the Cloud 9 board of directors.

The accounting firm W&S Partners is tendering for the 31 December 2016 audit of Cloud 9. The partner responsible for writing the tender, Jo Wadley, asks Sharon Gallagher and Josh Thomas to assist. Sharon will be the audit manager if the tender is successful. Her task is to help write the tender documents and win the job for the firm. However, even more importantly, she must make sure that there are no nasty surprises for the audit team once they win the audit. Sharon knows how crucial this is. She still has nightmares about an audit she worked on when she was a new graduate at another audit firm. The client in that case threatened to dismiss the auditor when the auditor wanted him to recognise an impairment loss on some assets. The client was the firm's largest account and the partner was under a lot of pressure to keep the client.

Josh is an audit senior. He has not been involved in the tendering process before and needs the experience so he can be promoted to audit manager. Sharon and Josh do not know anything about Cloud 9 yet other than that it manufactures and retails customised basketball shoes, it is a subsidiary of Cloud 9 Inc., a publicly listed US company, and that the business was purchased from Ron McLellan in 1996. Sharon stresses to Josh that they want to know that the client is not going to be difficult to deal with and that W&S Partners can do a good job of the audit. Josh asks how they can know that now, before they start the audit.

Audit process in focus

The purpose of this chapter is to provide an overview of the current audit environment. We start by considering the fundamental principles of professional ethics. In particular, we discuss the principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

Auditor independence is then defined and its importance is explained. Independence of mind (actual independence) is compared and contrasted with independence in appearance (perceived independence). The factors that can threaten auditor independence are then explained. Safeguards that can reduce these threats are also discussed. These safeguards to auditor independence have been established in the law, in professional standards or in accounting firm policies and procedures.

Financial report auditors liaise with a number of groups when completing their audit. Apart from their client's management and staff, who aid the auditor directly throughout the audit, other groups are fundamental to the successful completion of an audit. These groups include the client's shareholders, board of directors, audit committee and internal auditors. The nature of the relationship that the auditor has with each of these groups is explored in this chapter.

An overview of the legal liability of the auditor is provided next. In that summary we explore the current status of an auditor's liability to their client and third parties. The concept of contributory negligence is also explained.

Finally, we consider the factors that impact on an auditor's client acceptance/continuation decision. This section of the chapter marks the beginning of our substantive overview of how an audit is conducted, as the first step for any audit is the decision to accept a company as a new audit client or continue as the auditor of an existing client.

2.1 The fundamental principles of professional ethics

LEARNING OBJECTIVE 2.1 Explain the fundamental principles of professional ethics.

According to section 100.1 of APES 110 *Code of Ethics for Professional Accountants* issued by the Accounting Professional and Ethical Standards Board (APESB), it is the responsibility of every member of the accountancy profession to act in the public interest. This means that members should be mindful of how their actions affect others. In this context, the public refers to clients, credit providers, governments, employers, employees, investors, the business community, the financial community and others who rely on the work produced by members of the professional bodies, including Chartered Accountants Australia and New Zealand, CPA Australia and the Institute of Public Accountants (IPA).

The fundamental ethical principles that apply to all members of the professional bodies are to act with integrity, objectivity, professional competence and due care, confidentiality and professional behaviour (APES 110, s. 100.5). Compliance with these fundamental ethical principles is mandatory for all members of the accountancy profession. Non-compliance can lead to disciplinary measures by the member's professional body (that is, Chartered Accountants Australia and New Zealand, CPA Australia or the IPA).

2.1.1 Integrity

Section 110 of APES 110 provides an overview of the fundamental principle of integrity. **Integrity** refers to the obligation that all members of the professional bodies be straightforward and honest. Members should not be associated with information that is materially false or misleading. To behave with integrity requires adherence to APES 110. Section 110.2 of APES 110 notes that:

> A Member shall not knowingly be associated with reports, returns, communications or other information where the Member believes that the information:
> (a) Contains a materially false or misleading statement;
> (b) Contains statements or information furnished recklessly; or
> (c) Omits or obscures information required to be included where such omission or obscurity would be misleading.

2.1.2 Objectivity

Section 120 of APES 110 provides an overview of the fundamental principle of objectivity. **Objectivity** refers to the obligation that all members of the professional bodies not allow their personal feelings or prejudices to influence their professional judgement. Members should be unbiased and not allow a conflict of interest or the influence of others to impair their decision process. When a member believes that their objectivity is being impaired, they should discontinue the relevant service. According to section 120.2 of APES 110, members of the professional bodies may be exposed to situations that could impair their objectivity. When faced with such a situation, a member shall not perform a service if a circumstance or relationship biases or unduly influences the member's professional judgement with respect to that service.

2.1.3 Professional competence and due care

Section 130 of APES 110 provides an overview of the fundamental principles of professional competence and due care. **Professional competence** and **due care** refers to the obligation that all members maintain their knowledge and skills at a level required by the professional bodies. According to section 130 of APES 110, members must attain a level of competence and keep up-to-date with changes in regulations and standards. The attainment of competence comes from education and work experience. Competence is maintained via continuing education and work experience. The maintenance of professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. Continuing professional development enables members to develop and maintain the capabilities to perform competently within the professional environment.

Members must also act diligently, taking care to complete each task thoroughly, document all work and finish on a timely basis. Members in positions of seniority have an obligation to ensure that their staff are adequately trained and act appropriately in their dealings with clients and employers.

2.1.4 Confidentiality

Section 140 of APES 110 provides an overview of the fundamental principle of confidentiality. **Confidentiality** refers to the obligation that all members of the professional bodies refrain from disclosing information to people outside of their workplace that is learned as a result of their employment. Members must maintain confidentiality, including in a social environment. It is important to be alert to the possibility of inadvertent disclosure, particularly to a close business associate or a family member. Members in positions of seniority must take reasonable steps to ensure that their staff are aware of their duty of confidentiality. When members change employment or acquire a new client they are entitled to utilise their prior experience, but they must not use or disclose any confidential information. An exception is made where a client has allowed this disclosure to occur or where there is a legal requirement to disclose such information. Members are also not allowed to use information — that is not publicly available — gained as a result of their employment to their advantage or to the advantage of another person (for example, using information learned at a client to trade shares).

According to section 140.8 of APES 100, when deciding whether to disclose confidential information members should consider:

- whether the interests of all parties could be harmed
- whether all the relevant information is known and substantiated to the extent it is practicable
- when the situation involves unsubstantiated facts, incomplete information or unsubstantiated conclusions, professional judgement shall be used in determining the type of disclosure to be made, if any
- the type of communication that is expected and to whom it is addressed
- whether the parties to whom the communication is addressed are appropriate recipients.

2.1.5 Professional behaviour

Section 150 of APES 110 provides an overview of the fundamental principle of professional behaviour. **Professional behaviour** refers to the obligation that all members of the professional bodies comply with rules and regulations and ensure that they do not harm the reputation of the profession. Members should be honest in their representations to current and prospective clients. Members should not claim to be able to provide services that they are not able to provide. They should not claim to possess qualifications that they do not possess. They should not claim to have gained experience in areas where they have little or none. Finally, members should not undermine the quality of work produced by others or question their reputation.

APES 110 section 100.6 notes that members of the professional bodies may find themselves in situations where there are threats to their capacity to comply with the fundamental principles of ethical conduct. As members work in many different contexts and the threats to their ethical behaviour are many and varied, APES 110 provides broad guidelines to help members resolve ethical dilemmas. When complying with the fundamental principles, members may need to enter into conflict resolution. Section 100.18 contains an overview of a process that can be used by members needing to resolve a conflict. The suggested process is to:

- gather all relevant facts
- consider the ethical issues involved
- consider the fundamental principles related to the matter
- establish procedures to deal with the matter
- consider alternative courses of action.

Members should consult with senior staff in their organisation when faced with an issue that threatens their conformity with the fundamental principles. If an issue remains unresolved, it is appropriate to consult with appropriate staff in their professional body (CPA Australia, Chartered Accountants Australia and New Zealand or the IPA) who can advise on the appropriate course of action.

CLOUD 9

Josh is confident that he understands the fundamental principles of professional ethics. They apply to all of their audits, as well as their professional behaviour as accountants. Josh and Sharon can see no reason why they would not be able to abide by these fundamental principles in the audit of Cloud 9.

BEFORE YOU GO ON

- What does it mean to act in the public interest?
- List and explain the five fundamental ethical principles included in APES 110.
- Who must comply with the fundamental ethical principles included in APES 110?

2.2 Independence

LEARNING OBJECTIVE 2.2 Describe and assess auditor independence.

Independence is essential when complying with the ethical principles to act with integrity and objectivity. It is defined as acting with integrity, objectivity and professional scepticism in section 290 of APES 110. Independence is fundamental to every audit, and must be adhered to by every registered company auditor. APES 110, section 290 'Independence — assurance engagements' deals with auditor independence. An external auditor is often referred to as an independent auditor, which highlights the importance of independence in every audit engagement. Financial reports must be relevant, reliable, comparable, understandable, and true and fair (refer to chapter 1 for a detailed description of these terms). It is the responsibility of those charged with governance in a company (the **board of directors** and management) to ensure that the financial report meets these requirements. It is the responsibility of the external auditor to form an opinion on the truth and fairness of the financial report. If an auditor is not independent of their client, it will affect the credibility and reliability of the financial report. It is vital that financial report users believe that the external auditor is independent of the company they audit. If that independence is compromised in any way, it will detract from the ability of users to rely on the financial report to make decisions.

According to APES 110, section 290 there are two forms of independence.

1. *Independence of mind* is the ability to act with integrity, objectivity and professional scepticism. It is the ability to make a decision that is free from bias, personal beliefs and client pressures. Independence of mind is also referred to as actual independence.
2. *Independence in appearance* is the belief that independence of mind has been achieved. It is not enough for an auditor to be independent of mind; they must also be seen to be independent. Auditors must consider their actions carefully and ensure that nothing is done to compromise their independence both of mind and in appearance. Independence in appearance is also referred to as perceived independence.

Both independence of mind and independence in appearance are important for every auditor on every audit engagement. It is the responsibility of every auditor to consider potential threats to their independence and to seek out appropriate safeguards to reduce those threats to the extent possible. If a threat to an auditor's independence appears insurmountable for a particular client, an auditor should consider discontinuing as the auditor of that client.

APES 110, section 290 sets out a conceptual framework to help members identify threats to independence, evaluate the significance of those threats and apply safeguards to minimise those threats. The conceptual framework approach set out in APES 110 is applied by members of the professional bodies to:

(a) identify threats to independence
(b) evaluate the significance of the threats identified
(c) apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level.

If a member decides that appropriate safeguards are not available or cannot be applied to eliminate the threats or reduce them to an acceptable level, they must remove themselves from the situation by declining or terminating the audit engagement.

The next section includes a discussion of the various threats to auditor independence and some of the safeguards that have been put in place by regulation, the profession and accounting firms to minimise the threats to auditor independence.

CLOUD 9

Sharon tells Josh about her experience at another audit firm where the client tried to pressure the audit partner into dropping a request to write down the asset values. It was an example of a threat to the auditor's independence. Although it is difficult to stop a client asking for a favour, the audit firm needs to have safeguards to prevent a simple request turning into unreasonable pressure on the audit team to meet that request. Sharon and Josh agree they need to consider the specific independence threats and safeguards for the audit of Cloud 9. The audit must be independent, as well as be seen to be independent.

2.2.1 Threats to independence

The *Code of Ethics for Professional Accountants* identifies five key threats to auditor independence (APES 110, s. 290). They are the self-interest, self-review, advocacy, familiarity and intimidation threats.

Self-interest threat

According to APES 100, section 290, **self-interest threat** refers to the threat that can occur when an accounting firm or its staff has a financial interest in an audit client. Section 200.4 of APES 110 provides the following examples of circumstances that create a self-interest threat:

- a member of the assurance team having a direct financial interest in the assurance client
- a firm having undue dependence on total fees from a client
- a member of the assurance team having a significant close business relationship with an assurance client
- a firm being concerned about the possibility of losing a significant client
- a member of the audit team entering into employment negotiations with the audit client
- a firm entering into a contingent fee arrangement relating to an assurance engagement
- a member discovering a significant error when evaluating the results of a previous professional service performed by a member of the member's firm.

CLOUD 9

Sharon's old firm had a fee dependence problem. The audit fees they earned from the client resisting the recommended accounting treatment for asset values were a significant proportion of the firm's total fees. APES 110 does not specify how much is 'too much', but safeguards are required if the client's fees exceed 15 per cent of the firm's total fees. W&S Partners is a much larger audit firm than Sharon's old firm and Cloud 9's fees will be well below 15 per cent of total fee revenue.

Self-review threat

Self-review threat refers to the threat that can occur when the assurance team need to form an opinion on their own work or work performed by others in their firm. Section 200.5 of APES 110 provides the following examples of circumstances that create a self-review threat:

- a firm issuing an assurance report on the effectiveness of the operation of financial systems after designing or implementing the systems
- a firm having prepared the original data used to generate records that are the subject matter of the assurance engagement
- a member of the assurance team being, or having recently been, a director or officer of the client
- a member of the assurance team being, or having recently been, employed by the client in a position to exert significant influence over the subject matter of the engagement
- the firm performing a service for an assurance client that directly affects the subject matter information of the assurance engagement.

CLOUD 9

Josh and Sharon do not know of any current work being done for Cloud 9 by W&S Partners, or any other relationships between members of the audit team and the client's staff. However, they will check with all other departments at W&S Partners, particularly the consulting department. They will also ask any new member of the audit team to disclose their interests and relationships with the client before they join the team.

Advocacy threat

Advocacy threat refers to the threat that can occur when an accounting firm or its assurance staff acts, or is believed to act, on behalf of its assurance client. In such a case, the objectivity of the assurance provider may come under question. Section 200.6 of APES 110 provides the following examples of circumstances that create an advocacy threat:

- the firm promoting shares in an audit client
- a member acting as an advocate on behalf of an audit client in litigation or disputes with third parties.

CLOUD 9

The partner, Jo Wadley, advises Sharon and Josh that the audit firm is not acting for Cloud 9 in any other matter.

Familiarity threat

Familiarity threat refers to the threat that can occur when a close relationship exists or develops between the assurance firm and the client or between members of the assurance team and directors or employees of the client. The result can be that the assurance team become too sensitive to the needs of the client and lose their objectivity. Section 200.7 of APES 110 provides the following examples of circumstances that create a familiarity threat:

- a member of the engagement team having a close or immediate family member who is a director or officer of the client
- a member of the engagement team having a close or immediate family member who is an employee of the client who is in a position to exert significant influence over the subject matter of the engagement
- a director or officer of the client or an employee in a position to exert significant influence over the subject matter of the engagement having recently served as the engagement partner
- a member accepting gifts or preferential treatment from a client, unless the value is trivial or inconsequential
- senior personnel having a long association with the assurance client.

CLOUD 9

Familiarity is usually a greater issue for existing clients than for new clients, such as Cloud 9 for W&S Partners. However, there could be personal familiarity issues in any audit engagement. Josh is worried about asking the senior staff to declare their relationships with the management of Cloud 9. He thinks they might regard that question as impertinent. Sharon tells Josh that she knows that the senior staff at W&S Partners are very committed to ethical behaviour. If they were not to ask this question as part of the process of accepting the new client, Sharon and Josh would be disciplined for poor performance.

Intimidation threat

Intimidation threat refers to the threat that can occur when a member of the assurance team feels threatened by the client's staff or directors. The result can be that the assurance team member is unable to act objectively, believing that if they do so there may be some negative consequence based upon the threat received. Section 200.8 of APES 110 provides the following examples of circumstances that create an intimidation threat:

- a firm being threatened with dismissal from a client engagement
- an audit client indicating that it will not award a planned non-assurance contract to the firm if the firm continues to disagree with the client's accounting treatment for a particular transaction
- a firm being threatened with litigation by the client
- a firm being pressured to reduce inappropriately the extent of work performed in order to reduce fees
- a member feeling pressured to agree with the judgement of a client employee because the employee has more expertise on the matter in question
- a member being informed by a partner of the firm that a planned promotion will not occur unless the member agrees with an audit client's inappropriate accounting treatment.

CLOUD 9

The partner at Sharon's old firm was threatened by a client with dismissal from the audit, and Sharon has heard of other clients pressuring auditors to reduce their fees. Sharon is confident that W&S Partners do not rely unreasonably on any one audit and are therefore less vulnerable to threats. She also knows that auditors at W&S Partners keep very detailed records of time spent on any audit tasks and can justify their fees if a client questions the amount.

According to the conceptual framework approach set out in APES 110, when any of these threats are recognised, steps should be taken to remove or reduce the threat to an acceptably low level. This can be achieved by utilising an appropriate safeguard.

2.2.2 Safeguards to independence

Safeguards are mechanisms that have been developed by the accounting profession, legislators, regulators, clients and accounting firms (APES 110, s. 290). They are used to minimise the risk that a threat will surface (for example, through education) and to deal with a threat when one becomes apparent (for example, through reporting processes within the assurance firm).

Safeguards created by the profession, legislation or regulation

The accounting profession, legislation and regulation have created a range of safeguards to independence including ASQC 1 (ISQC 1) *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, Other Assurance Engagements and Related Services Engagements*. Safeguards to independence include education of accountants about the threats to independence, the establishment of a code of ethics, and legislation that requires that an auditor be independent and that a declaration be made about that independence in a client's annual report. Another safeguard is a requirement in the *Corporations Act 2001* that a retired partner must not take on a senior role in an audit client for two years.

CLOUD 9

Sharon and Josh know that any safeguards required by legislation, such as the independence declaration, will be used on the Cloud 9 audit.

Safeguards created by clients

Clients can put in place appropriate mechanisms that will reduce the threat to independence. They can put in place appropriate corporate governance mechanisms, such as the establishment of an audit committee (see section 2.3.3 for a discussion of the role of audit committees) to liaise between the assurance partner and management to enhance independence. They can ensure that the responsibility for the appointment and removal of an auditor rests with **independent directors** on the audit committee or the board of directors. They can establish policies and procedures dedicated to ensuring that the financial report is true and fair. Finally, clients can put in place policies and procedures dedicated to ensuring that the assurance team has access to all required documents and records when required. These safeguards can reduce but not eliminate the threat to independence. To ensure their effectiveness, clients must ensure that policies and mechanisms established are working effectively.

CLOUD 9

Sharon explains to Josh that one of their key tasks will be to discover, document and evaluate any independence safeguards created by Cloud 9. She explains that safeguards created by the profession and W&S Partners apply to all audits, so the relative success of an audit with respect to independence problems is significantly affected by the safeguards created by the client. The greater these safeguards, the less likely there will be any problems with the audit. The auditor needs to know that if any problem does arise, the client has committed to protect the integrity of the audit.

Sharon asks Josh to document the governance structure at Cloud 9, including background information on the directors and senior management. Sharon will investigate the structure governing the relationships between the directors and management of Cloud 9 and the parent company, Cloud 9 Inc.

Safeguards created by accounting firms

Accounting firms have in place a range of safeguards to ensure independence. They have policies and procedures to ensure the quality of their service, and they provide continuing education for their staff regarding these policies and procedures. Firms have client acceptance and continuance procedures to ensure that they identify any threats to independence on a timely basis. Firms have partner rotation policies to enhance audit partner independence. They also have a policy of peer review, where audit partners review the work files of other partners and provide comment and feedback. Finally, firms establish procedures, such as checklists and declarations, for staff to follow if they become aware of a threat to their independence. These safeguards can reduce but not eliminate threats to independence. To ensure the effectiveness of these safeguards, accounting firms must ensure that policies and mechanisms established are working effectively.

Table 2.1 lists the five threats to independence identified in APES 110, section 290, together with examples of those threats and some of safeguards that can help to reduce each threat to an acceptably low level.

TABLE 2.1 **Summary of independence threats and safeguards**

Threats to independence	Examples	Safeguards to independence
Self-interest threat	• An auditor has a financial interest in their client. • An audit firm relies on the fees from a client. • An audit partner is concerned about losing a prestigious client. • An auditor has a business relationship with a client.	• Policies and procedures within an accounting firm identifying any staff with financial interest in an assurance client. • Regular review of assurance and other fees earned from each client in comparison to total fees from all assurance clients. • Minimising the provision of non-audit services to assurance clients. • Policies and procedures prohibiting business relationships with clients.

Threats to independence	Examples	Safeguards to independence
Self-review threat	• An assurance team is asked to evaluate the effectiveness of an operating system that a colleague in their firm implemented on behalf of the client. • An assurance team audits records that were prepared by a colleague in their firm on behalf of the client. • A member of the assurance team has recently been an employee of the client in a position that impacted the subject matter being assured.	• Minimising the provision of non-audit services to assurance clients. • When providing non-audit services, ensuring that the client is responsible for overseeing and guiding that work and making any final decisions regarding the outcomes of that work. • Having a cooling-off period before an audit partner can be employed in a senior role at an audit client.
Advocacy threat	• A firm promotes shares of an audit client. • An auditor represents an audit client in a legal case.	• Policies and procedures prohibiting business relationships with clients. • Policies and procedures prohibiting the representation of clients in any disputes or legal matters. • Rotating staff assigned to clients so they do not spend too much time at any one client's premises.
Familiarity threat	• An auditor has a family member who is a director on the board of an audit client. • An auditor has a family member involved in the preparation of the accounting information subject to audit. • An auditor accepts special gifts from their client. • A long association exists between members of the audit team and an audit client. • A director is on the board of an audit client who was until recently the engagement partner on the audit.	• Partner and staff rotation policies. • Education regarding acceptance of gifts and hospitality from assurance clients providing examples of what is and what is not acceptable. • Procedures when assigning staff to assurance clients ensuring no close personal relationships exist between assurance team members and client personnel. • Education regarding socialising with client personnel.
Intimidation threat	• A client threatens to dismiss the audit firm. • The audit firm is threatened with litigation by their audit client. • The client places pressure on the audit team to reduce the scope of the audit to reduce audit fees or to meet an unrealistic deadline. • A member of the client's staff places undue pressure on the audit team to allow them to use an inappropriate accounting technique.	• Avoidance of fee dependence. • Appropriate corporate governance structures within clients, such as an audit committee, to liaise with senior assurance team members and client management. • Adherence to stringent procedures regarding the removal of assurance providers.

Source: Based on Accounting Professional and Ethical Standards Board 2011, APES 110, section 290.

PROFESSIONAL ENVIRONMENT

Network audit firms

Audit firms frequently form relationships with other firms and entities with the aim of enhancing their ability to provide professional services. Even when these firms and entities remain legally separate and distinct, the grouping or structure may be regarded as a 'network' under section 290 of APES 110.

APES 110 defines a 'network' as a larger structure whose goal is to share profits and costs, which shares common ownership or control, common business strategies, common policies and procedures, a common brand name or a significant part of professional resources.

(*continued*)

Audit firms that regard themselves as separate for the purposes of determining the existence of any audit conflicts must examine the systems they use to screen for conflicts of interest and potential auditor independence problems. The systems must be network wide, not just audit-firm wide. The network could be international, meaning that audit partners in one country must consider whether other offices around the world are not consulting to their audit clients (and vice versa).

Thomson argues that the partner in charge of the audit engagement should act as a gatekeeper and screen all new consulting services offered by the network to ensure that there are no conflicts of interest.[1] This means that the network must have systems to refer all new services to the audit engagement partner for final approval before work commences.

Procedures have to be very specific to ensure that 'scope creep' does not occur and place the engagement at risk. Scope creep is the practice of gradually expanding the consulting service beyond the originally approved scope. In each case, the additional service appears to be a minor increase so it is not referred for approval. However, such increases in the scope of the consulting service can inadvertently create perceived, if not real, conflicts of interest.

The size of the task facing partners who need to ensure conflicts of interest do not occur for their audit clients is illustrated by the huge size of the largest network firms. The four network firms with the highest global income in 2014 were: Deloitte (US$32 400 million), PwC (US$32 088 million), EY (US$25 829 million) and KPMG (US$23 420 million).[2]

BEFORE YOU GO ON

- Why is auditor independence so important?
- What are some of the things an assurance firm can do to avoid the threat of intimidation?
- What are some examples of circumstances that may cause a familiarity threat?

2.3 The auditor's relationships with others

LEARNING OBJECTIVE 2.3 Describe the relationship between an auditor and key groups they have a professional link with during the audit engagement.

The external auditor has the responsibility to form an opinion on the truth and fairness or fair presentation of the financial report prepared by their client. In conducting their audit, the external auditor comes into contact with client staff and management on a regular basis. The key groups that the external auditor will have a professional link with are the client's shareholders as a group, the board of directors, the audit committee and the internal audit team.

2.3.1 Auditors and shareholders

The audit report is addressed to the **shareholders** (sometimes referred to as the members) of the company being audited. This means that the shareholders are acknowledged as the main recipients of the financial report and the attached audit report. Shareholders own the company. If the company fails, shareholders stand to lose most, if not all, of their investment. Shareholders rely on the audit report and the opinion contained within it to inform them about the reliability of the information provided by the management of their company in the financial report. Auditors will not often meet the shareholders they report to except when they attend their client's annual general meeting. Exceptions include major shareholders, who the auditor may meet with from time to time, and shareholding board members and client personnel, who the auditor will meet with during the course of their audit. Shareholders are responsible for the appointment and removal of their company's auditors. The board of directors, or the audit committee, will facilitate this process on behalf of shareholders. Generally, the board of directors will select an audit firm that they believe is appropriate or will propose when it is time to appoint a new audit firm. The board will then make a recommendation to shareholders. Shareholders generally follow recommendations made by their board of directors.

2.3.2 Auditors and the board of directors

The board of directors represents the shareholders and oversees the activities of a company and its management. It is the role of the board to ensure that the company is being run to benefit the shareholders. A board of directors will generally comprise a mixture of executive and non-executive directors. **Executive directors** are also part of the company's management team; they are full-time employees of the company. **Non-executive directors** are not part of the company's management team; their involvement is limited to preparing for and attending board meetings and, where relevant, board committee meetings. It is the directors' responsibility to ensure that the financial report is prepared so as to provide a true and fair view. A company's financial report must include the directors' declaration (s. 295A of the Corporations Act). In their declaration, the directors indicate to the shareholders whether they believe that the financial report and accompanying notes comply with Australian Accounting Standards and the Corporations Act and are true and fair, and whether the company will be able to pay its debts when they fall due. It is the responsibility of the external auditor to audit the financial report. The audit partner will meet with members of the board of directors when necessary throughout the audit.

It is important that the board of directors has a mixture of executive and non-executive members. The executive members have a deeper understanding of the company and its workings. Auditors meet with executive directors throughout the audit. The non-executive members are better representatives of shareholders as they are not employees of the company and can be more impartial in their dealings with management. The external auditor will read the minutes of board meetings to learn about the key decisions regarding the strategic direction the board plans to take the company in the future. Other information that may be found in the minutes includes the level of dividends declared, plans for significant asset purchases, purchases and sales of major investments, and major agreements with other companies that may be contemplated.

Boards of larger companies will also have a series of committees made up of various (but not all) members of the board. It is the role of these committees to efficiently deal with specific important issues. The main board committee that the auditor deals with is the audit committee. The audit committee is described in more detail in the next section.

Examples of other board committees are the nomination committee, the remuneration committee and the **risk committee**. The nomination committee is responsible for oversight of the board of directors, its membership and its succession planning. The remuneration committee is responsible for establishing policies regarding the payment, hiring, retention and removal of senior staff and directors of the board. The risk committee is responsible for the oversight of risk identification, mitigation and awareness among employees. Risks include, but are not limited to, those that may affect the financial report. While the auditor does not liaise on a regular basis with the members of these committees, the activities of the committees are of interest. The risks identified by the risk committee, for example, can affect the audit plan and the direction of the audit.

2.3.3 Auditors and the audit committee

An effective **audit committee** will enhance the independence of the external audit function: an audit committee acts on behalf of the full board of directors to ensure that the financial report is true and fair and that the external auditor has access to all records and other evidence required to form their opinion. While ultimate responsibility for the truth and fairness of the financial report rests with the full board of directors, an audit committee can improve the efficiency of achieving this goal.

In Australia, the Australian Securities Exchange (ASX) requires that the largest listed companies have an audit committee. The top 300 listed companies must follow the ASX Corporate Governance Council's recommendations regarding the composition, operation and responsibility of an audit committee. These recommendations appear in the ASX Corporate Governance Council's *Corporate governance principles and recommendations*, 3rd edition. Principle 4 'Safeguard integrity of corporate reporting' includes the following recommendations for listed entities.

- The board of directors of a listed entity should establish an audit committee.
- The audit committee should be structured so that it
  - has at least three members, all of whom are non-executive directors and a majority of whom are independent directors
  - is chaired by an independent director, who is not the chair of the board of directors.
- The board of directors should disclose the charter of the audit committee, the relevant qualifications and experience of the members of the audit committee and the number of times the audit committee met over the reporting period and the meetings attended by each member of the audit committee.
- If a listed entity does not have an audit committee it should disclose that fact and the process in place to independently verify and safeguard the integrity of its corporate reporting, including the process used to appoint and remove the external audit firm and ensure the timely rotation of the audit engagement partner.

According to Principle 4 of the ASX Corporate Governance Council's *Corporate governance principles and recommendations*, the role of the audit committee is usually to review and make recommendations to the board of directors in relation to:

- the adequacy of the entity's corporate reporting processes
- whether the entity's financial statements reflect the understanding of the committee members of, and otherwise provide a true and fair view of, the financial position and performance of the entity
- the appropriateness of the accounting judgements or choices exercised by management in preparing the entity's financial statements
- the appointment or removal of the external auditor
- the rotation of the audit engagement partner
- the scope and adequacy of the external audit
- the independence and performance of the external auditor
- any proposal for the external auditor to provide non-audit services and whether it might compromise the independence of the external auditor.

If the entity has an internal audit function the audit committee may review and make recommendation in relation to:

- the appointment or removal of the head of internal audit
- the scope and adequacy of the internal audit work plan
- the objectivity and performance of the internal audit function.

From an audit perspective it is important that the audit committee be independent of the remainder of the board of directors and of the financial reporting function. The audit committee should consist of only non-executive directors, with a majority also being independent. As noted earlier, a non-executive director is not part of the company's management team. An independent director is a non-executive director without any business or other ties to the company that could impede their ability to act impartially.

An audit committee should consist of members who can read and understand the contents of the financial report. It is important that audit committee members have some understanding of the accounting policies used by the company and can communicate easily with the auditor about those choices. The audit partner will report to the audit committee when they have had a significant disagreement with management regarding accounting choices made and/or the content of the notes to the financial report.

A formal charter sets out the structure, composition and responsibilities of the audit committee. When a company does not have an audit committee, the audit partner will meet with members of the board of directors.

2.3.4 Auditors and internal auditors

The role of internal audit (and **internal auditors**) is determined by those charged with governance, ideally the audit committee. The role of the internal audit function was explained in chapter 1. The external auditor views the internal audit function as part of the company being audited and, as such, the internal audit function can never be wholly independent of the company. However, if a company has an effective internal audit function, the external auditor can consider modifying the nature and timing of their procedures and reduce the extent of their audit testing. The final opinion on the truth and fairness of the financial report remains with the external auditor, as does the responsibility for gathering and evaluating sufficient appropriate audit evidence to form that opinion. If the external auditor intends to use the work of the internal audit function they should consider various internal audit characteristics (ASA 610 (ISA 610) *Using the Work of Internal Auditors*), including the objectivity, technical competence and due professional care of the internal audit function and the effectiveness of communication between internal and external audit. These characteristics are described in the following sections.

Objectivity

Objectivity refers to how the internal audit function fits within the client's organisational structure. This is important as it establishes the level of independence of the internal audit function from the rest of the organisation. The more independent the internal audit function, the more reliance that can be placed upon it by the external auditor. Ideally, internal audit should report directly to the audit committee or the board of directors.

Technical competence

Technical competence refers to the skills, training and ability of the internal audit team. The external auditor may consider the background and qualifications, the level and recency of training undertaken, and the extent of the experience of internal audit staff. The external auditor will also be concerned as to whether internal audit staff are appropriately qualified for their roles.

Due professional care

Due professional care refers to the documentation, planning and supervision of the internal audit function. The external auditor is interested in the level of planning undertaken by internal audit. They will also want to see evidence of the procedures undertaken by internal audit in formulating their conclusions.

Communication

Communication between internal and external auditors is achieved through the scheduling of regular meetings, the external auditor having access to internal audit documentation as needed, and the external auditor informing internal audit of any issues affecting their work that arise through the course of the external audit. It is important that internal and external auditors are free to communicate without interference from client management or staff.

CLOUD 9

Understanding the board of directors and its subcommittees will be a part of Josh and Sharon's work in documenting Cloud 9's governance structure. In particular, they have to find out whether Cloud 9 has an audit committee, and the background of the directors who sit on the board. They also have to check for the existence of an internal audit department at Cloud 9, and find out what they can about the role and function of the internal audit department at Cloud 9 Inc. (the parent company) as it relates to Cloud 9.

BEFORE YOU GO ON

- What is the difference between a non-executive and an independent director?
- Why is it important that an audit committee be independent?
- Why might an external auditor want to use the work of the internal audit function?

2.4 Legal liability

LEARNING OBJECTIVE 2.4 Illustrate the auditor's legal liability to their client, contributory negligence and the extent to which an auditor is liable to third parties.

As noted in chapter 1, the external auditor must exercise due care when conducting an audit. This means that the auditor must be diligent in applying technical and professional standards, and document each stage in the audit process. If the auditor is found to be **negligent** (to have not exercised due care) they may be sued for damages by their client or a third party.

Under tort law, to prove that an auditor has been negligent it must be established that:

- a duty of care was owed by the auditor
- there was a breach of the duty of care
- a loss was suffered as a consequence of that breach.

Tort law is a body of rights, obligations and remedies that is applied by courts in civil proceedings to provide relief for persons who have suffered harm from the wrongful acts of others. The person who sustains injury or suffers pecuniary damage is known as the plaintiff, and the person who is alleged to be responsible for inflicting the injury and is accused of being liable for the damage is known as the defendant.[3]

2.4.1 Legal liability to clients

In the first instance, a client must prove that the auditor owes them a duty of care. A client can establish that its auditor owes them a duty of care using either the tort of negligence or contract law. Under the tort of negligence, the client must prove that the auditor failed in the performance of their audit by being careless and breaching their duty of care. Under contract law, the client must establish that the auditor breached the duty of care to their client that is implicit in agreeing to act as auditor, and made explicit in an engagement letter.

An auditor's duty of care to their client has been established and defined through case law over more than a century. In these cases, the definition of reasonable care and skill has changed over time to reflect the establishment and changes in professional standards. To prove that an auditor has been negligent, a plaintiff, whether a client or a third party, must establish, for example, that an auditor did not comply with auditing standards, ethical pronouncements, an element of the law in place at the time of conducting their audit or apply due care when conducting their audit. Some of the most important cases are now described.

London and General Bank Ltd (No. 2) (1895) 2 Ch. 673

This case established that an auditor has a duty to report to the shareholders, not the directors, of the company being audited. In forming his judgement, Lord Justice Linley noted that 'an auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs. What is reasonable care and skill in any particular case must depend upon the circumstances of that case.' This case provided an explanation of the extent to which an auditor could be held liable for the actions of its clients.

Kingston Cotton Mill (No. 2) (1896) 2 Ch. 279

In this case, Lord Justice Lopes noted that 'it is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution, which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound.' This finding indicated that an auditor is not to *assume* that their client's accounts are materially misstated.

Pacific Acceptance (1970) 90 WN (NSW) 29

This case recognised that standards of reasonable care and skill had changed considerably since the Kingston Cotton Mill case of 1896. Many of the auditing standards in use today are based in part upon the principles established by Justice Moffit in arriving at his judgement in the Pacific Acceptance case. His pronouncements included the following.

- Auditors have a duty to use reasonable care and skill.
- Auditors have a duty to check and see for themselves rather than rely on client management and staff.
- Auditors must audit the whole year.
- Auditors must closely supervise and review the work of junior staff.
- Auditors must properly document procedures used.
- Auditors have a duty to warn and inform the appropriate level of management.
- Auditors have a duty to take further action where suspicion is aroused that a misstatement may have occurred.
- Auditors should be guided by professional standards.

HIH Royal Commission Report (2003)

The HIH Royal Commission findings are discussed in this section of the chapter as Justice Owen made a number of recommendations that will likely influence legal cases in the future. In this report, Justice Owen made a number of recommendations with regard to the importance of auditor independence and their duty of care. The report included the following observations and recommendations.

- Auditor independence is a critical element in establishing the credibility and reliability of an auditor's reports.
- It is widely accepted that the auditor must be, and be seen to be, free from any interest that is incompatible with objectivity.
- An independent and objective audit, conducted with an appropriate degree of professional scepticism, is required.
- The maintenance of high standards of honesty and propriety is required by those who are under a duty to act in the interests of others.

Centro Properties Group (2011–12)

In 2011, the Australian Securities and Investments Commission (ASIC) took a civil action against the directors of the Centro Properties Group (Centro) (ASIC v. Healey & Ors [2011] FCA 717). In that case it was established that in 2007 the directors of Centro approved accounts, which contained significant errors. Specifically, $1.5 billion of current liabilities were misclassified as being non-current. Also, post balance date contingent liabilities of $1.75 billion were omitted. The misclassification was discovered by Centro in 2008, resulting in a trading halt.

In the civil action brought by ASIC, the directors claimed to have relied on their management and auditors to uncover such misclassifications. Justice Middleton noted that the directors of Centro were intelligent, experienced and well paid. He explained that company directors must understand and monitor the financial position of their company. It is their responsibility to apply an enquiring mind to the work conducted by management and auditors. They cannot just rely on the work of others.

The directors of Centro were found to have breached their duties under the Corporations Act when approving the 2007 accounts. The chief executive officer (CEO) of Centro was fined $30 000 and the chief financial officer (CFO) was banned from managing a company for 2 years. The non-executive directors were not fined or banned. Rather than changing directors' duties, this case clarified director responsibilities under existing laws. This case demonstrated that directors cannot rely on their management and auditors when approving their company's accounts. The case raised concerns that companies may find it difficult to attract non-executive directors.

In 2008 and 2010, Centro shareholders brought class actions against Centro and its auditors, PwC. There were five class actions issued by different groups of Centro investors, represented by different law firms. In their claims against Centro, the investors argued that they had suffered a loss as a result of Centro's misclassification of its debt in its financial statements; that is, understating its current debt and overstating its non-current debt by $1.5 billion, thus breaching the Corporations Act. Centro admitted the misclassification and failure to comply with accounting standards, but denied liability.

In their claim against PwC, Centro investors argued that PwC reported that Centro's accounts were true and fair when they were not, and that they complied with the Corporations Act and accounting standards when they did not. PwC admitted that Centro's accounts did not comply with AASB 101 *Presentation of Financial Statements*, but denied liability.

In May 2012, Centro and PwC settled the class actions brought against them by Centro shareholders while maintaining their denial of liability. They agreed to pay out $200 million, comprising $85 million from Centro Retail Australia, $67 million from PwC, $10 million from Centro Properties Group and $38 million from insurance proceeds.[4]

To summarise, when establishing that an auditor has breached their duty of care to their client, negligence must be proved. Negligence is any behaviour that is careless or unintentional and breaches the duty of care. In proving that an auditor has been negligent, a client or its shareholders would need to prove that the auditor had not complied with auditing standards, ethical guidelines, the Corporations Act, or had failed to apply due care when conducting their audit. After establishing that the auditor owed them a duty of care and that the auditor has been in some way negligent (has breached that duty of care), the client or its shareholders would need to establish that they suffered a loss as a result of that negligence. To ascertain a causal relationship between the negligent act and the loss suffered, reasonable foreseeability must be proven. This means that the auditor must have been aware that any negligence on their part could cause a loss to the client or its shareholders.

2.4.2 Contributory negligence

The ruling in the AWA (1992) 10 ACLC 933 case recognised that where a plaintiff (in this case, the directors of the company being audited) as well as a defendant (the auditor) can be proven to have been negligent, each party must be held accountable in proportion to their guilt. This case involved a weakness in internal controls that resulted in a significant loss being incurred by AWA. The judge in this case found that the management of the company was responsible for putting in place an adequate system of internal controls. The auditor did uncover a weakness in the internal controls and did report that weakness to management, but failed to report to the directors when management did not repair the deficient control. As a result, the management, as well as the auditor, was found to have been negligent and to have contributed to the loss.

In the civil action brought by ASIC in 2011 against the directors of Centro, the directors argued that they had relied upon their management, audit committee and external auditors when reviewing the accuracy of the financial report. Justice Middleton held that:

> Directors are entitled to delegate to others the preparation of books and accounts and the carrying on of the day-to-day affairs of the company. What each director is expected to do is to take a diligent and intelligent interest in the information available to him or her, to understand that information, and apply an enquiring mind to the responsibilities placed upon him or her. Such a responsibility arises in this proceeding in adopting and approving the financial statements. Because of their nature and importance, the directors must understand and focus upon the content of financial statements, and if necessary, make further enquiries if matters revealed in these financial statements call for such enquiries.
>
> Directors cannot substitute reliance upon the advice of management for their own attention and examination of an important matter that falls specifically within the Board's responsibilities as with the reporting obligations. The Act places upon the Board and each director the specific task of approving

> the financial statements. Consequently, each member of the board was charged with the responsibility of attending to and focusing on these accounts and, under these circumstances, could not delegate or abdicate that responsibility to others.[5]

This case highlights that company directors play an important role in ensuring financial reports are true and fair. While auditors also have an important role in assuring financial reports, that does not abrogate the responsibilities of company directors.

2.4.3 Legal liability to third parties

Establishing that auditors owe a duty of care to third parties is not straightforward. **Third parties** include anyone other than the client and its shareholders who use the financial report to make a decision (for example, creditors). As third parties generally do not have a contractual relationship with the auditor, they must rely on tort law if they wish to sue the auditors of a company with which they have an association. While third parties must prove the auditor's negligence and that they suffered a loss as a consequence of that negligence, the key challenge for third parties is establishing that a duty of care was owed to them by the auditor. Below is a very brief summary of the key cases that have established the legal liability of auditors to third parties.

Candler (1951) 2 KB 164

In this case, Lord Denning, in a dissenting judgement, argued that auditors owe a duty of care to their clients, third parties that the auditors show the accounts to and third parties that the auditors know their clients will show the accounts to. This duty of care is not extended to other parties that are not known to auditors. This case made it more difficult for third parties to establish that an auditor owes them a duty of care.

Scott Group (1978) 1 NZLR 553

In this case, the auditor was successfully sued by a third party unknown to the auditor when conducting their audit. This case established that auditors owe a duty of care to parties they can reasonably foresee may rely on the financial report of their client; in this case, a company planning to take over the auditor's client. This case made it easier for third parties to establish that an auditor owes them a duty of care.

Caparo (1990) 1 All ER 568

This case introduced the concept of reasonable proximity between the auditor and third parties. This case established that auditors owe a duty of care to shareholders as a group and not to individual shareholders who may use the financial report to make decisions that the auditor could not foresee. This case, again, made it more difficult for an auditor to be successfully sued by a third party. The concept of reasonable proximity is key, as the auditor must be aware of the third party as a group and the decision they intend to make when using the audited report.

Columbia Coffee and Tea (1992) 10 ACLC 1659

The audit firm in this case had an audit manual that stated that it was firm policy to acknowledge that third parties would rely on the audited accounts of their clients. The judge used the audit firm's manual to rule that a duty of care was owed to the third party that sued for negligence. This case made it significantly easier for third parties to establish that an auditor owes them a duty of care.

Esanda (1997) 15 ACLC 483

The judge in this case argued against the finding in the Columbia Coffee and Tea case. The High Court of Australia found in favour of the auditor and ruled that for a third party to be able to establish that an auditor owes them a duty of care they would need to show the following.

- The report was prepared on the basis that it would be communicated to a third party.
- The report was likely to be relied upon by that third party.
- The third party ran the risk of suffering a loss if the report was negligently prepared.

The judgement in the Esanda case provided some relief for auditors, as it made it far more difficult for a third party to establish that a duty of care is owed by the auditor. Currently, auditors are subject to a range of laws, including common law and statute.[6] They must adhere to the standards set out by the professional bodies (CPA Australia, Chartered Accountants Australia and New Zealand and the IPA) as well as ASIC and the Australian Competition and Consumer Commission.

Methods have been proposed to limit auditor liability, including legislated capping and the introduction of proportionate liability. Professional standards legislation is in operation in various states and territories around Australia. This legislation provides for the capping of liability for professionals, including accountants. For accounting firms, the cap varies with the fees earned from a client to a maximum of $75 million.

A system of proportionate liability has been introduced in many states where a judge is left to determine the extent of liability of each defendant in a case, giving consideration to what is just and fair based on the facts of the case. This system was introduced to reduce the extent to which auditors were held accountable for losses suffered by claimants. In the past auditors were believed to have generous insurance policies and became a target and were often attributed 100 per cent of the blame by claimants to maximise pay outs. The introduction of proportionate liability has gone some way to remedy this situation.

Currently, for auditors to be liable to third parties for negligence, a duty of care must exist. It must be more than reasonably foreseeable to the auditor that:

- the third party would rely on the audit report
- the auditors must have in some way attempted to induce the third party to some form of action or inaction or else had knowledge that their advice was going to be used in relation to a specific transaction
- the duty of care was breached
- quantifiable damages resulted as a breach of duty.[7]

2.4.4 Avoidance of litigation

There are a number of ways that an auditor can avoid litigation. These include:

- hiring competent staff
- training staff and updating their knowledge regularly
- ensuring compliance with ethical regulations
- ensuring compliance with auditing regulations
- implementing policies and procedures that ensure
  - appropriate procedures are followed when accepting a new client
  - appropriate staff are allocated to clients
  - ethical and independence issues are identified and dealt with on a timely basis
  - all work is fully documented
  - adequate and appropriate evidence is gathered before forming an opinion
- meeting with a client's audit committee to discuss any significant issues identified as part of the audit
- following up on any significant weaknesses in the client's internal control procedures in a previous year's audit.

PROFESSIONAL ENVIRONMENT

The Bannerman case

Audit reports are addressed to 'the members' of the company. ASA 700 (ISA 700) paragraph 22 requires the report to be addressed as required by the circumstances of the engagement. Paragraph A16 notes that the report is addressed to those for whom the report is prepared, often either shareholders or those charged with governance of the entity whose financial report is being audited. The question arises: can those to whom the audit report is not addressed rely on the contents of the report? There is a view that auditors should use disclaimers to protect themselves from claims by third parties.[8] This view is based on the statements by judges in the Bannerman case.

The Bannerman case [Royal Bank of Scotland v. Bannerman Johnstone Maclay, (Scottish Court of Session)] arose when the bank (RBS) sued the auditors of a company that went into receivership in 1998 with debts of around £13 million. RBS claimed that the auditors did not discover a fraud that led to the accounts being misstated. The lending agreement between RBS and the company required monthly management accounts and audited accounts to be sent to the bank as soon as practicable. Initially, the court held in favour of RBS on the basis that the auditors knew the identity of the third party (RBS), the use to which the information would be put, and that RBS intended to rely on the accounts for the known purpose. The court also held that the auditors could have disclaimed responsibility to the bank. The case went to appeal, but it was dismissed. A duty of care can be established even in the absence of such an intention by the auditors, provided there was actual or deemed knowledge that the information was likely to be relied upon by a third party for a known purpose.[9]

Following the Bannerman case, the UK Companies Act 2006 allows auditors to disclaim liability with a statement similar to the following:[10]

> This report is made solely to the company's members, as a body, in accordance with [Sections 495 and 496/ Sections 495, 496 and 497] of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

In Australia, disclaimers are not included in audit reports where the audits are performed under the Corporations Act. However, Australian auditors have begun inserting into their non-Corporations Act audit reports a paragraph restricting the distribution of the audit report, which is effectively the same as a 'Bannerman disclaimer'.

BEFORE YOU GO ON

- What is contributory negligence?
- What must be established under tort law to prove that an auditor has been negligent?
- How can an auditor avoid litigation?

2.5 Client acceptance and continuance decisions

LEARNING OBJECTIVE 2.5 Categorise the factors to consider in the client acceptance or continuance decision.

The first stage of any audit is the client acceptance or continuance decision. While the decision to take on a new client is more detailed than the decision to continue with an existing client, they have much in common. ASQC 1 (ISQC 1) provides guidance on the procedures to be followed when making the client acceptance or continuance decision.

The first step involves the assessment of client integrity. When assessing client integrity the auditor will consider:

- the reputation of the client, its management, directors and key stakeholders
- the reasons provided for switching audit firms (client acceptance decision)
- the client's attitude to risk exposure and management
- the client's attitude to the implementation and maintenance of adequate internal controls to mitigate (minimise) identified risks
- the appropriateness of the client's interpretation of accounting rules
- the client's willingness to allow the auditor full access to information required to form their opinion
- the client's attitude to audit fees and its willingness to pay a fair amount for the work completed.

Information relevant to the client acceptance or continuance decision can be found through:

- communication with the previous auditor (client acceptance decision). APES 110 (AUST 210.11.1) requires that an auditor seek the prospective client's permission before communicating with its previous auditor. If that permission is refused, the auditor should decline the appointment as auditor.
- communication with client personnel
- communication with third parties such as client bankers and lawyers
- communication with the client's key competitors
- review of press articles about the client.

Section 210 of APES 110 *Code of Ethics for Professional Accountants* deals with professional appointments. Before accepting a new client, consideration must be given to any threats to compliance with the fundamental principles of professional ethics (integrity, objectivity, professional competence and due care, confidentiality and professional behaviour). Threats to the fundamental principles of professional ethics will occur if the prospective client is dishonest, involved in illegal activities, or aggressive in its interpretations of accounting rules. An audit firm should not accept an entity as a new client if it is concerned about any of these issues. Potential threats to compliance with the fundamental principles of professional ethics for existing clients should be considered from time to time.

To ensure professional competence and due care, an audit firm must make certain that it has the staff available at the time required to complete the audit (client acceptance decision). The audit firm must ensure that its audit staff have the knowledge and competence required to conduct the audit. The auditor must have access to independent experts if required.

To ensure that it is independent of prospective and continuing clients, the audit firm must review the threats to independence, described earlier, and make certain that safeguards are put in place to limit or remove those threats. If an independence threat appears insurmountable, an audit firm should consider declining an offer to act as an auditor of a prospective client or resign from the audit of an existing client. An example of such a threat is fee dependence, where the fees from a client would form a significant proportion of total fees earned. This can occur if a prospective client is much larger than an audit firm's current clients or if an existing client has grown significantly.

Part 2M.4 of the Corporations Act covers auditor appointments and removals and itemises threats to independence that should be considered when making the client acceptance/continuance decision. ASIC administers the Corporations Act, registering auditors, investigating suspected breaches of the law, issuing infringement notices where applicable and seeking penalties in the courts where appropriate. An auditor will contravene sections 324CE, 324CF and 324CG of the Corporations Act if there is a relevant relationship between the auditor (or their firm) and the audited body (their client) as defined in section 324CH of the Corporations Act. According to section 324CH a relevant relationship will exist if the auditor:

- is an officer of the audited body
- is an audit-critical employee of the audited body
- is a partner of an officer or audit-critical employee of the audited body
- is an employer or employee of an officer or audit-critical employee of the audited body
- has an investment in the audited body
- owes an amount to or is owed an amount by the audited body.

The final stage in the client acceptance and continuance decision process involves the preparation of an **engagement letter**. ASA 210 (ISA 210) *Agreeing the Terms of Audit Engagements* provides guidance on the preparation of engagement letters. An engagement letter is prepared by an auditor and acknowledged by a client before the commencement of an audit. It is a form of contract between an auditor and their client. It is not necessary to send a new engagement letter each year for a continuing client, unless the terms of the engagement change significantly.

The purpose of an engagement letter is to set out the terms of the audit engagement, to avoid any misunderstandings between the auditor and their client. The letter will confirm the obligations of the client and the auditor in accordance with the Corporations Act. While the engagement letter can expand upon the requirements that appear in legislation and standards, it cannot limit or contradict those requirements.

An engagement letter includes an explanation of the scope of the audit, the timing of the completion of various aspects of the audit, an overview of the client's responsibility for the preparation of the financial report, the requirement that the auditor have access to all information required, independence considerations and fees. An example of an engagement letter is provided in the appendix to ASA 210 and is reproduced in figure 2.1.

To the appropriate representative of management or those charged with governance of ABC Company:

[The objective and scope of the audit]

You have requested that we audit the financial report of ABC Company which comprises the statement of financial position as at 30 June 20XX and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes comprising a summary of significant accounting policies and other explanatory information, and the directors' declaration. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of expressing an opinion on the financial report.

[The responsibilities of the auditor]

We will conduct our audit in accordance with Australian Auditing Standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial report is free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial report. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial report, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial report.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with Australian Auditing Standards.

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial report in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial report that we have identified during the audit.

[The responsibilities of management and identification of the applicable financial reporting framework (for purposes of this example, it is assumed that the auditor has not determined that the law or regulation prescribes those responsibilities in appropriate terms; the descriptions in paragraph 6(b) of this Auditing Standard are therefore used).]

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance] acknowledge and understand that they have responsibility:

(a) For the preparation of the financial report that gives a true and fair view in accordance with the *Corporations Act 2001* and Australian Accounting Standards;

(b) For such internal control as [management] determines is necessary to enable the preparation of the financial report that is free from material misstatement, whether due to fraud or error; and

(c) To provide us with:
   (i) Access to all information of which the directors and management are aware that is relevant to the preparation of the financial report such as records, documentation and other matters;
   (ii) Additional information that we may request from the directors and management for the purpose of the audit; and
   (iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation from your staff during our audit.

[Other relevant information]

FIGURE 2.1 Example of an audit engagement letter

FIGURE 2.1 *(continued)*

[Insert other information, such as fee arrangements, billings and other specific terms, as appropriate.]

[Reporting]

[Insert appropriate reference to the expected form and content of the auditor's report.]

The form and content of our report may need to be amended in the light of our audit findings.

Other Matters under the *Corporations Act 2001*

Independence

We confirm that, to the best of our knowledge and belief, we currently meet the independence requirements of the *Corporations Act 2001* in relation to the audit of the financial report. In conducting our audit of the financial report, should we become aware that we have contravened the independence requirements of the *Corporations Act 2001*, we shall notify you on a timely basis. As part of our audit process, we shall also provide you with a written independence declaration as required by the *Corporations Act 2001*. The *Corporations Act 2001* includes specific restrictions on the employment relationships that can exist between the audited entity and its auditors. To assist us in meeting the independence requirements of the *Corporations Act 2001*, and to the extent permitted by law and regulation, we request you discuss with us:

- the provision of services offered to you by [insert firm name] prior to engaging or accepting the service; and
- the prospective employment opportunities of any current or former partner or professional employee of [insert firm name] prior to the commencement of formal employment discussions with the current or former partner or professional employee.

Annual General Meetings

The *Corporations Act 2001* provides that shareholders can submit written questions to the auditor before an Annual General Meeting provided that they relate to the auditor's report or the conduct of the audit. To assist us in meeting this requirement in the *Corporations Act 2001* relating to Annual General Meetings, we request you provide to us written questions submitted to you by shareholders as soon as practicable after the question(s) is received and no later than five business days before the Annual General Meeting, regardless of whether you believe them to be irrelevant. [Applicable only to listed entities]

Presentation of Audited Financial Report on the Internet

It is our understanding that ABC Company intends to publish a hard copy of the audited financial report and auditor's report for members, and to electronically present the audited financial report and auditor's report on its internet web site. When information is presented electronically on a web site, the security and controls over information on the web site should be addressed by the entity to maintain the integrity of the data presented. The examination of the controls over the electronic presentation of audited financial information on the entity's web site is beyond the scope of the audit of the financial report. Responsibility for the electronic presentation of the financial report on the entity's web site is that of the governing body of the entity.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial report including our respective responsibilities.

Yours faithfully

....

Partner

XYZ & Co.

Acknowledged and agreed on behalf of ABC Company by

(signed)

....

Name and Title

Date

Source: Auditing and Assurance Standards Board 2011, ASA 210 *Agreeing the terms of Audit Engagements*, 'Appendix 1'.

CLOUD 9

Sharon and Josh have already discussed some of the specific client acceptance issues, such as independence threats and safeguards. Sharon explains that they also have to consider the overall integrity of the client (that is, the management of Cloud 9). This means they need to perform and document procedures that are likely to provide information about the client's integrity. Josh is a little sceptical, 'Do you mean that we should ask them if they are honest?' Sharon suggests that it is probably more useful to ask others, and the key people to ask are the existing auditors. Josh is still sceptical, 'The existing auditors are Ellis & Associates. Are they going to help us take one of their clients from them?' Sharon says that the client must give permission first, and, if that is given, the existing auditor will usually state whether or not there were any issues that the new auditor should be aware of before accepting the work. This type of communication is covered by APES 110, and is part of professional ethics. Sharon also gives Josh the task of researching Cloud 9's press coverage, with special focus on anything that may indicate poor management integrity.

Sharon emphasises that they must perform and document procedures to test whether W&S Partners is competent to perform the engagement and has the capabilities, time and resources to do so. For example, they must make sure that they have audit team members who understand the clothing and footwear business. They also must have enough staff to complete the audit on time. Cloud 9 has a 31 December year-end, not a 30 June year-end. This means that most of the audit work will be done at a quiet time of year, so there should be enough staff available.

In addition, Sharon and Josh must perform and document procedures to show that W&S Partners can comply with all parts of the ethical code, not just those that focus on independence threats and safeguards. Finally, they can draft the engagement letter to cover the contractual relationship between W&S Partners and Cloud 9.

BEFORE YOU GO ON

- What will an auditor consider in assessing the integrity of a client's management, board and other personnel?
- What are the key components of an engagement letter?
- Why must an auditor seek a client's permission before communicating with its prior auditor or any other relevant third party?

SUMMARY

2.1 Explain the fundamental principles of professional ethics.

The fundamental principles of professional ethics include integrity (being straightforward and honest), objectivity (not allowing personal feelings or prejudices to influence professional judgement), professional competence and due care (maintaining knowledge and skill at an appropriate level), confidentiality (not sharing information that is learned at work) and professional behaviour (upholding the reputation of the profession).

2.2 Describe and assess auditor independence.

Independence is the ability to make a decision that is free from bias, personal beliefs and client pressures. An external auditor must not only be independent of their client, they must also appear to be independent of their client. Threats to auditor independence include self-interest, self-review, advocacy, familiarity and intimidation threats. A self-interest threat is a financial interest in a client. A self-review threat is the audit of their own work or work done by others in their firm. An advocacy threat is an auditor acting on behalf of their client. A familiarity threat is a close relationship between the auditor and their client. An intimidation threat is when an auditor feels threatened by their client. Safeguards to auditor independence include the code of ethics, legislation, the establishment of audit committees by clients, client acceptance and continuance procedures, partner rotation policies and education within accounting firms.

2.3 Describe the relationship between an auditor and key groups they have a professional link with during the audit engagement.

Auditors report to their clients' shareholders. These are the owners, who rely on the audited financial report when evaluating the performance of their company. The board of directors represents the shareholders and oversees the activities of the company and its management. It is the directors' responsibility to ensure that the financial report being audited is prepared so as to provide a true and fair view. The audit committee is responsible for liaising between the external auditor, the internal auditor and those charged with governance to aid the board of directors in ensuring that the financial report is true and fair and that the external auditor has access to all records and other evidence required to form their opinion. The external auditor may use the work performed by internal audit after considering the function's objectivity, technical competence and due professional care and the effectiveness of communication between internal and external audit.

2.4 Illustrate the auditor's legal liability to their client, contributory negligence and the extent to which an auditor is liable to third parties.

To successfully sue an auditor, a plaintiff must prove that a duty of care was owed by the auditor, there was a breach of that duty, and a loss was suffered as a result of that breach. Several cases are discussed in the chapter in relation to an auditor's liability to their clients and to third parties. Contributory negligence is where a client is found to be negligent and to have contributed to the loss suffered by the plaintiff. To establish that an auditor owes them a duty of care, a third party must now establish that the audit report was prepared on the basis that it would be communicated to a third party, or the report was likely to be relied upon by that third party and the third party ran the risk of suffering a loss if the report was negligently prepared.

2.5 Categorise the factors to consider in the client acceptance or continuance decision.

Factors to consider include the integrity of a client, such as its reputation and its attitude to risk, accounting policies and internal controls. An auditor will gain an understanding of the client via communication with the client's prior auditor (in the case of a client acceptance decision), staff, management and other relevant parties. The final stage in the client acceptance or continuance decision process involves the preparation of an engagement letter, which sets out the terms of the audit engagement, to avoid any misunderstandings between the auditor and their client.

KEY TERMS

Advocacy threat The threat that can occur when a firm or its staff acts on behalf of its assurance client.

Audit committee A sub-committee of the board of directors. The audit committee enhances auditor independence and ensures that the financial report is true and fair and that the external auditor has access to all records and other evidence required to form their opinion.

Board of directors The group that represents the shareholders and oversees the activities of a company and its management.

Confidentiality The obligation that all members of the professional bodies refrain from disclosing information that is learned as a result of their employment to people outside of their workplace.

Due care The obligation to complete each task thoroughly, document all work and finish on a timely basis.

Engagement letter Sets out the terms of the audit engagement, to avoid any misunderstandings between the auditor and their client.

Executive directors Employees of the company who also hold a position on the board of directors.

Familiarity threat The threat that can occur when a close relationship exists or develops between the assurance firm (staff) and the client (staff).

Independence The ability to act and be seen to act with integrity, objectivity and professional scepticism.

Independent director A non-executive director without any business or other ties to the company.

Integrity The obligation that all members of the accounting professional bodies be straightforward and honest.

Internal auditors Employees of the company who evaluate and make recommendations to improve risk management, internal control procedures and elements of the governance process.

Intimidation threat The threat that can occur when a member of the assurance team feels threatened by client staff or directors.

Negligent To not exercise due care.

Non-executive directors Board members who are not employees of the company. Their involvement on the board is limited to preparing for and attending board meetings and relevant board committee meetings.

Objectivity The obligation that all members of the professional bodies not allow their personal feelings or prejudices to influence their professional judgement.

Professional behaviour The obligation that all members of the professional bodies comply with rules and regulations and ensure that they do not harm the reputation of the profession.

Professional competence The obligation that all members of the accounting professional bodies maintain their knowledge and skill at a required level.

Risk committee A sub-committee of the board of directors generally responsible for risk identification, mitigation and awareness among employees.

Self-interest threat The threat that can occur when an accounting firm or its staff has a financial interest in an assurance client.

Self-review threat The threat that can occur when the assurance team need to form an opinion on their own work or work performed by others in their firm.

Shareholders Owners (members) of the company.

Technical competence The skills, training and ability of the internal audit team.

Third parties Anyone other than the client and its shareholders that uses the financial report to make a decision.

MULTIPLE-CHOICE QUESTIONS

2.1 Professional competence and due care means that members of professional bodies must: **LO1**
(a) act diligently.
(b) maintain their knowledge and skill at the required level.
(c) keep up to date with changes in regulations and standards.
(d) all of the above.

2.2 Professional behaviour means that members of professional bodies must: **LO1**
(a) claim to possess all qualifications.
(b) comply with rules and regulations.
(c) provide all services clients request.
(d) question the reputation of accountants who are not members of professional bodies.

2.3 Professional independence for auditors: **LO2**
(a) is only relevant to audits for new clients, not continuing clients.
(b) is the ability to act with integrity, objectivity and professional scepticism.
(c) detracts from the ability of users to rely on the financial report to make their decisions.
(d) is important when the auditor acts independently, and it does not matter what people believe about the auditor's independence.

2.4 A self-interest threat arises when: **LO2**
(a) the client threatens to use a different auditor next year.
(b) the auditor encourages others to buy shares in the client.
(c) an assurance team member has recently been a director of the client.
(d) the auditor owns shares in a business that is a major supplier to the client.

2.5 A self-review threat arises when: **LO2**
(a) the auditor has a loan from the client.
(b) the auditor represents the client in negotiations with a third party.
(c) there is a long association between the assurance firm and its client.
(d) the auditor performs services for the client that are then subject of the assurance engagement.

2.6 Safeguards to independence: **LO2**
(a) deal with a threat when one becomes apparent.
(b) minimise the risk that a threat to independence will surface.
(c) are developed by the accounting profession, legislators, regulators, clients and accounting firms.
(d) all of the above.

2.7 Safeguards to independence: **LO2**
(a) include audit committees.
(b) are not the responsibility of the client.
(c) are too difficult to implement by audit firms; they must be contained in legislation.
(d) apply only to business relationships between auditors and clients, not social relationships.

2.8 Audit committees for companies in the top 300 on the ASX: **LO3**
(a) can be any size.
(b) should have a formal charter.
(c) must have the same chair as the board of directors.
(d) must include the chief financial officer (CFO) if the CFO is on the board of directors.

2.9 Generally, the auditor could be legally liable under: **LO4**
(a) contract law to third parties and to the client.
(b) the tort of negligence but not contract law to the client.
(c) contract law and under the tort of negligence to the client.
(d) contract law but not under the tort of negligence to third parties.

2.10 If a prospective new audit client does not allow the auditor to contact its existing auditor: **LO5**
(a) the auditor should refuse to take on the prospective new client.
(b) the auditor should respect the prospective client's right to privacy.
(c) the auditor should contact the existing auditor anyway because it is their duty.
(d) the existing auditor should contact the new auditor to tell them all about the client.

REVIEW QUESTIONS

2.11 What are the five fundamental principles in APES 110? Who must comply with them? **LO1**
2.12 What are the threats to compliance with the fundamental principles? Explain the five categories of threats identified in APES 110, and include examples. **LO1**
2.13 If a threat to compliance with the fundamental principles is identified, must it always be eliminated? Explain. **LO1**
2.14 What are safeguards in the context of APES 110? **LO2**
2.15 Explain the difference between the self-interest, self-review and familiarity threats. How do they pose a problem for the value of the audit? **LO2**
2.16 Why is it so important that an audit committee not have any executive directors as members? **LO3**
2.17 Some companies outsource their internal audit function to a public accounting firm. Explain how this would affect the external auditor's evaluation of the reliability of the internal audit function. **LO3**
2.18 What are the three conditions that must be proven for an auditor to be found negligent under tort law? Based on a review of the legal cases discussed in the chapter, which conditions appear to be most difficult to prove? **LO4**
2.19 Why are there procedures governing the client acceptance or continuance decision? Explain why auditors do not accept every client. **LO5**
2.20 What is the purpose of an engagement letter? Are all engagement letters the same? **LO5**
2.21 What is proportionate liability? Does it offer any protection for auditors? **LO4**
2.22 Explain the difference between independence of mind and independence in appearance. Give an example of each. **LO2**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

2.23 ETHICAL PRINCIPLES ★ **LO1**

Charles is at a neighbourhood Christmas party with several of his flatmates. Over a few beers, Charles gets into a conversation with a neighbour, William, about mutual acquaintances. Charles is a junior auditor with a large accounting firm (although he tells William that he is a partner at the firm) and William works for a large bank. During the conversation Charles and William discover that they have both had professional dealings with a particular family-owned manufacturing company. William reveals that the company's line of credit is about to be cancelled because of some irregularities with the security documents. Charles is concerned to hear this news because he has just participated in the company's financial report audit and there was no indication of any problems with its borrowings. Charles tells William that he believes that the founder of the family-owned company (and the current CEO) is having an affair with his personal assistant, and has quietly increased his shareholdings in a listed company that supplies components to the family manufacturing company. The components manufacturing company is about to announce to the share market that it has just won a very large, and very profitable, contract with a Chinese company.

Required

Discuss the ethical principles that are potentially breached by Charles's behaviour at the party.

2.24 CLIENT ACCEPTANCE DECISION ★ **LO1, 2, 5**

McGrath and Partners Chartered Accounting firm is tendering for the audit of Harris Ltd for the next financial year. During the tender preparation, the manager of the audit team discovers that a separate division of the same city office of McGrath and Partners is also tendering to provide taxation services to Harris Ltd.

Required

Explain whether the audit team should continue to tender for the audit work of Harris Ltd.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2010.

2.25 CLIENT ACCEPTANCE DECISION ★ **LO1, 2, 5**

Starc and Partners Chartered Accounting firm has built up its audit work over the last five years. It has obtained new clients each year and many of its existing clients have grown in size. It has clients in many industries, but none of its clients are in the mining industry. At this month's planning meeting, the audit partners will consider whether they will tender for audit work for a potential new client that has several divisions including oil and gas, gold mining and steel fabrication.

Required

Explain whether Starc and Partners should tender for the audit work for the potential new client.

2.26 CLIENT CONTINUANCE ★ **LO1, 5**

Super Software Ltd is a client of FFF Partners. Super Software's bank has asked it for an audited financial report for the six months ended 31 December 2016. The bank's request is made in December 2016, and the report must be delivered to the bank by the end of January 2017 in order to finalise negotiations on Super Software's loan application. Super Software asks FFF Partners to provide the audit report on the six monthly financial report and suggests that due to the tight timeframe, FFF Partners can simply update its audit report for the financial statements to the year ended 30 June 2016, without doing any additional work.

Required

Should FFF Partners agree to Super Software's request? Explain.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2010.

2.27 CLIENT CONTINUANCE ★ **LO1, 5**

Dhoni and Kholi are the senior partners in a mid-size audit firm. They have both acted as the lead audit partner at different times with a long-standing audit client, Ibis Industries Ltd. The new CEO of Ibis has requested a meeting with Dhoni and Kholi to discuss issues with the firm's work, including the length of time the audit team are on the Ibis premises completing the audit work and the size of the audit fee charged in the past two years.

Required

What concerns should Dhoni and Kholi have about the requested meeting? Explain.

2.28 SETTING AUDIT FEES ★ **LO1, 2**

CCC Partners is negotiating with its audit client, Muir Industries, for the audit fees for the coming year. The partner in charge of the Muir Industries' audit offers the company a discounted audit fee if it also gives all its tax consulting work to the firm.

Required

Explain whether the managing partner at CCC Partners should agree to approve the deal negotiated by the audit partner in charge of Muir Industries' audit.

2.29 OWNING SHARES IN AUDIT CLIENTS ★ **LO2, 3**

Kerry is a senior auditor and a member of the team auditing a long-standing client, the listed public company Darcy Industries Ltd. Darcy Industries has just announced a takeover bid for Blacklight Ltd. Kerry has a substantial shareholding in Blacklight through his self-managed superannuation fund. Kerry did not know about the takeover bid until he read it in the paper over breakfast one morning. Kerry's wife is very worried because she knows that Kerry must abide by strict rules laid down by his audit firm about holding shares in client companies. She asks him if he will be dismissed because of this.

Required

Advise Kerry's wife of the options available to Kerry to avoid any conflict of interest, and thus avoid being dismissed from the audit firm.

2.30 CLIENT ACCEPTANCE DECISION ★★ **LO1, 2, 5**

You are part of the audit team at DDD Partners, tendering for the audit of WaterFun for the 2015 financial year. During your review of an Australian Securities and Investments Commission (ASIC) company extract for WaterFun, you note that DDD holds an interest in WaterFun. The interest is material to DDD.

Required

(a) What is the threat to compliance with the fundamental principles?
(b) Explain whether any safeguards could be put in place to reduce the threat to an acceptable level.
(c) Would it make any difference to your answers if the shares were held by a tax partner in the office, rather than being held directly by DDD?

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2010.

2.31 AUDITOR LIABILITY FOR MISLEADING ACCOUNTS ★★ **LO4**

Bumpa Shopping Centres has borrowed heavily in recent years. The pressures of rapid expansion have been felt within its finance department, and the chief financial officer (CFO) has begun to make mistakes. The CFO neglected to reclassify some of its debts from non-current liabilities to current liabilities following default on some terms of the contract with an international banking syndicate, and omitted contingent liabilities from the notes to the accounts. The billion dollar mistakes were not detected by either the directors or the auditors, and the financial report and audit report were published. Following discovery of the mistake, the shares in Bumpa Shopping Centres lost value rapidly and the company was placed into liquidation.

Required

Discuss the auditor's liability for losses suffered by (a) Bumpa Shopping Centres investors and (b) other parties.

2.32 PROVISION OF NON-AUDIT SERVICES TO AUDIT CLIENTS ★★ **LO2, 3**

Elise Dallimore is the partner in charge of the audit of Hertenstein Ltd, a large listed public company. Elise took over the audit from Marjorie Platt, who has recently retired from the audit firm. Marjorie was a very experienced auditor and the author of several reports into ethical standards in business, but Elise did not regard her highly for her ability to grow non-audit service fee revenue. Elise sees an opportunity to increase the provision of non-audit services to Hertenstein Ltd and thus increase her reputation within the audit firm.

Required

(a) Comment on Elise's belief that increasing non-audit service fee revenue from her audit client would increase her reputation in the audit firm.
(b) Which non-audit services would you advise Elise to avoid trying to sell to Hertenstein Ltd because of the potential ethical issues for the audit firm?
(c) Would it make any difference to your answers if Hertenstein Ltd was a proprietary company, not a listed public company?

2.33 UNPAID AUDIT FEES ★★ **LO1, 2, 3**

Linda is the managing partner of Moss and Associates, a small audit firm. Linda's role includes managing the business affairs of the firm, and she is very worried about the amount of fees outstanding from audit clients. One client, Dreamers Pty Ltd, has not paid its audit fees for two years despite numerous discussions between Linda, the audit partner, Bill, and the management of Dreamers Pty Ltd. Dreamers Pty Ltd's management promised the fees would be paid before the audit report for this year was issued.

Linda rang Bill this morning to ensure that the audit report was not issued because Dreamers Pty Ltd had paid only 10 per cent of the outstanding account. She discovers that Bill is about to sign the audit report.

Required

Explain the ethical problem in this case. Why is it a problem? What can be done about it?

2.34 USING THE WORK OF INTERNAL AUDITORS ★★ LO5

Theobald Ltd has an internal audit department that primarily focuses on audits of the efficiency and effectiveness of its production departments. The other main role of the internal audit department is auditing compliance with various government regulations surrounding correct disposal of waste and storage of raw materials at its five factories. Theobald Ltd's internal audit department is run by Harry Potts, a CPA and a member of the Institute of Internal Auditors. There are three other members of the department, all of whom have experience in performance auditing and, in addition, have completed industry-run training courses in waste management and handling dangerous goods. Harry meets regularly with the chief production manager and sends monthly reports to the CEO and the board of directors. Your initial investigations suggest that Harry is highly regarded within Theobald Ltd, and his reports are often discussed at board meetings. In most cases, the board authorises the actions recommended in Harry's reports with respect to major changes to production and logistics.

Required

Comment on the extent of reliance the external auditor should place on the work of the internal audit department at Theobald Ltd. Explain the likely impact of the internal audit department's work on the audit plan.

2.35 LEGAL IMPLICATIONS OF CLIENT ACCEPTANCE ★★★ LO4, 5

Godwin, Key & Associates is a small, but rapidly growing, audit firm. Its success is largely due to the growth of several clients that have been with the firm for more than five years. One of these clients, Carolina Company Ltd, is now listed on the ASX and must comply with additional reporting regulations. Carolina Company Ltd's rapid growth has meant that it is financially stretched and its accounting systems are struggling to keep up with the growth in business. The client continuance decision is about to be made for the next financial year.

The managing partner of Godwin, Key & Associates, Rebecca Sawyer, has recognised that the audit firm needs to make some changes to deal with the issues created by the changing circumstances of its major client and the audit firm's overall growth. She is particularly concerned that the audit firm could be legally liable if Carolina Company Ltd's financial situation worsens and it fails.

Required

(a) Provide guidance to Rebecca about the steps she can take to avoid the threat of litigation if Carolina Company Ltd fails.

(b) What should Rebecca consider when making the client continuance decision for Carolina Company Ltd for the next financial year?

2.36 INDEPENDENCE THREATS AND SAFEGUARDS ★★★ LO2, 3

Dolphin Surf & Leisure Holidays Pty Ltd (Dolphin) is a resort company based on the Great Barrier Reef. Its operations include boating, surfing, diving and other leisure activities, a backpackers' hostel, a family hotel and a five-star resort. Justin and Sarah Morris own the majority of the shares in the Morris Group which controls Dolphin. Justin is the chairman of the board of directors of both Dolphin and the Morris Group, and Sarah is a director of both companies as well as the CFO of Dolphin.

In February 2017, Justin Morris approached your audit firm, Clarke Partners, to carry out the Dolphin audit for the year ended 30 June 2017. Dolphin has not been audited before but this year the audit has been requested by the company's bank and a new private equity investor group which has just acquired a 20 per cent share of Dolphin. You know that one of the partners at Clarke Partners went to school with Justin and has been friends with both Justin and Sarah for many years.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

Required

(a) Identify and explain the significant threats to independence for Clarke Partners in accepting the audit of Dolphin.
(b) Explain any relevant and practical safeguards that Clarke Partners could implement to reduce the threats.

2.37 INDEPENDENCE THREATS AND SAFEGUARDS ★★★ LO2, 3

MaxSecurity Limited (MaxSecurity) has been an audit client of Smith & Associates (S&A) for the past 15 years. MaxSecurity is based in Wollongong, where it manufactures high-tech armour-plated personnel carriers. MaxSecurity often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialised and MaxSecurity only does business with nations that have a recognised, democratically elected government. MaxSecurity maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

Clarke Field has been the engagement partner on the MaxSecurity audit for the last five years. Clarke is a specialist in the defence industry and intends to remain as review partner when the audit is rotated next year to a new partner (Sally Woodrow, who is to be promoted to partner to enable her to sign-off on the audit).

In September 2016, MaxSecurity installed an off-the-shelf costing system to support the highly sophisticated and cost sensitive nature of its product designs. The new system replaced a system that had been developed in-house as the old system could no longer keep up with the complex and detailed manufacturing costing process that provides tender costings. The old system also had difficulty with the company's broader reporting requirements.

MaxSecurity's information technology (IT) department, together with the consultants from the software company, implemented the new manufacturing costing system. There were no customised modifications. Key operational staff and the internal audit team from MaxSecurity were significantly engaged in the selection, testing, training and implementation stages.

The manufacturing costing system uses all of the manufacturing unit inputs to calculate and produce a database of all product costs and recommended sales prices. It also integrates with the general ledger each time there are product inventories movements such as purchases, sales, wastage and damaged stock losses.

MaxSecurity has a small internal audit department which is headed by an ex-partner of S&A, Rydell Creek. Rydell joined MaxSecurity after leaving S&A six years ago after completing his Chartered Accountants qualifications. Rydell is assisted by three junior internal auditors, all of whom are completing Bachelor of Business studies at Swanston University.

MaxSecurity's end of financial year is 30 June.

Source: Adapted from the CA Program's *Audit & assurance exam,* May 2008.

Required

(a) Are there any threats to independence for S&A in its audit of MaxSecurity?
(b) Can you propose any recommendations to safeguard S&A against the potential independence threats you have identified? Explain.

Questions 2.38 and 2.39 are based on the following case.

Chan and Partners Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year Chan and Partners gained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home
- Total Cancer Specialists Limited (TCSL), a private oncology clinic that specialises in the treatment of cancer.

Year-end for all MSHG entities is 30 June.

TCSL owns two relatively old linear accelerators used in radiation therapy. Recently, radiographers using these linear accelerators have raised concerns that they have adverse radiation impacts on patients.

The CEO of TCSL, Betty Buick, has approached Tania Fellowes, the audit partner responsible for the financial report audit, about undertaking an engagement in respect of the linear accelerators. Betty has requested Tania provide an opinion that the linear accelerators are fit for use. Betty pointed out that the TCSL audit is up for tender the following year and suggested Chan and Partners might like to take on the linear accelerators engagement without charging a fee as a gesture of goodwill.

Prior to the appointment of Chan and Partners as the auditor for the group which controls TCSL, MSHG, for the 2017 financial year, some preliminary analysis by Tania Fellowes identified the following situations:

1. One of the accountants intended to be part of the 2017 audit team owns shares in MSHG. The accountant's interest is not material to him.
2. Chan and Partners was previously engaged by MSHG to value its intellectual property. The consolidated balance sheet (statement of financial position) as at 30 June 2017 includes intangible assets of $30 million, which were valued by Chan and Partners on 1 March 2017 following MSHG's acquisition of the subsidiary Shady Oaks Hospital. The intangibles are considered material to MSHG.

Source: Adapted from the CA Program's *Audit & assurance exam,* December 2008.

2.38 ETHICS OF ACCEPTING ENGAGEMENTS ★★★ **LO1, 5**

Explain why Tania should have reservations about accepting the engagement in respect of the linear accelerators. Make appropriate reference to fundamental ethical principles in your answer.

2.39 INDEPENDENCE ISSUES IN ACCEPTING ENGAGEMENTS ★★★ **LO1, 2, 3, 5**

(a) Using your knowledge of APES 110, identify and explain the potential type of threat to Chan and Partners' independence in situations (1) and (2) above.

(b) What action should Chan and Partners take to eliminate the potential threats to independence in situations (1) and (2) above? What safeguards should be instituted to reduce the risk of similar independence threats occurring in the future?

CASE STUDY — CLOUD 9

Sharon Gallagher, Josh Thomas and Jo Wadley are members of the audit firm W&S Partners. Sharon is the audit manager and Josh is the audit senior assisting the partner, Jo Wadley, evaluate the decision to accept the Cloud 9 Pty Ltd (Cloud 9) audit engagement for the year ended 31 December 2016.

Background information about the company is presented in the appendix to this text. In addition, Josh has discovered the following facts and has requested your help to document and assess the factors that affect the client acceptance decision.

- The Finance Director of Cloud 9, David Collier, is married to a distant relation of PS Nethercott, a partner in W&S Partners' consulting department.
- The consulting department at W&S Partners has tendered for an IT installation project at Cloud 9. The fees from this project, if the tender is successful, would be twice the size of the audit fee.
- A survey of audit staff at W&S Partners has revealed that 30 per cent have purchased Cloud 9's products (basketball shoes or workboots) in the past.
- Four members of the IT department at W&S Partners have shares in retailers that sell Cloud 9's products. In each case, the shareholdings were disclosed on the firm's financial interests register and the size of the shareholding is deemed material under W&S Partners' ethical guidelines.
- An article in a newspaper published in the United States has claimed that Cloud 9 Inc. (Cloud 9's parent company) was secretly running 'third-world sweat shops'. The article alleged that shoes made by other wholly owned subsidiaries of Cloud 9 Inc. in China and Brazil were using illegal child labour in factories that did not meet local health and safety rules. Cloud 9 Inc. has vehemently disputed the accuracy of the article, suggesting it was planted by a rival company. Cloud 9 Inc. has invited international advocacy groups to visit its factories at any time.

Required

Answer the following questions based on the information presented in the appendix to this text and that presented above and throughout chapters 1 and 2. Consider your answer to the case study questions in chapter 1 where relevant.

(a) Prepare a document that explains the impact, if any, of each piece of relevant information on your client acceptance decision for Cloud 9.

(b) List and explain any additional actions you would take before making your client acceptance recommendation to the partner, Jo Wadley, in this case.

(c) Assume the decision is made to accept Cloud 9 as a client. Prepare the client engagement letter.

RESEARCH QUESTION

One way of getting accounting expertise onto audit committees is to recruit ex-audit firm partners and/or employees onto the board of directors. However, appointing former audit firm partners to boards and audit committees raises independence concerns and there is a requirement in the Corporations Act that a retired partner must not take on a senior role in an audit client for two years from retiring.

Naiker and Sharma provide evidence that financial reports are of higher quality when former audit partners are on the audit committee, and raise doubts about the benefits of a rule limiting their recruitment.[11]

Required

(a) What are the arguments for and against allowing former audit firm partners and/or employees to join audit committees?

(b) Explain how these accounting experts could help or hinder the audit process and thereby have an impact on the quality of a company's internal controls and financial reports.

FURTHER READING

ASX Corporate Governance Council 2014, *Corporate governance principles and recommendations*, 3rd edition, www.asx.com.au.

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SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. d, 2. b, 3. b, 4. d, 5. d, 6. d, 7. a, 8. b, 9. c, 10. a.

NOTES

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CHAPTER 3

Risk assessment I

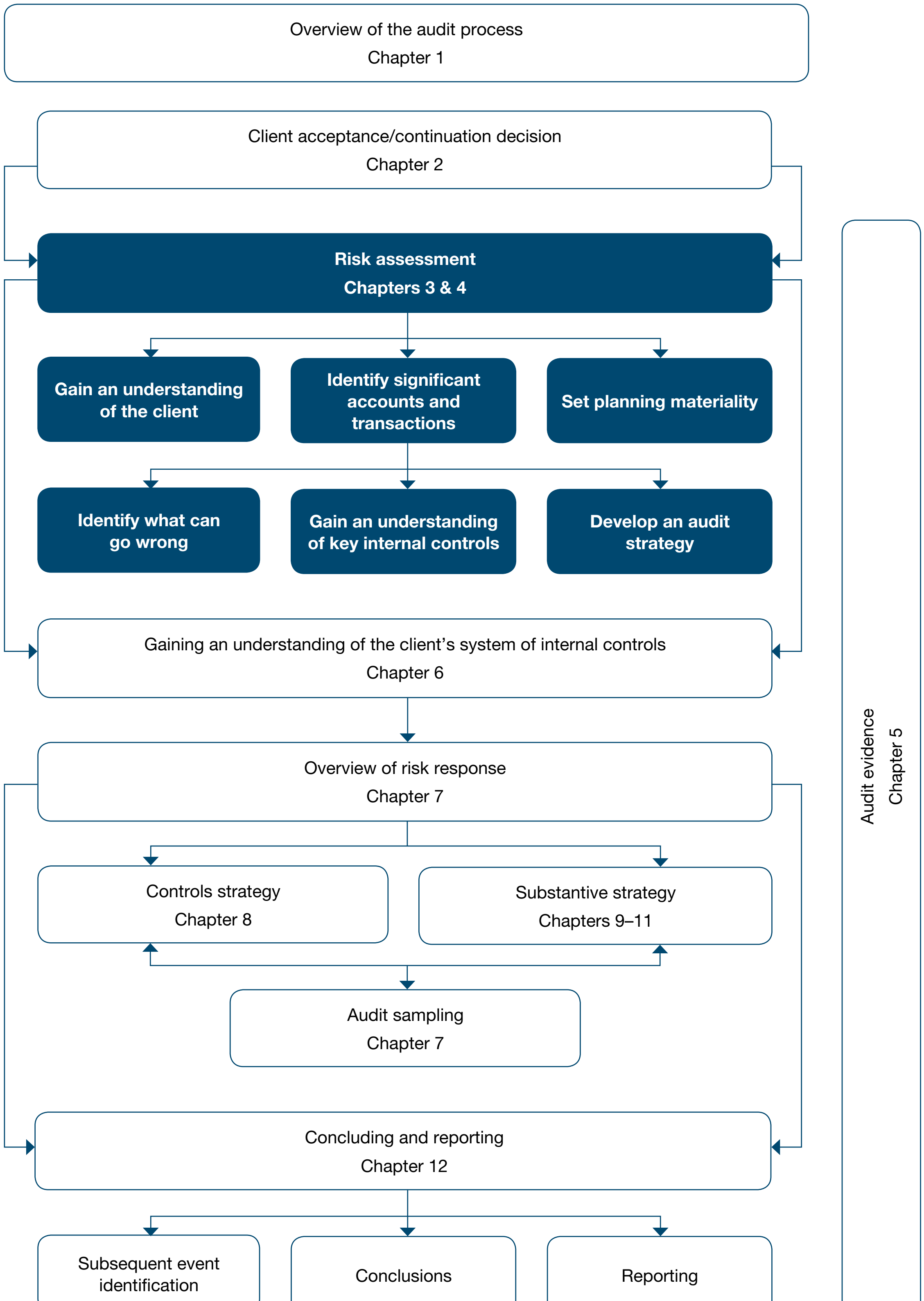
LEARNING OBJECTIVES

After studying this chapter you should be able to:

3.1 explain the different phases of an audit
3.2 relate the process used in gaining an understanding of the client
3.3 evaluate fraud risk
3.4 explain the going concern assumption
3.5 appraise corporate governance structures
3.6 evaluate how a client's information technology (IT) can affect risk
3.7 demonstrate how client closing procedures can affect reported results.

AUDITING AND ASSURANCE STANDARDS

AUSTRALIAN	INTERNATIONAL
ASA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*	ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*
ASA 300 *Planning an Audit of a Financial Report*	ISA 300 *Planning an Audit of Financial Statements*
ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*	ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*
ASA 550 *Related Parties*	ISA 550 *Related Parties*
ASA 570 *Going Concern*	ISA 570 *Going Concern*


Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client's system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

'Great news!' announces Sharon Gallagher at the weekly team meeting. 'We have just had word that the audit engagement letter for Cloud 9 Pty Ltd (Cloud 9) has been signed. We are now officially their financial report auditors and the risk assessment phase starts now!'

Later, at the first planning meeting, Sharon and Josh Thomas focus on assigning the tasks for gaining an understanding of Cloud 9. Ian Harper, a first year graduate, is not happy. He grumbles to another new member of the team, Suzie Pickering, as he leaves the room, 'This is such a waste of time. Why did we sign an engagement letter if we don't understand the client? Why don't we just get on with the audit? What else is there to know?'

'Oh boy, are you missing the point!' Suzie says. 'If you don't understand where the risks are greatest, where are you going to start "getting on with it"?'

'The same place you always start,' replies Ian. Suzie realises that she has a big job explaining to Ian, and invites him for a coffee in the staff room so that they can talk. Although Suzie is new to the team, she has audit experience with other clothing and footwear clients, and will be helping Sharon and Josh manage the Cloud 9 audit. Her first question to Ian at coffee is 'What do you think could go wrong at Cloud 9 that would cause the financial report to be materially misstated?'

Audit process in focus

Risk assessment is an important topic that we will cover in this and the next chapter. In this chapter we commence with a discussion of the different phases (or stages) of the audit: the risk assessment phase, the risk response phase (where the detailed work is conducted) and the reporting phase (where the audit opinion is formed). At the risk assessment and reporting phases the auditor adopts a broad view of the client as a whole and the industry in which it operates. An understanding of the client is gained in the early stages of each audit and that knowledge drives the planning of the audit. It informs the choice of where to focus most attention throughout the audit. When forming an opinion on the truth and fairness of the financial report, consideration is given to the evidence gathered during the risk response phase of the audit, placing that information within the context of the knowledge of the client gained from the risk assessment phase.

During the risk assessment phase of an audit an assessment is made of the risk that a material misstatement (significant error or fraud) could occur in the client's financial report. By understanding where the risks are most significant, an auditor can plan their audit to spend more time where the risks are greatest. During the risk assessment phase of an audit an auditor will gain an understanding of their client, their client's internal controls, their client's information technology (IT) environment, their client's corporate governance environment and their client's closing procedures. An auditor will identify any related parties, factors that may affect their client's going concern status and significant accounts and classes of transactions that will require close audit attention to gauge the risk of material misstatement. Each of these important elements of the risk assessment phase of the audit is considered in this chapter.

The process adopted when gaining an understanding of a client is also explained in detail. That explanation is followed by a discussion of the risk that a client's financial report is misstated due to fraud. The audit procedures used to assess the risk that a fraud has occurred and common frauds are included in the discussion. That is followed by a discussion of the processes used to assess the going concern assumption.

Corporate governance comprises the rules, systems and processes within companies used to guide and control. During the risk assessment phase of an audit an auditor will assess the adequacy of their client's corporate governance structure in assessing the risk that the financial report is materially misstated.

A client's IT system is used to capture process and report on accounting records. During the risk assessment phase of an audit an auditor will assess the adequacy of their client's IT system. This process is discussed in this chapter.

The final section of this chapter includes a discussion of the procedures used by an auditor to assess their client's closing procedures. Closing procedures aim to ensure that transactions are recorded in the appropriate accounting period. An auditor will assess the adequacy of their client's closing procedures to assess the risk that a material misstatement will occur in the financial report as a consequence.

3.1 Phases of an audit

LEARNING OBJECTIVE 3.1 Explain the different phases of an audit.

Before commencing our discussion of risk assessment we provide an overview of the various phases of the audit, which is represented diagrammatically in figure 3.1. The main phases of an audit are risk assessment, risk response and reporting. Once the client acceptance or continuation decision has been made (described in chapter 2), the first phase of an audit is assessing client risk and planning the audit. Broadly, the **risk assessment phase** involves gaining an understanding of the client, identifying factors that may impact the risk of a material misstatement in the financial report, performing a risk and **materiality** assessment and developing an **audit strategy**. The risk of a material misstatement is the risk that the financial report includes a significant error or fraud. The **risk response phase** of the audit involves the performance of detailed tests of control and substantive testing of transactions and accounts. The **reporting phase** involves an evaluation of the results of the detailed testing in light of the auditor's understanding of their client and forming an opinion on the truth and fairness of the client's financial report. An overview of each phase of the audit follows.

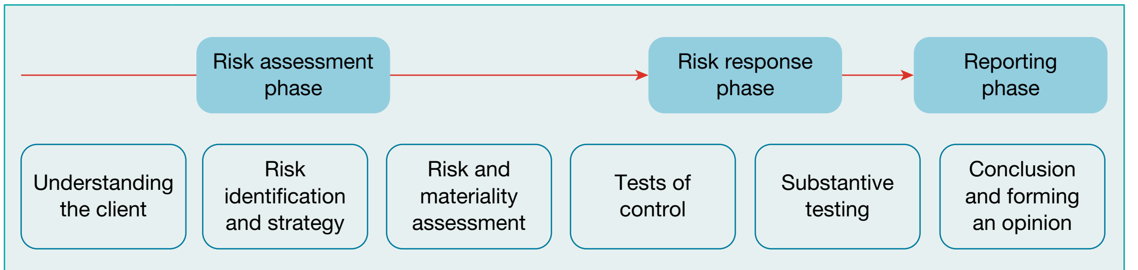


FIGURE 3.1 Overview of the audit

3.1.1 Risk assessment phase

ASA 300 (ISA 300) *Planning an Audit of a Financial Report* requires that an auditor plan their audit by assessing risk to reduce audit risk to an acceptably low level (para. 6). Audit risk is the risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated. An auditor will undertake various risk assessment procedures to ensure that appropriate attention is paid to the accounts and transactions most at risk of material misstatement (see figure 3.1). The risk assessment phase of the audit provides the opportunity to optimise efficiency and effectiveness when conducting an audit. Efficiency refers to the amount of time spent gathering audit evidence. Effectiveness refers to the minimisation of audit risk. A well-planned audit will ensure that **sufficient appropriate evidence** is gathered for those accounts most at risk of material misstatement. Figure 3.2 provides a graphical depiction of the preliminary risk assessment phase of the audit.

Figure 3.2 includes elements of the preliminary risk assessment phase of the audit. Each element is now discussed, starting with 'understand the client' and proceeding clockwise. The process used by an auditor when gaining an understanding of their client is outlined in section 3.2 of this chapter. Part of the risk assessment process involves the search for related parties. According to AASB 124 (IAS 24) *Related Party Disclosures*, related parties include parent companies, subsidiaries, joint ventures and associates. It is the responsibility of the auditor to ensure that related parties are identified and appropriately disclosed, in line with relevant accounting standards, in the notes to the financial report. ASA 550 (ISA 550) *Related Parties* provides audit guidance associated with related party transactions and disclosures.

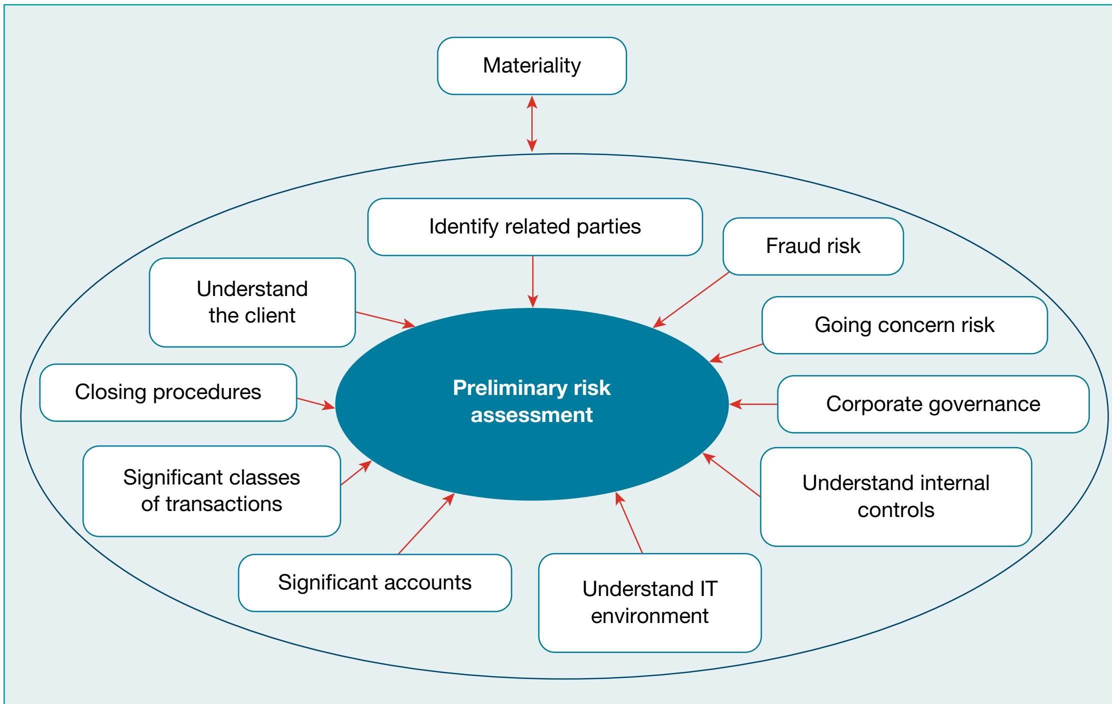


FIGURE 3.2 Preliminary risk assessment

During the risk assessment phase of the audit, an auditor will evaluate the risk of material misstatement due to **fraud** (ASA 240 (ISA 240) *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*) and consider whether it is appropriate to assume that their client will remain as a **going concern** (ASA 570 (ISA 570) *Going Concern*). Fraud risk is discussed in section 3.3 of this chapter and going concern is discussed in section 3.4.

A client's **corporate governance** structure is assessed during the risk assessment phase of an audit. It is the process used to ensure that companies are well managed and that, among other things, risks are identified and controlled. The Australian Securities Exchange (ASX) Corporate Governance Council's *Corporate governance principles and recommendations*, 3rd edition (2014) provides guidelines on corporate governance practices. Auditors use these guidelines when assessing the effectiveness of a client's corporate governance structures. These recommendations are listed and discussed in section 3.5 of this chapter.

According to ASA 315 (ISA 315) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, an auditor must gain an understanding of their client's system of internal controls. Elements of control risk are discussed in chapter 4, and chapter 6 contains a discussion of the procedures used by an auditor in gaining an understanding of a client's system of internal controls. When gaining an understanding of their client's system of internal controls, an auditor will consider the impact of information technology (IT) (ASA 315, ISA 315). IT is discussed in more detail in section 3.6 of this chapter.

Significant accounts and classes of transactions are identified when planning so that an auditor can structure their audit testing to ensure that adequate time is spent testing these accounts and classes of transactions. During the risk assessment phase, an auditor will also consider the adequacy of their client's **closing procedures**. An auditor's consideration of their client's closing procedures and the associated risks are discussed in section 3.7 of this chapter. An important task in the early stages of every audit is to set the planning materiality. This important concept is discussed in detail in chapter 4.

CLOUD 9

Ian thinks that all audits are pretty much the same and that W&S Partners must have an audit plan that they can use for the Cloud 9 audit. Suzie explains that if they tailor the plan to the client, the audit is far more likely to be efficient and effective. That is, they will get the job done without wasting time and ensure that sufficient appropriate evidence is gathered for the accounts that are most at risk of being misstated. If they can do this, W&S Partners will not only issue the right audit report, but make a profit from the audit as well. In other words, if the plan is good, performing the audit properly will be easier.

3.1.2 Risk response phase

The risk response phase of the audit involves detailed testing of controls, transactions and account balances. If an auditor plans on relying on their client's system of internal controls, they will conduct tests of control (discussed in chapter 8). An auditor will conduct detailed substantive tests of transactions throughout the year and detailed substantive tests of balances recorded at year-end (discussed in chapters 9, 10 and 11). This detailed testing provides the evidence that the auditor requires when determining whether, in their opinion, the financial report is true and fair (discussed in chapter 12).

3.1.3 Concluding and reporting on an audit

The final phase of the audit involves drawing conclusions based upon the evidence gathered and arriving at an opinion regarding the truth and fairness of the financial report. The auditor's opinion is expressed in the audit report (discussed in chapter 12). At this stage of the audit, an auditor will draw on their understanding of the client, their detailed knowledge of the risks faced by the client and the conclusions drawn when testing the client's controls, transactions and account balances.

BEFORE YOU GO ON

- What are the three main phases of the audit?
- List three factors that affect an auditor's preliminary risk assessment.
- What are related parties?

3.2 Gaining an understanding of the client

LEARNING OBJECTIVE 3.2 Relate the process used in gaining an understanding of the client.

At the outset of every audit an auditor must gain an understanding of their client. The purpose of this procedure is to assess the risk that the financial report contains a material misstatement due to:

- the nature of the client's business
- the industry in which the client operates
- the level of competition within that industry
- the client's customers and suppliers
- the regulatory environment in which the client operates.

ASA 315 (ISA 315) provides guidance on the steps to take when gaining an understanding of a client. In gaining that understanding the auditor will consider issues at the entity level, the industry level and the economy level.

CLOUD 9

Ian knows that there are many possible problems in an audit that would cause the auditor to issue the wrong type of audit report, but is struggling to understand why the audit team will be spending time gaining an understanding of a client. How does this help? Why aren't audits all the same?

Suzie explains to Ian that issuing the wrong type of audit report is a risk the auditor always faces, but the risk varies across audits. The variation in the risk is partly related to how well the audit team performs its tasks, which is dependent on the team members' level of skill, effort, supervision and so on. But the variation in risk is also related to the particular characteristics of the client and its environment. Some clients are more likely than others to have errors or deficiencies in their accounting and financial reporting systems, operations or underlying data. Even within one client's business, some areas are more likely to have problems than, or will have problems different to, others. Suzie asks Ian to think about what sort of problems Cloud 9's draft financial report is most likely to have, and why.

3.2.1 Entity level

It is important that an auditor gains a detailed knowledge of their client. Knowledge about the entity is gained through interviews with client personnel, including those charged with governance. The auditor will ask questions about what the client does, how the client functions, the ownership structure of the client and its sources of finance. For new clients, this process is very detailed and time consuming. For a continuing client, this process is less onerous and involves updating the knowledge gained on previous audits. By gaining an understanding of the client, the auditor is in a stronger position to assess entity-level risks and the financial report accounts that require closer examination. The following paragraphs outline some of the procedures followed by an auditor when gaining an understanding of their client at the entity level.

Major customers are identified so that the auditor may consider whether those customers have a good reputation, are on good terms with the client (that is, likely to remain a customer in future) and are likely to pay the client on a timely basis. Dissatisfied customers may withhold payment, which affects the allowance for doubtful debts and the client's cash flow, or decide not to purchase from the client in the future, which can affect the going concern assumption. If a client has only one or a few customers this risk is increased. The auditor also considers the terms of any long-term contracts between their client and their client's customers.

Major suppliers are identified to determine whether they are reputable and supply quality goods on a timely basis. Consideration is given to whether significant levels of goods are returned to suppliers as faulty, the terms of any contracts with suppliers and the terms of payment to suppliers. The auditor assesses whether the client pays its suppliers on a timely basis. If the client is having trouble paying its suppliers, it may have trouble sourcing goods as suppliers may refuse to transact with a company that does not pay on time.

Whether the client is an *importer or exporter* of goods is identified. If the client trades internationally, the auditor considers the stability of the country(s) the client trades with, the stability of the foreign currency(s) the client trades in and the effectiveness of any risk management policies the client uses to limit exposure to currency fluctuations (such as hedging policies).

The client's *capacity to adapt to changes in technology and other trends* is assessed. If the client is not well positioned to adjust to such changes, it risks falling behind competitors and losing market share, which in the longer term can affect the going concern assumption. If the client operates in an industry subject to frequent change, it risks significant losses if it doesn't keep abreast of such changes and 'move with the times'. For example, if a client sells laser printers, the auditor will need to assess whether their client is up-to-date with changes in technology and customer demands for environmentally friendly printers.

The nature of any *warranties* provided to customers is assessed. If the client provides warranties on products sold, the auditor needs to assess the likelihood that goods will be returned and the risk the client has underprovided for that rate of return (adequacy of the provision for warranty). The auditor will pay particular attention to goods being returned for the same problem, indicating that there may be a systemic fault. For example, if the client sells quality pens and the auditor notices that a number of pens are being returned because the mechanism to twist the pen open is faulty, they will assess the likelihood that other pens will be returned for the same reason, the steps being taken by the client to rectify the problem, and whether the provision for warranty is adequate in light of this issue.

The terms of *discounts* given by the client to its customers and received by the client from its suppliers are reviewed. An assessment is made of the client's bargaining power with its customers and suppliers to determine whether discounting policies are putting profit margins at risk, which may place the future viability of the client at risk.

An assessment is made of the client's *reputation* with its customers, suppliers, employees, shareholders and the wider community. A company with a poor reputation places future profits at risk. It is also not in the best interests of the auditor to be associated with a client that has a poor reputation.

An understanding is gained of client *operations*. The auditor will note where the client operates, the number of locations it operates in and the dispersion of these locations. The more spread out the client's operations are, the harder it is for the client to effectively control and coordinate its operations, increasing the risk of errors in the financial report. The auditor will need to visit locations where the risk of material misstatement is greatest to assess the processes and procedures at each site. If the client has operations interstate or overseas, the auditor may plan for a visit to those sites by staff from affiliated offices at those locations where risk is greatest. For example, an auditor is more likely to visit client operations if the client opens a new, large site, or if the business is located in a country where there is a high rate of inflation or where there is a high risk of theft.

An understanding is gained of the *nature of employment contracts* and the client's *relations with its employees*. The auditor will consider how a client pays its employees, the mix of wages and bonuses, the level of unionisation among the workforce and the attitude of staff to their employer. The more complex a payroll system, the more likely that errors can occur. When staff are unhappy, there is greater risk of industrial action, such as strikes, which disrupt client operations.

The client's *sources of financing* are reviewed. An assessment is made of a client's debt sources, the reliability of future sources of financing, the structure of debt and the reliance on debt versus equity financing. An auditor assesses whether their client is meeting interest payments on funds borrowed and repaying funds raised when they are due. If a client has a covenant with a debt provider, the auditor will need to understand the terms of that covenant and the nature of the restrictions it places on their client. Debt covenants vary. A company may, for example, agree to limit further borrowings. They may agree to maintain a certain debt to equity ratio. If the client does not meet the conditions of a debt covenant, the borrower may recall the debt, placing the client's liquidity position at risk, and increasing the risk that the client may not be able to continue as a going concern.

The client's *ownership structure* is assessed. The auditor is interested in the amount of debt funding relative to equity, the use of different forms of shares and the differing rights of shareholder groups. The client's dividend policy and its ability to meet dividend payments out of operating cash flow are also of interest.

CLOUD 9

Ian is starting to think about Cloud 9 more closely. He can remember something being said about Cloud 9 importing the shoes from a production plant in China and then wholesaling them to major department stores.

'OK,' says Suzie. 'Let's just take that one aspect of the operations and think about the issues that could arise.'

Ian realises that the department stores would be debtors of Cloud 9 (although they should check that the stores actually purchase the shoes rather than hold them on consignment). If there was a mistake or a dispute with one of the stores, or if the store was in financial difficulties, the collectability of debtors would be in doubt, so assets could be overstated. If the store disputed a sale, or a sale return was not recorded correctly, sales (and profit) could be overstated. Is Cloud 9 liable for warranty expenses if the shoes are faulty? The auditors would need to read the terms of the contract to determine if a warranty liability should be recorded on the balance sheet (statement of financial position). What about the balance of inventories? Do the shoes belong to Cloud 9 when they are being shipped from China, or only after they arrive at the warehouse? Is Cloud 9 exposed to foreign exchange risk?

Suzie points out that the answer to each of these questions could be different for Cloud 9 than for other clients because of its different circumstances. The auditors need to gain an understanding of these circumstances so that they can assess the risk that debtors, sales, sales returns, inventories and liabilities are misstated. Once they understand the risks, they are in a position to decide how they will audit Cloud 9.

3.2.2 Industry level

At the industry level, an auditor is interested in their client's position within its industry, the level of competition in that industry and their client's size relative to competitors. The auditor evaluates their client's reputation among its peers and the level of government support for companies operating in that industry. Another consideration is the level of demand for the products sold or services supplied by companies in that industry and the factors that affect that demand. For example, a soft drink manufacturer is affected by the weather; that is, revenue is seasonal. Also, competition is generally strong.

A comparison is made between the client and its close competitors nationally and internationally. When an auditor has a number of clients that operate in the one industry, this stage of the audit is more straightforward than if the client operates in an industry that the auditor is not already familiar with. The following paragraphs outline some of the procedures followed by auditors when gaining an understanding of their client at the industry level.

The *level of competition* in the client's industry is assessed. The more competitive the client's industry, the more pressure placed on the client's profits. In an economic downturn, the weakest companies in highly competitive industries face financial hardship and possible liquidation. A key issue for an auditor is their client's position among its competitors and its ability to withstand downturns in the economy.

An auditor also considers their client's *reputation* relative to other companies in the same industry. If the client has a poor reputation, customers and suppliers may shift their business to a competing firm, threatening their client's profits. In such circumstances a client's management may resort to aggressive accounting choices to improve their profits (or reduce their losses). The auditor can assess their client's reputation by reading articles in the press and industry publications.

Consideration is given to the level of *government support* for the client's industry. This issue is important if the industry faces significant competition internationally or the industry is new and requires time to become established. Support is sometimes provided to industries that produce items in line with government policy, such as manufacturers of water tanks, solar heating and reduced-flow taps in the context of environmental policies.

An assessment is made of the impact of *government regulation* on the client and the industry in which it operates. Regulations include tariffs on goods, trade restrictions and foreign exchange policies. Regulations can affect a client's viability and continued profitability. An auditor will consider the level of taxation imposed on companies operating in their client's industry. The auditor assesses the different taxes and charges imposed on their client and the impact these have on profits.

The level of *demand* for the goods sold or services provided by companies in the client's industry is considered. If a client's products or services are seasonal, this will affect revenue flow. If a client is an ice-cream producer, sales would be expected to increase in summer. However, if the weather is unseasonal, profits may suffer. If a client sells swim wear, sales will fall in a cool summer. If a client sells ski equipment, sales will fall if the winter brings little snow. If a client operates in an industry subject to changing trends, such as fashion, the client risks inventories obsolescence if it does not keep up and move quickly with changing styles. When a product or process is subject to technological change there is the risk that a client will quickly be left behind by its competitors. Either its products will become obsolete or its outdated processes will mean that it may find it difficult to compete with competitors that stay abreast of technological innovations.

3.2.3 Economy level

Finally, when gaining an understanding of a client, an auditor assesses how economy level factors affect the client. Economic upturns and downturns, changes in interest rates and currency fluctuations affect all companies. An auditor is concerned with their client's susceptibility to these changes and its ability to withstand economic pressures.

During an economic upturn, companies are under pressure to perform as well as or better than competitors, and shareholders expect consistent improvements in profits. When conducting the audit in this environment, more focus is given to the risk of overstatement of revenues and understatement of expenses. During an economic downturn, companies may decide to 'take a bath'. This means that companies may purposefully understate profits. When the economy is poor there is a tendency to maximise write-offs as a fall in profits can easily be explained to the share market as most companies experience a decline in earnings. A benefit of 'taking a bath' is that it provides a low base from which to demonstrate an improvement in results in the following year. When conducting the audit where the economy is in recession and clients may be tempted to 'take a bath', more focus is given to the risk of understatement of revenues and overstatement of expenses.

CLOUD 9

Suzie explains to Ian that the partner, Jo Wadley, has asked her to join the team for this audit because she has extensive experience in the clothing and footwear industry. Wadley wants to make sure that the team's industry knowledge is very strong. Several other members of the team also have experience in auditing clients in the retail industry, including Jo Wadley and manager Sharon Gallagher. In addition, Josh is highly regarded at W&S Partners for his knowledge of debtors and cash receipts systems.

Suzie has the task of leading the team writing the report on the industry-specific economic trends and conditions. The report has to include an assessment of the competitive environment, including any effects of technological changes and relevant legislation. So that Ian can appreciate how understanding the client is an important part of the risk assessment phase, Suzie asks him to help write the report on the product, customer and supplier elements. Then, together, they will assess the specific risks arising from the entire report, including risks at the economy level, for the Cloud 9 audit.

BEFORE YOU GO ON

- What is the purpose of gaining an understanding of a client?
- What will an auditor consider if their client is an importer or exporter?
- What does a client risk if it operates in an industry subject to changing trends?

3.3 Fraud risk

LEARNING OBJECTIVE 3.3 Evaluate fraud risk.

During the risk assessment phase of the audit, an auditor will assess the risk of a material misstatement due to fraud (ASA 240, ISA 240). When assessing fraud risk an auditor will adopt an attitude of

professional scepticism to ensure that any indicator of a potential fraud is properly investigated. This means that the auditor must remain independent of their client, maintain a questioning attitude and search thoroughly for corroborating evidence to validate information provided by the client. The auditor must not assume that their past experience with client management and staff is indicative of the current risk of fraud.

Fraud is an intentional act to obtain an unjust or illegal advantage through the use of deception (ASA 240, para. 11; ISA 240, para. 11). An auditor can use red flags to alert them to the possibility that a fraud may have occurred.[1] Red flags include:

- a high turnover of key employees
- key finance personnel refusing to take leave
- overly dominant management
- poor compensation practices
- inadequate training programs
- a complex business structure
- no (or ineffective) internal auditing staff
- a high turnover of auditors
- unusual transactions
- weak internal controls.

There are two broad types of fraud. Financial reporting fraud is intentionally misstating items or omitting important facts from the financial report. Misappropriation of assets fraud generally involves some form of theft. Figure 3.3 provides examples of financial reporting and misappropriation of assets frauds.

Financial reporting frauds

- Improper asset valuations
- Unrecorded liabilities
- Timing differences — bringing forward the recognition of revenues and delaying the recognition of expenses
- Recording fictitious sales
- Understating expenses
- Inappropriate application of accounting principles

Misappropriation of assets frauds

- Using a company credit card for personal use
- Employees remaining on the payroll after ceasing employment
- Unauthorised discounts or refunds to customers
- Theft of stock by employees or customers
- Using a company car for unauthorised personal use

FIGURE 3.3 Examples of frauds

The responsibility for preventing and detecting fraud rests with those charged with governance at the client. Prevention refers to the use of controls and procedures aimed at avoiding a fraud. Detection refers to the use of controls and procedures aimed at uncovering a fraud should one occur. It is the responsibility of the auditor to assess the risk of fraud and the effectiveness of the client's attempts to prevent and detect fraud via their internal control system. When assessing the risk of fraud an auditor can consider incentives and pressures to commit a fraud, opportunities to perpetrate a fraud, and attitudes and rationalisations used to justify committing a fraud (ASA 240 'Appendix 1'; ISA 240 'Appendix 1').

3.3.1 Incentives and pressures to commit a fraud

In assessing the risk of fraud, an auditor will consider incentives and pressures faced by their client to commit a fraud. While the examples provided below indicate that a client may be inclined to committing a fraud, they in no way indicate that a fraud has definitely occurred. When an auditor becomes aware of any of these risk factors, in isolation or combination, they will plan their audit to obtain evidence in relation to each risk factor.

Examples of incentives and pressures that increase the risk of fraud include:

- the client operates in a highly competitive industry
- a significant decline in demand for the client's products or services
- falling profits
- a threat of takeover
- a threat of bankruptcy
- ongoing losses
- rapid growth
- poor cash flows combined with high earnings
- pressure to meet market expectations
- planning to list on a stock exchange
- planning to raise debt or renegotiate a loan
- about to enter into a significant new contract
- a significant proportion of remuneration, which is tied to earnings (that is, bonuses, options).

3.3.2 Opportunities to perpetrate a fraud

After identifying one or more incentives or pressures to commit a fraud, an auditor will assess whether a client has an opportunity to perpetrate a fraud. An auditor will utilise their knowledge of how other frauds have been perpetrated to assess whether the same opportunities exist at the client. While the examples below of opportunities to commit a fraud suggest that a fraud may have been carried out, their existence does not mean that a fraud has definitely occurred. An auditor must use their professional judgement to assess each opportunity in the context of other risk indicators and consider available evidence thoroughly.

Examples of opportunities that increase the risk that a fraud may have been perpetrated include:

- accounts that rely on estimates and judgement
- a high volume of transactions close to year-end
- significant adjusting entries and reversals after year-end
- significant related party transactions
- poor corporate governance mechanisms
- poor internal controls
- a high turnover of staff
- reliance on complex transactions
- transactions out of character for a business (for example, if a client leases its motor vehicles they should not have car registration expenses).

3.3.3 Attitudes and rationalisation to justify a fraud

Together with the identification of incentives or pressures to commit a fraud and opportunities to perpetrate a fraud, an auditor will assess the attitudes and rationalisation of client management and staff to fraud. Attitude refers to ethical beliefs about right and wrong and rationalisation refers to an ability to justify an act. While the examples below indicate that a fraud may occur in companies where these characteristics are identified, they do not mean that a fraud has occurred.

Examples of attitudes and rationalisations used to justify a fraud include:

- a poor tone at the top (that is, from senior management)
- the implementation of an effective internal control structure is not seen as a priority
- an excessive focus on maximisation of profits and/or share price
- a poor attitude to compliance with accounting regulations
- rationalisation that other companies make the same inappropriate accounting choices.

CLOUD 9

Suzie explains that fraud risk is always present, even though actual fraud is reasonably rare, and that auditors must explicitly consider it as part of their risk assessment. Being aware of the incentives and pressures, opportunities and attitudes within the client relating to fraud helps the auditor make the assessment. Ian admits he has a little trouble understanding the difference between incentives and attitudes; he thinks he understands the concept of opportunity. Suzie explains that incentives relate to the factor that pushes (or pulls) a person to commit a fraud. Examples include a need for money to pay debts or gamble. Attitudes, or rationalisation, relate to the thinking about the act of fraud. For example, the person believes it is acceptable to steal from a nasty boss; that is, the theft is justified by the boss's 'nastiness'.

BEFORE YOU GO ON

- What are the responsibilities of the client and the auditor when it comes to fraud?
- Why is an attitude of professional scepticism important?
- List four incentives and pressures that increase the risk of fraud.

3.4 Going concern

LEARNING OBJECTIVE 3.4 Explain the going concern assumption.

During each phase of an audit, an auditor will consider whether it is appropriate to assume that their client will remain as a going concern (ASA 570, ISA 570). The concept of going concern is introduced here and will reappear throughout this text. The going concern assumption is made when it is believed that a company will remain in business for the foreseeable future (ASA 570, para. 2; ISA 570, para. 2). Under this assumption, assets are valued on the basis that they will continue to be used for the purposes of conducting a business and liabilities are recorded and classified as current and non-current on the basis that the client will pay its debts as they fall due in the years to come. It is the responsibility of management and those charged with governance to assess whether their company is likely to remain a going concern. It is the responsibility of the auditor to obtain sufficient appropriate evidence to assess the validity of the going concern assumption made by their client's management and those charged with governance when preparing the financial report.

3.4.1 Going concern risk — indicators

For each client, an auditor will use their professional judgement to assess whether the going concern assumption is valid. There are a number of indicators that, alone or combined, can suggest that the going concern assumption may be at risk. A comprehensive list of events and conditions that place doubt on the going concern assumption is provided in ASA 570 (ISA 570). Indicators include:

- a significant debt to equity ratio
- long-term loans reaching maturity without alternate financing in place
- prolonged losses
- an inability to pay debts when they fall due
- supplier reluctance to provide goods on credit
- the loss of a significant customer
- overreliance on a few customers or suppliers
- high staff turnover
- the loss of key, long-standing personnel
- staff regularly out on strike
- uncertainty around the future availability of a key input or raw material
- rapid growth with insufficient planning

- inadequate risk management procedures
- being under investigation for non-compliance with legislation
- falling behind competitors
- significant rapid increase in competition
- prolonged drought for the agricultural sector.

If the auditor identifies risk factors that indicate that the going concern assumption is in doubt, they will undertake procedures to gather evidence regarding each risk factor. For example, if a client has lost a number of key, long-standing personnel, an auditor may assess the quality of the remaining staff and the likelihood that the client will be able to hire suitable replacements in the near future. If the auditor believes there is an unresolved going concern issue outstanding, an assessment is made of the appropriateness of management disclosures in the notes to the financial report regarding that issue. An auditor will assess the process used by management to evaluate the extent of the going concern risk. If a company has a history of losses and difficulties, an auditor will expect management to take a great deal of time and care in their going concern assessment. Once the auditor has an understanding of the process used by management, which may include the careful preparation of detailed cash flow projections and budgets, they will assess the adequacy of that process and conduct additional procedures if necessary.

If the auditor concludes that the going concern assumption is in doubt, further procedures are undertaken. ASA 570 (ISA 570) provides a list of appropriate audit procedures. They include:

- assessment of cash flows
- assessment of revenue and expense items
- assessment of interim financial reports
- review of debt contracts
- review of board and other meetings
- discussions with client management and lawyers
- identification and assessment of mitigating factors.

3.4.2 Going concern risk — mitigating factors

Mitigating factors reduce the risk that the going concern assumption may be in doubt. For example, if a client is experiencing a severe cash shortage but has a letter from its bank agreeing to provide additional financing, the letter reduces (but does not remove) the risk that the going concern assumption may be invalid. Other mitigating factors include:

- a letter of guarantee from a parent company
- the availability of non-core assets, which can be sold to provide needed cash, without interrupting the company's operating capacity
- the ability to raise additional funds via the sale of shares
- the ability to raise additional funds via borrowings
- the ability to sell an unprofitable segment of the business.

CLOUD 9

When management adopt the going concern assumption they record assets and liabilities on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. If the going concern assumption is not valid, the financial report should include adjustments to the recoverability and classification of recorded assets and liabilities. If these adjustments are not made, the auditor must qualify the audit report.

Suzie explains that in most cases, the assessment of going concern is not clear-cut. Sometimes there are questions about the going concern assumption and various circumstances that mitigate such questions. The auditor's job is to gather evidence about the issues in order to make a judgement about the nature of the uncertainties surrounding the going concern assumption, and decide if, and how, these affect the audit report.

PROFESSIONAL ENVIRONMENT

Going concern case study

Auditors are required to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial report and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern (ASA 570, para. 6 (ISA 570)). If uncertainty about a going concern exists and the auditor believes that management have made adequate disclosures in the financial report, the auditor is required to express an unmodified opinion and include an emphasis of matter paragraph in the audit report to draw attention to the issue (ASA 570, para. 19 (ISA 570)). If management has not made adequate disclosure, the auditor shall express a qualified or adverse audit opinion in accordance with ASA 705 (ISA 705) (ASA 570, para. 20 (ISA 570)).

A recent case in Australia provides an example of an audit report with an emphasis of matter paragraph for a going concern uncertainty. Namoi Cotton is a cotton processing and marketing group, with a network of ginning, marketing and logistics operations in New South Wales and Queensland.[2] In 2012, Namoi Cotton reported a consolidated net loss after tax and before other comprehensive items of $67.5 million, with net assets of $108 million.[3] The poor result was blamed on cotton market price volatility, which affected the entire industry. The economic conditions meant that Namoi lost sales and was adversely affected by the default of spinning mill customers on contractual obligations, and increased borrowing costs associated with financing margin calls on cotton future hedges.[4] Better weather conditions and more secure water availability leading to higher harvest volumes and throughput were not enough to offset the loss.

Namoi Cotton's financial year end was 29 February 2012. At the time the financial report was released the group was working to reduce its debt exposure risk by seeking additional capital, but the arrangements had not been finalised.[5] The company was also working on changing its business model to reduce the risk that cotton market volatility would continue to adversely affect the business. The plan was to increase earnings before interest, tax, depreciation and rebate in 2013 to around $30 million.[6] Note 1a to the financial statements reports that the company did not meet certain financial covenants, or borrowing conditions. It also explains management's assessment of the ability of the organisation to continue as a going concern despite the incomplete nature of the refinancing. As such, management did not write down the values of the group's assets.

The auditors assessed management's disclosures and included an emphasis of matter paragraph in their 2012 audit report to draw attention to Note 1a and the significant uncertainty regarding Namoi Cotton's continuation as a going concern because the refinancing was not complete.[7] However, the auditors did not qualify their opinion. The inclusion of a note referring to the auditors' doubt about Namoi's ability to continue as a going concern did not mean that the auditors believed that Namoi would eventually go into liquidation, just that there were some doubts. It appears that the doubt about Namoi has been resolved. In subsequent years (2013[8] and 2014[9]), Namoi Cotton has reported profits from continuing operations and the audit reports do not contain any qualifications or references to doubts about its ability to continue as a going concern.

BEFORE YOU GO ON

- What is the going concern assumption?
- List three factors that indicate that the going concern assumption may be at risk.
- List three factors that mitigate the risk that the going concern assumption may be in doubt.

3.5 Corporate governance

LEARNING OBJECTIVE 3.5 Appraise corporate governance structures.

According to the ASX, corporate governance comprises the rules, systems and processes within companies used to guide and control.[10] Governance structures are used to monitor the actions of staff and assess the level of risk faced. Controls are designed to reduce identified risks and ensure the future viability of the company. The ASX Corporate Governance Council published its *Principles of good corporate governance and best practice recommendations* in 2003 and updated them in 2007, 2010 and 2014. The *Corporate governance principles and recommendations* contains core principles and recommendations that apply to companies listed on the ASX. The principles and recommendations are listed in figure 3.4. It is not expected that all listed companies will follow all of these guidelines. Instead, the ASX suggests that all companies consider the recommendations as a means to improve corporate structures, improve performance and enhance accountability to shareholders and other interested parties.

Principle 1: Lay solid foundations for management and oversight

A listed entity should establish and disclose the respective roles and responsibilities of its board and management and how their performance is monitored and evaluated.

- *Recommendation 1.1:* A listed entity should disclose:
  (a) the respective roles and responsibilities of its board and management; and
  (b) those matters expressly reserved to the board and those delegated to management.
- *Recommendation 1.2:* A listed entity should:
  (a) undertake appropriate checks before appointing a person, or putting forward to security holders a candidate for election, as a director; and
  (b) provide security holders with all material information in its possession relevant to a decision on whether or not to elect or re-elect a director.
- *Recommendation 1.3:* A listed entity should have a written agreement with each director and senior executive setting out the terms of their appointment.
- *Recommendation 1.4:* The company secretary of a listed entity should be accountable directly to the board, through the chair, on all matters to do with the proper functioning of the board.
- *Recommendation 1.5:* A listed entity should:
  (a) have a diversity policy which includes requirements for the board or a relevant committee of the board to set measurable objectives for achieving gender diversity and to assess annually both the objectives and the entity's progress in achieving them;
  (b) disclose that policy or a summary of it; and
  (c) disclose as at the end of each reporting period the measurable objectives for achieving gender diversity set by the board or a relevant committee of the board in accordance with the entity's diversity policy and its progress towards achieving them, and either:
    (1) the respective proportions of men and women on the board, in senior executive positions and across the whole organisation (including how the entity has defined "senior executive" for these purposes); or
    (2) if the entity is a "relevant employer" under the Workplace Gender Equality Act, the entity's most recent "Gender Equality Indicators", as defined in and published under that Act.
- *Recommendation 1.6:* A listed entity should:
  (a) have and disclose a process for periodically evaluating the performance of the board, its committees and individual directors; and
  (b) disclose, in relation to each reporting period, whether a performance evaluation was undertaken in the reporting period in accordance with that process.
- *Recommendation 1.7:* A listed entity should:
  (a) have and disclose a process for periodically evaluating the performance of its senior executives; and
  (b) disclose, in relation to each reporting period, whether a performance evaluation was undertaken in the reporting period in accordance with that process.

Principle 2: Structure the board to add value

A listed entity should have a board of an appropriate size, composition, skills and commitment to enable it to discharge its duties effectively.

- *Recommendation 2.1:* The board of a listed entity should:
  - (a) have a nomination committee which:
    - (1) has at least three members, a majority of whom are independent directors; and
    - (2) is chaired by an independent director, and disclose:
    - (3) the charter of the committee;
    - (4) the members of the committee; and
    - (5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or
  - (b) if it does not have a nomination committee, disclose that fact and the processes it employs to address board succession issues and to ensure that the board has the appropriate balance of skills, knowledge, experience, independence and diversity to enable it to discharge its duties and responsibilities effectively.
- *Recommendation 2.2:* A listed entity should have and disclose a board skills matrix setting out the mix of skills and diversity that the board currently has or is looking to achieve in its membership.
- *Recommendation 2.3:* A listed entity should disclose:
  - (a) the names of the directors considered by the board to be independent directors;
  - (b) if a director has an interest, position, association or relationship but the board is of the opinion that it does not compromise the independence of the director, the nature of the interest, position, association or relationship in question and an explanation of why the board is of that opinion; and
  - (c) the length of service of each director.
- *Recommendation 2.4:* A majority of the board of a listed entity should be independent directors.
- *Recommendation 2.5:* The chair of the board of a listed entity should be an independent director and, in particular, should not be the same person as the CEO of the entity.
- *Recommendation 2.6:* A listed entity should have a program for inducting new directors and provide appropriate professional development opportunities for directors to develop and maintain the skills and knowledge needed to perform their role as directors effectively.

Principle 3: Act ethically and responsibly

A listed entity should act ethically and responsibly.

- *Recommendation 3.1:* A listed entity should:
  - (a) have a code of conduct for its directors, senior executives and employees; and
  - (b) disclose that code or a summary of it.

Principle 4: Safeguard integrity in corporate reporting

A listed entity should have formal and rigorous processes that independently verify and safeguard the integrity of its corporate reporting.

- *Recommendation 4.1:* The board of a listed entity should:
  - (a) have an audit committee which:
    - (1) has at least three members, all of whom are non-executive directors and a majority of whom are independent directors; and
    - (2) is chaired by an independent director, who is not the chair of the board, and disclose:
    - (3) the charter of the committee;
    - (4) the relevant qualifications and experience of the members of the committee; and
    - (5) in relation to each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or

FIGURE 3.4 ASX Corporate Governance Council *Corporate governance principles and recommendations*, 3rd edition

FIGURE 3.4 (*continued*)

(b) if it does not have an audit committee, disclose that fact and the processes it employs that independently verify and safeguard the integrity of its corporate reporting, including the processes for the appointment and removal of the external auditor and the rotation of the audit engagement partner.

- *Recommendation 4.2:* The board of a listed entity should, before it approves the entity's financial statements for a financial period, receive from its CEO and CFO a declaration that, in their opinion, the financial records of the entity have been properly maintained and that the financial statements comply with the appropriate accounting standards and give a true and fair view of the financial position and performance of the entity and that the opinion has been formed on the basis of a sound system of risk management and internal control which is operating effectively.
- *Recommendation 4.3:* A listed entity that has an AGM should ensure that its external auditor attends its AGM and is available to answer questions from security holders relevant to the audit.

Principle 5: Make timely and balanced disclosure

A listed entity should make timely and balanced disclosure of all matters concerning it that a reasonable person would expect to have a material effect on the price or value of its securities.

- *Recommendation 5.1:* A listed entity should:

  (a) have a written policy for complying with its continuous disclosure obligations under the Listing Rules; and

  (b) disclose that policy or a summary of it.

Principle 6: Respect the rights of security holders

A listed entity should respect the rights of its security holders by providing them with appropriate information and facilities to allow them to exercise those rights effectively.

- *Recommendation 6.1:* A listed entity should provide information about itself and its governance to investors via its website.
- *Recommendation 6.2:* A listed entity should design and implement an investor relations program to facilitate effective two-way communication with investors.
- *Recommendation 6.3:* A listed entity should disclose the policies and processes it has in place to facilitate and encourage participation at meetings of security holders.
- *Recommendation 6.4:* A listed entity should give security holders the option to receive communications from, and send communications to, the entity and its security registry electronically.

Principle 7: Recognise and manage risk

A listed entity should establish a sound risk management framework and periodically review the effectiveness of that framework.

- *Recommendation 7.1:* The board of a listed entity should:

  (a) have a committee or committees to oversee risk, each of which:

    (1) has at least three members, a majority of whom are independent directors; and

    (2) is chaired by an independent director, and disclose:

    (3) the charter of the committee;

    (4) the members of the committee; and

    (5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or

  (b) if it does not have a risk committee or committees that satisfy (a) above, disclose that fact and the processes it employs for overseeing the entity's risk management framework.

- *Recommendation 7.2:* The board or a committee of the board should:

  (a) review the entity's risk management framework at least annually to satisfy itself that it continues to be sound; and

  (b) disclose, in relation to each reporting period, whether such a review has taken place.

- *Recommendation 7.3:* A listed entity should disclose:
  (a) if it has an internal audit function, how the function is structured and what role it performs; or
  (b) if it does not have an internal audit function, that fact and the processes it employs for evaluating and continually improving the effectiveness of its risk management and internal control processes.
- *Recommendation 7.4:* A listed entity should disclose whether it has any material exposure to economic, environmental and social sustainability risks and, if it does, how it manages or intends to manage those risks.

Principle 8: Remunerate fairly and responsibly

A listed entity should pay director remuneration sufficient to attract and retain high quality directors and design its executive remuneration to attract, retain and motivate high quality senior executives and to align their interests with the creation of value for security holders.

- *Recommendation 8.1:* The board of a listed entity should:
  (a) have a remuneration committee which:
    (1) has at least three members, a majority of whom are independent directors; and
    (2) is chaired by an independent director, and disclose:
    (3) the charter of the committee;
    (4) the members of the committee; and
    (5) as at the end of each reporting period, the number of times the committee met throughout the period and the individual attendances of the members at those meetings; or
  (b) if it does not have a remuneration committee, disclose that fact and the processes it employs for setting the level and composition of remuneration for directors and senior executives and ensuring that such remuneration is appropriate and not excessive.
- *Recommendation 8.2:* A listed entity should separately disclose its policies and practices regarding the remuneration of non-executive directors and the remuneration of executive directors and other senior executives.
- *Recommendation 8.3:* A listed entity which has an equity-based remuneration scheme should:
  (a) have a policy on whether participants are permitted to enter into transactions (whether through the use of derivatives or otherwise) which limit the economic risk of participating in the scheme; and
  (b) disclose that policy or a summary of it.

Source: ASX Corporate Governance Council 2014, *Corporate governance principles and recommendations*, 3rd edition.

The ASX has adopted an 'if not, why not' approach to its recommendations, where listed companies are required to disclose whether they have complied with the principles and recommendations. If they have not complied, they must explain why not. Smaller companies, for example, may find that, in some instances, the cost of compliance exceeds the benefit. An exception to the 'if not, why not' requirement is that all top 300 companies must comply with the guidelines regarding the establishment and composition of an audit committee (see chapter 2 for more details).

When gaining an understanding of a listed client, an auditor will consider their client's compliance with the ASX's corporate governance principles and recommendations and the client's reasons for non-compliance, where applicable. A client that does not take its corporate governance obligations seriously may not take its obligation to prepare a financial report that provides a true and fair view seriously. While an auditor is most concerned with principles 4 and 7, which deal with safeguarding integrity in financial reporting and managing risk, it is important that a client complies with all principles and recommendations as appropriate.

CLOUD 9

The partner Jo Wadley and manager Sharon Gallagher are working on the task of assessing the quality of corporate governance at Cloud 9. Typically, the most senior people on the audit team talk to the client's senior people. However, the work done by Suzie, Ian and others on the audit team will also inform the assessment of Cloud 9's corporate governance quality because lower level workers often have some interesting stories to tell about how things really run at a company. Suzie will be thinking about these issues when she visits the client's premises next week.

BEFORE YOU GO ON

- Name some of the uses for governance structures.
- Explain the ASX Corporate Governance Council's 'if not, why not' approach to its recommendations.
- Which principles will an auditor be most concerned with?

3.6 Information technology

LEARNING OBJECTIVE 3.6 Evaluate how a client's information technology (IT) can affect risk.

When gaining an understanding of a client, an auditor will consider the particular risks faced by their client associated with **information technology** (IT). IT is a part of most company's accounting processes, which include transaction initiation, recording, processing, correction as necessary, transfer to the general ledger and compilation of the financial report. ASA 315 (ISA 315) requires that the auditor gain an understanding of the client's IT system and the associated risks.

Risks associated with IT include unauthorised access to computers, software and data; errors in programs; lack of backup and loss of data. Unauthorised access to data can occur when there is insufficient security or poor password protection procedures. Unauthorised access can result in data being lost or distorted. Unauthorised access to computer programs can result in misstatements in the financial report. Access can be limited in a number of ways, including through the use of security (such as locked doors) and passwords.

Errors in computer programming can occur if programs are not tested thoroughly. It is important that new programs and changes to programs are tested extensively before being put into operation. Errors can also occur if mistakes are made when writing a program or if programs are deliberately changed to include errors. Deliberate changes may be made by staff or outsiders who gain unauthorised access to a client's IT system. For example, unhappy staff may purposefully change a program causing errors to embarrass their boss. It is therefore important that access be limited to authorised staff. Errors can also occur if programming changes are not processed on a timely basis. Programs need to be changed from time to time for a variety of reasons including, for example, changes in sales prices, updating of discounts being offered to customers and so on. It is important that these changes be made by authorised personnel on a timely basis to avoid errors.

New programs can be purchased 'off the shelf' from a software provider or developed internally by a client's staff. When a client purchases a general-purpose program off the shelf there is a risk that it will require modification to suit the client's operations, which can lead to errors. An advantage of purchasing general-purpose programs from reputable companies is that they will have been tested before being made available for sale. In contrast, when a client's staff develop a program internally, the program is more likely to have the features required but there is a risk of errors if the program is written by inexperienced staff or the program is not adequately tested before being put into operation.

When a client installs a new IT system there are a number of risks. There is the risk that the system may not be appropriate for the client and its reporting requirements. After installation there is the risk that data may be lost or corrupted when transferring information from an existing system to the new system. There is the risk that the new system does not process data appropriately. There is the risk that client staff are not adequately trained to use the new system effectively. It is important that a client has appropriate procedures for selecting new IT systems, changing from an old to a new system, training staff in using the new system and ensuring that a new system includes embedded controls to minimise the risk of material misstatement.

CLOUD 9

Suzie explains to Ian that her experience in the clothing and footwear industry has taught her to be very inquisitive about the systems used to manage orders. She has seen a few clothing businesses fail because they could not get their goods to retail outlets in time. Fashion is such a fickle market that even being a few weeks late means that stores run out of stock, and when stock does arrive stores have to discount it to sell it. After this occurs a couple of times, retailers turn to more reliable suppliers, even if the designs aren't as imaginative.

Suzie has heard that Cloud 9 is very reliant on an inventories management software program developed by their US parent. Because it is not a widely used package, she does not know anything about it and is concerned about its ability to provide reliable data. Suzie and Ian decide to allocate extra time to assessing the reliability of this software.

BEFORE YOU GO ON

- What are some of the risks associated with the purchase of a new IT system?
- What are two common sources of new computer programs?
- Why might errors occur in computer programming?

3.7 Closing procedures

LEARNING OBJECTIVE 3.7 Demonstrate how client closing procedures can affect reported results.

When finalising the financial report, a client will close off its accounts for the financial period. Revenue and expense items must include all transactions that occurred during the financial period and exclude transactions that relate to other periods. Asset and liability balances must include all relevant items, accruals must be complete and contingent liabilities must accurately and completely reflect potential future obligations. From an audit perspective there is a risk that the client's closing procedures are inadequate.

An auditor is concerned that transactions and events have been recorded in the correct accounting period. This is the responsibility of those charged with governance. It is the responsibility of the auditor to ensure that their client has applied its closing procedures appropriately.

An auditor will determine the risk associated with their client's closing procedures. In addition to the annual financial report, clients prepare monthly, quarterly and/or half-yearly financial reports for internal and/or external purposes. An auditor can check these reports to assess the accuracy of their client's closing procedures when preparing those reports. If there is significant slippage, where closing procedures are inadequate and transactions are not always recorded in the appropriate reporting period, an auditor will plan on spending more time conducting detailed testing around year-end.

There are a number of ways that an auditor can assess the adequacy of their client's closing procedures. Clients that report monthly are more likely to have in place well-established closing procedures than clients that report only annually. An auditor will check the accuracy of accruals calculations around year-end. An auditor can look at earnings trends to assess whether the reported income is in line with similar periods (months or quarters) in prior years. For example, revenues are generally higher for an ice-cream seller in warmer months, and wages are generally higher during the months when a client holds its annual sales and extra staff are hired to help out with the increased activity.

If an auditor believes that their client is under pressure to report strong results, there is a risk that revenues earned after year-end will be included in the current year's income and expenses incurred before year-end will be excluded. If the auditor believes that their client is under pressure to smooth its income and not report any unexpected increases, there is a risk that revenues earned just before year-end will be excluded from current income and expenses incurred after year-end will be included. In both cases the auditor will vouch transactions recorded close to year-end to source documentation and confirm that all transactions are recorded in the appropriate accounting period.

CLOUD 9

The partner, Jo Wadley, has learned that Cloud 9's management has set annual revenue targets of 3 per cent (compound). Jo is also aware of cost increases associated with opening new stores and sponsorship deals, as well as introducing a new product line. Jo believes that this places additional pressure on Cloud 9's management to meet targets resulting in additional risks for closing procedures, and has instructed Suzie to allocate additional time to auditing closing procedures on the Cloud 9 audit.

BEFORE YOU GO ON

- Explain how an auditor can assess the risk associated with their client's closing procedures.
- Outline how an auditor can assess the adequacy of their client's closing procedures.
- What is the particular risk when an auditor believes that their client is under pressure to report strong results?

PROFESSIONAL ENVIRONMENT

Boards and performance

Recommendation 1.5 of the ASX *Corporate governance principles and recommendations* requires companies to have a diversity policy with measurable objectives for achieving gender diversity and to disclose that policy and its progress towards achieving the measurable objectives set in accordance with the policy. The inclusion of this recommendation suggests that the ASX regards better gender balance as consistent with good governance. A recent report by accounting firm EY supports the case for better gender balance at work.[11] The report finds that women waste less time (and money) than their male colleagues, suggesting that if female workforce participation could be increased Australian businesses would boost their productivity. In another report, Bennett suggests that this result is evidence of the value of female employees, and that the benefits extend all the way to the board room.[12] Bennett quotes research from around the world supporting the argument that there is greater performance when boards have better gender balance. However, although much attention has been paid to gender balance on the board of directors, the ASX also requires disclosure of women in senior executive positions. The rationale for this disclosure appears to be twofold. First, although boards set direction and make important decisions, it is senior executives that implement those decisions. If better gender balance is associated with greater performance, it is more valuable for the company if that performance also occurs at the implementation stage. Second, candidates for board positions typically have experience in senior executive positions. If there is an underrepresentation of women at this level, it will be harder for companies to find suitably qualified female candidates for their next board vacancy.

In all companies, one of the most important tasks for the board is hiring and remunerating the chief executive officer (CEO). The issue of executive remuneration has become controversial in recent years as the apparent gap between the pay of CEOs and the average worker widens. Recent changes to

Australian regulations allow shareholders to voice their disapproval of executive pay. If sufficient shareholders vote against the remuneration report at two consecutive shareholders meetings, the board of directors is 'spilled', requiring directors to be voted in again.[13] As this could be quite embarrassing for the directors, there is an increased chance that directors will not approve bonuses for executives when the companies have not performed well. In 2012, both Rio Tinto and BHP Billiton (two of Australia's largest mining companies) announced that their chief executives had advised that they did not wish to be considered for a bonus, avoiding the need for directors or shareholders to object.[14]

Academic research suggests that auditors need to be aware of the potential effects of incentives related to compensation packages. For example, Healy provided evidence that when top executives are paid a bonus according to a formula with a floor and a ceiling, the companies' profits appear to be 'managed' in predictable ways.[15] The floor means that no bonus is earned unless profit exceeds a certain figure, and the ceiling means that no further bonuses are paid once profit reaches a specified high figure. Healy's evidence suggests that if the profit is not likely to reach the floor, managers will take action (through accruals such as closing entries) to reduce profit in the expectation that they can reverse this action next year when profit is above the floor. This action means that managers receive a bonus on the amount that they are able to 'shift'. Managers take the same action to reduce profit if it is likely to be above the ceiling (deferring the profit and bonus to the following year). However, if profit is between the floor and the ceiling, managers will try to increase profit to increase their bonus.

The lesson from the academic research is that if auditors understand how the bonus scheme works, they will be more alert to the type of profit shifting likely to be attempted by managers.

SUMMARY

3.1 Explain the different phases of an audit.

The phases of an audit include risk assessment, risk response and reporting. During the risk assessment phase, an auditor will gain an understanding of their client, identify risks, develop an audit strategy and set their planning materiality. During the risk response phase, an auditor will execute their detailed testing of account balances and transactions. The final phase of every audit involves reviewing all of the evidence gathered throughout the audit and arriving at a conclusion regarding the truth and fairness of the client's financial report. The auditor will then prepare an audit report that reflects their opinion based upon their findings.

3.2 Relate the process used in gaining an understanding of the client.

An auditor will gain an understanding of their client to aid in the risk assessment process. This process involves consideration of issues at the entity level, the industry level and the broader economic level. At the entity level, an auditor will identify the client's major customers, suppliers and stakeholders (that is, banks, shareholders and employees), whether their client is an importer or exporter, who the client's competitors are, the capacity of the client to adapt to changes in technology and the nature of any warranties provided to customers. At the industry level, an auditor is interested in their client's position within its industry. At the economic level, an auditor will assess how well positioned the client is to cope with current and changing government policy and economic conditions.

3.3 Evaluate fraud risk.

Fraud is an intentional act through the use of deception to obtain an unjust or illegal advantage. The two kinds of fraud are financial reporting fraud and misappropriation of assets fraud. There are a number of techniques the auditor uses to assess the risk of fraud.

3.4 Explain the going concern assumption.

The going concern assumption is made when it is believed that a company will remain in business for the foreseeable future. An auditor will consider the appropriateness of this assumption during the risk assessment phase and then throughout the audit.

3.5 Appraise corporate governance structures.

Corporate governance is the rules, systems and processes within companies used to guide and control. Amongst other things, governance structures are used to assess the level of risk faced and design controls to reduce identified risks.

3.6 Evaluate how a client's information technology (IT) can affect risk.

There are a number of risks associated with information technology. During the risk assessment phase of the audit the auditor will assess the likelihood that their client's financial report is misstated due to limitations in its IT system.

3.7 Demonstrate how client closing procedures can affect reported results.

There are a number of risks associated with a client's closing procedures. Closing procedures are the processes used by a client at year-end to ensure that transactions are recorded in the appropriate accounting period. From an audit perspective there is a risk that the client's closing procedures are inadequate.

KEY TERMS

Audit strategy The determination of the amount of time spent testing the client's internal controls and conducting detailed testing of transactions and account balances.

Closing procedures Processes used by a client when finalising the accounts for an accounting period.

Corporate governance The rules, systems and processes within companies used to guide and control.

Fraud An intentional act through the use of deception to obtain an unjust or illegal advantage.
Going concern The viability of a company to remain in business for the foreseeable future.
Information technology The use of computers to store and process data and other information.
Materiality Information that impacts on the decision-making process of users of the financial report.
Professional scepticism Maintaining an independent questioning mind.
Reporting phase Evaluation of the results of the detailed testing in light of the auditor's understanding of their client and forming an opinion on the truth and fairness of the client's financial report.
Risk assessment phase Gaining an understanding of the client, identifying risk factors, developing an audit strategy and setting planning materiality.
Risk response phase Performing tests of control and detailed substantive testing of transactions and accounts, concentrating effort where the risk of material misstatement is greatest.
Sufficient appropriate evidence Sufficiency is the quantity, and appropriateness is the quality of audit evidence gathered.

MULTIPLE-CHOICE QUESTIONS

3.1 When gaining an understanding of the client, the auditor will identify the geographic location of the client because: **LO2**
(a) more spread out clients are harder to control.
(b) the auditor will plan to use staff from affiliated offices to visit overseas locations.
(c) the auditor will need to visit the various locations to assess processes and procedures at each site.
(d) all of the above.

3.2 When gaining an understanding of the client's sources of financing the auditor: **LO2**
(a) will assess if the client is meeting interest payments when they are due.
(b) is not interested in debt covenants because all debt contracts are the same.
(c) will ignore the relative reliance on debt versus equity funding because that is a management decision, not an audit issue.
(d) none of the above.

3.3 When gaining an understanding of the client at the industry level the auditor will: **LO2**
(a) use information about the client's industry.
(b) not consider government taxes on the industry because they are out of the client's control.
(c) ignore bad news reports about the client firm because the client's reputation in the press is not important.
(d) not consider the level of demand for the goods and services provided by other companies in the client's industry.

3.4 The ASX Corporate Governance Council's *Corporate governance principles and recommendations* are designed to help companies: **LO5**
(a) improve performance.
(b) improve their corporate structure.
(c) enhance their accountability to shareholders and other interested third parties.
(d) all of the above.

3.5 An attitude of professional scepticism means: **LO3**
(a) any indicator of fraud is properly investigated.
(b) the auditor can rely on management assertions.
(c) the auditor can rely on past experience to determine current risk of fraud.
(d) all of the above.

3.6 An example of an incentive or pressure that increases the risk of fraud is: **LO3**
(a) the client operates in a stable industry.
(b) the client has a history of making losses.

(c) management remuneration mostly comprises base salary.
(d) all of the above.

3.7 The auditor must consider whether it is appropriate to assume that the client will remain as a going concern: **LO4**
(a) if there are mitigating circumstances.
(b) only if the client is listed on a stock exchange.
(c) because going concern means the client is facing bankruptcy.
(d) because this question affects the appropriate basis for valuing assets.

3.8 The risk assessment phase of an audit does not include: **LO1**
(a) audit execution and reporting.
(b) gaining an understanding of the client.
(c) development of an audit strategy and a risk and materiality assessment.
(d) identification of factors that may affect the risk of a material misstatement in the financial report.

3.9 When gaining an understanding of the client the auditor will consider: **LO2**
(a) related party identification.
(b) controls over the technology used to process and store data electronically.
(c) the appropriateness of the client's system of internal controls to mitigate identified business risks.
(d) all of the above.

3.10 Client closing procedures: **LO7**
(a) affect expense accounts only.
(b) are routine transactions that do not affect audit risk.
(c) are the responsibility of those charged with governance who must ensure that transactions are recorded in the correct accounting period.
(d) all of the above.

REVIEW QUESTIONS

3.11 Explain the relationship between the risk assessment, risk response and reporting phases of an audit. **LO1**

3.12 What are the audit activities in the risk assessment phase of a financial report audit? **LO1**

3.13 Why does an auditor need to consider the client's corporate governance as part of the preliminary risk assessment? **LO5**

3.14 Why does an auditor need to understand a client's IT system? Explain how IT issues affect the financial report. **LO6**

3.15 What is a related party? Why is an auditor interested in identifying related parties during the risk assessment phase of an audit? **LO2**

3.16 When gaining an understanding of a client an auditor will be interested in an entity's relationships with both its suppliers and customers. What aspects of these relationships will the auditor be interested in and how would they affect the assessment of audit risk? **LO2**

3.17 What does the 'entity' level mean when gaining detailed knowledge of the client? How does this differ from the 'industry' level? **LO2**

3.18 Why would an auditor consider the state of the economy when gaining detailed knowledge of a client? **LO2**

3.19 In the context of fraud, explain what 'opportunities' means. **LO3**

3.20 Explain the difference between 'incentives and pressures' and 'attitudes and rationalisation' in the context of fraud. **LO3**

3.21 What does it mean when we say that a business is a 'going concern' or, alternatively, has 'going concern issues'? Why must an auditor specifically consider evidence about the going concern assessment for each client? **LO4**

3.22 What are mitigating factors in the context of the going concern assessment? Give some examples of mitigating factors for a loss-making client. **LO4**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

3.23 RISK ASSESSMENT ★ **LO1, 2**

Melinda has drafted an audit plan for a new client. The client is Jimmy's Cakes, a café and catering business. Jimmy's Cakes earns 60 per cent of its revenue from the café (food and beverage sales for sit-down customers and take-away) and 40 per cent from catering. Melinda's plan shows that audit time is divided to reflect this revenue pattern (that is, 60 per cent of the audit time is spent on the café business and 40 per cent of the time is spent on the catering business). Melinda believes that the significance of the revenue activities should be the only driver of the audit plan because the client has no related parties and a simple, effective corporate governance structure.

Required

What questions would you have for Melinda before accepting her audit plan?

3.24 UNDERSTANDING THE CLIENT ★ **LO2**

Stokes Ltd operates in the steel fabrication industry. Its business is organised into domestic and international sales, and has many clients in each area. It obtains most of its raw materials from two suppliers, both located in the same state as Stokes' main operations. The government is currently considering relaxing the tariffs on steel, so that more overseas suppliers can enter the domestic market in competition with Stokes.

Required

What issues would the auditor be interested in researching further for Stokes Ltd?

3.25 UNDERSTANDING THE CLIENT ★ **LO2**

The audit team is preparing to audit a new client in the toy retail industry. The client imports items from manufacturers in several Asian countries and retails them in a chain of shops located throughout the country.

You have access to the following information for the client:

- prior period financial reports
- anticipated results for the current year
- industry averages.

Required

Explain how you would use the information to understand your new client.

3.26 UNDERSTANDING THE CLIENT AND ITS GOVERNANCE ★ **LO2, 5**

Ajax Ltd is a listed company and a new client of Delaware Partners, a medium sized audit firm. Jeffrey Rush is the engagement partner on the audit and has asked the members of the audit team to commence the process of gaining an understanding of the client, in accordance with ASA 315. One audit manager is leading the group investigating the industry and economic effects while another is helping Jeffrey consider issues at the entity level. Jeffrey is holding discussions with members of the audit committee and his talks will cover a wide range of issues, including the ASX Corporate Governance Council's *Corporate governance principles and recommendations.* He has a meeting arranged for next week with the four members of the audit committee, including the chair of the committee, Stella South, who, like the other members of the audit committee, is an independent director and is the chair of the board of directors.

Required

(a) Make a list of the main factors that will be considered by each audit manager's group.

(b) Based on the above information, can you conclude that Ajax Ltd complies with Principle 4 of the ASX Corporate Governance Council's *Corporate governance principles and recommendations*? Explain.

3.27 RISK ASSESSMENT — CONSIDERING GOING CONCERN: FINANCIAL ★ **LO1, 4**

A new client has been paying its suppliers late consistently; well in excess of the suppliers' agreed credit terms. As a result, some suppliers have begun demanding cash on delivery from the client. You are also aware that a review of correspondence between the new client and its bank reveals that the new client has been experiencing cash flow problems for two years.

Required

Discuss whether there are any events or conditions that may cast significant doubt on the new client's ability to continue as a going concern.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2010.

3.28 RISK ASSESSMENT — CONSIDERING GOING CONCERN: OPERATING ★ **LO1, 4**

Celebrity Land is a theme park operated by an audit client of Best Partners. It is located on the Gold Coast and, due to its proximity to the ocean, the rides are prone to rust and corrosion. During the 2017 school holidays, two of the most popular rides experienced major breakdowns. Children were trapped on the rides for several hours, resulting in several being taken to hospital with minor injuries. An inspection following the incident revealed that key parts needed urgent replacement. The parts are made in the United States and imported by Celebrity Land. The cost of the replacement parts is $3.5 million (against profit after tax in the previous year of $300 million). The repairs are scheduled to begin in April, with completion in July 2017.

Required

Discuss whether there are any events or conditions that may cast significant doubt on the new client's ability to continue as a going concern.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2010.

3.29 CLOSING PROCEDURES ★ **LO7**

Abacus Ltd sells office equipment and supplies. In recent years, it has faced increasing competition from a chain of office supplies stores which is owned by one of the major supermarkets. The management of Abacus have tried a series of promotions to boost sales and have introduced new products to attract new customers. In addition, they have closed several of the smaller stores which were suffering from the increased competition. Chris Smith has been the audit partner for Abacus for three years and has noticed that the monthly reports for Abacus are being produced later each year and the CEO and CFO at Abacus are just qualifying for their annual bonuses.

Required

What concerns would Chris Smith have about Abacus Ltd's closing procedures when preparing for this year's audit? Explain.

3.30 IT RISK ASSESSMENT ★★ **LO6**

Expansion Aviation has installed a new payroll module to its existing accounting system which integrates with the general ledger application. The new payroll application was purchased from the software company that supplied the general ledger application. The new system is more complex than the old system, but its reporting function provides more details. For example, the new application calculates: leave, superannuation, payroll tax and work cover expenses, as well as the corresponding accounting accruals. There was very little time available to implement the new system, so the old application ceased operation on 31 December 2016 and the new application went live on 1 January 2017. There was no time to run the two systems in parallel as well as limited staff training and testing of the new application.

Required

What concerns would you have about the payroll application's integration with the general ledger application?

Source: Adapted from the CA Program's *Audit & assurance exam*, July 2010.

3.31 FRAUD RISK ★★ LO3

An airline company has been adversely affected by a slump in business travel during the last two years. In addition to lower overall demand, the airline company faces increased competition from other airlines who are heavily discounting flights. The airline company policy for revenue is to credit sales to revenue received in advance, and subsequently transfer to revenue when passengers or freight are uplifted or tours and travel air tickets and land content are utilised.

In preparing for the 2017 audit, you review the 2016 financial statements and note that revenue from passengers represents 8 per cent of total revenue. The interim financial information for the 2017 year shows a 6 per cent fall in revenue from passengers, and an 11 per cent decrease in revenue from passengers in advance.

You read in the financial press that the global airline industry is facing an increased incidence of fraud and the majority of these frauds are committed by company directors and senior managers.

Required

Explain why the revenue from passenger accounts in the income statement is at significant risk of fraudulent financial reporting by management.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2010.

3.32 UNDERSTANDING THE CLIENT AND ITS RISKS — RISK ASSESSMENT ★★ LO1, 2

Ivy Brown is preparing a report for the engagement partner of an existing client, Scooter Ltd, an importer of scooters and other low-powered motorcycles. Ivy has been investigating certain aspects of Scooter Ltd's business given the change in economic conditions over the past 12 months. She has found that Scooter Ltd's business, which experienced rapid growth over its first five years in operation, has slowed significantly during the last year. Initially, sales of scooters were boosted by good economic conditions and solid employment growth, coupled with rising petrol prices. Consumers needed transport to get to work and the high petrol prices made the relatively cheap running costs of scooters seem very attractive. In addition, the low purchase price of a small motorcycle or scooter, at between \$3000 and \$8000, meant that almost anyone who had a job could obtain a loan to buy one.

However, Ivy has discovered that this year, the sales of small motorcycles and scooters have slowed significantly and all importers of these products, not just Scooter Ltd, are being adversely affected. Sales are down because the economic recession has caused many people to lose their jobs. Petrol prices have fallen this year, reducing the demand for more economical vehicles, and changes in banking laws have meant it is harder to get loans for vehicles which cost less than \$10 000.

Required

(a) Identify the issues that potentially impact on the audit of Scooter Ltd.

(b) Explain how each issue affects the risk assessment, by identifying the risks and the financial report accounts that require closer examination.

3.33 FINANCIAL REPORTING FRAUD RISK ★★ LO3

Morne Enterprises Ltd has experienced sustained growth in recent years under the leadership of the last two CEOs, both of whom were promoted from within the business. The company began by making steel, but has now diversified into manufacturing and supplying all types of packaging, including metal, plastic and paper-based products. It has also diversified into a range of other businesses including household appliances in Europe, the United States and Asia.

At the beginning of last year, the incumbent CEO died of a heart attack and the board took the opportunity to appoint a new CEO from outside the company. Despite the company's growth, returns to shareholders have not increased during the last decade. The new CEO has a reputation of turning around struggling businesses by making tough decisions. The new CEO has a five-year contract with generous bonuses for improvements in various performance indicators, including sales/assets, profit from continuing operations/net assets, and share price.

During the first year, the new CEO disposed of several segments of the business that were not profitable. Very large losses on the discontinued operations were recorded and most non-current assets throughout the business were written down to recognise impairment losses. These actions resulted in a large overall loss for the first year, although a profit from continuing operations was recorded. During the second year, recorded sales in the household appliances business in the United States increased dramatically, and, combined with various cost-saving measures, the company made a large profit.

The auditors have been made aware through various conversations with middle management that there is now an extreme focus on maximising profits through boosting sales and cutting costs. The attitude towards compliance with accounting regulations has changed, with greater emphasis on pleasing the CEO than taking care to avoid breaching either internal policies or external regulations. The message is that the company has considerable ground to make up to catch up with other companies in both methods and results. Meanwhile, the share price over the first year and a half of the CEO's tenure has increased 80 per cent, and the board has happily approved payment of the CEO's bonuses and granted the CEO additional options over the company's shares in recognition of the change in the company's results.

Required

(a) Discuss the incentives, pressures and opportunities to commit financial report fraud, and attitudes and rationalisations to justify a fraud in the above case.

(b) What financial report frauds would you suspect could have occurred at Morne?

3.34 ASSESSING THE RISKS ASSOCIATED WITH INFORMATION TECHNOLOGY ★★ LO6

Shane is getting to know his new client Clarrie Potters, a large discount electrical retailer. Ben was the engagement partner on the Clarrie Potters audit for the past five years, but had to rotate off the audit this year. Shane discovers that towards the end of last year Clarrie Potters installed a new IT system for inventories control. The system was not operating prior to the end of the last financial year so its testing was not included in the previous audit. The new system was custom-built for Clarrie Potters by a Melbourne-based software company by modifying another system they had designed for a furniture manufacturer and retailer.

Required

What audit risks are associated with the installation of the new inventories IT system at Clarrie Potters?

3.35 GOING CONCERN ★★★ LO4

The Duke Plaza Hotel is located close to the main railway station in a large regional city. Its main client base is business people visiting the city for work-related purposes. Other important groups of clients include groups of (mainly) women visiting the city for its great shopping, and (mainly) men visiting the city to attend important sport matches.

Occupancy rates have been reasonable, but not growing, during the last few years, providing a steady but low rate of return for the owners of the hotel. Revenues have been sufficient to cover operating costs but no substantial progress has been made on repaying the large, long-term loans used to finance the hotel. In an effort to increase the hotel's profitability, a major renovation program was undertaken and completed earlier this year. The renovation was predicted to increase the relative attractiveness of the hotel to guests. It was also undertaken to earn additional revenue from the rent of a new coffee shop on the ground floor. The coffee shop is run by a separate company that has purchased a franchise of a major international brand.

Business travel is down by 25 per cent across the country this year due to tougher economic conditions. Further, discretionary retail spending is down by 40 per cent, particularly in the regions. Several specialty shops in the city have already shut and others are cutting their opening hours. The sport matches have not drawn large crowds, and the coffee shop owners went bankrupt and closed down, breaking their lease. The hotel owners are seeking legal advice on whether they can claim penalty fees on the broken lease.

Finally, the hotel owners' bank is warning that the short-term finance obtained for the renovations will not be renewed when it is due (one month after year-end). The hotel managers had expected to repay the debt from this year's bookings and the coffee shop lease. The hotel owners are still hopeful that the winter will bring a large lift in occupancy (and revenue) as the local football teams are doing very well and several key games are scheduled for the city. This expected winter trade is essential to meet repayments on the long-term debt as well as convince the bank to extend the short-term debt.

Required

(a) Is there a going concern issue in this case? Explain.

(b) Are there mitigating factors? Explain them and how they would affect the auditor's conclusion.

3.36 IMPACT OF CLOSING PROCEDURES ON PERFORMANCE ★★★ LO7

Pinetree Holdings Ltd (Pinetree) is an importer of kitchen appliances and distributes the goods to retailers around the country. Pinetree has benefited from rising house prices in most capital cities over the past five years which have encouraged homeowners to spend money on kitchen renovations and make a profit on the sale of the property. However, some analysts believe that recent government changes to tax laws will discourage home renovations because it will be more profitable to sell houses unrenovated.

Pinetree's share price has fallen over the last year as doubt about its ability to grow its profits in the current year spreads. The CEO and other senior management have large bonuses linked to both share prices and company profitability and there is a mood within the company that achieving sales and profit targets this year is vital to avoid job losses at the company.

Pinetree has a monthly reporting system for internal management, but the audit team notice that the reports are being issued later in the following month this year than they were last year on the instructions of senior management.

Required

(a) Explain why and how the circumstances described above could affect the audit risk assessment.

(b) How would you audit Pinetree's closing procedures? Which potential errors would be of most interest? Explain.

Questions 3.37 and 3.38 are based on the following case.

Dolphin Surf & Leisure Holidays Pty Ltd (Dolphin) is a resort company based on the Great Barrier Reef. Its operations include boating, surfing, diving and other leisure activities, a backpackers' hostel, a family hotel and a five-star resort. Justin and Sarah Morris own the majority of the shares in the Morris Group which controls Dolphin. Justin is the chairman of the board of directors of both Dolphin and the Morris Group, and Sarah is a director of both companies as well as the CFO of Dolphin.

In February 2016, Justin Morris approached Clarke Partners to carry out the Dolphin audit for the year ended 30 June 2016. Dolphin has not been audited before but this year the audit has been requested by the company's bank and a new private equity investor group which has just acquired a 20 per cent share of Dolphin.

Dolphin employs 30 full-time staff. These workers are employed in administration, accounting, catering, cleaning and hotel/restaurant duties. During peak periods, Dolphin also uses part-time and casual workers. These workers tend to be travellers visiting the Great Barrier Reef who are looking for short-term work to help pay their travelling expenses.

Justin and Sarah have a fairly laid back management style. They trust their workers to work hard for the company and reward them well. Justin tells you that some accounts staff enjoy their jobs so much they have never taken any annual leave, and hardly any workers ever take sick leave.

There are three people currently employed as accounts staff, the most senior of which is Peter Pinn. Peter heads the accounts department and reports directly to Sarah. He is in his fifties and plans to retire in two or three years. Peter prides himself on his ability to delegate most of his work to his two accounts staff, Kristen and Julie. He claims he has to do this because he is very busy developing a policy and procedures manual for the accounting department. This delegated work includes opening mail, processing payments and receipts, banking funds received, performing reconciliations, posting journals and performing the payroll function. Julie is a recent Chartered Accountant graduate. Kristen works part-time — coming into the office on Mondays, Wednesdays and Fridays. Kristen is responsible for posting all journal entries into the accounting system and the payroll function. Julie does the balance of the work, but they often help each other out in busy periods.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

3.37 GAINING AN UNDERSTANDING OF A NEW CLIENT ★★★ **LO2**

What financial information could Clarke Partners use to understand its new client, Dolphin? Explain how it would be useful.

3.38 ASSESSING FRAUD RISK ★★★ **LO3**

(a) Identify and explain any significant fraud risk factors for Dolphin.
(b) For each fraud risk factor you identify in (a), explain how the risk will affect the approach to the audit of Dolphin.

3.39 FRAUD RISK ★★★ **LO3**

Chan and Partners Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year Chan and Partners gained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home
- Total Cancer Specialists Limited, a private oncology clinic that specialises in the treatment of cancer.

Year-end for all MSHG entities is 30 June.

The audit partner for the audit of MSHG, Tania Fellowes, has discovered that two months before the end of the financial year, one of the senior nursing officers at Gardens Nursing Home was dismissed. Her employment was terminated after it was discovered she had worked in collusion with a number of patients to reduce their fees. The nurse would then take secret payments from the patients.

The nursing officer had access to the patient database. While she was only supposed to update room-located changes for patients, she was able to reduce the patient period of stay and the value of other services provided. The fraud was detected by a fellow employee who overheard the nurse discussing the 'scam' with a patient. The employee reported the matter to the Gardens Nursing Home's general manager.

Source: Adapted from the CA Program's *Audit & assurance exam,* December 2008.

Required

(a) Which accounts — balance sheet and income statement — are potentially affected by the fraud?
(b) Describe how Gardens Nursing Home's business could be affected as a result of the fraud event.

CASE STUDY — CLOUD 9

You are a graduate working for W&S Partners, an Australian accounting firm with offices located in each of the major cities. W&S Partners has just won the 31 December 2016 statutory audit for Cloud 9 Pty Ltd (Cloud 9). The audit team assigned to this client is:

- Partner, Jo Wadley
- Audit Manager, Sharon Gallagher
- Audit Seniors, Josh Thomas and Suzie Pickering
- IT Audit Manager, Mark Batten
- Graduates, Ian Harper and you.

As a part of the risk assessment phase for the new audit, the audit team needs to gain an understanding of Cloud 9's structure and its business environment. By understanding the client's business, the audit team can identify potential risks that may have a significant effect on the financial report. This will assist the team complete the audit.

Required

Answer the following questions based on the additional information about Cloud 9 presented in the appendix to this text and the current and earlier chapters. You should also consider your answer to the case study questions in earlier chapters where relevant.

Your task is to research the retail and wholesale footwear industries and report back to the audit team. Your report will form part of the overall understanding of Cloud 9's structure and its environment.

You should concentrate your research on providing findings from those areas that have a financial reporting impact and are considered probable given Cloud 9's operations. In conducting your research, you should consider the following key market forces, as they relate to Cloud 9's operations.

General and industry-specific economic trends and conditions

(a) What is the current condition of the economy?
(b) Is the business affected by developments in other countries, foreign currency fluctuations or other global forces?
(c) If the industry is labour intensive, are there unusual or unique labour relations issues?
(d) How does the company's growth and overall financial performance compare with the industry, and what are the reasons for any significant differences?
(e) What is the volume and type of transactions in the business?
(f) Are the client's operations centralised or decentralised?
(g) Is the client's business cyclical in nature or influenced by seasonal fluctuations in the market?
(h) What is the susceptibility to fraud/theft? (Is the product something that can easily be stolen and has a sale market?)

Competitive environment

(i) What products does the client sell, and have there been significant changes with respect to:
  i. major products or brands?
  ii. selling strategies?
  iii. sales/gross margin by product?
(j) Who are the client's major competitors, and what share of the market does each hold?
(k) Is there significant differentiation between the client's and competitors' merchandise?
(l) What is the effect on the client of potential new entrants into the market? Are there any significant barriers to entering the market?

Product information

(m) Is there a specific lifecycle for the product?
(n) Is the product dependent on trends or styles?

Customer information

(o) Are there specific customers on whom the client is highly dependent?
(p) What is the overall profile of the client's customers? Have there been significant fluctuations in the client's customer base?

Supplier information

(q) Who are the key suppliers?
(r) Are the materials subject to significant price movements or influenced by external market forces?

Technological advances and the effect of the internet

(s) How does the industry use technology?
(t) What technological trends are impacting the industry?

Laws and regulatory requirements

(u) Are the client's operations affected significantly by local or foreign legislation?
(v) What new laws and regulations recently enacted (or pending) may have significant effects on the company?

RESEARCH QUESTION

The auditor and the Ponzi scheme

Bernard Madoff was convicted in 2009 of running a Ponzi scheme, the biggest in US history. A Ponzi scheme is essentially the process of taking money from new investors on a regular basis and using the cash to pay promised returns to existing investors. The high and steady returns received by existing investors are the attraction for new investors, but they are not real returns from investments.

As long as new investors keep contributing and existing investors do not seek redemptions, or the return of their money, the scheme continues. However, eventually, as in the Madoff situation, circumstances change, the scheme is discovered and the remaining investors find that their capital has disappeared.

At age 71, Madoff was sentenced to prison for 150 years, and will die in jail. Madoff's auditor, David G. Friehling was also the subject of attention from the investigators. Friehling was accused of creating false and fraudulent audited financial reports for Madoff's firm, Bernard L. Madoff Investment Securities LLC. Prosecutors allege that these fraudulent reports covered the period from the early 1990s to the end of 2008.[16]

Required

(a) Research the outcome of the case against David Friehling. Write a report explaining his alleged role in the Madoff Ponzi scheme and the result of the legal action against him.

(b) Friehling was subject to US auditing standards and legislation. Explain if, and how, Friehling's alleged actions would violate Australian Auditing Standards and professional ethics.

FURTHER READING

ASX Corporate Governance Council 2014, *Corporate governance principles and recommendations*, 3rd edition, www.asx.com.au.

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SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. d, 2. a, 3. a, 4. d, 5. a, 6. b, 7. d, 8. a, 9. d, 10. c.

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ACKNOWLEDGEMENTS

Figure 3.4: © Copyright 2015 ASX Corporate Governance Council Association of Superannuation Funds of Australia Ltd, ACN 002 786 290, Australian Council of Superannuation Investors, Australian Financial Markets Association Limited ACN 119 827 904, Australian Institute of Company.

CHAPTER 4

Risk assessment II

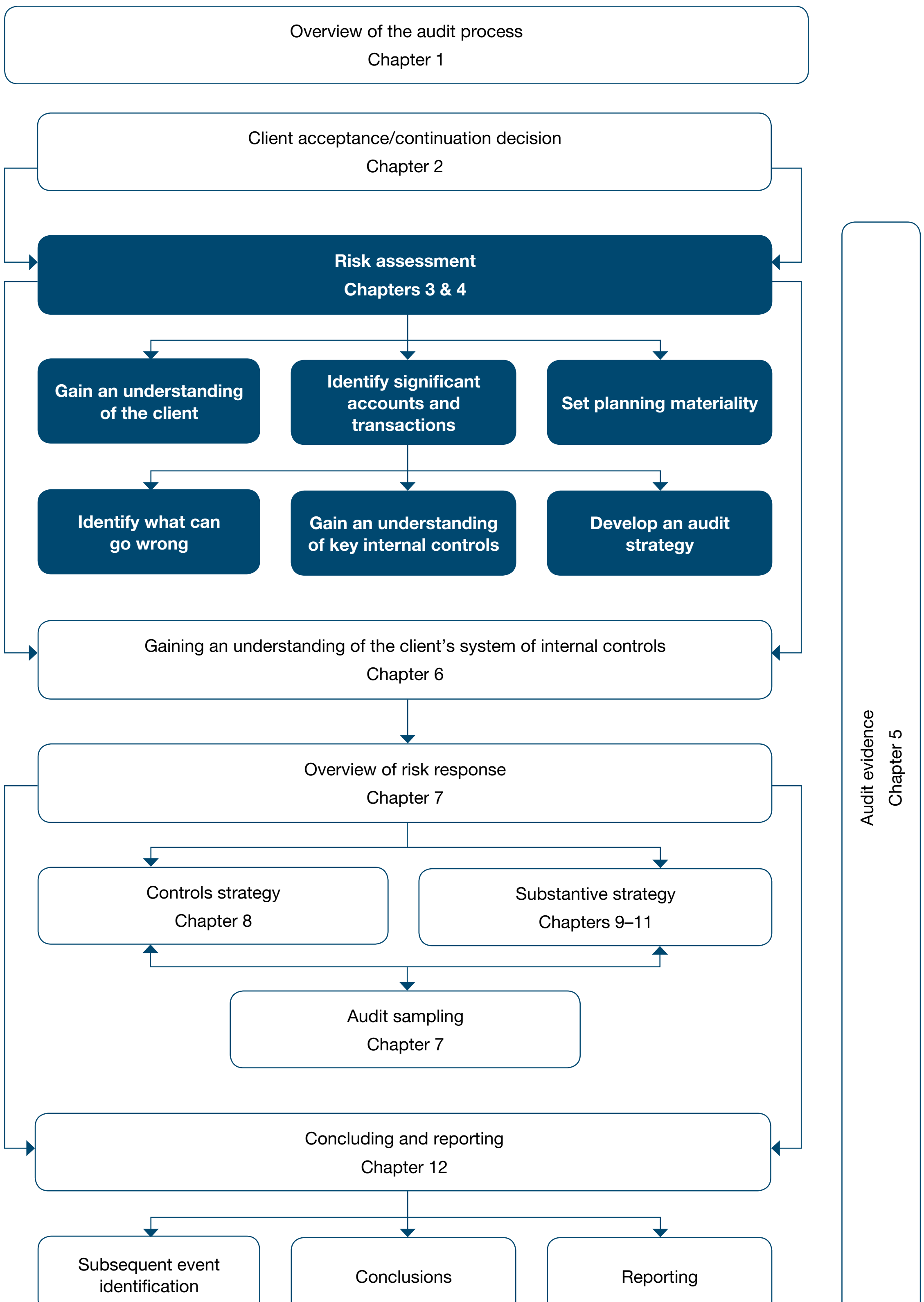
LEARNING OBJECTIVES

After studying this chapter you should be able to:

4.1 evaluate audit risk
4.2 explain the concept of materiality
4.3 describe how an auditor determines their audit strategy
4.4 describe how clients measure performance
4.5 describe how an auditor uses analytical procedures when assessing risk.

AUDITING AND ASSURANCE STANDARDS

AUSTRALIAN	**INTERNATIONAL**
ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*	ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*
ASA 300 *Planning an Audit of a Financial Report*	ISA 300 *Planning an Audit of Financial Statements*
ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*	ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*
ASA 320 *Materiality in Planning and Performing an Audit*	ISA 320 *Materiality in Planning and Performing an Audit*
ASA 520 *Analytical Procedures*	ISA 520 *Analytical Procedures*


Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client's system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

Ian Harper is still impatient. Despite his lengthy conversation with Suzie Pickering about the importance of gaining an understanding of the client in order to identify and manage audit risk, he is still not convinced that it makes a real difference to the audit. He has been with W&S Partners only a few months, but every audit seems to him to be the same. Suzie knows that Ian has not yet seen enough audits to be able to understand the different strategies being used for different areas of the audit. How can she explain this to him?

Suzie calls Ian to her office. 'I want you to work with me on the draft audit plan for Cloud 9,' she tells him. 'We have already started, but there is a still lot of work to do. What do you think is already in the plan?'

Ian is a bit surprised by Suzie's question, but he thinks about their previous discussions. 'Well, first we have the results of the work done to assess the client before the engagement, followed by the engagement letter which sets out the work we have promised to perform. Then, after the client was accepted, we have the results of the partner's assessment of Cloud 9 Pty Ltd's (Cloud 9) corporate governance. We also have the report on the economy-wide conditions likely to affect firms in the clothing and footwear industry, plus the specific industry reports on competition, technology and so on. I helped you with the preliminary risk assessments based on those reports, which identify the accounts most at risk. Those risk assessments are not complete, because we haven't yet done a control system evaluation. However, the preliminary risk assessments include some consideration of going concern and fraud risk.'

'That's very good,' says Suzie. 'So, what do you think we need to do next?'

Audit process in focus

In chapter 3 we began our discussion of risk assessment by considering the audit as a whole and then focusing on gaining an understanding of the client's business and identifying key risk factors that impact the audit plan. Auditors use this information to develop their audit strategy.

Auditors consider the risk that there will be a material misstatement in their client's financial report when gaining an understanding of their client's business. They then plan on conducting audit procedures to uncover any material misstatements in their client's financial report. This chapter begins with a discussion of audit risk, which is the risk that an auditor will arrive at an inappropriate audit opinion when a financial report contains a material misstatement.

The process of setting planning materiality is then described. Qualitative and quantitative materiality factors are explained. We then move on to describe how auditors develop their audit strategy based upon their assessment of audit risk.

The final sections of this chapter deal with performance measurement and analytical procedures. By understanding how a client assesses its own performance, an auditor gains an insight into which accounts may be at risk of material misstatement. An overview is provided of the performance measurement mechanisms used by companies that an auditor will focus on when planning their audit. The conduct of analytical procedures is a key element of the risk assessment phase of each audit and is explained in detail in this chapter.

4.1 Audit risk

LEARNING OBJECTIVE 4.1 Evaluate audit risk.

Audit risk is the risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated (ASA 200 (ISA 200) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*). This means that an auditor reports that in their opinion the financial report is true and fair when it contains a significant error or fraud. While it is impossible to eliminate audit risk, an auditor will aim to reduce it to an acceptably low level.

Audit risk is reduced at the risk response phase of the audit by identification of the key risks faced by the client and allocating more audit time where the risk of material misstatement is highest.

The first stage in audit risk assessment involves the identification of accounts and related assertions most at risk of material misstatement (**inherent risk**). An **assertion** is a statement made by management regarding the recognition, measurement, presentation and disclosure of items included in the financial report and notes. They help guide the testing conducted by an auditor. For example, if a client sells valuable goods, there is a risk of overstatement of inventories as goods may be stolen but remain recorded in the client's books. Therefore, there is a risk that management's assertion that recorded inventories exists is not valid. In this example, the auditor may spend more time testing for the existence of recorded inventories than in the case of a client that sells lower valued goods.

When identifying accounts and related assertions at risk of material misstatement, some risks are classified as being more significant than others. A **significant risk** is an identified and assessed risk of material misstatement that, in the auditor's judgement, requires special audit consideration (ASA 315 (ISA 315) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*). When classifying risks as being significant consideration is given to whether the risk:

- involves fraud
- is related to significant economic or accounting developments
- involves complex transactions
- involves significant related party transactions
- involves significant subjectivity in measurement of financial information
- involves significant transactions outside the client's normal course of business.

The second stage in audit risk assessment involves gaining an understanding of the client's system of internal controls (**control risk**). The auditor is interested in whether their client has controls in place that are designed to minimise the risk of material misstatement for each account and related assertion identified as being high risk by the auditor. In the above example, if a client sells valuable goods, an auditor will assess whether their client has controls in place to reduce the risk that inventories may be stolen.

Finally, an auditor will plan to undertake detailed testing of each identified account to the extent determined necessary. This final assessment will depend upon the assessed riskiness of the account and related assertion and the deemed effectiveness of the client's system of internal controls.

CLOUD 9

Ian is still struggling with the idea of risk. He knows that audit risk is the risk that the auditor issues the wrong audit report, or gives an inappropriate audit opinion, and that this risk is related to the client's circumstances. But how does that actually work in practice? What does an auditor do differently for each audit?

Suzie reminds Ian of how taking just one issue, such as how sales are made to major department stores, helped him to focus on some specific questions about debtors, sales, liabilities and inventories.

'Let's break this down,' she advises. 'Auditors face the risk of stating that in their opinion the financial report is not materially misstated, when in fact it is. So, how does a material misstatement get into the published financial report?'

Ian works through the logic. 'First, the error has to be created, either by accident or on purpose. Second, the client's control system must fail to either prevent the error getting into the accounts or detect the error once it is in the system. And, finally, the auditor had to fail to find the error during the audit.'

'Correct!' says Suzie. 'Now, before we go on, I want to break down the idea of "financial report" too. A financial report is the balance sheet (statement of financial position), income statement (statement of comprehensive income), cash flow statement (statement of cash flows), statement of changes in equity and all the notes. So when we talk of the risk of misstatements, we are referring to the risk of misstatement in every line item in each of these statements. If we focus on just one line in a balance sheet — say, debtors — what are the possible misstatements that could occur?'

(*continued*)

Ian tries to work through the logic again. 'The amount could be either understated or overstated. I suppose there are lots of errors that could occur. Obviously, basic adding up mistakes and other clerical errors could affect the total in either direction. In addition, debtors would be understated if management omitted some debtors when they calculated the total. I think the deliberate "mistakes" are more likely to overstate debtors because that makes the balance sheet look better, and probably means profit is overstated too. Debtors would be overstated if some of the debtors they claimed in the total did not exist at year-end, or did not belong to Cloud 9, or were overvalued because bad debts were not written off, or sales from the next period were included in the earlier period.'

'Very good,' says Suzie. 'It is the same for every line item. Every time management prepares a financial report they *assert* that all these errors did not occur — that all the individual items in the report are not materially misstated. The auditor has to break down the financial report audit into accounts and assertions and consider the risk of misstatement for *each* assertion for *each* account. The auditor deals with the risk of material misstatement of the entire financial report by gathering evidence at the assertion level for each account. Then all the evidence is put together so the auditor can form an opinion on the overall financial report. Now, let's see how this works for Cloud 9.'

4.1.1 The audit risk model and its components

Audit risk is a function of the risk of material misstatement and detection risk (ASA 200, ISA 200). The risk of material misstatement exists at the financial report level and at the assertion level. At the financial report level, the risk of material misstatement refers to risks that affect the report as a whole. For example, if a client purchases a new computer system and does not adequately train staff in its use, there is a risk of errors when recording transactions used to prepare the financial reports. All accounts are at risk of material misstatement. At the assertion level, the risk of material misstatement refers to risks that affect classes of transactions, account balances and disclosures. For example, if a client sells goods overseas, there is a risk that transactions may not be recorded correctly using appropriate exchange rates at the date of each transaction. The risk of material misstatement at the assertion level comprises inherent risk and control risk (ASA 200, para. 13; ISA 200, para. 13).

An inherent risk is the possibility that a material misstatement could occur. Control risk is the risk that a client's system of internal controls will not prevent or detect such a material misstatement. Taken together, an auditor must identify client characteristics that place its financial report at risk of material misstatement (inherent risk) and determine whether controls designed to limit such a risk exist and are effective (control risk). Inherent risk and control risk are the client's risks and exist separately from the audit of the financial report. An auditor will set detection risk in response to the assessed risk of material misstatement (inherent and control risk combined). **Detection risk** is the risk that the auditor's testing procedures will not be effective in detecting a material misstatement should there be one. It is impossible to reduce detection risk to zero. Detection risk is set at a level that allows an auditor to achieve a low audit risk, given the client's risk of material misstatement.

As noted in ASA 200, para. A36 (ISA 200, para. A36), audit risk can be presented in a model that indicates the relation between its components. The model states that audit risk is a function (f) of inherent risk, control risk and detection risk, as illustrated below.

$$AR = f(IR, CR, DR)$$

where:

AR = Audit risk

IR = Inherent risk

CR = Control risk

DR = Detection risk

An auditor will plan and perform their audit to hold audit risk at an acceptably low level (ASA 200, ISA 200). If inherent and control risk are high, the auditor will set detection risk as low, to maintain a low audit risk (see figure 4.1). There is an inverse relation between the risk of material misstatement (inherent and control risk combined) and detection risk (as set by the auditor). By setting a low detection risk, an auditor will increase the level of reliance placed on their detailed **substantive procedures**, which involves intensive testing of year-end account balances and transactions from throughout the year.

Audit risk = *f*	Inherent risk	Control risk	Detection risk
	High	High	Low

FIGURE 4.1 High-risk client

Example
A client sells high-end fashion clothing and has inadequate security. Inherent risk is high for the existence of inventories as clothing may be stolen. Control risk is high as there is inadequate security, increasing the already high risk of theft. The auditor cannot rely on the client's security system to reduce the risk of material misstatement associated with the existence of inventories. The auditor will set a low detection risk and spend more time checking that recorded inventories (clothing) actually exists.

Example
A client is an importer with inexperienced clerical staff. Inherent risk is high for the accuracy of recorded purchases as they involve foreign currency translation. Control risk is high as clerical staff are inexperienced and not accustomed to recording complex foreign currency transactions. The auditor will set a low detection risk and spend more time checking that purchases are recorded at appropriate amounts.

In contrast, if inherent risk and control risk are low, the auditor can set detection risk as high (see figure 4.2). As above, there is an inverse relation between audit risk (the risk of material misstatement; that is, inherent and control risk combined) and detection risk (as set by the auditor). By setting high detection risk, an auditor will reduce the level of reliance placed on their detailed substantive procedures. In setting a high detection risk, the auditor is not eliminating their detailed testing of year-end account balances and transactions from throughout the year. Rather, the auditor is acknowledging that the client is low risk, that is, there is a low risk of material misstatement in the client's financial report and extensive substantive testing is not required.

Audit risk = *f*	Inherent risk	Control risk	Detection risk
	Low	Low	High

FIGURE 4.2 Low-risk client

Example
A client sells mud bricks and has a high-voltage fence surrounding the stock of bricks. Inherent risk is low for the existence of inventories as mud bricks are very heavy and difficult to move; it is unlikely that recorded bricks do not exist. After checking that the security system is working and has been operational throughout the year, the auditor can set control risk as low. In this case the auditor will need to spend relatively little time checking that recorded inventories (bricks) actually exist.

Example
A client uses a reputable off-the-shelf computer program to record purchases of raw materials. Inherent risk is low for the accuracy of recorded purchases as the program is considered reliable and so purchases should be recorded accurately. After checking that the program is working properly and checking that transactions are recorded correctly, the auditor will verify that access to the program is limited to authorised personnel and that the program has not been tampered with. When the auditor is satisfied that the program is working well and that the client's controls are effective, the auditor can set control risk as low. In this case, the auditor will need to spend relatively little time testing that purchases are recorded accurately.

Another way of viewing audit risk is to highlight the role of detection risk, which is the element that auditors can change in response to their client's risk of material misstatement.

$$DR = AR/RMM$$

where:

DR = Detection risk

AR = Audit risk

RMM = Risk of material misstatement

The examples provided in this section are extremes. The reality will often fall somewhere in between, where inherent risk is high but the client has an effective system of internal controls in place to mitigate that risk. For example, a client sells high-end fashion clothing and has adequate security, so the risk for the existence of inventories is moderate. Alternatively, inherent risk is low and the client does not consider it worthwhile investing in sophisticated control procedures (that is, any benefit is perceived to exceed the cost). For example, a client sells mud bricks and has low security, reasoning that the bricks would be very difficult to steal. In both cases, an auditor will spend a moderate amount of time testing for the existence of inventories.

CLOUD 9

Cloud 9 sells customised basketball shoes. The shoes are likely to 'go out of fashion' reasonably quickly, making obsolescence a big issue. These factors affect the inherent risk of inventories valuation. Based on their brief discussion of the complications surrounding transporting the shoes from the overseas factory to the department stores in Australia, Ian can see that there is a risk of errors occurring in transactions with suppliers and debtors, which will also affect inventories balances. How high is the control risk? Much to Suzie's delight, Ian suggests that they will be able to make better assessments of both inherent and control risk for all assertions now that they have a better understanding of the client.

PROFESSIONAL ENVIRONMENT

Suspension of companies from the stock exchange for late lodgement of accounts

The Australian Securities Exchange (ASX) has rules about when a company must lodge its full-year accounts. Listing Rule 4.5.1 states that a listed entity must give ASX a copy of its annual documents 'which a disclosing entity must lodge with ASIC under section 319 of the Corporations Act. It must give the documents to ASX when it lodges them with ASIC and in any event no later than three months after the end of the accounting period. It must also give ASX a copy of any concise report at the same time.'[1] If a company is late publishing its financial statements it runs the risk of being suspended from the exchange. The consequences of being suspended from the exchange include shareholders being unable to trade the company's shares and possible damage to the company's reputation arising from its inability to complete its financial reporting obligations and inability to reach agreement with its auditors.

In October 2012, 21 companies were suspended from the ASX for not handing in their full-year accounts (for the period ending 30 June 2012).[2] Greenblat reports that many of the companies blamed their auditors for the late lodgement of their financial statements. It seems that the auditors were unable, or unwilling, to sign off on the accounts. One company, CBD Energy, was reported to be delayed by lengthy discussions with its auditors over the appropriate amount for impairment write-downs of various assets. In October 2014, Kruger reported that the audit committee of CBD Energy met the company's auditor, PwC, to discuss the adequacy of the disclosures about related-party transactions for the financial years 2012, 2013 and 2014.[3] The related-party transactions involved the executive chairman of the company. Kruger also reported that the auditor had identified material weaknesses in financial controls and the audit committee was considering if there had been any 'potential improprieties and irregularities'. In December 2014, Kruger reported that the executive chairman of CBD Energy had been stood down and the company was considering if its accounts (financial reports) needed to be restated for the previous three years.[4] In addition, the auditors, PwC, resigned from the company because it was no longer independent of the company due to non-payment of its professional fees by the company. The company had been placed into administration in November 2014 and was likely to become insolvent.

BEFORE YOU GO ON

- What are the three components of audit risk?
- What is the relation between audit risk and detection risk?
- What is inherent risk?

4.2 Materiality

LEARNING OBJECTIVE 4.2 Explain the concept of materiality.

Materiality is used to guide audit testing and assess the validity of information contained in the financial report and the notes to the report. Information is considered material if it impacts on the decision-making process of users of the financial report. This includes information that is misstated, and information that is omitted but should be disclosed. ASA 320 (ISA 320) *Materiality in Planning and Performing an Audit* provides guidelines on materiality from an audit perspective.

Materiality is a key auditing concept and is assessed during the risk assessment phase of every audit. This preliminary assessment of materiality guides audit planning and testing. Before explaining how an auditor arrives at their preliminary materiality assessment, it is important to differentiate between the qualitative and quantitative considerations of materiality.

4.2.1 Qualitative and quantitative materiality

Information can be considered material because of its nature and/or its magnitude. An item that is considered material due to its nature is referred to as being qualitatively material. An item that is considered material due to its magnitude is referred to as being quantitatively material. While these concepts are not mutually exclusive, as it is possible for information to be both qualitatively and quantitatively material, they are now explained separately to aid understanding.

Qualitative materiality factors

Information is considered **qualitatively material** if it affects a user's decision-making process for a reason other than its magnitude. For example, a fraud by its nature is considered to be significant and when uncovered is investigated further by an auditor. Disclosures and notes to the financial report are checked by the auditor to ensure that they accurately reflect the auditor's understanding of their client.

When reading the notes to the financial report, an auditor will assess accounting disclosure accuracy, and compliance with any regulations and legislation, and ensure that any legal matters that should be disclosed are disclosed correctly. If any of these disclosures are inaccurate or omitted in error, an auditor will consider the potential impact on users. If an auditor believes that an inaccurate disclosure or omission will affect a user's decision-making process it is considered to be qualitatively material and the auditor will request that the client amends the disclosure or includes any omitted information.

Quantitative materiality factors

Information is considered **quantitatively material** if it exceeds an auditor's preliminary materiality assessment. An auditor uses their professional judgement to arrive at an appropriate planning materiality figure for each client. Planning materiality can be a percentage of an appropriate base, in which case an auditor will select an appropriate base and then decide on the percentage to use depending upon the client's circumstances.

4.2.2 Setting materiality

When setting materiality an auditor will use professional judgement and their detailed knowledge of their client while being mindful of the primary users of the financial report. For listed companies, the primary users are the shareholders. For unlisted companies, the primary users are generally the owners and/or major lenders of funds. Auditors vary in the method they use to set materiality in the risk assessment phase of the audit. Some will calculate a percentage of an appropriate base. When selecting an appropriate base, an auditor can choose an item from the balance sheet or the income statement. Balance sheet bases are generally total assets or equity. Income statement bases are generally profit before tax, revenue or gross profit. An auditor will select an appropriate base using their professional judgement based on their knowledge of the client and the needs of financial report users for their decision making. For example, if a client is listed on the securities exchange, profit before tax is likely to be important as this drives dividends and return on investment decisions. Therefore, the base selected would be profit before tax. However, if a client is a not-for-profit organisation, either assets or revenue are more generally used as a base.

Profit before tax will not be used as a base when a client is in a loss position or profits vary significantly from one year to the next. In that case, revenue may be used as a base. For newly established companies with little or no revenue, equity or total assets is generally the preferred base. These choices depend upon an auditor's knowledge of their client and their professional judgement.

As a rule of thumb, any item that is 10 per cent or greater of profit before tax is considered to be material. Any item less than 5 per cent of profit before tax is considered to be immaterial. The materiality of any item between 5 and 10 per cent of the profit before tax is a matter for professional judgement. When using total assets or revenue as a base, the percentages fall to 0.5–1 per cent and when equity is the base, the percentages are 1–2 per cent. Whichever base is used, there is a percentage above which items are deemed to be clearly material, a percentage below which items are deemed to be immaterial and a range in the middle that is a matter for an auditor's professional judgement.

When setting a lower planning materiality level, an auditor increases the quality and quantity of evidence that needs to be gathered during the remainder of the audit. When gathering evidence, one of the criteria used to determine the scope of a test may be to test material items. The lower the materiality level set, the more items will fall into this definition. Also, by setting a lower materiality level, an auditor increases their sensitivity to a potential misstatement. When analysing test results, an auditor will assess potential misstatements in aggregate with reference to their planning materiality. The lower the materiality, the more likely the auditor will conclude that misstatements are material and further testing is required.

CLOUD 9

Throughout their conversation, Suzie and Ian have been discussing 'material' misstatements in financial reports. What is material for Cloud 9? Suzie explains that if they set materiality at a low level in the risk assessment phase, they will have to plan to gather more and better quality evidence to be sure that a mistake of this low magnitude has not occurred. This will give the auditor confidence that the opinion is the appropriate one, but it will also increase the cost of the audit. If their risk assessment for Cloud 9 indicates that there is low risk at the assertion level, then they can set materiality levels relatively high and control the audit costs.

Ian is worried about getting the materiality level right. 'What if we set it too low or too high?' Suzie explains that all parts of the audit plan, including the materiality decision, will be reviewed throughout the audit and changed if necessary.

BEFORE YOU GO ON

- What is qualitative materiality?
- What is quantitative materiality?
- What are considered appropriate bases when setting planning materiality?

4.3 Audit strategy

LEARNING OBJECTIVE 4.3 Describe how an auditor determines their audit strategy.

ASA 300 (ISA 300) *Planning an Audit of a Financial Report* requires that an auditor establish an overall **audit strategy**, which sets the scope, timing and direction of the audit and provides the basis for developing a detailed audit plan. An audit strategy depends upon the auditor's preliminary inherent and control risk assessment (that is, their overall assessment of the risk of material misstatement). Figures 4.3 and 4.4 provide examples of audit strategies for two extreme cases: a high-risk client and a low-risk client.

Audit risk = *f*	Inherent risk	Control risk	Detection risk
	High	High	*Low*
Audit strategy		*No (or very limited) tests of controls*	*Increased reliance on substantive tests of transactions and account balances*

Note: The items in italics are determined by the auditor.

FIGURE 4.3 Audit strategy — high-risk client

When inherent and control risk are assessed as high (see figure 4.3), the risk of material misstatement is assessed as high and an auditor will set detection risk as low, to maintain audit risk at an acceptably low level. There is an inverse relation between the risk of material misstatement (a client's inherent and control risk combined) and detection risk, as set by the auditor. By assessing control risk as high, an auditor has determined that their client's system of internal controls is non-existent, very poor or unlikely to be effective in mitigating inherent risks identified. When the risk of material misstatement is high, the audit strategy set by the auditor is to do no (or very limited) tests of control and place increased reliance on substantive tests of transactions and account balances.

For example, a client sells expensive medical testing equipment and has limited security. Even if a few pieces of equipment go missing or are stolen it will have a material impact on the value of inventories. Regular stocktakes are not held. Inherent risk is high for the existence of inventories; stock may be recorded that does not exist. In this case, control risk is high as there are no controls in place to mitigate (reduce) the identified inherent risk.

By assessing control risk as high (see figure 4.3), an auditor will adopt a predominantly substantive approach. When this audit strategy is adopted, an auditor will gain the minimum necessary knowledge of the client's system of internal controls as required by the auditing standards (ASA 315, ISA 315), but generally conduct no tests of those controls. If a client's system of internal controls is non-existent, very poor or unlikely to be effective in mitigating an identified inherent risk, there is generally no point testing the internal controls as the auditor will not be planning on relying on them. Instead, an auditor will increase their level of reliance on detailed substantive procedures, which involves intensive testing of year-end account balances and transactions from throughout the year.

When assessing control risk as low (see figure 4.4), an auditor will generally obtain a detailed understanding of their client's system of internal controls as they plan to rely on that system to identify, prevent and detect material misstatements. Once an auditor has gained a detailed understanding of their client's system of internal controls, their audit strategy will be to conduct extensive tests of those controls. When the cost of testing controls exceeds the benefit expected, an auditor may decide not to test their client's internal controls. For low-risk clients, if **tests of controls** are conducted and found to be effective, the audit strategy will be to reduce reliance on detailed substantive testing of transactions and account balances. An auditor can never completely rely on a client's system of internal controls and will always conduct some substantive procedures to gather independent evidence regarding the numbers that appear in their client's financial report. Control risk and testing of controls are discussed further in chapters 6, 7 and 8.

Audit risk = *f*	Inherent risk	Control risk	Detection risk
	Low	Low	*High*
Audit strategy		*Increased reliance on tests of controls*	*Reduced reliance on substantive tests of transactions and account balances*

Note: The items in italics are determined by the auditor.

FIGURE 4.4 Audit strategy — low-risk client

For example, a client sells nuts and bolts and conducts regular stock counts. Inherent risk is low as a significant number of nuts and bolts would need to be stolen before having a material impact on the amount recorded for inventories. The auditor will plan on testing that the stock counts are effective and that records are updated on a timely basis for any stock losses.

The example provided above is for the development of an audit strategy at the financial report (client) level. In practice, an audit strategy is developed for each identified risk at the assertion level. Figure 4.5 provides details of the process used when developing an audit strategy for identified risks. Risks are identified when gaining an understanding of the client, as described in chapter 3. The factors that impact the identification of risks ahead of developing an audit strategy include consideration of the economic and regulatory environment in which the client operates, the client's business processes, activities and so on. At the transaction level, as described in figure 4.5, the auditor will first gain an understanding of the flow of transactions for the client. Part of that process involves conducting a **walkthrough** for each transaction cycle. This means that each transaction flow is traced from inception to recording in the general ledger. When conducting a transaction walkthrough, an auditor will identify risk factors.

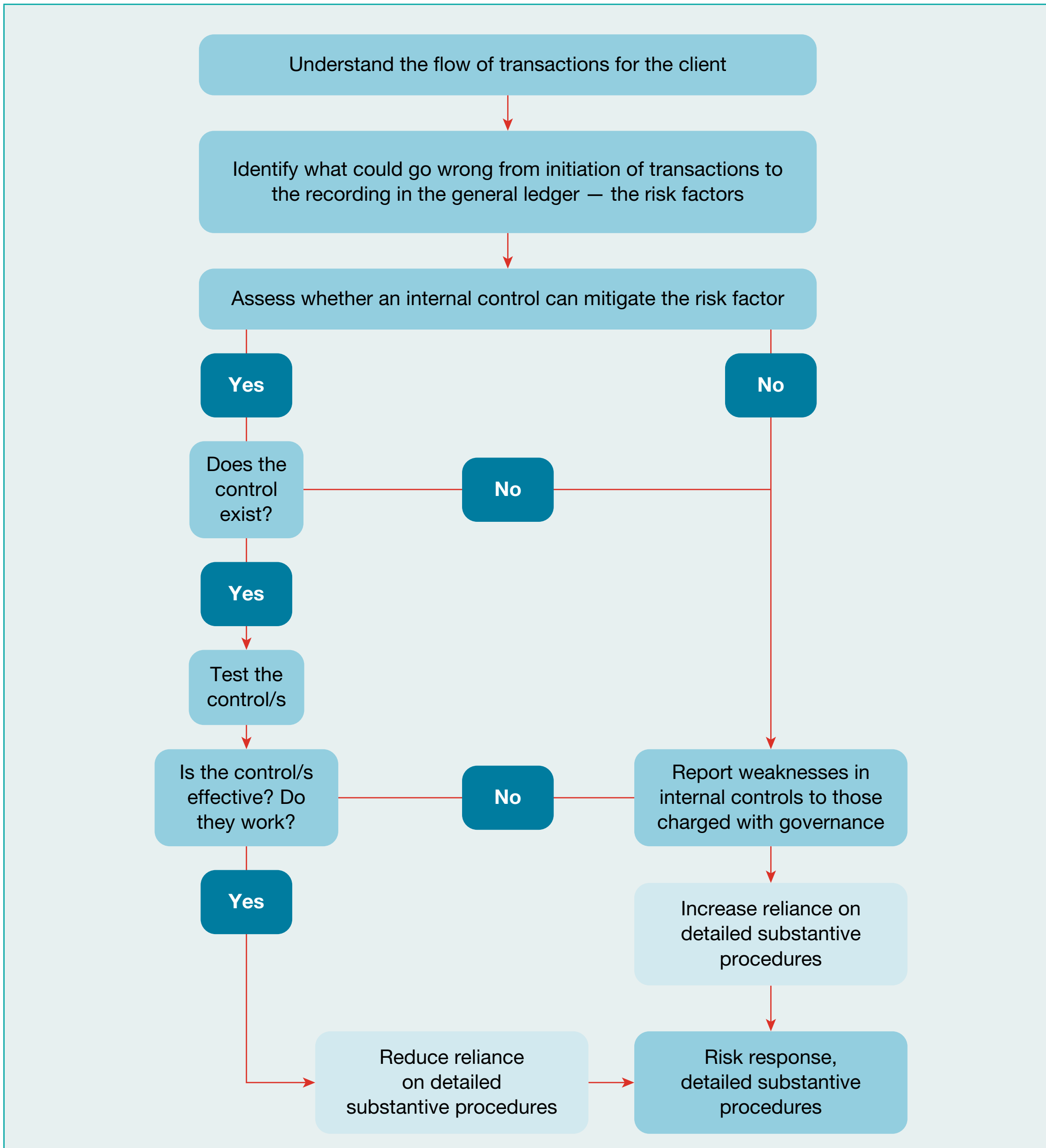


FIGURE 4.5 The process used when developing an audit strategy for risks identified

For each identified risk, the first step is to assess whether an internal control could reduce the likelihood of a material misstatement occurring as a result of the risk. If the auditor believes one or more internal controls could be designed to mitigate the identified risk, they will assess whether the client has controls in place: that is, do they exist?

If the client has one or more appropriate controls in place the audit strategy is to test the effectiveness of those controls; that is, do they work? If, after testing those controls, the auditor concludes that they are effective, the auditor plans to rely on those controls and is able to reduce their reliance on detailed substantive procedures. However, if the auditor tests the controls and believes them to be ineffective (that is, the controls do not work), the auditor cannot rely on the controls. In this case, the auditor reports the weaknesses identified to those charged with governance, makes recommendations on improving the controls and increases the reliance placed on detailed substantive procedures.

If the client does not have appropriate controls for the identified risk in place, the audit strategy is to conduct few or no tests of controls for the identified risk. The auditor reports the weaknesses identified to those charged with governance, makes recommendations on improving the controls and increases the reliance placed on detailed substantive procedures.

CLOUD 9

Suzie explains that Cloud 9's audit could be planned and conducted in different ways, depending on the audit strategy adopted. In fact, the overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.

'What audit strategy would be suitable for Cloud 9? Start by thinking about the scope of the audit,' she prompts. 'The scope is about the different types of work we have to do — some audits have extra requirements.'

'I suppose we should find out if Cloud 9's parent company has any special requirements. The fact that it is a US company might mean it has some additional regulations that apply,' Ian suggests. 'Plus, Cloud 9's statements would have to be consolidated into the parent's group accounts. We would have to make sure that we plan to do the work they would need for that.'

'That is a good start,' says Suzie. 'What else?'

'Well, I can think of several other things such as whether any other auditors will be involved (including Cloud 9 Inc.'s internal auditors), whether there are any foreign currency translation issues, any industry specific regulations (although I don't think this is as big an issue for clothing and footwear as it would be for banks, for example), whether there are any service organisations involved such as payroll services, and whether computer-aided audit technology is going to be used.'

'Very good,' says Suzie. 'That will do for now. What about timing issues? Are there any special things we should take into account for Cloud 9?'

'What is the date the audit has to be finished?' asks Ian.

'Good question,' says Suzie. 'If we have a deadline, we obviously have to work towards it.'

'Also,' says Ian, when are our staff available and when are their key people available to talk to us?'

'Yes,' says Suzie. 'This is all kind of basic. But if we don't ask these really important questions we will find ourselves unable to meet the deadlines, and perhaps under pressure to cut corners. We also have to think about timing of requests to third parties for information and so on. Now, can you think of anything to say about the direction of the audit?'

'I understand about the extra requirements, and working out the timing. But I don't really know what you mean by "direction",' Ian says, confused.

'We have already discussed it to some extent,' Suzie explains. 'Remember when we spoke about the risk for Cloud 9 created by complex inventories transactions, and dealing with purchases from international suppliers? "Direction" is about where we think there should be extra attention because of higher risk, and how we give that extra attention. We could, for example, make sure we have suitable experts available, if required, to value the inventories. This is also where we bring in our work on materiality, both setting materiality for planning purposes, and identifying the material account balances. In our plan, we need to allocate additional time to areas where there may be higher risk of material misstatement. And, one of our biggest tasks will be considering the evidence about the design and operating effectiveness of internal controls at Cloud 9, which we haven't yet considered in detail.'

'I see,' says Ian. 'If we assess the internal controls as being strong, then we plan to do more testing of controls (to confirm our assessment), and less testing of the underlying substance of transactions and account balances. We have to put this in our plan now. But what if our first thoughts about controls are wrong? Our plan will be wrong!'

'That happens,' replies Suzie. 'That is why a plan is constantly changing as we gather more information about the client. Particularly, as in this case, for a new client that we don't have a lot of detailed information on yet. However, we already know what accounts are important to Cloud 9 — its previous years' statements and interim results show us that. We have an understanding of the drivers of its profits, and the pressure to increase profits coming from the US office. We also know about its new store opening this year (including the new debt) and the change in marketing strategy. We actually know quite a lot — certainly enough to make a start on a detailed audit plan.'

BEFORE YOU GO ON

- What is the purpose of developing an overall audit strategy?
- Describe the audit strategy when the auditor adopts a predominantly substantive approach.
- To whom will an auditor report uncovered weaknesses in a client's system of internal controls?

4.4 Client approaches to measuring performance

LEARNING OBJECTIVE 4.4 Describe how clients measure performance.

Part of the process used when gaining an understanding of a client involves learning how a client measures its own performance. The **key performance indicators (KPIs)** used by a client to monitor and assess its own performance and the performance of its senior staff provide an auditor with insights into the accounts that their client focuses on when compiling its financial report and which accounts are potentially at risk of material misstatement.

Some KPIs are common to many clients, such as return on assets and return on shareholder funds. Other KPIs will vary from industry to industry and client to client. For example, a client in the airline industry is concerned about revenue per passenger kilometre, a client in the retail industry is concerned about inventories turnover and a client in the finance industry is concerned about its risk-weighted assets and interest margins. It is very important for an auditor to understand which KPIs a client is most concerned about in that year so that the audit can be planned around relevant accounts. It is inappropriate to assume that all clients use the same KPIs. It is also inappropriate to assume that a client will use the same KPIs every year. Just as businesses change their focus, KPIs change to help businesses achieve new goals.

4.4.1 Profitability

It is common for companies to use **profitability** measures to assess their performance and that of their senior staff. Companies will track their revenue and expenses over time and assess any variability. They will compare their revenue and expenses with close competitors and assess their ability to compete, as well as provide valuable insights to management as to whether results are matching expectations based on known factors such as seasonality or economic downturns. This also provides the auditor with valuable insights into the expectations of management.

A company will track revenues from month to month to identify and explain trends. Large companies will compare revenues earned across divisions to highlight good and poor performance. Comparisons between divisions may be used to assess how well the managers of those divisions are controlling costs. Changes from one year to the next may reflect an increased cost of doing business or highlight that it may be time to source cheaper suppliers.

Companies are concerned about their shareholders (owners). The **price–earnings (PE) ratio** (market price per share divided by earnings per share) shows how much a shareholder is willing to pay per dollar of earnings. For example, a PE of 10 means that investors (and potential investors) are willing to pay

10 times current earnings for a company's shares. This gives value to the future earning capacity of the enterprise. **Earnings per share (EPS)** (profit divided by weighted average ordinary shares issued) reflects the earnings return on each issued share. When a client's PE ratio or EPS are in decline an auditor may be concerned that management may be under pressure to manipulate earnings. **Cash earnings per share (CEPS)** (operating cash flow divided by outstanding shares) shows the cash flow capacity of a company for each issued share. CEPS helps determine a company's ability to service debt, pay dividends and such.

Retailers and manufacturers are generally concerned about their inventories turnover (cost of sales divided by average inventories). An assessment of this ratio is made within the context of the industry in which a company operates. For example, a company that sells perishable goods such as ice cream requires a much higher turnover than a company that sells non-perishable goods such as furniture. If a client's inventories turnover falls sharply an auditor may be concerned that stock is overvalued.

4.4.2 Liquidity

Liquidity is the ability of a company to meet its needs for cash in the short and long term. It is vital for a company to have access to cash to pay its debts when they fall due. If it cannot meet these obligations, a company may go into liquidation. Companies require cash to pay their employees' wages, utility bills, supplier bills, interest payments on money lent, dividends to shareholders and so on. In the longer term companies need cash to repay long-term debt and undertake capital investment.

Companies enter into debt covenants with lenders when taking on significant loans. That is, they promise to maintain specified profitability, liquidity or other financial ratios, or to seek the lender's permission before taking on new borrowings or acquiring other companies. These covenants are written into the borrowing contracts and restrict a company's activities. If a company breaches a debt covenant it will need to renegotiate or repay the loan.

By understanding how their client measures and assesses its own performance and any restrictions implied by debt covenants, an auditor will gain a deeper understanding of the accounts potentially at risk of material misstatement. An auditor will use their own ratio calculations and trend analyses to identify any unusual fluctuations that warrant further investigation. This analysis is referred to as analytical procedures, which are explained in detail in the next section.

CLOUD 9

In her discussions with the partner, Jo Wadley, Suzie learns that the senior people in the Cloud 9 finance section are entitled to participate in the company's employee share-purchase plan, and also receive stock options in the US parent company if revenue and profit before tax targets are met. The US parent company is a listed company and its share price (which determines the value of the stock options) reflects market expectations about the group's future profits.

Cloud 9 has taken on additional debt this year, and costs are rising because of issues associated with its drive to increase market share. When these results are consolidated into the group, they increase debt/equity ratios and decrease profitability ratios, potentially reducing the value of the stock options. Suzie decides to allocate time in the audit plan to consider whether these pressures could impact any of the senior staff's incentives and increase audit risk.

PROFESSIONAL ENVIRONMENT

Working hard can create risks

One of the biggest problems faced by business, according to Allen, is the accrued liability for unused holiday pay.[5] Allen reports that in 2008 the amount of unused holiday pay in Australia was 123 million days, worth $33.9 billion. A vigorous campaign by the government to encourage people to take leave had reduced the liability to 118 million days by 2010, but it was still worth the same amount because of increasing salaries.

Two main issues arise from such a large balance of untaken leave, especially for companies with unpredictable cash flows. The first risk is that the sudden departure of a high number of staff can decimate cash flows as the leave liability is paid out to departing employees. The second risk is more subtle, but perhaps even more dangerous. Staff who do not take leave can become tired and lose the ability to see problems from a fresh perspective. Tired staff are also more likely to become ill or contribute to a greater risk of work accidents.

Westpac is so concerned about accrued leave they have a program encouraging staff to take holidays. Westpac's 'Take a Break Day' encouraged staff to take an extra day off before a public holiday weekend.[6] At Carnival Corp, the company that owns P&O Cruises, questions are asked about why staff have not taken leave if they have more than eight weeks leave accrued, and Leighton Holdings has limited accrued leave to six weeks since 1980.[7]

An auditor needs to consider the implications of staff who do not take regular leave. Some staff could be concerned that if they do go on leave other people could discover that they have not been doing their job properly. When one employee is solely responsible for a task or is in control of assets or bank accounts without adequate segregation of duties, internal control can break down and the risk of material misstatement increases.

BEFORE YOU GO ON

- What is a PE ratio?
- Explain how internal performance reports may be used.
- What is a debt covenant?

4.5 Analytical procedures

LEARNING OBJECTIVE 4.5 Describe how an auditor uses analytical procedures when assessing risk.

ASA 520 (ISA 520) *Analytical Procedures* defines **analytical procedures** as an evaluation of financial information by studying plausible relationships among both financial and non-financial data. They involve the identification of fluctuations in accounts that are inconsistent with the auditor's expectations based upon their understanding of their client. For example, if an auditor is aware that their client has borrowed a significant amount of money in the previous financial year, a reduction in the client's debt to equity ratio would be unusual and would warrant further investigation. It is essential that an auditor has clear expectations about their client's results for the reporting period before conducting analytical procedures, so that unexpected fluctuations can be correctly identified and investigated. An auditor's expectations are based upon their understanding of their client, the industry in which it operates and the economy as a whole.

Analytical procedures are conducted throughout an audit. During the risk assessment phase, analytical procedures are used to aid in the risk identification process. During the **risk response phase** analytical procedures are an efficient method of estimating account balances. At the final review stage, analytical procedures are used to assess whether the financial report reflects the auditor's knowledge of their client. In this chapter we will concentrate on the application of analytical procedures at the risk assessment phase of the audit. The use of analytical procedures when conducting substantive procedures is discussed in chapters 9–11.

Analytical procedures are conducted at the risk assessment phase of the audit to:

- highlight unusual fluctuations in accounts
- aid in the identification of risk
- enhance the understanding of a client
- identify the accounts at risk of material misstatement
- minimise audit risk by concentrating audit effort where the risk of material misstatement is greatest.

ASA 315 (ISA 315) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* stipulates that an auditor should perform analytical procedures as part of their risk identification process. Analytical procedures include simple comparisons, trend analysis, common-size analysis and ratio analysis. Each of these forms of analysis is now discussed, followed by a review of factors to consider when undertaking analytical procedures.

4.5.1 Comparisons

Simple comparisons are made between account balances for the current year and the previous year and the current year and the budget. When comparing account balances from one year to the next, significant changes can be tracked and investigated further by the auditor. An auditor will assess these changes in light of their expectations based upon their understanding of the client and any changes experienced over the past year. For example, if the client has opened a new retail outlet, sales may be expected to have increased since last year. When comparing account balances with budgeted amounts, an auditor is concerned with uncovering variations between actual results and those expected by the client. Significant unexpected variations are discussed with client personnel.

4.5.2 Trend analysis

Trend analysis (horizontal analysis) involves a comparison of account balances over time. It is conducted by the selection of a base year and then restating all accounts in subsequent years as a percentage of that base. It allows the auditor to gain an appreciation of how various accounts have changed through time. When conducting a trend analysis it is important for an auditor to consider significant changes in economy-wide factors, such as a recession, which may affect their interpretation of the trend. Figure 4.6 provides an example of a trend analysis.

	2015	2016	2017	2018
	$M	%	%	%
Income statement items				
Sales	250	(20)	(10)	20
Cost of sales	110	(10)	0	10
Interest expense	10	(30)	30	0
Wages expense	70	(20)	30	6
Rent expense	40	0	0	0
Balance sheet items				
Cash	400	20	10	25
Inventories	350	30	20	10
Trade receivables	300	(10)	5	15

FIGURE 4.6 Trend analysis

Various accounts can be selected for inclusion in a trend analysis. Accounts that vary from one year to the next are generally the focus. In the trend analysis depicted in figure 4.6, 2015 was selected as the base year. The following years appear as a percentage increase or decrease of the 2015 amount. For example, sales in 2016 were 20 per cent lower than sales in 2015; in 2017 sales were only 10 per cent lower than the 2015 figure, and in 2018 sales grew to 20 per cent higher than the 2015 amount. A trend analysis allows an auditor to assess movements in the accounts over time and determine whether the underlying trends discovered through this type of analysis match their understanding of the client and its activities over the period under review.

4.5.3 Common-size analysis

Common-size analysis (vertical analysis) involves a comparison of account balances to a single line item. In the balance sheet, the line item used is generally total assets. In the income statement, the line item used is generally sales or revenue. A common-size analysis allows the auditor to gain a deeper appreciation of how much each account contributes to the totals presented in the financial report. By preparing common-size accounts for a number of years, an auditor can trace the relative contribution of various accounts through time. Figure 4.7 provides an example of a common-size analysis.

	2015	2016	2017	2018
	%	%	%	%
Income statement items				
Sales	100	100	100	100
Cost of sales	44	50	48	40
Interest expense	4	4	6	3
Wages expense	28	28	22	25
Rent expense	16	20	18	13
Balance sheet items				
Cash	5	4	4	3
Inventories	20	27	23	23
Trade receivables	18	25	22	18
Payable	15	15	17	16
Total assets	100	100	100	100

FIGURE 4.7 Common-size analysis

The common-size analysis depicted in figure 4.7 shows that cost of sales grew and then reduced as a proportion of sales. This may reflect a change in prices charged by suppliers, prices charged to customers and/or quantity of goods on hand. In the balance sheet, inventories levels rose and then dropped, which may indicate a build up of inventories on hand when sales dropped in 2016.

4.5.4 Ratio analysis

Ratio analysis is conducted by an auditor to assess the relationship between various financial report account balances. An auditor will calculate profitability, liquidity and solvency ratios.

Profitability ratios

Profitability ratios reflect a company's ability to generate earnings and ultimately the cash flow required to pay debts, meet other obligations and fund future expansion. Common profitability ratios include the gross profit margin, profit margin, return on assets and return of shareholders' equity.

Ratio	Definition
Gross profit margin	$\frac{\text{Gross profit}}{\text{Net sales}}$
Profit margin	$\frac{\text{Profit}}{\text{Net sales}}$
Return on assets	$\frac{\text{Profit}}{\text{Average assets}}$
Return on shareholders' equity	$\frac{\text{Profit}}{\text{Average equity}}$

The gross profit and profit margins indicate the proportion of sales turned into profits. The **gross profit margin** indicates whether a seller of goods has a sufficient mark-up on goods sold to pay for other expenses. A mark-up is the difference between the selling price and cost price for goods sold. A decline in this ratio indicates that a client may be paying more for their inventories or charging less to their customers. If the gross profit margin continues to decline, the client may face making an overall loss if they are not able to cover their operating expenses.

The **profit margin** indicates the profitability of a company after taking into account all operating expenses. By looking at the trend in the profit margin over time, the auditor is able to identify variability in the profit earning capacity of their client. If the profit margin is steadily falling, this may affect the future viability of the client. If the profit margin varies widely from year to year, this indicates volatility and uncertainty, which makes it difficult to assess the truth and fairness of the current reported earnings without further investigation.

The **return on assets (ROA)** indicates the ability of a company to generate income from its average investment in total assets. The **return on shareholders' equity (ROE)** indicates the ability of a company to generate income from the funds invested by its common (ordinary) shareholders. If a company is unable to generate a sufficient return on funds invested, there may be insufficient funds available to pay dividends and invest in future growth. An auditor will calculate these ratios to assess trends in profitability. If the ROA and ROE are falling, it will affect the ability of their client to pay dividends and interest and repay loans, which are also dependent on the client's ability to generate cash.

An auditor will make comparisons between the current year and previous years to identify trends in their client's profitability. Comparisons will also be made with budgeted results and with competitors. When comparing current year results with budget, an auditor will assess how profitable the client is compared to management's expectations. An auditor will discuss any significant variance with management. When comparing current year results with their client's competitors, an auditor will assess their client's profitability relative to companies of a similar size operating in the same industry. Any significant trends that appear unusual when compared to previous years, budget or competitors are investigated further by an auditor as unusual or unexpected differences indicate that there may be a risk of a material misstatement.

Liquidity ratios

Liquidity ratios reflect a company's ability to meet its debt obligations. If a company is unable to pay its debts when they fall due they may lose key employees, suppliers may refuse to supply goods and lenders may recall funds borrowed. An auditor is concerned with their client's liquidity situation as an indicator of potential going concern issues. There are a number of short-term ratios that can be used by auditors when assessing their client's liquidity situation. These include the current ratio and the asset-test (quick) ratio. The inventories and receivables turnovers are used as liquidity ratios as well as being indicators of managerial efficiency and client activity.

Ratio	Definition
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$
Acid-test (quick) ratio	$\frac{\text{Cash + Short-term investments + Receivables (net)}}{\text{Current liabilities}}$
Inventories turnover	$\frac{\text{Cost of sales}}{\text{Average inventories}}$
Receivables turnover	$\frac{\text{Net credit sales}}{\text{Average net receivables}}$

The **current ratio** indicates how well current assets cover current liabilities. A ratio that is greater than one indicates that a company should be able to meet its short-term commitments when they fall due. In reality this will depend upon the ability of a company to convert its inventories and receivables into cash on a timely basis. The **acid-test (quick) ratio** indicates how well liquid (cash or near cash) assets cover current liabilities. Liquid assets include cash, short-term investments and receivables. Acceptable current and asset-test ratio benchmarks vary from one industry to another. An auditor will compare the trend in both ratios over time to assess whether their client's liquidity situation is improving or deteriorating. An auditor will also compare their client's ratios with the industry average to assess their client's liquidity relative to close competitors. If a client's liquidity situation is deteriorating or is poor when compared to the industry average, an auditor may be concerned about the future viability of the company.

Inventories turnover measures how many times a company sells its inventories in a year. An auditor will look at the trend in this ratio to determine whether inventories are being turned over more or less frequently from year to year. This turnover will vary widely from one industry to another. For example, the turnover for a supermarket would be expected to be much higher than for a luxury boat manufacturer. An auditor will compare the inventories turnover for their client to the industry average to determine whether their client is competitive and has as high a turnover as its rivals. If a client operates in a high-technology industry or the fashion industry, where customer preferences change quickly, a slowing down of inventories turnover may indicate that the client is not keeping up with change. When a client's inventories turnover slows by more than expected, an auditor will spend more time testing for the valuation of inventories, as stock may need to be written down in response to slowing demand. In this situation, an auditor will also investigate whether sales have fallen in line with the slowing turnover.

Receivables turnover measures how many times a year a company collects cash from its debtors. A slowdown in this ratio may indicate that the client is making sales to customers who are unable to pay for their goods on a timely basis or the client is not following up on customers who are late in paying in an efficient manner. If receivables turnover falls, an auditor will spend more time considering the adequacy of the allowance for doubtful debts.

Solvency ratios

Solvency ratios are used to assess the long-term viability of a company. Liquidity ratios tend to take a short-term view of a company; solvency ratios have a long-term perspective. Common solvency ratios are the debt to equity ratio and times interest earned.

Ratio	Definition
Debt to equity ratio	$\frac{\text{Liabilities}}{\text{Equity}}$
Times interest earned	$\frac{\text{Profit before income taxes and Interest expense}}{\text{Interest expense}}$

The **debt to equity ratio** indicates the relative proportion of total assets being funded by debt relative to equity. A high debt to equity ratio increases the risk that a client will not be able to meet interest payments to borrowers when they fall due. Companies with long-term debt are more likely to have a debt covenant with a lender, which restricts the company's activities. An auditor will consider the trend in the client's debt to equity ratio over time. An increasing ratio increases the risk that a client will not be able to repay their loans when they fall due, and the risk that a client will breach a debt covenant, as many covenants restrict the raising of additional debt. An auditor will also compare a client's debt to equity ratio with similar companies in the same industry as this ratio tends to vary across industries.

Times interest earned measures the ability of earnings to cover interest payments. A low ratio indicates that a client may have difficulty meeting its interest payments to lenders if there is a lack of evidence that the client has the capacity to service its debt. An auditor will consider how this ratio has changed over time. A downward trend is a concern as it indicates that lenders may charge the client a higher rate of interest on future borrowings. At the extreme, lenders may recall monies lent if the client does not meet interest payments.

4.5.5 Other analytical procedures

There are other more sophisticated analytical procedures used by some firms. Computer programs are used in some audit firms to conduct detailed analysis of client data (such as information contained in their ledgers and journals). These programs can be used to conduct the analysis outlined above, as well as searching for unusual transactions, including those that occur at odd times, are for unusual amounts or within unusual accounts. They can be used to conduct multidimensional analysis, journal entry summaries, validation reports, criteria-generated reports, times series analysis and regression analysis.

Multidimensional analysis involves sorting client data into various dimensions or measures. For example, client data can be sorted across dimensions such as location, cost centre or manager. It can then be measured as inventories purchased, inventories sold, inventories on hand, sales or rent expense across those dimensions. Once measured data are sorted by dimensions, they can be analysed to determine whether the relationship between the various data are consistent with the auditor's understanding of their client. Journal entry summaries provide condensed overviews of transactions. Summaries can be prepared using a range of criteria. For example, summaries can be made by month, by division or by manager.

Validation reports can be used to report on the validity of the client's data. For example, a validation report can include details of character checks, where fields are searched to ensure they include only appropriate data (for example, a numeric field includes only numbers), checks for missing data, checks for data that are less or greater than a certain amount, checks for negative amounts or balances, checks that customer numbers are valid and checks that inventories numbers are valid.

Criteria-generated reports are summaries of information and data based on conditions set by the auditor. These reports are used to help auditors manage the significant amount of information and data held in client computer files. By setting conditions or criteria, auditors are able to collect data that are most at risk of material misstatement. In this way auditors can focus their attention.

Times series analysis can be used to analyse data that occur regularly within the client; for example, sales and purchases. This form of analysis involves using data from the past to predict the future. For example, sales made in the past can be used to predict sales in the period under audit. Significant fluctuations in expected sales trends are investigated by the auditor. When assessing variations, auditors will incorporate their understanding of changes that have occurred in the current year that may explain the variations observed. For example, the client may have closed a number of retail outlets, which would explain a sharp decline in sales. When conducting a times series analysis auditors can look at the long-term trend, seasonal variation (for example, sales of ice cream are likely to be higher in summer) and irregularities.

Regression analysis can be used to investigate the relationships between different groups of data (or variables). This analysis involves consideration of the relationship between a dependent variable, such as sales, and various independent variables, such as selling costs, purchases and advertising expense. Regression analysis provides a statistical measure of the association between data. It establishes whether movements in the independent variables result in a change in the dependent variable. Insignificant relationships are investigated as they indicate a potential misstatement (such as an overstatement of sales relative to associated expenses).

4.5.6 Factors to consider when conducting analytical procedures

There are a number of factors to consider when conducting analytical procedures. The first is the reliability of client data. If the auditor believes that there is a significant risk that the client's records are unreliable due to, for example, poor internal controls, then they are less likely to rely on analytical procedures. Another issue is the ability to make comparisons over time. If the client has changed accounting methods, this will reduce the comparability of the underlying data. In this case, an auditor will need to restate prior years' financial report data using the current accounting methods before making any comparisons. If past results are unaudited they are considered less reliable for comparison purposes.

During the risk assessment phase of an audit, an auditor may only have access to their client's half-year results. In this case, an auditor will need to annualise revenue and expense items before making comparisons with the prior year. If a client earns revenues evenly throughout the year it is appropriate to double the half-year revenues. If a client earns more revenues in some months relative to others (for example, an ice seller in warmer months) trends must be catered for when annualising half-year results.

When comparing actual financial results to budgeted results, an auditor will consider the reliability of the budget. This can be assessed by comparing budget to actual results for prior years. If the client continually overestimates earnings, for example, an auditor can take this into account when comparing actual and budgeted results for the current period.

When benchmarking a client with industry data, care must be taken. If the client is significantly smaller or larger than most companies in its industry, comparison may not be valid. If competitors do not use the same accounting methods, the comparison is problematic. If the client has very different results and ratios to the industry average, there may be a problem with the industry data rather than with the client data.

In conducting analytical procedures, the following information sources are generally considered to be reliable:

- information generated by an accounting system that has effective internal controls
- information generated by an independent reputable external source
- audited information
- information generated using consistent accounting methods
- information from a source internal to the client that has proven to be accurate in the past (for example, when preparing budgets).

After conducting analytical procedures an auditor will investigate every significant unexpected fluctuation uncovered. This includes fluctuations where none were expected and no fluctuations where they were expected. An example of the former would be a significant increase in sales for no apparent reason.

An example of the latter would be no significant change in inventories turnover when the auditor is aware that sales have fallen significantly.

CLOUD 9

Ian volunteers to start the analysis of Cloud 9's interim results and previous period's financial data. He has previously attended a training session on the W&S Partners' software that he will use to produce reports showing unusual relationships and fluctuations. Suzie is grateful for the help, but cautions Ian. 'You do realise that judging what is "unusual" is a little more complex than getting a software program to identify a change above a certain percentage? You need considerable industry experience and client knowledge to make sense of the information. For example, no change in a figure can be more suspicious than a large change, depending on the circumstances.'

'Yes, I realise that, and I know that I don't have the experience to complete the analysis, but I am hoping that I will learn from you by seeing what you do with the data and reports that I hadn't even considered doing,' he says.

BEFORE YOU GO ON

- Why are liquidity ratios calculated?
- Define the gross profit ratio and explain what it indicates.
- What is a trend analysis and why might an auditor use this form of analysis?

SUMMARY

4.1 Evaluate audit risk.

Audit risk is the risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated. The three components of audit risk are inherent risk, control risk and detection risk.

4.2 Explain the concept of materiality.

Information is considered to be material if it impacts the decision-making process of users of the financial report.

4.3 Describe how an auditor determines their audit strategy.

The audit strategy is a key component of the risk assessment phase of the audit. It sets the scope, timing and direction of the audit and provides the basis for developing a detailed audit plan. An audit strategy will depend upon the auditor's preliminary inherent and control risk assessment.

4.4 Describe how clients measure performance.

The review of the different ways that clients measure their own performance was included in this chapter to highlight that by understanding how a client measures its own performance an auditor can plan their audit to take into consideration areas where their client may be under pressure to achieve certain outcomes.

4.5 Describe how an auditor uses analytical procedures when assessing risk.

Analytical procedures are conducted at the risk assessment phase of the audit to identify unusual fluctuations, help identify risks, help when gaining an understanding of a client, identify the accounts at risk of material misstatement and reduce audit risk by concentrating audit effort where the risk of material misstatement is greatest. There are many processes that can be used when conducting analytical procedures. The processes discussed in this chapter included simple comparisons, trend analysis, common-size analysis and ratio analysis.

KEY TERMS

Acid-test (quick) ratio Liquid assets to current liabilities.

Analytical procedures Evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Assertion Statement made by management regarding the recognition, measurement, presentation and disclosure of items included in the financial report.

Audit risk The risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated.

Audit strategy The determination of the amount of time spent testing the client's internal controls and conducting detailed testing of transactions and account balances.

Cash earnings per share (CEPS) Cash to issued shares.

Common-size analysis A comparison of account balances to a single line item.

Control risk The risk that a client's system of internal controls will not prevent or detect a material misstatement.

Current ratio Current assets to current liabilities.

Debt to equity ratio Liabilities to equity.

Detection risk The risk that the auditor's testing procedures will not be effective in detecting a material misstatement.

Earnings per share (EPS) Profit to weighted average ordinary shares issued.

Gross profit margin Gross profit to net sales.

Inherent risk The susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming there are no related controls.
Inventories turnover Cost of sales to average inventories.
Key performance indicators (KPIs) Measurements, agreed to beforehand, that can be quantified and reflect the success factors of an organisation.
Liquidity The ability of a company to pay its debts when they fall due.
Materiality Information that impacts on the decision-making process of users of the financial report.
Price–earnings (PE) ratio Market price per share to earnings per share.
Profitability The ability of a company to earn a profit.
Profit margin Profit to net sales.
Qualitative materiality Information that impacts a user's decision-making process for a reason other than its magnitude.
Quantitative materiality Information that exceeds an auditor's preliminary materiality assessment, which is between 5 and 10 per cent of an appropriate base.
Receivables turnover Net credit sales to average net receivables.
Return on assets (ROA) Profit to average assets.
Return on shareholders' equity (ROE) Profit to average equity.
Risk response phase Performing tests of controls and detailed substantive testing of transactions and accounts, concentrating effort where the risk of material misstatement is greatest.
Significant risk An identified and assessed risk of material misstatement that, in the auditor's judgement, requires special audit consideration.
Substantive procedures Audit procedures designed to detect material misstatements at the assertion level.
Tests of controls The audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.
Times interest earned Profit before income taxes and interest expense.
Trend analysis A comparison of account balances over time.
Walkthrough Tracing a transaction through a client's accounting system.

MULTIPLE-CHOICE QUESTIONS

4.1 Adopting an audit strategy that relies heavily on substantive testing: **LO3**
(a) is appropriate when internal controls are very strong.
(b) requires the auditor to conduct extensive control testing.
(c) means that the auditor will conduct some interim testing and minimal year-end account balance testing.
(d) means that the auditor will gain the minimum necessary knowledge of the client's system of internal controls.

4.2 Adopting an audit strategy that does not rely heavily on substantive testing: **LO3**
(a) is appropriate when internal controls are minimal.
(b) requires the auditor to conduct extensive control testing.
(c) means that the auditor will conduct extensive year-end account balance testing.
(d) means that the auditor will gain the minimum necessary knowledge of the client's system of internal controls.

4.3 Which of the following is a true statement about profitability ratios? **LO4**
(a) All companies have a high inventories turnover ratio.
(b) Auditors will be interested in trends in profitability ratios.
(c) Profitability ratios should be the same for all divisions of the company.
(d) Companies will try to have the same profitability ratio in each month of operation.

4.4 Common uses of analytical procedures include: **LO5**
(a) risk identification during the risk assessment stage.
(b) estimating account balances during the risk response stage.
(c) overall assessment of the financial report at the final review stage of the audit.
(d) all of the above.

4.5 An auditor is interested in the client's inventories turnover ratio because it helps the auditor understand: **LO5**
(a) if the client is in the right industry.
(b) if the industry is the same as another industry.
(c) if the client's debtors are paying their accounts on time.
(d) if the client is as competitive and has as high a turnover as the industry average.

4.6 Analytical procedures: **LO5**
(a) can only be performed on annual data.
(b) are only useful if the client's variation from budget is low.
(c) are not affected if the client changes its accounting methods.
(d) must take into account seasonal variation in the client's business.

4.7 An auditor will identify accounts and related assertions at risk of material misstatement: **LO3**
(a) after testing internal controls.
(b) before writing the audit report.
(c) in order to plan the audit to focus on those accounts.
(d) to eliminate audit risk and make the audit report more timely.

4.8 For an audit, the auditor can control: **LO1**
(a) inherent risk.
(b) control risk.
(c) financial risk.
(d) detection risk.

4.9 The relationship between risk and the materiality level set in the risk assessment phase: **LO2**
(a) is positive.
(b) is inverse.
(c) is irrelevant.
(d) depends on the size of the client.

4.10 Testing controls means that: **LO3**
(a) no substantive testing is required.
(b) the auditor can completely rely on a client's system of internal controls.
(c) the auditor can plan to reduce their reliance on detailed substantive testing of transactions and account balances.
(d) all of the above.

REVIEW QUESTIONS

4.11 What is audit risk? What are the components of audit risk? **LO1**

4.12 Which components of audit risk can an auditor control? Explain. **LO1**

4.13 Are all accounts likely to have the same risk of material misstatement? Explain and give an example of an account that is likely to have a high level of risk of material misstatement for a retail store. **LO1**

4.14 Why do auditors identify accounts and related assertions at risk of material misstatement? What are the implications of identifying an account as having a significant risk? **LO1**

4.15 Explain how an auditor's preliminary assessment of materiality affects audit planning. **LO2**

4.16 What guidance is there for an auditor when considering the quantitative materiality of an item when setting planning materiality? **LO2**

4.17 Explain how the choice of audit strategy affects the amount of substantive and control testing that the auditor does. **LO3**

4.18 A client has physical controls over inventories, including a locked warehouse with access restricted to authorised personnel. Testing of these physical controls over inventories shows that they are very effective. Can the auditor conclude that there are likely to be no errors in the valuation of inventories? Explain. **LO3**

4.19 What are some possible explanations of a change in the inventories turnover ratio? How could the auditor investigate which of these explanations is the most likely cause of the change in the ratio? **LO5**

4.20 Why is an auditor interested in a client's liquidity? **LO5**

4.21 Consider the following statement: 'If inherent and control risk are high, the auditor will set detection risk as low to maintain a low audit risk'. Explain what it means to set detection risk as low. What does this mean for the operation of the audit? **LO3**

4.22 Explain how setting a lower planning materiality level affects quality and quantity of audit evidence that needs to be gathered. **LO2**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

4.23 AUDIT RISK AND REVENUE ★ **LO1**

Ajax Finance Ltd (Ajax) provides small and medium sized personal, car and business loans to clients. It has been operating for more than 10 years and run throughout this time by Bill Short. Bill has been the public face of the finance company, appearing in most of its television and radio advertisements, and developing a reputation as a friend of the 'little person' who has been mistreated by the large finance companies and banks.

Ajax's major revenue stream is generated by obtaining large amounts on the wholesale money market and lending in small amounts to retail customers. Margins are tight, and the business is run as a 'no frills' service. Offices are modestly furnished and the mobile lenders drive small, basic cars when visiting clients. Ajax prides itself on full disclosure to its clients and all fees and services are explained in writing to clients before loans are finalised. However, although full disclosure is made, clients who do not read the documents closely can be surprised by the high exit charges when they wish to make early repayments or transfer their business elsewhere.

Ajax's mobile lenders are paid on a commission basis; they earn more when they write more loans. For example, they are encouraged to sell credit cards to any person seeking a personal loan. Ajax receives a commission payment from the credit card companies when it sells a new card and Ajax also receives a small percentage of the interest charges paid by clients on the credit card.

Required

(a) What type of misstatements would be most likely for Ajax's revenue?

(b) What type of controls should be in place at Ajax to stop the misstatement of revenue?

4.24 AUDIT RISK AND INVENTORIES ★ **LO1**

Biggest Bargains stocks thousands of items that range in value from $1 to $100. The inventories on hand represent a material portion of current assets. The merchandise items change according to the season and the promotional theme adopted by the stores' management for the year. Merchandise is ordered up to four months in advance from Chinese and Korean suppliers. These special orders require Biggest Bargains to give the suppliers substantial deposits upon placement of the orders.

Required

Identify the accounts (balance sheet and income statement) that are at risk of material misstatement for Biggest Bargains. Explain why they are at risk.

Source: Adapted from the CA Program's *Audit & assurance exam,* December 2010.

4.25 MATERIALITY ASSESSMENT ★ **LO2**

One of the clients of MMM Chartered Accountants operates a restaurant. From January of the current year, the business has consistently paid its suppliers late, well in excess of the suppliers' normal credit terms. This has resulted in some suppliers requesting cash on delivery from the business. The auditor has reviewed the correspondence between the business and its bank and finds that the business has been experiencing cash flow problems for two years.

Required

Explain whether (and, if so, how) the information provided impacts on the auditor's assessment of preliminary materiality.

Source: Adapted from the CA Program's *Audit & assurance exam,* March 2012

4.26 CONTROL RISK ★ **LO1**

Clear Sky Aviation credits prepayments of air travel to a deferred revenue account until the travel service is provided, at which point it transfers the appropriate amount to the credit of sales revenue. A problem with its control system means that the proper allocation of revenue between 'sales revenue' recorded in the profit and loss and the 'deferred revenue' account balance in the balance sheet does not always occur. The auditor is considering conducting additional substantive testing to determine whether the sales transactions have been properly classified.

Required

Explain the type of misstatements in the balance sheet and income statement that the auditor should be expecting if the controls regarding the proper allocation of revenue are not functioning properly.

Source: Adapted from the CA Program's *Audit & assurance exam,* December 2010.

4.27 AUDIT STRATEGY ★ **LO3**

Clarence is a new audit junior and is attending training sessions at the audit firm. Clarence is trying to focus on the main points in the training because there will be a test at the end of the week. The topic today is audit strategy, with specific reference to the standard on planning audits. Clarence needs some advice to help him study.

Required

(a) What is an audit strategy? What is the auditing standard that directs auditors to establish an overall audit strategy?

(b) Make a summary of the process used by an auditor to determine the degree of reliance on detailed substantive procedures for a particular class of transaction.

4.28 CLIENT PERFORMANCE MEASUREMENT ★ **LO4**

Red Ltd is a media services company. It has radio, television and magazine divisions and operates in all states. Each division manager has a remuneration package that includes a base salary and short-term and long-term incentive payments based on a range of indicators. The CEO and other senior management also have remuneration packages with base salary and incentive payments, but the formulae used for each incentive payment varies. The following performance measures are used in the company's balance scorecard measure of performance and calculation of incentive payments at various levels of management:

i. net profit after tax (NPAT) performance
ii. leadership and executive development
iii. ratings performance for the television business
iv. share of advertising revenue performance
v. development and execution of business strategy
vi. cost management across the group
vii. divisional earnings before interest and tax (EBIT) performance
viii. performance for launch of new shows in the television business
ix. circulation performance for the newspaper executives
x. cost management and delivery of cost targets.

Required

(a) Why is an auditor interested in the details of senior management salary calculations?

(b) At which level of management would you expect to see the above performance measures? What would their implications be (if any) for the audit of the financial report?

4.29 ANALYTICAL PROCEDURES ★ **LO5**

Blue Ltd is in the computer sales business. Blue's auditor has conducted an analysis of the unaudited figures in preparation for setting the audit strategy. The calculations reveal that inventories turnover is lower this year than last, even more than the auditor expected given the additional competition in Blue's main markets.

Required

Explain how the turnover ratio analysis would affect the audit strategy for Blue.

4.30 PERFORMANCE MEASURES ★★ **LO4**

Unifactor provides equipment to the construction industry. The following is an extract of its unaudited 2019 financial report in relation to the property, plant and equipment (PPE) account:

	30 June 2016 (unaudited) $'000	30 June 2015 (audited) $'000
Property, plant and equipment at cost	176 250	$167 650

The auditor was appointed in November 2015. The new auditor is aware that there were major repairs conducted during the period commencing 27 April 2016 with an expected completion date of 30 July 2016. Discussions between the auditor and management of Unifactor indicate that there is a risk that Unifactor will capitalise all repair costs to minimise the impact on expenses.

Required

Explain how and why PPE would be at risk of misstatement if there is not good control over the treatment of repair costs.

Source: Adapted from the CA Program's *Audit & assurance exam,* December 2010.

4.31 AUDIT RISK COMPONENTS AND MATERIALITY ★★ **LO1, 2**

Cathy's Computers imports computer hardware and accessories from China, Japan, Korea and the United States. It has branches in every capital city and the main administration office and central warehouse is in Melbourne. There is a branch manager in each store plus a number (depending on the size of the store) of permanent staff. There are also several casual staff who work on weekends — the stores are open both Saturday and Sunday. Either the branch manager or a senior member of the permanent staff is rostered on duty at all times to supervise the casual staff. Both casual and permanent staff members are required to attend periodic company training sessions covering product knowledge and inventories and cash handling requirements.

The inventories are held after their arrival from overseas at the central warehouse and distributed to each branch on receipt of an inventories transfer request authorised by the branch manager. The value of inventories items ranges from a few cents to several thousand dollars. Competition is fierce in the computer hardware industry. New products are continuously coming onto the market and large furniture and office supply discount retailers are heavy users of advertising and other promotions to win customers from specialists like Cathy's Computers. Cathy's Computers' management has faced difficulty keeping costs of supply down and has started to use new suppliers for some computer accessories such as printers and ink.

Required

(a) Explain the inherent risks for inventories for Cathy's Computers. How would these risks affect the accounts?

(b) What strengths and weaknesses in the inventories control system can you identify in the above case?

(c) Comment on materiality for inventories at Cathy's Computers. Is inventories likely to be a material balance? Would all items of inventories be audited in the same way? Explain how the auditor would deal with these issues.

4.32 PLANNING ANALYTICAL PROCEDURES USING PROFITABILITY RATIOS ★★ LO4, 5

Li Chen has calculated profitability ratios using data extracted from his client's pre-audit trial balance. He also has the values for the same ratios for the preceding two years (using audited figures).

The data for the gross profit and profit margins are as follows:

	2018	2017	2016
Gross profit margin	0.40	0.30	0.35
Profit margin	0.09	0.15	0.18

Li is a little confused because the profit margin shows declining profitability but the gross profit margin has improved in the current year and is higher in 2018 than in the previous two years.

Required

(a) Make a list of possible explanations for the pattern observed in the gross profit and profit margins.

(b) Which of your explanations suggest additional audit work should be planned? For each, explain the accounts and/or transactions that would need special attention in the audit.

4.33 DETERMINING AN AUDIT STRATEGY ★★★ LO1, 3

Princess Island Vineyards is a boutique wine-maker based on Princess Island. Over the years, the business has grown firstly by supplying local retailers, and then through exports. In addition, there is a cellar door shop and café located next to the main processing plant on Princess Island, serving tourists who also visit the other specialist food and wine businesses in the region. Quality control over the wine manufacturing process and storage of casks and bottles at Princess Island Vineyards is extremely high. All members of the business are committed to high product quality because any poor practices which could result in a drop in wine quality would ruin the business very quickly.

The export arm has been built up to become the largest revenue earner for the business by the younger of the two brothers who have run Princess Island Vineyards since it was established. Jim Bannock has a natural flair for sales and marketing, but is not so good at completing the associated detailed paperwork. Some of the export deals have been poorly documented and Jim often agrees to different prices for different clients without consulting his older brother, Bob, or informing the sales department. Consequently, there are often disputes about invoices and Jim makes frequent adjustments to debtor accounts using credit notes when clients complain about their statements. Jim sometimes falls behind in responding to customer complaints because he is very busy juggling the demands of making export sales and running his other business, Café Consulting, which provides contract staff for the café business at Princess Island Vineyards.

Required

(a) Identify the factors that would affect the preliminary assessment of inherent risk and control risk at Princess Island Vineyards.

(b) Explain how these factors would influence the auditor's reliance on control testing and substantive testing for sales, inventories and debtors.

4.34 ANALYTICAL PROCEDURES FOR LIQUIDITY ISSUES ★★★ LO4, 5

Shapely Shoes has retail outlets in six large regional cities in the eastern states, selling ladies shoes and handbags. The shops are run by local managers but purchasing decisions for all stores are handled by Rosie Bright, the owner of the business. Shapely Shoes sells only for cash and generates sales through a reputation of low prices for quality goods. Sales are low in summer, but winter sales are usually very good and lots of high-priced boots are usually sold. Rosie is constantly monitoring cash flow, and negotiating with suppliers about payment terms and banks about interest rates and extensions of credit.

Jim Kowalski has the tasks of assessing the liquidity of Shapely Shoes and identifying the audit risks arising from this aspect of the business. Jim discovers that a major long-term debt is due for repayment one month after the close of the financial year, but Rosie is having difficulty obtaining approval from her current bank for a renewal of the debt for a further two-year term. In addition, interest rates have risen since the last fixed rate was agreed two years ago, adding an additional 2 per cent to the likely rate for the new debt (if it is approved).

The seasonality of the business means that inventories levels fluctuate considerably. At the end of the financial year (30 June) Rosie has placed pre-paid orders for the summer range and the goods have started arriving in the stores by November.

Required

(a) What liquidity and solvency issues does Shapely Shoes face? Explain the likely impact of each issue on the usual liquidity ratios.

(b) Advise Jim Kowalski about the audit risks for Shapely Shoes and suggest how he could take these into account in the audit plan.

4.35 RISK ASSESSMENT AND MATERIALITY ★★ **LO1, 2**

Dolphin Surf & Leisure Holidays Pty Ltd (Dolphin) is a resort company based on the Great Barrier Reef. Its operations include boating, surfing, diving and other leisure activities, a backpackers' hostel, a family hotel and a five-star resort. Justin and Sarah Morris own the majority of the shares in the Morris Group which controls Dolphin. Justin is the chairman of the board of directors of both Dolphin and the Morris Group, and Sarah is a director of both companies as well as the CFO of Dolphin.

In February 2017, Justin Morris approached your audit firm, Clarke Partners, to carry out the Dolphin audit for the year ended 30 June 2017. Dolphin has not been audited before but this year the audit has been requested by the company's bank and a new private equity investor group which has just acquired a 20 per cent share of Dolphin.

Dolphin employs 30 full-time staff. These workers are employed in administration, accounting, catering, cleaning and hotel/restaurant duties. During peak periods, Dolphin also uses part-time and casual workers. These workers tend to be travellers visiting the Great Barrier Reef who are looking for short-term work to help pay their travelling expenses.

Justin and Sarah have a fairly laid back management style. They trust their workers to work hard for the company and reward them well. Justin tells you that some accounts staff enjoy their jobs so much they have never taken any annual leave, and hardly any workers ever take sick leave.

There are three people currently employed as accounts staff, the most senior of which is Peter Pinn. Peter heads the accounts department and reports directly to Sarah. He is in his fifties and plans to retire in two or three years. Peter prides himself on his ability to delegate most of his work to his two accounts staff, Kristen and Julie. He claims he has to do this because he is very busy developing a policy and procedures manual for the accounting department. This delegated work includes opening mail, processing payments and receipts, banking funds received, performing reconciliations, posting journals and performing the payroll function. Julie is a recent Chartered Accountant graduate. Kristen works part-time, coming into the office on Mondays, Wednesdays and Fridays. Kristen is responsible for posting all journal entries into the accounting system and the payroll function. Julie does the balance of the work, but they often help each other out in busy periods.

The effects of global warming on the Great Barrier Reef have been investigated by a Royal Commission. The Royal Commission's report reveals that climate change is likely to cause increasing damage to the coral reefs and devastating tropical storms over the next 10 years.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

Required

(a) What factors in the background information would you consider when determining preliminary materiality for the 2017 audit of Dolphin?

(b) Explain the effect of the factors identified in (a) above on your assessed audit risk and your initial assessment of the preliminary materiality.

Questions 4.36 and 4.37 are based on the following case.

MaxSecurity Limited (MaxSecurity) has been an audit client of Smith & Associates (S&A) for the past 15 years. MaxSecurity is based in Wollongong, where it manufactures high-tech armour-plated personnel carriers. MaxSecurity often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialised and MaxSecurity only does business with nations that have a recognised, democratically elected government. MaxSecurity maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

In September 2015, MaxSecurity installed an off-the-shelf costing system to support the highly sophisticated and cost sensitive nature of its product designs. The new system replaced a system that had been developed in-house as the old system could no longer keep up with the complex and detailed manufacturing costing process that provides tender costings. The old system also had difficulty with the company's broader reporting requirements.

The manufacturing costing system uses all of the manufacturing unit inputs to calculate and produce a database of all product costs and recommended sales prices. It also integrates with the general ledger each time there are product inventories movements such as purchases, sales, wastage and damaged stock losses.

MaxSecurity's end of financial year is 30 June.

Source: Adapted from the CA Program's *Audit & assurance exam,* May 2008.

4.36 ASSESSING INHERENT RISK ★★★ **LO1**

Based on the background information, what are the major inherent risks in the MaxSecurity audit? Consider both industry and entity risks in your answer.

4.37 ASSESSING PRELIMINARY MATERIALITY ★★★ **LO2**

Discuss the factors to consider when determining preliminary materiality for MaxSecurity.

Questions 4.38 and 4.39 are based on the following case.

Chan and Partners Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year Chan and Partners gained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home
- Total Cancer Specialists Limited (TCSL), a private oncology clinic that specialises in the treatment of cancer.

Year-end for all MSHG entities is 30 June.

On 1 April 2017, Gardens Nursing Home Pty Ltd switched from its 'home grown' patient revenue system to the MSHG equivalent system. MSHG is confident that its 'off the shelf' enterprise system would perform all of the functions that Gardens Nursing Home's home grown system performed.

Gardens Nursing Home's home grown patient revenue system comprised the following.

1. *Billing system* — produces the invoice to charge the patient for services provided such as accommodation, medications and medical services. This software includes a complex formula to calculate the patient bill allowing for government subsidies, pensioner benefits and private medical insurance company benefits plans.
2. *Patient database* — a master file containing personal details about the patient as well as the period of stay, services provided and patient's medical insurance details.
3. *Rates database* — a master file that shows all accommodation billing rates, rebate discounts and government assistance benefits.

At the request of the board, the group's internal audit unit was involved throughout the entire switch-over process. The objective of its engagement, as the board stated, is to 'make sure the switch-over worked without any problems'.

As part of the planning arrangement for the 2017 financial report audit, the audit partner Tania Fellowes asked her team to speak with a number of Gardens Nursing Home staff about the impact of the switching to the MSHG patient revenue system. Set out below is an extract of the staff feedback comments:

- 'There were some occasions where we invoiced people that were past patients. This seems to have happened when they shared the same surname as a current patient.'
- 'We seem to have some patient fee invoices where for no reason we have billed patients at a lower room rate than what we hold on the rates database.'
- 'Lately we've had an unusually high number of complaints from recently discharged patients that the fee invoice we sent them does not line up with the agreed medical fund and pensioner subsidy rates. We then found out that halfway during last month someone from the IT team made a software change to fix a bug in the billing calculation formula.'
- 'There was some sort of power surge last Friday and we had to re-enter every patient invoice that we processed in the last two weeks'.

Source: Adapted from the CA Program's *Audit & assurance exam,* December 2008.

4.38 PLANNING IN CONTEXT OF IT SYSTEM CHANGES ★★★ **LO1, 2**

Identify the audit risks associated with the installation of the new IT system for patient revenue.

4.39 DETERMINING AUDIT STRATEGY ★★ **LO3**

Comment on the audit strategy likely to be adopted for the audit of patient revenue for Gardens Nursing Home.

CASE STUDY — CLOUD 9

PART 1 Materiality

W&S Partners commenced planning the Cloud 9 audit by gaining an understanding of the client's structure and its business environment. A major task is to consider the concept of materiality as it applies to the client. The auditor will design procedures in order to identify and correct errors or irregularities that would have a material effect on the financial report and affect the decision making of the users of the financial report. Materiality is used in determining audit procedures and sample selections, and evaluating differences from client records to audit results. It is the maximum amount of misstatement, individually or in aggregate, that can be accepted in the financial report. In selecting the base figure to be used to calculate materiality, an auditor should consider the key drivers of the business. They should ask, 'What are the end users (that is, shareholders, banks etc.) of the accounts going to be looking at?' For example, will shareholders be interested in profit figures that can be used to pay dividends and increase share price?

W&S Partners' audit methodology dictates that one planning materiality (PM) amount is to be used for the financial report as a whole (that is, rather than separate PMs for the income statement and the balance sheet). Further, only one basis should be selected — a blended approach or average should not be used. The basis selected is the one determined to be the key driver of the business.

W&S Partners use the following percentages as starting points for the various bases:

Base	Threshold (%)
Profit before tax	5.0
Turnover	0.5
Gross profit	2.0
Total assets	0.5
Equity	1.0

These starting points can be increased or decreased by taking into account qualitative client factors, which could be:

- the nature of the client's business and industry (for example, rapidly changing, either through growth or downsizing, or an unstable environment)
- if the client is a listed entity (or subsidiary of) subject to regulations
- the knowledge of or high risk of fraud.

Typically, profit before tax is used; however, it cannot be used if reporting a loss for the year, if profitability is impacted significantly by 'one off' adjustments or transactions, or if the users of the financial report are not basing their investment (or other) decisions on a profit basis.

When calculating PM based on interim figures, it may be necessary to annualise the results. This allows the auditor to plan the audit properly based on an approximate projected year-end balance. Then, at year-end, the figure is adjusted, if necessary, to reflect the actual results.

Required

Using the 30 September 2016 trial balance (in the appendix to this text), calculate planning materiality and include the justification for the basis that you have used for your calculation.

When you are answering the question, you should refer to the information presented for Cloud 9 in the appendix to this text and in the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

PART 2 Analytical procedures

Required

Answer the following questions based on the information presented for Cloud 9 in the appendix to this text and the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

The trial balance for Cloud 9 as at September 2016 is included in the appendix. Note the following when analysing the company:

> The current and non-current assets and liabilities for 31 December 2015 are shown in the balance sheet. In the trial balance, non-current assets are Property, Plant and Equipment, and Deferred Tax. The non-current liabilities are Provisions $110 744 (other Provisions are current liabilities), Interest Bearing Loans — Loan with Bank $850 000 (the remainder of the balance of this account is a current liability), and Provision for Deferred Tax Liabilities $352 231.
>
> Where a ratio requires an average balance and the prior year is not available, use the current year only.
>
> Items of revenue and expense in the trial balance for September 2016 should be annualised where appropriate.

(a) Using analytical procedures and the information provided in the appendix, perform an analysis of Cloud 9's financial position and its business risks. Discuss the ratios indicating a significant or an unexpected fluctuation.

(b) Which specific areas do you believe should receive special emphasis during your audit? Consider your discussion of the analytical procedures results as well as your preliminary estimate of materiality. Prepare a memorandum to Suzie Pickering outlining potential problem areas (that is, where possible material misstatements in the financial report exist) and any other special concerns (for example, going concern).

RESEARCH QUESTION

Listed companies are required to make certain disclosures in their annual reports about the compensation paid to their top executives. One reason for this is to help interested stakeholders assess the performance of executives. It also helps executives and companies set appropriate compensation levels, based on what other companies in the same industry and/or of the same size are paying their executives. These disclosures are audited.

Required

Obtain the annual reports of 10 listed Australian companies in the same industry. (*Hint:* See www.asx.com.au for a list of companies on the ASX, industry membership and links to company websites where you can download annual reports.) Extract the information on executive remuneration and describe the data using graphs and tables. Write a report addressing the following questions (justify your responses by referring to the data where appropriate).

- How are the executives paid (cash, bonuses etc.)?
- Which companies' executives are paid the most and what is the range of pay?
- Which companies' executives' pay is most linked to the company's profit and/or share price performance? (Explain any assumptions you have to make.)
- Overall, what do you conclude about how Australian company executives are paid and how clearly the compensation data is reported?

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. d, 2. b, 3. b, 4. d, 5. d, 6. d, 7. c, 8. d, 9. b, 10. c.

NOTES

1. ASX 2010, *ASX Listing Rules — Chapter 4: Periodic disclosure*, ASX, p. 407, www.asxgroup.com.au.
2. Greenblat, E 2012, 'By all accounts, 21 companies suspended', *The Age*, 2 October, p. 3, www.theage.com.au.
3. Kruger, C 2014, 'CBD', *The Age*, 29 October, p. 22. www.theage.com.au.
4. ibid.
5. Allen, L 2010, 'Everyone needs a big holiday', *The Australian Financial Review*, 31 August, p. 1.
6. Anonymous, 2013, '$26 000 all in a day's leave', *The Australian Financial Review*, 31 May, p. 37.
7. Allen, L, loc. cit.

CHAPTER 5

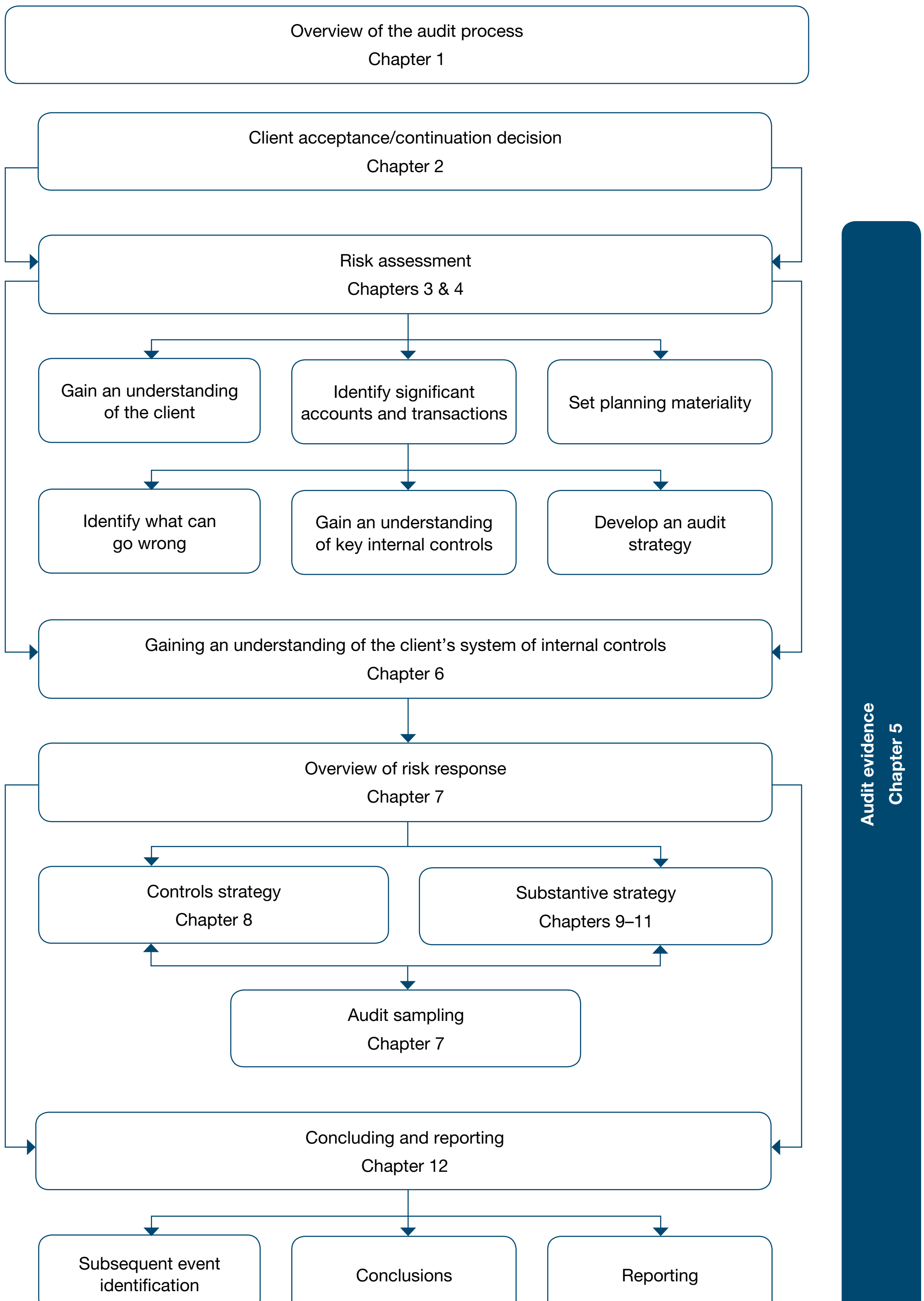
Audit evidence

LEARNING OBJECTIVES

After studying this chapter you should be able to:

5.1 explain the audit assertions
5.2 explain and appraise different types of audit evidence and assess sufficient appropriate audit evidence
5.3 describe the persuasiveness of audit evidence
5.4 explain the issues to consider when using the work of an expert
5.5 describe the issues to consider when using the work of another auditor
5.6 explain the evidence gathering procedures most often used by auditors.

AUDITING AND ASSURANCE STANDARDS	
AUSTRALIAN	**INTERNATIONAL**
ASA 230 *Audit Documentation*	ISA 230 *Audit Documentation*
ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*	ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*
ASA 330 *The Auditor's Responses to Assessed Risks*	ISA 330 *The Auditor's Responses to Assessed Risks*
ASA 500 *Audit Evidence*	ISA 500 *Audit Evidence*
ASA 502 *Audit Evidence — Specific Considerations for Litigation and Claims*	ISA 501 *Audit Evidence — Specific Considerations for Selected Items*
ASA 505 *External Confirmations*	ISA 505 *External Confirmations*
ASA 580 *Written Representations*	ISA 580 *Written Representations*
ASA 600 *Special Considerations — Audits of a Group Financial Report (Including the Work of Component Auditors)*	ISA 600 *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)*
ASA 620 *Using the Work of an Auditor's Expert*	ISA 620 *Using the Work of an Auditor's Expert*
APES 110 *Code of Ethics for Professional Accountants*	*Code of Ethics for Professional Accountants*
APES 320 *Quality Control for Firms*	ISQC 1 *Quality Control for Firms that Perform Audits and reviews of Historical Financial Information, and other Assurance and Related Services Engagements*


Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client's system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

At the next planning meeting for the Cloud 9 Pty Ltd (Cloud 9) audit, Suzie Pickering presents the results of the analytical procedures performed so far and the working draft of the audit program. The audit manager, Sharon Gallagher, and the audit senior, Josh Thomas, are also involved in the planning, with special responsibility for the internal control assessment.

The meeting's agenda is to discuss the available sources of evidence at Cloud 9 and specify these in the detailed audit program. The team also have to make sure that they have enough evidence to conduct the audit. There are two specific issues worrying members of the team. First, there are three very large asset balances on Cloud 9's trial balance that have particular valuation issues. Suzie suggests that an expert valuer will be required for the derivatives, but they can handle the trade debtors and inventory themselves. Second, Sharon is worried about the auditors of Cloud 9's parent company, Cloud 9 Inc. — the auditors did some audit work on the relationship between the two companies (Cloud 9 Inc. and Cloud 9 Pty Ltd) during the year and she hasn't been able to gain access to the confidential report yet.

The questions the team are considering in the planning meeting include the following.
- What evidence is available?
- What criteria will the team use to choose between alternative sources of evidence?
- What are the implications of using the work of experts and other auditors?

Audit process in focus

In this chapter we look at audit evidence. In chapters 3 and 4 we considered audit risk and risk assessment. A great deal of that discussion considered the importance of risk identification to help ensure that the auditor's desired level of risk is achieved. Once an auditor has identified the key risk factors for their client, they will plan their audit to obtain sufficient appropriate audit evidence to ensure that relevant accounts and related note disclosures are reported accurately. In the chapters that follow we discuss the detailed testing conducted by auditors. In these chapters, the evidence gathering procedures introduced in this chapter will be explained in more detail.

We start this chapter by defining and describing audit assertions, which are used when designing and conducting audit testing. We then consider the different types of evidence that an auditor will gather, including evidence gathered via confirmations, documentary evidence, representations, verbal evidence, computational evidence, physical evidence and electronic evidence. Each form of evidence is used to substantiate the information provided by the client in its trial balance and preliminary financial report. Some forms of evidence are more persuasive than others: internally generated evidence is the least persuasive; externally generated evidence sent directly to the auditor is the most persuasive. Examples are provided of different types of evidence and include the kinds of evidence that auditors tend to rely on most as providing the most dependable, independent proof that the amounts included in the client's financial report are true and fair.

After considering the relative persuasiveness of different types of evidence, we consider special types of evidence. In particular we consider evidence provided by experts and evidence provided by other auditors. Using the work of these two groups presents particular challenges for an auditor. These challenges are discussed in this chapter.

In the final section of this chapter, we provide an overview of the evidence gathering procedures used by auditors. These procedures include inspection of records and physical assets, observation of procedures used by clients where no audit trail is left, enquiry of client management and personnel, confirmation of balances with external parties, recalculation to ensure numerical accuracy, re-performance of procedures used by a client and analytical procedures.

5.1 Assertions

LEARNING OBJECTIVE 5.1 Explain the audit assertions.

It is the responsibility of those charged with governance to ensure that the financial report is prepared so as to give a true and fair view of the entity and its operations. When preparing the financial report, management makes **assertions** about each account and related disclosures in the notes. For example, when reporting on inventory, management should ensure that the items disclosed exist, are owned by the entity, represent a complete list of the inventory owned and are valued appropriately. When reporting on sales, management should ensure that the amount disclosed represents sales of the entity that occurred during the accounting period. They should also ensure that sales are recorded at the correct amount, represent a complete list of all sales and are classified correctly.

Auditors use assertions for transactions, account balances, and presentations and disclosures when assessing the risk of material misstatement and when designing their audit procedures. ASA 315 (ISA 315) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* provides a summary of the assertions used by auditors. Figure 5.1 shows the assertions used for transactions and events, including income statement items, for an accounting period.

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

FIGURE 5.1 Assertions about classes of transactions and events for the period under audit

When testing for **occurrence**, an auditor searches for evidence to verify that a recorded transaction or event, such as revenue or an expense item, took place and relates to the entity. This assertion is particularly important when the auditor believes that there is a risk of overstatement and that some transactions or events are recorded but did not actually occur. For example, false sales recorded to overstate revenue and profit.

When testing for **completeness**, an auditor searches for transactions or events and makes sure these have been recorded. This assertion is particularly important when the auditor believes there is a risk of understatement and that some transactions or events that should have been recorded have not been recorded; for example, expenses incurred but not recorded to understate expenses and overstate profit.

When testing for **accuracy**, an auditor searches for evidence that transactions and events have been recorded at appropriate amounts. This assertion is particularly important when the auditor believes there is a risk that the reported amounts are not accurate. For example, when a client has complex discounting systems or foreign exchange calculations where errors can easily occur.

When testing for **cut-off**, an auditor searches for evidence that transactions have been recorded in the correct accounting period. This assertion is particularly important for transactions close to year-end. For example, a client may record a sale before year-end that occurred after year-end. Or, a client may record an expense after year-end that was incurred before year-end. When testing for **classification**, an auditor ensures that transactions and events have been recorded in the proper accounts.

Figure 5.2 shows the list of assertions used when testing balance sheet items. When testing for **existence**, an auditor searches for evidence to verify that asset, liability and equity items included in the balances that appear in the financial report actually exist. This assertion is particularly important when the auditor believes there is a risk of overstatement.

Existence	Assets, liabilities and equity interests exist.
Rights and obligations	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
Completeness	All assets, liabilities and equity interests that should have been recorded have been recorded.
Valuation and allocation	Assets, liabilities and equity interests are included in the financial report at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

FIGURE 5.2 Assertions about account balances at year-end

When testing for **rights and obligations**, an auditor searches for evidence to verify that recorded assets are owned by the entity and that recorded liabilities represent commitments of the entity. This assertion is particularly important when the auditor believes there is a risk that recorded assets or liabilities are not owned by the entity. This assertion is different to existence, as the assets and liabilities may exist but may not be owned by the entity. An example of inventory that physically exists but does not satisfy the rights and obligations assertion is inventory held on consignment (and therefore not owned by the entity) which is recorded as an asset of the entity.

When testing for completeness, an auditor searches for assets, liabilities and equity items and ensures they have been recorded. This assertion is particularly important when the auditor believes there is a risk of understatement and the client has omitted some items from the balance sheet. For example, an auditor will search for unrecorded loans.

When testing for **valuation and allocation**, an auditor searches for evidence that assets, liabilities and equity items have been recorded at appropriate amounts and allocated to the correct general ledger accounts. This assertion is particularly important when the auditor believes there is a risk of over or undervaluation. For example:

- an auditor checks that inventory has been appropriately recorded at the lower of cost and net realisable value (risk of overstatement)
- an auditor tests for the adequacy of the allowance for doubtful debts provision (risk of understatement)
- an auditor checks that transactions are allocated to the correct account when auditing research and development expenditure (risk of understatement of the expense account).

CLOUD 9

Ian and Suzie have already talked in general terms about the errors that could occur in Cloud 9's debtors. For example, basic adding-up mistakes and other clerical errors could affect the debtors' total in either direction. Suzie emphasises that Cloud 9's management asserts that this error does not exist when they prepare the financial statements — they assert that debtors are valued correctly. The auditor has to gather evidence about each assertion for each transaction class, account and note in the financial report. Now that Ian understands this idea better, he is able to identify the assertions that relate to the potential errors in debtors that they discussed earlier:

- No adding-up mistakes or other clerical errors that could affect the total in either direction — valuation and allocation.

(*continued*)

- No debtors omitted when calculating the total — completeness.
- Debtors included in the total do exist at year-end — existence.
- Debtors belong to Cloud 9 — rights and obligations.
- Bad debts are written off — valuation and allocation. Suzie confirms that there can be more than one instance of a type of assertion for an account.
- Sales from the next period are not included in the earlier period — cut-off. Ian is a bit confused about this one, because cut-off is an assertion for transactions, not assets. Suzie agrees that it is a special sort of assertion that relates to transactions or events but also gives evidence about balance sheet accounts.

Figure 5.3 shows the list of assertions for presentation and disclosure. An auditor ensures that all items included in the financial report are presented and disclosed appropriately. They check that disclosed items represent events and transactions that occurred for the entity, are recorded at appropriate amounts and are described accurately. An auditor searches to ensure that all items that should have been disclosed are included in the financial report.

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

FIGURE 5.3 Assertions about presentation and disclosure

BEFORE YOU GO ON

- What will an auditor search for when testing for rights and obligations?
- What does the accuracy assertion mean?
- What is the auditor trying to ensure when conducting cut-off tests?

5.2 Types of audit evidence

LEARNING OBJECTIVE 5.2 Explain and appraise different types of audit evidence and assess sufficient appropriate audit evidence.

Audit **evidence** is the information that an auditor uses when arriving at their opinion on the truth and fairness of their client's financial report (ASA 500 (ISA 500) *Audit Evidence*). It is the responsibility of those charged with governance at a client to ensure that the financial report is prepared in accordance with Australian Accounting Standards and the *Corporations Act 2001*. They are also responsible for ensuring that accurate accounting records are maintained and any potential misstatements are prevented, or detected and corrected. It is the responsibility of the auditor to gather sufficient appropriate evidence to arrive at their opinion. Before considering the different types of evidence that an auditor will use, we start this section with a discussion of what is meant by the term sufficient appropriate evidence.

5.2.1 Sufficient appropriate audit evidence

Sufficient appropriate evidence is a core concept in auditing. Sufficiency relates to the quantity and appropriateness relates to the quality of audit evidence gathered. These concepts are interrelated as the quality of evidence gathered will affect the quantity required. In chapter 7, we will describe audit sampling, which is related to the concept of sufficiency of evidence gathered.

Audit risk affects the quantity and quality of evidence gathered by an auditor during the risk response phase of the audit. When there is a significant risk that an account will be misstated and the client's system of internal controls is not considered to be effective at reducing that risk, detection risk is set as low and more high-quality evidence is gathered when conducting substantive tests of that account. This relationship is demonstrated in figure 5.4.

Audit risk = *f*	Inherent risk	Control risk	Detection risk	Evidence
	High	High	Low	High

FIGURE 5.4 High-risk account

When there is a low risk that an account will be misstated and the client's system of internal controls is considered to be adequate for that account, detection risk is set as high and less high-quality evidence is gathered when conducting substantive tests of that account. This relation is demonstrated in figure 5.5.

Audit risk = *f*	Inherent risk	Control risk	Detection risk	Evidence
	Low	Low	High	Low

FIGURE 5.5 Low-risk account

The risk patterns illustrated in figures 5.4 and 5.5 are extremes. The risk of material misstatement associated with most accounts falls somewhere in between. As such, the amount of evidence gathered when conducting substantive procedures is a matter for professional judgement and will vary from account to account and client to client. Nevertheless, there is a direct relationship between the risk of material misstatement (inherent and control risk) and the extent of quality evidence gathered when testing transactions and balances (this concept is revisited in chapter 7 where audit sampling is discussed).

The appropriateness of audit evidence is affected by its source (externally generated evidence is considered more reliable than evidence produced by the client) and by the audit assertions at risk. Evidence is considered to be more appropriate if it provides confirmation about an assertion most at risk of material misstatement. For example, if the auditor determines that the primary assertion at risk is the existence of inventory, it would not be appropriate to spend more time gathering evidence in relation to the completeness assertion than the existence assertion. By identifying the key risk areas for the client, an auditor is able to focus on gathering more (sufficient) high-quality (appropriate) evidence where the risk of material misstatement is believed to be most significant.

CLOUD 9

Ian thinks he finally understands: in order to limit the risk of an inappropriate audit opinion for Cloud 9, the audit team will assess inherent risk and control risk at the assertion level for account balances and transactions. They make these assessments after gaining an understanding of the client because these risks are influenced by the client's circumstances.

(*continued*)

If the risk of material misstatement is assessed as high, then the audit team will set detection risk as low. This means that they will need to gather more, better quality evidence than if the risk of material misstatement is assessed as low. In addition, planning materiality is set by considering what would be influential to users of the financial report. The lower the detection risk and materiality level, the more sufficient and appropriate evidence that needs to be gathered.

Suzie thinks the time spent having coffee with Ian has been well worth it!

The different types of audit evidence described in the remainder of this section include confirmations, documentary evidence, representations, verbal evidence, computational evidence, physical evidence and electronic evidence.

5.2.2 External confirmations

ASA 505 (ISA 505) *External Confirmations* provides guidance on the use of **external confirmations**. An external confirmation is sent directly by an auditor to a third party, who is asked to respond to the auditor on the matter(s) included in the confirmation letter. External confirmations can be sent to the client's bank, lawyers, lenders and debtors, and third parties holding the client's inventory.

A **bank confirmation** letter is a request for information about the amount of cash held in the bank or in overdraft, details of any loans with the bank, details of any pledges of assets made to guarantee loans and interest rates charged. This information is used to confirm, via the bank reconciliation, that the asset, cash at bank, is recorded at the appropriate amount (valuation and allocation assertion), is in the client's name (rights and obligations assertion) and that all loans with the bank are included in the liability section of the balance sheet (completeness assertion). The bank confirmation letter also requests details of interest rates paid on cash deposits and term deposits, and interest rates charged on bank overdrafts and loans. This information is used when auditing interest income and interest expense items (accuracy assertion).

An external confirmation may be sent to a client's lawyer (**legal confirmation**) if the lawyer holds documents on behalf of the client that are of relevance to the audit. A client's lawyer may hold property title deeds, patents and other documents that provide audit evidence. If a client's lawyer holds title deeds to property owned by the client, the auditor will send a confirmation letter requesting that the lawyer confirms that the title is in the client's name (rights and obligation assertion). A confirmation letter is different to a legal representation letter. A confirmation letter asks about matters of fact, such as the details of a property title deed. A representation letter asks about matters of legal opinion, such as the likely outcome of a court case. Legal representation letters are described in section 5.2.4 of this chapter.

While rare, an external confirmation may be sent to a client's suppliers and lenders (**payable confirmation**) to confirm the details of amounts owed to creditors and significant loans. Where payable confirmations are used, lenders provide details of amounts outstanding at year-end (completeness and valuation and allocation assertions) and interest rates changed on those amounts (accuracy assertion). They also confirm that the amounts owed are to be paid by the client (rights and obligations assertion). Payable confirmations can only be used if an auditor is certain that the list of lenders supplied by their client is complete as it does not provide evidence regarding the completeness assertion.

External confirmations can be sent to debtors (**receivable confirmation**) to verify the receivables balance. The auditor will select the debtors to whom they will send confirmations. Criteria used when selecting the debtors to be sent confirmations include materiality (large trade receivables), age (overdue accounts) and location (if debtors are dispersed, a selection from various locations). The primary assertion when using receivable confirmations is existence — they provide audit evidence that debtors exist. They also provide some evidence on ownership (rights and obligations assertion), as debtors confirm that they owe money to the client. As debtors are asked to confirm that they owe the amount outstanding at year-end, very little evidence is provided regarding the valuation and allocation assertion. Debtors only confirm the amount owing; they do not confirm their intention to pay the amount due.

External confirmations may be used when a client owns inventory that is held on its behalf in another location; that is, the inventory is held in premises not owned by the client. In this case the auditor may send a confirmation asking the third party owner of the premises where the inventory is held to verify the description and quantity of inventory held. This type of confirmation provides audit evidence that the inventory recorded by the client exists (existence assertion), is complete (completeness assertion) and is owned by the client (rights and obligations assertion).

There are two broad types of external confirmations: positive and negative confirmations. **Positive confirmations** ask the recipient to reply in all circumstances. **Negative confirmations** ask the recipient to reply only if they disagree with the information provided. If a recipient does not respond to a negative confirmation it is assumed that they agree with the information provided. This form of request is of limited benefit when the assertion being tested is existence. A negative confirmation may be used when an auditor has conducted detailed testing for existence using alternate procedures such as sighting signed delivery dockets. In this case the negative confirmation is used to corroborate other evidence. Positive confirmations provide superior evidence as a non-response from a negative confirmation request may provide false reassurance. For example, a client may record fake sales to customers that do not exist close to year-end to boost revenue. A non-response from a non-existent customer may be interpreted by an auditor as confirmation that the customer agrees with the amount outstanding. In this case the conclusion would be unjustified.

When an auditor sends a receivable confirmation they ordinarily include the amount recorded in their client's records for each debtor to confirm. There is a risk that a debtor may sign and return the confirmation to the auditor without checking the balance outstanding. As the primary assertion being tested when using this audit procedure is existence, rather than valuation and allocation, this issue is not of great concern. The auditor will rely on other procedures to provide evidence on the valuation and allocation of the trade receivable balance. If an auditor were to send a confirmation to debtors requesting that they provide the balance outstanding, there is a risk that debtors will not respond as locating the amount owed takes some effort to find, which would reduce the overall response rate and the amount of evidence available for the existence assertion.

PROFESSIONAL ENVIRONMENT

Updating audit confirmation standards

How has technology influenced audit practice and standards? According to Daniel Goelzer, a member of the Public Company Accounting Oversight Board (PCAOB) in the United States, it has affected practice more than the standards. Goelzer believes that changes to the US standard on audit confirmations (AU Section 330[1]) are necessary to bring it into the twenty-first century.[2] Goelzer suggests that technological innovations such as the internet and email have changed confirmation practice since AU Section 330 was written in the early 1990s.[3]

In the United States the practice of audit confirmations is essentially mandatory, unlike the situation that typically prevails in the rest of the world where confirmations are an optional procedure — a tool available for auditors to select as part of a package of audit procedures.[4] The US requirement to use confirmations dates back to a famous fraud case, McKesson Robbins, in the 1930s.[5] In that case around US$19 million of a total of US$87 million in assets were entirely fictitious and the fraud would probably have been discovered if audit confirmations had been used appropriately.[6] More recent scandals, such as the Madoff, Satyam and Parmalat cases, have meant that the confirmation process is back in the spotlight.[7]

(*continued*)

The PCAOB is still debating responses to a concept release on possible revisions to the audit confirmations standard. Public comment has been sought on whether changes are necessary, and, if they are required, how those changes would have an impact on a new standard.

The PCAOB believes that the new confirmations standard should take into account today's sophisticated security and encryption tools for email and online transactions. Specifically, some confirming parties have indicated that instead of responding to confirmation requests, they prefer to allow the auditors to have electronic access to the company's accounts so the auditor may directly check the confirming party's records.[8] PCAOB member Steven Harris believes 'the standard should address the use and reliability of confirmations received electronically'. 'It should address the authenticity and accuracy of direct access to online account information.'[9] In addition, auditors are continually faced with disclaimers — clauses inserted into a client's customer's reply to a confirmation request disclaiming responsibility for any inaccuracy in the information provided. In a litigious society such as the United States, these disclaimers are routinely used to avoid legal liability for statements made. However, the auditor is then faced with a decision; that is, how much weight to place on a statement that is accompanied by a disclaimer? The PCAOB has included this issue in its request for public comment on the new standard.

Following the redrafting of the Australian Auditing Standards, paragraph A12 of ASA 505 addresses the issue of validating the source of replies received in electronic format, such as email. It may be possible for the auditor to establish a secure environment for electronic responses, for example, by the use of encryption, electronic digital signatures, and procedures to verify website authenticity. However, if this is not possible and the auditor has doubts about the reliability of any form of evidence obtained through the confirmation procedure, ASA 505 requires the auditor to consider alternative procedures; for example, telephone contact with the respondent (ASA 505, para. A14). Several banks, including Westpac, are now using online audit confirmation services and have advised their customers and auditors that as of 1 June 2015 they do not accept paper requests.[10]

CLOUD 9

Suzie explains to Ian that they can use external confirmations to gather sufficient and appropriate evidence about Cloud 9's debtors' existence, and rights and obligations. However, the confirmations will not be sufficient for valuation purposes, as a reply from a debtor to confirm the debt exists does not mean that the debtor is going to be able to pay the debt when it is due. They will use other evidence to provide evidence about the valuation assertion for debtors.

Suzie also suggests that bank confirmations will be useful on the Cloud 9 audit for the rights and obligations, existence, and valuation assertions for bank accounts. Because they will also ask the banks to supply any information they have about any other bank accounts or loans, bank confirmations will also be useful for gathering evidence about the completeness assertion for these accounts. Suzie suggests that they do not rely on payable confirmations. This is because the biggest issue with these liabilities is discovering any omitted liabilities, not confirming the existence of the liabilities the client has already disclosed to them.

Suzie incorporates her ideas on confirmations into the draft audit program.

5.2.3 Documentary evidence

Documentary evidence includes invoices, suppliers' statements, bank statements, minutes of meetings, correspondence and legal agreements. It may be internally generated or externally generated. Internally generated documents are produced by the client. Externally generated documents are generated by third parties. The persuasiveness of audit evidence varies depending on its source. This issue is explained in detail in the next section of this chapter.

There are a number of ways that documentary evidence can be used during an audit. An auditor can match details recorded in a client's accounting records to supporting (external) documents to verify the amount recorded. For example, details of the price paid for inventory may be vouched to a supplier's invoice to verify the amount recorded. This provides evidence on the accuracy of the purchase price (accuracy assertion). Recorded investments may be vouched to share scripts or their electronic equivalent to gain evidence that the investments exist (existence assertion) and they are owned by the client (rights and obligations assertion).

Documents can be read and details traced to a client's accounting records and financial report to ensure that items are included correctly (classification and understandability assertion). An auditor may ensure that all inventory held by a third party is included in the client's records (completeness assertion). An auditor may ensure that all loans confirmed by external parties are included in the client's records (completeness assertion). Details of lease agreements can be read to ensure that leases are disclosed accurately in the body and the notes to the financial report (classification and understandability assertion). The minutes of board meetings are read to ensure that relevant issues are adequately disclosed in the notes to the financial report (classification and understandability assertion).

CLOUD 9

An example of documentary evidence that will be useful for auditing Cloud 9's debtors is cash receipts from debtors after year-end. If the debtor pays the account owing at year-end, there is little doubt about its valuation at year-end. However, sales returns or evidence of disputes with debtors during the post-year-end period provide evidence that valuation and existence are in doubt.

Also, Suzie recommends in the draft audit program that the complex inventory transactions (importing from overseas plants with payment in US dollars) can be audited through the relevant documents showing dates of shipping and arrival, and details of the goods. She is particularly concerned about auditing the 'goods in transit' balance using this evidence. The forward exchange contracts (used because the goods are purchased in US dollars but the accounts are kept in Australian dollars) are vital pieces of evidence that will be used to establish the correct valuation of the inventory balances, trade creditors and cost of sales.

Sharon and Josh note in the audit program that there are many other documents that will be used as evidence, including the board meeting minutes, lease agreement (for the premises), sponsorship agreements, loan agreements and other documents supporting the accounting records.

5.2.4 Representations

ASA 502 (ISA 501) *Audit Evidence — Specific Considerations for Litigation and Claims* requires an auditor to gather sufficient appropriate audit evidence regarding any legal matters involving their client. Evidence is gathered from board meeting minutes, discussions with client personnel and representation letters from their client's lawyers. When an auditor has reason to believe that legal issues exist which may affect the financial report, such as the client being sued by a third party, or when a legal firm is engaged by the client for the first time, a representation letter is requested from the legal firm(s) that their client deals with. An auditor will come to this conclusion after enquiries of client personnel, reading board meeting minutes, reading other documentation such as contracts and leases, reviewing legal expenses and reading correspondence between their client and third parties.

A **legal representation letter** is generally sent by the client to its lawyers asking them to complete the representation letter and send it directly to the auditor. According to ASA 502 the legal representation letter can include any legal matters involving the client, the lawyer's opinion on the client's description of any outstanding legal matters and whether the client's evaluation of those matters appear reasonable. It can include a request to provide details of any legal matters that the lawyer is in disagreement with the client. Appendix 1 of ASA 502 contains an example of a request for a representation letter from a client to their lawyer. Figure 5.6 contains another example of a legal (solicitor's) representation letter.

FJR Limited

29 July 2016
Lawless and Associates
21 Cherrytree Lane
Big City

Dear Mr Jones

SOLICITOR'S REPRESENTATION LETTER REQUEST

In connection with the preparation and audit of the financial report of the entity and the following controlled entities:

PLD Ltd
XFS Ltd
Rom Ltd
Rubicon Ltd

for the financial year ended 30 June 2016 we request that you provide to this entity, at our cost, the following information, including reference to any matters which have arisen in the period between the date of this letter and your reply, and based upon the instructions received by your firm:

1. Confirmation that you are acting for the entity (and the above mentioned controlled entities/divisions) in relation to the respective matters mentioned below and that the directors' description and estimates of the amounts of the financial settlement (including costs and disbursements) which might arise in relation to those matters are in your opinion reasonable.

Name of entity (subsidiary or division)	Directors' description of matter (including current status)	Directors' estimate of the financial settlement (inclusive of costs and disbursements)
FJ Sales Division	Unfair dismissal claim by ex-employee	$150 000
FJR Limited	Warranty claim regarding faulty raw materials used in production	$1.5 million

2. Should you disagree with any of the information included in 1 above, please comment on the nature of your disagreement.

3. In addition to the above, a list of open files that you maintain in relation to the entity (and the above mentioned controlled entities/divisions). Separately identify items that have arisen since (date of end of financial year) and up to the date of your reply.

   For your information, the term 'legal matters' refers to matters referred to solicitors by an entity relating to pending or potential litigation which may result in actual or contingent liabilities, and other matters referred to solicitors which may affect the financial position or the results of the entity's operations.

4. Having regard to the present status of the matters under consideration and on the basis that your opinion may change during the conduct of such matters, please outline any factors that have limited your response to these enquiries.

5. In relation to the matters identified above, we authorise you to discuss these matters with our auditor Bill Smythe at EY, if requested.

It is understood that:

(a) The entity (or the above mentioned controlled entities/divisions) may have used other solicitors in certain matters.

(b) The information sought relates only to information relating to legal matters referred to your firm (including branches or controlled entities) which were current at any time during the above mentioned financial year, or have arisen since the end of the financial year and up to the date of your response.

(c) Unless separately requested in writing, you are not responsible for keeping the auditors advised of any changes after the date of your reply.

(d) You are only required to respond on matters referred to you as solicitors for the entity (and the above mentioned controlled entities/divisions), not on those within your knowledge solely because of the holding of any office as director, secretary or otherwise of the entity (and the above mentioned controlled entities/divisions) by a consultant, partner or employee of your firm.

(e) Your reply is sought solely for the information of, and assistance to, this entity in connection with the audit of, and report with respect to, the financial report of the entity (and the above mentioned controlled entities/divisions), and will not be quoted or otherwise referred to in any financial report or related documents of the entity (or the above mentioned controlled entities/divisions), nor will it be furnished to any governmental agency or other person, subject to specific legislative requirements, without the prior written consent of your firm.

Your prompt assistance in this matter will be appreciated.

Would you please forward a signed copy of your reply directly to our auditors, EY, attention Bill Smythe, 23 Eucalyptus Lane Big City, by 12 August 2016.

Yours faithfully

K. Edwards

....

Kelly Edwards
Chief Financial Officer

FIGURE 5.6 Example of a legal representation letter

Source: EY 2012.

ASA 580 (ISA 580) *Written Representations* requires that an auditor attempt to obtain written representations from their client's management. A **management representation letter** generally includes an acknowledgement that management is responsible for the preparation of the financial report. Management is responsible for ensuring that the report is prepared in accordance with the Corporations Act giving a true and fair view of the company's financial position and complying with Australian Accounting Standards. The letter will include written details of any verbal representations made by management during the course of the audit. As verbal evidence is weaker than written evidence, an auditor will seek written confirmation of any significant discussions in the management representation letter.

The management representation letter can also include an undertaking that laws and regulations have been complied with, that there have been no material frauds or errors that would affect the financial report and that the internal controls system is effective. The letter can acknowledge that the auditor was provided with access to all documents, records and other evidence as requested. It can include an undertaking that the financial report includes required disclosures in relation to related parties, share options, contingent liabilities and that the company owns all assets listed. Appendix 2 of ASA 580 contains an example of a management representation letter. Figure 5.7 contains another example of a management representation letter.

FJR Limited

LETTER OF REPRESENTATION

AUDIT OF FINANCIAL REPORT

21 September 2016

Bill Smythe
Partner
EY

Dear Mr Smythe

FJR Limited and its controlled entities

This representation letter is provided in connection with your audit of the financial report of FJR Limited and its controlled entities ('the entity') for the year ended 30 June 2016. We recognise that obtaining representations from us concerning the information contained in this letter is a significant procedure in enabling you to form an opinion as to whether the financial report gives a true and fair view of the financial position of FJR Limited and the group as of 30 June 2016 and of its financial performance for the year then ended in accordance with Accounting Standards and other mandatory financial reporting requirements in Australia and the *Corporations Act 2001*.

We understand the purpose of your audit is to express an opinion on our financial report in accordance with Australian Auditing Standards. We understand the audit involved an examination of the accounting system, internal control and related data, to the extent you considered necessary in the circumstances, and is not designed to identify — nor necessarily be expected to disclose — fraud, shortages, errors and other irregularities, should any exist.

Accordingly, we make the following representations, which are true to the best of our knowledge and belief:

A. Financial Report and Financial Records

1. We acknowledge, as members of management of the entity, our responsibility for the fair presentation of the financial report. We believe the financial report referred to above gives a true and fair view of the financial position and financial performance of FJR Limited and the group in accordance with Accounting Standards and other mandatory financial reporting requirements in Australia and the *Corporations Act 2001* and is free of material misstatements, including omissions. We have approved the financial report.
2. The significant accounting policies adopted in the preparation of the *financial* report are appropriately described in the financial report.
3. Each element of the financial report is properly classified, described and disclosed in accordance with Accounting Standards and other mandatory financial reporting requirements in Australia and the *Corporations Act 2001*.

4. As members of management of the entity, we believe the entity has a system of internal controls adequate to permit the preparation of an accurate financial report in accordance with Accounting Standards and other mandatory financial reporting requirements in Australia and the *Corporations Act 2001*.

5. The financial records of the entity have been kept so as to be sufficient to enable a financial report to be prepared and audited, and other records and registers required by the *Corporations Act 2001* have been properly kept and are up-to-date.

B. Fraud and Error

1. We acknowledge we are responsible for the design and implementation of internal controls to prevent and detect fraud and error.

2. We have disclosed to you the results of our assessment of the risk that the financial report may be materially misstated as a result of fraud.

3. We have no knowledge of any fraud or suspected fraud involving management or other employees who have a significant role in the entity's internal controls over financial reporting. In addition, we have no knowledge of any fraud or suspected fraud involving other employees in which the fraud could have a material effect on the financial report. We have no knowledge of any allegations of financial improprieties, including fraud or suspected fraud, (regardless of the source or form and including without limitation, any allegations by "whistleblowers") which could result in a misstatement of the financial report or otherwise affect the financial reporting of the entity.

4. There are no unadjusted audit differences identified during the current audit and pertaining to the latest period presented.

C. Compliance with Laws and Regulations

1. We have disclosed to you all known actual or possible noncompliance with laws and regulations whose effects should be considered when preparing the financial report.

2. There has been no noncompliance with requirements of regulatory authorities that could have a material effect on the financial report in the event of noncompliance.

3. We have brought to your attention any Class Orders the entity has applied for relief during the *[period]* under the *Corporations Act 2001*.

D. Completeness of Information

1. We have made available to you all financial records and related data and all minutes of the meetings of shareholders, directors and committees of directors (or summaries of actions of recent meetings for which minutes have not yet been prepared) held through the year to the most recent meeting on the following date: 16 September 2016.

2. There are no material transactions that have not been properly recorded in the accounting records underlying the financial report.

3. We confirm the completeness of information provided regarding the identification of related parties. We have disclosed to you all information required to meet the disclosure requirements of AASB 124 Related Party Disclosures and section 300A of the *Corporations Act 2001*, in particular information relating to personally related entities for key management personnel.

4. We have brought all uncorrected misstatements to your attention.

FIGURE 5.7 Example of a management representation letter

FIGURE 5.7 (*continued*)

E. Recognition, Measurement and Disclosure

1. We believe that the significant assumptions underlying the fair value measurements and disclosures used in the preparation of the financial report are reasonable and appropriate in the circumstances. These assumptions reflect our intent and ability to carry out the restructure of the sales division and the closure of the production facility in Campbelltown.
2. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities reflected in the financial report.
3. We have disclosed to you, and the entity has complied with, all aspects of contractual agreements that could have a material effect on the financial report in the event of non-compliance, including all covenants, conditions or other requirements of all outstanding debt.

F. Ownership and Carrying Value of Assets

1. Except for assets capitalised under finance leases, the entity has satisfactory title to all assets appearing in the balance sheet, and there are no liens or encumbrances on the entity's assets, nor has any asset been pledged as collateral, other than those that are disclosed in Note 7 to the financial report. All assets to which the entity has satisfactory title appear in the balance sheet.
2. All agreements and options to buy back assets previously sold have been properly recorded and adequately disclosed in the financial report.
3. We have no plans to abandon lines of product or other plans or intentions that will result in any excess or obsolete inventory, and no inventory is stated at an amount in excess of net realisable value.
4. There are no formal or informal compensating balance arrangements with any of our cash and investment accounts. Except as disclosed in Note 12 to the financial report, we have no other line of credit arrangements or other arrangements involving restrictions on cash balances.
5. We have considered the requirements of AASB 136 *Impairment of Assets* when assessing the carrying values of non-current assets and in ensuring that no non-current assets are stated in excess of their recoverable amount.
6. Adequate provision has been made for adjustments and losses in collection of receivables.
7. Allowances for depreciation have been adjusted for items of property, plant and equipment that have been abandoned or are otherwise unusable.

G. Liabilities and Contingencies

1. All material liabilities and contingencies, including those associated with guarantees and those arising under derivative financial instruments, whether written or oral, have been disclosed to you and are appropriately reflected in the financial report.
2. We have informed you of all outstanding and possible claims, whether or not they have been discussed with legal counsel.
3. We have recorded or disclosed, as appropriate, all liabilities, both actual and contingent, and have disclosed in Note 15 to the financial report all guarantees that we have given to third parties.
4. The legal claim by MCH Ltd has been settled for the total sum of $100 000 which has been properly accrued in the financial report. No other claims in connection with litigation have been or are expected to be received.

H. Equity

1. We have properly recorded or disclosed in the financial report the share repurchase options and agreements, and shares reserved for options, warrants, conversions and other requirements.

I. Purchase and Sales Commitments and Sales Terms

1. Losses arising from purchase and sales commitments have been properly recorded and adequately disclosed in the financial report.
2. At the year end, the entity had no unusual commitments or contractual obligations of any sort which were not in the ordinary course of business and which might have an adverse effect upon the entity (e.g., contracts or purchase agreements above market price; repurchase or other agreements not in the ordinary course of business; material commitments for the purchase of property, plant and equipment; significant foreign exchange commitments; open balances on letters of credit; purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices; losses from fulfillment of, or inability to fulfill, sales commitments, etc.).
3. All material commitments for construction or acquisition of property, plant and equipment or to acquire other non-current assets, such as investments or intangibles have been disclosed in the financial report.

J. Taxation

1. Adequate amounts have been accrued for all local and foreign taxes on income including amounts applicable to prior periods not finally settled and paid. Deferred income tax has been accounted for with respect to AASB 112 *Income Taxes*. The realisation of a deferred tax asset can be regarded as being probable.

K. Independence

1. We are not aware of any act or omission on the part of the entity that does or may impact on your ability to comply with your independence obligations as auditor of the entity. We have brought to your attention any items which we consider may affect your ability to remain independent of the entity and we will continue to work with you to maintain the independence of the audit relationship.

L. Subsequent Events

1. There have been no events subsequent to period end which require adjustment of or disclosure in the financial report or notes thereto.

M. Electronic Presentation of the Financial Report

1. With respect to publication of the financial report on our website, we acknowledge that:
   - (a) we are responsible for the electronic presentation of the financial report;
   - (b) we will ensure that the electronic version of the audited financial report and the auditor's report on the website will be identical to the final signed hard copy version;
   - (c) we will clearly differentiate between audited and unaudited information in the construction of the entity's web site as we understand the potential risk of misrepresentation;

FIGURE 5.7 (*continued*)

(d) we have assessed the controls over the security and integrity of the data on the web site and that adequate procedures are in place to ensure the integrity of the information published; and

(e) we will not present the auditor's report on the full financial report with extracts only of the full financial report.

N. Other Representations

1. There are no other representations that are appropriate in the circumstances.

Yours faithfully

Orlando Ramsay

21 September 2016

Orlando Ramsay DATE

Chief Executive Officer

K. Edwards

21 September 2016

Kelly Edwards DATE

Chief Financial Officer

Source: EY 2015.

CLOUD 9

Sharon notes in the draft audit program that a management representation letter will be obtained towards the end of the audit to confirm all verbal discussions held up to that point. The legal representation letter will be completed earlier, as there does not seem to be any pending legal cases that would complicate matters.

5.2.5 Verbal evidence

Throughout the audit, an auditor meets with client management and staff to discuss various issues. **Verbal evidence** is used when gaining an understanding of the client and its internal controls system. It can be used to corroborate other forms of evidence. Verbal evidence is documented in the auditor's working papers so that a record is kept of all key discussions with the client.

5.2.6 Computational evidence

Computational evidence is gathered when an auditor checks the mathematical accuracy of the numbers that appear in the financial report (accuracy and valuation and allocation assertions). This involves re-adding the entries included in a client's journals and ledgers. It involves recomputing more complex calculations such as foreign currency translation, fringe benefits tax, interest of loans outstanding and fair value modelling. When conducting complex re-computations, an auditor agrees the amounts included in the calculations to externally prepared documentary evidence, where available, as well as checking that the formulae used are applied appropriately.

5.2.7 Physical evidence

An auditor gathers **physical evidence** through **inspection** of a client's tangible assets, such as its inventory and fixed assets. An auditor vouches recorded amounts to assets to gain evidence that the assets exist (existence assertion). For example, an auditor will select inventory items from client ledgers for testing and vouch the quantities recorded to the physical items, and then count the items on hand to check that the quantities recorded are accurate. This test is done to ascertain whether the quantities recorded are accurate and that assets physically exist.

An auditor also traces details of tangible assets on hand back to the recorded amount (completeness assertion). For example, an auditor selects physical inventory items, counts the number on hand and traces them back to client records to make sure that the records are complete. This test is done to ascertain whether quantities on hand are accurately included in the client's records.

An auditor inspects a client's physical assets to ascertain whether machinery is functioning, inventory appear to be in good repair and fixed assets are well looked after. This evidence is used to determine whether assets should be written down below current book value (valuation and allocation assertion). If inventory appear dusty, perhaps the client is having difficulty selling those goods. If machinery is not being used, perhaps it is obsolete or redundant. If the auditor does not have the expertise to ascertain the value of a client's assets, they may ask an independent expert for some help. The process to use when using the work of an expert is discussed in section 5.4 of this chapter.

CLOUD 9

Suzie will head the team gathering evidence about inventory. There are some issues with Cloud 9's stock control, including difficulties in delivering merchandise from the warehouse to the store in a timely manner. Suzie is also concerned about the thefts at Cloud 9's retail store. Although Cloud 9's management has been very open in disclosing the thefts, Suzie is concerned about what this means for the quality of stock control. She plans to inspect inventory and gather physical evidence of its existence and quality (because obsolescence is another major concern).

Sharon will also assign a team to inspect the furniture and equipment, and the leasehold improvements, as there have been some major additions this year (because of the new store opening).

Ian is a little concerned about being asked to gather physical evidence. 'I don't understand how physical evidence can sometimes relate to the existence assertion and other times relate to the completeness assertion. How do I know when the evidence relates to one assertion and not the other?' he asks Suzie.

Suzie tries to explain that it depends on the process. If you start with the accounting records and then gather physical evidence to support the records, you are gathering evidence about existence. For example, the furniture and equipment ledger account has a record stating that Cloud 9 owns a photocopier. The record contains information about brand, size and other details. Can you agree the records to the physical item; that is, can you find the photocopier in the office? If so, you have evidence that it exists. (You would also do separate tests for its valuation and rights and obligations.) However, if you start with the photocopier, for example, you see a photocopier in the office, your question is then whether the item is in the accounting records. That is, are the accounting records complete? In this case you start with the physical item and trace it to the records. If the photocopier is entered in the ledger (furniture and equipment), you have evidence about the completeness of the accounting records.

5.2.8 Electronic evidence

Electronic evidence includes data held on a client's computer, files sent via email to the auditor, and scanned and faxed items. Transactions are commonly initiated and stored electronically. They leave no paper trail. To access the details of these transactions, an auditor must access their client's computer system, where details are kept. It is now common for companies to send their auditors copies of their accounting records and files via email. The auditor then searches for corroborating evidence to verify the amounts included in those files.

If a company initiates and completes a transaction electronically, its auditor will use the electronic evidence to establish that the transaction occurred (occurrence assertion). For example, a client emails a supplier placing an order; the supplier replies via email confirming the order has been received; the supplier provides details regarding the estimated delivery date and the amount to be invoiced upon delivery of the goods; the client's receiving department notifies the accounts department that the goods ordered have been received; the client initiates an electronic transfer of funds from its bank account to its supplier's bank account.

The extent to which an auditor can rely on electronic evidence produced by their client's computer system will depend a great deal on the internal controls in place. As discussed in chapter 3, IT creates risks within a client's accounting system. An auditor must consider those unique risks and assess the effectiveness of their client's internal controls in mitigating those risks. Chapter 8 contains a discussion of the methods used by an auditor when testing their client's internal controls, including those that protect data created and stored electronically.

CLOUD 9

Josh is an expert on the computer systems Cloud 9 uses to process transactions, and the audit program will show him as leading the team assessing the controls and performing the associated tests.

BEFORE YOU GO ON

- What is a bank confirmation?
- List three things that may be included in a legal representation letter.
- Which assertion is tested when an auditor traces details of tangible assets on hand back to the recorded amount?

5.3 Persuasiveness of audit evidence

LEARNING OBJECTIVE 5.3 Describe the persuasiveness of audit evidence.

As detailed earlier, when an auditor accesses their client's records, they then search for **corroborating evidence** to prove that recorded amounts are accurate. Corroborating evidence relates to each of the headings used in the previous section of this chapter. Specifically, an auditor verifies amounts recorded in their client's records using confirmations, documentary evidence, representations, verbal evidence, computational evidence, physical evidence and electronic evidence.

There are three broad categories of corroborating evidence. Each category varies in its persuasiveness. The categories are internally generated evidence, externally generated evidence held by the client, and externally generated evidence sent directly to the auditor. Each category will now be discussed in turn.

5.3.1 Internally generated evidence

Internally generated evidence held by the client includes records of cheques sent, copies of invoices and statements sent to customers, purchase orders, company documentation regarding policies and procedures, contracts, minutes of meetings, journals, ledgers, trial balances, spreadsheets, worksheets, reconciliations, calculations and computations. This evidence may be held electronically (soft copy) or in paper form (hard copy). Auditors document in their working papers details of their meetings with client management and staff to gain an understanding of the client's business and system of internal controls. Internally generated evidence is the least persuasive as it can only be used to verify that a client has accurately converted this information into the financial report. That is, as the client generates and holds this evidence, it is possible that evidence may be manipulated or omitted.

5.3.2 Externally generated evidence held by the client

Externally generated evidence held by the client includes supplier invoices and statements, customer orders, bank statements, contracts, lease agreements and tax assessments. These sources of evidence are quite persuasive as they are produced by third parties. It is, however, possible that the client can manipulate these documents, which reduces their reliability to the auditor. Also, if the client provides the auditor with photocopies of information from these external sources, rather than originals, the reliability is reduced.

5.3.3 Externally generated evidence sent directly to the auditor

Externally generated evidence sent directly to the auditor includes bank confirmations, debtors' confirmations, correspondence with the client's lawyers, including confirmations and representations, and expert valuations. These sources of evidence are considered to be the most reliable and best quality as they are independent of the client. As this evidence is generated by third parties and sent directly to the auditor, the client does not have an opportunity to alter it. Further, externally generated evidence is considered the most persuasive when the source of that evidence is considered to be reliable, trustworthy and independent of the client.

CLOUD 9

Whenever Suzie's draft audit program shows the team relying on internally generated evidence (or verbal evidence), it also includes additional requirements to obtain evidence from another source. This is because the evidence obtained from the client is less persuasive than evidence gathered directly by an auditor or externally sourced evidence that has passed through the client's hands.

BEFORE YOU GO ON

- What are the three broad categories of corroborating evidence?
- What is the risk when using evidence that is held by the client?
- Which is the least persuasive evidence?

5.4 Using the work of an expert

LEARNING OBJECTIVE 5.4 Explain the issues to consider when using the work of an expert.

It may be necessary to engage the services of an **expert** if an auditor does not have the requisite skills and knowledge to assess the validity of an account or a transaction. An expert is someone with the skill, knowledge and experience required to aid the auditor when gathering evidence. An expert may be a member of the audit firm, who is not a member of the audit team, an employee of the client, or a person independent of both the audit firm and its client.

ASA 620 (ISA 620) *Using the Work of an Auditor's Expert* provides guidelines for auditors when using the work of an expert. An auditor firstly assesses whether an expert is required. If it is decided that an expert is required, an auditor then determines the scope of work to be carried out. When selecting an expert to complete the work, an auditor assesses the capacity of the expert to do so and their objectivity. Once an expert has completed their work, an auditor assesses that work and draws conclusions based upon that assessment, as the ultimate responsibility for drawing conclusions based upon gathered evidence rests with the auditor. Each of these stages when considering the use of an expert is now discussed.

5.4.1 Assessing the need to use an expert

When gathering evidence, an auditor may decide that they do not have the expertise necessary to test and evaluate the accuracy of reported information. They may decide that they require assistance in the form of an expert opinion or report to corroborate other evidence obtained. For example, a registered valuer may be engaged to provide an opinion on the value of a client's property; a geologist may be engaged to evaluate the quantity and quality of mineral deposits; a vintner may be engaged to assess the quality and value of wine stocks; an actuary may be engaged to verify insurance premiums.

The need to engage the services of an expert depends upon the knowledge of the audit team, the significance and complexity of the item being assessed, and the availability of appropriate alternative corroborating evidence. If the audit team has experience with the item being audited and can draw on their knowledge from previous audits of that client or similar companies in the same industry, there is less need to use an expert. The greater the risk of material misstatement of the item under consideration, the more likely an auditor will turn to an expert for their advice. To summarise, the less knowledge an audit team has of the item under consideration, the greater the risk of material misstatement and the less corroborating evidence available, the more likely an auditor will conclude that an expert opinion is required.

5.4.2 Determining the scope of the work to be carried out

Once it has been determined that an expert opinion is required, the scope of the work to be carried out is determined by the auditor and communicated to the expert. This involves setting the nature, timing and extent of work to be completed by the expert. It is important that the auditor is involved in setting the scope of the work required as the judgement of the expert forms part of the audit evidence upon which the auditor forms their audit opinion.

Written instructions to an expert can cover the issues that the expert is to report upon, such as the market price of properties owned by the client; the details to be included in the report, such as the computations used in arriving at their opinion; the sources of data to be used, such as market interest rates or market prices of shares; clarification of the way that the auditor intends to use the information included in the expert's report; and notice of the requirement that the expert's report and the data used in compiling the report, must remain confidential.

5.4.3 Assessing the capability of the expert

Before contacting an expert, an auditor assesses their capacity to complete the work required. This involves an evaluation of the expert's qualifications as a member of a relevant professional (or similar) body. The reputation of the expert within their field and the extent of their experience in providing the type of opinion or report sought by the auditor are also assessed. It is important that the expert's knowledge and experience are appropriate.

5.4.4 Assessing the objectivity of the expert

Objectivity refers to the ability to form an opinion or arrive at a conclusion without the influence of personal preferences. An expert is expected to be more objective if they are not associated with the client. An association will exist when the expert is an employee of the company or in some other way connected with the client (for example, related to one of the key personnel of the client or financially linked with the client).

When an expert is an employee of the client or in some other way connected with the client, an auditor assesses the objectivity of the expert with reference to their professional status, their reputation and the auditor's prior experience with the expert. If an expert's opinion has proven to be accurate in the past, it increases the reliability the auditor may place on the expert's opinion in the current audit. Nevertheless, the less independent the expert is from the client, the more corroborating evidence the auditor will require.

5.4.5 Assessing the expert's report

It is important that an expert's report be written in such a way that an auditor, who is not an expert in the field being reported on, can understand the technical content of the report. The report should detail each stage of the process used in arriving at the overall opinion or conclusion of the report. It should include information about the data sources or estimation models used, or calculations conducted. The auditor assesses the appropriateness of the data sources used — it is essential that the expert uses data sources that are reputable and reliable. The auditor assesses the consistency of any assumptions made with those made in prior years and with other known information. The auditor assesses the consistency of information included in the expert's report with their understanding of the client. Finally, the auditor assesses the consistency of the conclusions drawn with corroborating evidence gathered by the audit team.

5.4.6 Responsibility for the conclusion

The responsibility for arriving at an overall conclusion regarding the truth and fairness of a client's financial report rests with the auditor. When an auditor decides to use an expert, that responsibility is not reduced in any way. It is the responsibility of the auditor to assess the quality of the evidence provided by an expert and determine whether it is reliable and objective. An auditor does this by following the process outlined above. They will determine the need for an expert, the scope of the expert's work and the competence and objectivity of the expert. Finally, the auditor will assess the quality of the expert's report and the reliability of the information included in it.

CLOUD 9

Suzie will take responsibility for obtaining an expert opinion on the derivatives. She knows that W&S Partners has other staff (who are not part of the audit team) who can provide additional expertise. However, because she believes the accounts are so material to the audit and derivatives have become such a big issue in audits in recent years, she deems an external expert's opinion is also required. She has some experience of using a derivatives expert on prior audits of clients in the footwear and clothing industry, and she also plans to ask Jo Wadley (the partner) to recommend a suitable expert.

Suzie plans to investigate any possible connections between the expert and Cloud 9 that could adversely affect the expert's independence before engaging them for this audit.

PROFESSIONAL ENVIRONMENT

Working with IT auditors

Specialist IT auditors are often used in audits of clients with complex information technology (IT) environments because the effective audit of the IT systems contributes to overall audit quality. Large audit firms usually have such specialists within the firm, but smaller audit firms could be forced to engage external IT consultants for this part of the financial report audit. In general, reliance on an IT specialist is appropriate when the financial auditor complies with the conditions of ASA 620 (ISA 620).

(*continued*)

If the IT expert and the financial report auditor do not work well together, audit quality can be impaired. For this reason, researchers have investigated the factors that affect the way that financial report auditors work with specialist IT auditors. Brazel reviewed the research evidence and drew the following conclusions.[11]

First, responses from financial report auditors in the United States who were surveyed about their experiences with IT auditors indicated that they believe IT auditors' competence levels vary in practice. Financial report auditors also said that IT auditors appear to be overconfident in their abilities in some settings, and questioned the value provided by IT auditors to the financial report audit.

Second, Brazel suggests that the research shows that both financial report auditors' IT ability and experience and the IT auditor's competence affect how these two professions interact on an audit engagement. This indicates that audit firms need to ensure that staff training and scheduling produce appropriate combinations of financial report auditors and IT auditors on an engagement.

Finally, Brazel argues that the research findings mean that auditors need to consider the implications of finding a balance between greater computer assisted audit technique (CAAT) training for financial report auditors and greater use of IT specialists for overall audit efficiency and effectiveness.

The role of IT audit specialists could grow to become even more than a support function for auditors. Some researchers suggest that in e-businesses the external financial auditor's authority will be challenged by IT audit specialists because of technological change and its impact on auditing.[12] In e-businesses, economic transactions are captured, measured, and reported on a real-time basis without either internal human intervention or paper documentation.[13] Auditing is likely to become more real-time and continuous to reflect the pattern of the transactions. If traditional auditors are unwilling or unable to adapt to the new environment, their role could be taken over by IT specialists.

Other developments such as reporting using XBRL (eXtensible Business Reporting Language) provide challenges for auditors as they have to adapt their techniques and approaches to audit financial information that is disaggregated and tagged. Users can extract and analyse XBRL data directly without re-entry and the tag provides additional information about the calculation and source of the data. This means that auditors have to recognise that their clients are reporting financial data with different levels of information and that users might have greater expectations of the data. Learn more about XBRL at www.xbrl.org.

BEFORE YOU GO ON

- What factors may influence an auditor's decision on the need to use an expert?
- How might an auditor assess the capacity of an expert?
- Why is it important that an expert's report include details of data sources used?

5.5 Using the work of another auditor

LEARNING OBJECTIVE 5.5 Describe the issues to consider when using the work of another auditor.

ASA 600 (ISA 600) *Special Considerations — Audits of a Group Financial Report (Including the Work of Component Auditors)* provides guidance when using the work of another audit firm. The auditor who is responsible for signing the audit report (the **group engagement partner**) may need to rely on evidence provided by another auditor for certain components of a client's financial report. This occurs when a client operates in a number of locations, has divisions or subsidiaries spread around the country or the globe, or has significant assets in other locations.

When making a client acceptance or continuance decision an auditor will consider their capacity to undertake the audit (APES 110 *Code of Ethics for Professional Accountants* and APES 320 *Quality Control for Firms* (ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and other Assurance and Related Service Engagements*)) and the proportion of the financial report for which they will have to rely on another auditor (**component auditor**). The group engagement partner's firm should audit the majority of a client's financial report and be knowledgeable about the components of the financial report that they do not audit themselves. If this is not the case, the firm should not accept or continue to audit the client.

When assigning work to a component auditor, the group engagement partner will consider the capacity of the other auditor to undertake the work. The group engagement partner will also consider the reputation of the component auditor and ensure that they are a member of a reputable professional body. It is the responsibility of the group engagement partner to ensure that the work completed by a component auditor meets the group engagement partner's requirements and standards.

ASA 600 (ISA 600) sets out the responsibilities of the group engagement partner when using the work of a component auditor. The group engagement partner sets out the work to be conducted by a component auditor. The two auditors may discuss the detailed procedures to be used and the group engagement partner then reviews the main conclusions drawn in the working papers of the component auditor. The extent of review of the component auditor's work depends on a number of factors. The group engagement partner will spend more time when the component of the client's financial report being audited by a component auditor is material and/or at risk of material misstatement. The group engagement partner will spend less time if the component auditor has a good reputation and/or has done audit work for the group engagement partner in the past.

The group engagement partner uses the evidence provided by a component auditor when drawing a final conclusion on the truth and fairness of a client's financial report. The findings of a component auditor on a component of the financial report will be placed in the context of the audit as a whole. If the group engagement partner is concerned about the conclusions arrived at by a component auditor they will discuss the findings with the component auditor. They may also discuss the implications of those findings with those charged with governance at the client to gain a more complete understanding of the component of the financial report audited by the component auditor. If the group engagement partner decides that the conclusions arrived at by the component auditor indicate a material misstatement in the component audited, the group engagement partner will consider issuing a modified audit opinion if the impact of the misstatement is material to the financial report taken as a whole.

If the group engagement partner is concerned that a component auditor has not been able to gather sufficient appropriate audit evidence regarding the component of the financial report audited, they will ask that further evidence be gathered. If the component auditor cannot access sufficient evidence, the engagement partner will consider issuing a modified audit opinion due to a scope limitation. This will occur when the group engagement partner is unable to obtain additional evidence on the elements of the component audited by a component auditor.

CLOUD 9

Sharon knows that Cloud 9 Inc.'s auditor in the United States completed some work that was relevant to Cloud 9 before W&S Partners was appointed to the Cloud 9 audit. She has not yet seen these audit findings and does not know whether they will affect their work. She is keen to see them because she believes that some of the findings relate to the inventory management software system (Swift). Because they don't yet have enough information to make a judgement about the usefulness of the other auditor's work, Sharon decides to include in the plan some time for a discussion between the partner (Jo Wadley) and the Cloud 9 management to discuss the other auditor's findings, and whether the audit team can have access to these findings.

BEFORE YOU GO ON

- Who is the group engagement partner?
- What are some of the factors that a group engagement partner will consider when assigning work to a component auditor?
- If the group engagement partner believes that the component auditor has not gathered sufficient appropriate audit evidence, what kind of audit report may be issued?

5.6 Evidence gathering procedures

LEARNING OBJECTIVE 5.6 Explain the evidence gathering procedures most often used by auditors.

The evidence gathering procedures described in this section are carried out at various stages of the audit, when assessing risk, gaining an understanding of the client, gaining an understanding of a client's system of internal controls, testing those controls, conducting detailed substantive testing and drawing the final conclusions. ASA 500 (ISA 500) provides guidelines, summarised below, on the primary evidence gathering procedures used by auditors.

An auditor will inspect records and documents for a variety of reasons. When testing controls, an auditor will inspect documents for evidence that, for example, calculations have been checked, balances have been reconciled, inputs have been agreed to outputs, and management have authorised significant purchases. Records and documents are inspected when conducting substantive testing to check, for example, the dates of transactions (cut-off assertion), that purchases were made by their client (rights and obligations assertion) and that a transaction occurred (occurrence assertion).

Tangible assets are inspected to provide evidence that they exist (existence assertion) and appear to be in good repair or damaged or past their use-by date (valuation and allocation assertion). When a client conducts a stocktake (inventory count) the auditor will attend and perform test counts (existence and completeness assertions).

Client staff are observed undertaking various procedures when there is no other way of establishing that a process is being used by their client. For example, an auditor will observe the opening of mail and the conduct of a stocktake to determine whether the appropriate procedures are being followed. Importantly, **observation** only provides evidence of a process at the time the auditor observes it being carried out. An auditor will need to determine whether there is evidence that the procedures observed have been applied consistently throughout the period under audit.

Enquiry is used when gaining an understanding of the client and to corroborate other evidence gathered throughout the audit. The results of enquiries of client personnel and third parties are documented by the auditor. If that evidence is particularly important, an auditor may document that information more formally and ask the other party to the discussion to sign their agreement that the auditor has recorded the discussion accurately.

Confirmations are written enquiries made by auditors of third parties. They are used to obtain evidence about particular items included in a client's records. As confirmations are costly, they will be used when alternative evidence is limited.

Recalculations are used to check the mathematical accuracy of client files and records. This will involve checking additions and more complex computations. Simple additions can be checked using **computer assisted audit techniques** (CAATs), where client data are copied into an auditor's computer and additions are recalculated using the auditor's software package. More complex calculations will be recalculated individually.

Re-performance means following a process used by a client. When testing controls, client procedures are re-performed to check controls are effective. When conducting substantive testing, client estimations are re-performed to verify amounts calculated by the client. For example, when testing the allowance for doubtful debts an auditor will re-perform the ageing of debtors to arrive at an estimated provision amount.

Analytical procedures are used to appraise relationships between financial and non-financial information. During the risk assessment phase of the audit, unusual fluctuations are identified. During the risk response phase of the audit, analytical procedures are used to evaluate the information included in the financial report (substantive analytical procedures). For example, hospital ward revenue can be estimated by counting the number of beds in the wards then multiplying by the average occupancy rate and the amount charged per day. At the final review stage of the audit, analytical procedures are used to assess whether the financial report reflects the auditor's understanding of their client.

CLOUD 9

Suzie and Ian have already begun gathering evidence by performing the analytical procedures on Cloud 9's interim results and prior period statements. Further evidence gathering at the risk assessment phase will be performed by Josh and Sharon when they begin their assessment of the internal controls system by inspecting the relevant documents. They will gather evidence from observing personnel performing their duties and making enquiries of members of Cloud 9's staff and management. In addition, the partner, Jo Wadley, held discussions with the previous auditors (Ellis & Associates) before accepting the client. The record of these discussions, plus others that Jo Wadley has held with the Cloud 9 management, are already in the evidence files.

Ian has some questions about the evidence; in particular, why the audit team is bothering to gather verbal evidence which has low persuasiveness. Suzie explains that all forms of evidence have their limitations. Observation is useful to see how staff perform their tasks (as opposed to what the manuals say they should be doing), but people often 'behave' better when they are being watched. Documents can be lost or altered, or misinterpreted, and not everything is written down. Electronic evidence is hard to audit if the system does not have a 'hack proof' audit trail. Signatures on documents do not mean that the author actually read the document properly; people can pre or post date documents. The auditor has to judge the appropriateness and sufficiency of the evidence by considering it as a whole and be prepared to follow up any problems or discrepancies until any doubts are satisfactorily resolved.

BEFORE YOU GO ON

- Why might an auditor inspect documents when testing controls?
- Provide some examples of how an auditor might use observation as part of their evidence gathering procedures.
- At which stage(s) of an audit will an auditor utilise a re-performance procedure? Explain.

SUMMARY

5.1 Explain the audit assertions.

When preparing the financial report, management will make assertions about each account and related disclosures in the notes. Auditors use these assertions to assess the risk of material misstatement and design audit procedures. The assertions used when testing transactions and events, including income statement items, are occurrence, completeness, accuracy, cut-off and classification. The assertions used when testing balance sheet items are existence, rights and obligations, completeness, and valuation and allocation.

5.2 Explain and appraise different types of audit evidence and assess sufficient appropriate audit evidence.

The different types of audit evidence include external confirmations, documentary evidence, representations, verbal evidence, computational evidence, physical evidence and electronic evidence. External confirmations are sent directly by an auditor to a third party. Documentary evidence may be generated internally by the client or externally by third parties. Representation letters are requested from a client's lawyers or management. Verbal evidence is the discussions between the auditor and client personnel or third parties. Computational evidence is gathered when an auditor checks the mathematical accuracy of figures included in the financial report. Physical evidence involves the inspection of tangible assets. Electronic evidence includes data held on a client's computer, files sent via email to the auditor, and items scanned and faxed.

Sufficiency refers to the quantity of evidence gathered. Appropriateness refers to the quality and relevance of audit evidence gathered.

5.3 Describe the persuasiveness of audit evidence.

The persuasiveness of evidence used to corroborate the details included in a client's accounts varies. Internally generated evidence held by the client is the least persuasive as the client can alter or hide this evidence. Externally generated evidence held by the client is more persuasive as it is created by an independent third party. Externally generated evidence sent directly to the auditor is the most persuasive as the client does not handle this evidence.

5.4 Explain the issues to consider when using the work of an expert.

When an auditor decides to use the work of an expert, the report produced by the expert forms part of the evidence used by an auditor when forming their audit opinion. An expert is someone with the skill, knowledge and experience required to help an auditor. The auditor determines the scope of the work to be carried out, and assesses the capability of the expert, the objectivity of the expert and the expert's report.

5.5 Describe the issues to consider when using the work of another auditor.

An auditor may need to use the work of another auditor when their client operates in a number of locations, has divisions or subsidiaries spread around the country or the globe or has significant assets in other places. When this occurs the principal auditor may need to rely on evidence provided by another auditor for certain components of their client's financial report.

5.6 Explain the evidence gathering procedures most often used by auditors.

An auditor will inspect records, documentation and tangible assets. They will observe client staff undertaking various procedures. An auditor will make enquiries of client personnel and third parties. Confirmations are sent to third parties, including banks, lawyers, lenders and debtors. An auditor will recalculate numbers appearing in client files and records to check mathematical accuracy. They will re-perform some processes used by the client to check the effectiveness of internal controls and the validity of amounts estimated by client personnel. Analytical procedures are used throughout the audit to appraise the relationships between financial and non-financial information.

KEY TERMS

Accuracy Amounts and other data relating to recorded transactions and events have been recorded appropriately.

Analytical procedures Evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Assertion Statement made by management regarding the recognition, measurement, presentation and disclosure of items included in the financial report.

Bank confirmation A letter sent directly by an auditor to their client's bank requesting information such as cash held in the bank (or overdraft), details of any loans with the bank and interest rates charged.

Classification Transactions and events have been recorded in the proper accounts.

Completeness All transactions, events, assets, liabilities and equity items that should have been recorded have been recorded.

Component auditor An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Computational evidence Evidence gathered by an auditor checking the mathematical accuracy of the numbers that appear in the financial report.

Computer assisted audit techniques Software used to interrogate and examine client data files.

Corroborating evidence Information gathered to confirm amounts recorded in client records.

Cut-off Transactions and events have been recorded in the correct accounting period.

Documentary evidence Information that provides proof about details recorded in a client's list of transactions (for example, invoices, bank statements).

Electronic evidence Data held on a client's computer, files sent via email to the auditor, items scanned and faxed.

Enquiry An evidence gathering procedure that involves asking questions verbally or in written form to gain an understanding of various matters throughout the audit.

Evidence Information gathered by the auditor which is used when forming an opinion on the truth and fairness of a client's financial report.

Existence Recorded assets, liabilities and equity interests exist.

Expert Someone with the skill, knowledge and experience required to aid the auditor when gathering sufficient appropriate evidence.

External confirmation A letter sent directly by an auditor to a third party, who is asked to respond to the auditor on the matter(s) included in the letter.

Externally generated evidence Information created by a third party (for example, supplier statements, bank statements).

Group engagement partner The auditor responsible for signing the audit report for a group of companies.

Inspection An evidence gathering procedure that involves checking documents and physical assets.

Internally generated evidence Information created by the client (for example, debtor's invoices, purchase orders).

Legal confirmation A letter sent directly by an auditor to their client's lawyer requesting information about any legal documents held by the lawyer on behalf of the client (for example, title deeds and patents).

Legal representation letter A letter sent to a client's lawyer asking them to confirm the details of legal matters outstanding identified by those charged with governance.

Management representation letter A letter from the client's management to the auditor acknowledging management's responsibility for the preparation of the financial report and details of any verbal representations made by management during the course of the audit.

Negative confirmation A letter sent directly by an auditor to a third party, who is asked to respond to the auditor on the matter(s) included in the letter only if they disagree with the information provided.
Observation An evidence gathering procedure that involves watching a procedure being carried out by another party.
Occurrence Transactions and events that have been recorded have occurred and pertain to the entity.
Payable confirmation A letter sent directly by an auditor to their client's lender or supplier requesting information about amounts owed by the client to the lender or supplier.
Physical evidence Inspection of a client's tangible assets, such as its inventory and fixed assets.
Positive confirmation A letter sent directly by an auditor to a third party, who is asked to respond to the auditor on the matter(s) included in the letter in all circumstances (that is, whether they agree or disagree with the information included in the auditor's letter).
Recalculation An evidence gathering procedure that involves checking the mathematical accuracy of client records.
Receivable confirmation A letter sent directly by an auditor to their client's debtors requesting information about amounts owed to the client by the debtor.
Re-performance An evidence gathering procedure that involves redoing processes conducted by the client.
Rights and obligations The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
Sufficient appropriate evidence Sufficiency is the quantity and appropriateness is the quality of audit evidence gathered.
Valuation and allocation Assets, liabilities and equity interests are included in the financial report at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
Verbal evidence Responses of key client personnel to auditor enquiries throughout the course of the audit.

MULTIPLE-CHOICE QUESTIONS

5.1 The auditor is responsible for: **LO2**
(a) ensuring that accurate accounting records are maintained.
(b) ensuring that any potential misstatements are prevented or detected and corrected.
(c) ensuring that the financial report is prepared in accordance with accounting standards and the law.
(d) gathering sufficient appropriate evidence to support an opinion regarding the truth and fairness of the client's financial report.

5.2 The quantity of evidence that an auditor will gather: **LO2**
(a) varies with audit risk.
(b) depends on the size of the audit team.
(c) is the same for all audits because it has to be appropriate.
(d) all of the above.

5.3 An external confirmation sent to a bank: **LO6**
(a) is relevant to the audit of interest revenue and expense.
(b) requests information about the bank balances and loan amounts.
(c) requests information about interest rates paid on deposits and charged on loans.
(d) all of the above.

5.4 When an auditor gathers documentary evidence or physical evidence to support an entry in the client's records, the auditor is gathering evidence to support: **LO1**
(a) the existence assertion.
(b) the completeness assertion.
(c) both (a) and (b).
(d) neither (a) nor (b).

5.5 When an auditor inspects tangible assets on hand and traces the details to the details recorded in the client's records, the auditor is gathering evidence to support: **LO1**
(a) the existence assertion.
(b) the completeness assertion.
(c) both (a) and (b).
(d) neither (a) nor (b).

5.6 Which is generally the most persuasive form of evidence? **LO3**
(a) Internally generated evidence.
(b) All types of evidence are equally persuasive.
(c) Externally generated evidence held by the client.
(d) Externally generated evidence sent directly to the auditor.

5.7 If an expert is engaged to assist with the audit: **LO4**
(a) ASIC must be contacted and permission obtained before the expert starts work.
(b) it means the auditor should not have taken on the audit because they are not qualified.
(c) it means the auditor does not have the requisite skill and knowledge to assess the item.
(d) the auditor does not have to take responsibility for the fair statement of the item in the financial report.

5.8 Inspecting documents, such as an invoice for the purchase of fixed assets, provides the auditor with evidence relevant to the: **LO1**
(a) accuracy assertion, because the document will show the purchase amounts.
(b) rights and obligations assertion, because the document will show the client's name as the purchaser.
(c) occurrence assertion, because the document will show that the transaction took place on the specified date.
(d) all of the above.

5.9 Analytical procedures are used to gather evidence: **LO6**
(a) at the risk assessment phase to gain an understanding of a client.
(b) at the risk response phase to evaluate information included in the financial report.
(c) at the final review stage to assess whether the financial report reflects the auditor's understanding of their client.
(d) all of the above.

5.10 Which shows the correct ranking of audit evidence from most persuasive to least persuasive? **LO3**
(a) (i) Bank statement, (ii) management representation letter, (iii) client prepared bank reconciliation, (iv) solicitor's representation letter
(b) (i) Bank statement, (ii) solicitor's representation letter, (iii) client prepared bank reconciliation, (iv) management representation letter
(c) (i) Management representation letter, (ii) solicitor's representation letter, (iii) client prepared bank reconciliation, (iv) bank statement
(d) (i) Solicitor's representation letter, (ii) management representation letter, (iii) client prepared bank reconciliation, (iv) bank statement

REVIEW QUESTIONS

5.11 Why is it important that the client records the date of a transaction accurately? **LO1**

5.12 In what way are the 'occurrence' and 'existence' assertions similar? **LO1**

5.13 Explain the difference between the 'completeness' assertion and the 'existence' assertion.

5.14 Explain how the quality of audit evidence is determined by the choice of audit procedure and the assertion at risk of material misstatement. **LO1, 2**

5.15 What is the difference between a legal confirmation and a legal representation letter? **LO6**

5.16 Why would an auditor be less likely to use payable confirmations than receivables confirmations? **LO6**

5.17 Why does an auditor have to consider the persuasiveness of corroborating evidence? Explain. **LO3**

5.18 If an auditor does not have sufficient knowledge and skill in an area, the auditor can ask for the assistance of an expert. This creates a problem — how does an auditor know if the expert's work is correct if the auditor is not also an expert? Explain. **LO4**

5.19 Under what circumstances does an auditor use the work of a component auditor? Why doesn't the group engagement partner do all of the work? **LO5**

5.20 What is the difference between recalculation and re-performance? Explain using examples. **LO6**

5.21 Explain why a search for physical items in the client's premises would be part of the test of the completeness assertion for fixed assets. **LO1, 6**

5.22 How does inspecting a client's tangible assets assist the audit of the existence assertion for fixed assets? **LO1, 6**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

5.23 ACCOUNT BALANCES AT RISK ★ **LO1**

Party Cruises is a new client of MMM Partners. Party Cruises is a low-cost cruise ship operator, travelling between Australia and five countries in South-East Asia. The planning for the first audit is underway. The auditors have become aware that police in two countries are investigating several Party Cruises employees for stealing food and other supplies from the ships' kitchens and selling it at local markets. The police have charged ten cabin stewards of Party Cruises with theft and fraud.

Required

(a) What account balances are at risk? Explain.

(b) What key assertions for the above accounts are likely to be affected?

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2010.

5.24 ASSERTIONS ★ **LO1**

A client has a material balance in property, plant and equipment. The discussions with management indicate that there is a risk the client will capitalise all repair costs to minimise the impact on profits. Repairs are likely to be material this year because of flooding at the city premises. Extensive repairs were due to be commenced in the month prior to year-end, with completion around two months later. In addition, the board papers reveal that several machines were sold during the year.

Required

Based on the above information, what accounts and assertions are likely to be affected? Explain.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2010.

5.25 ASSERTIONS AND EVIDENCE ★ **LO1, 2, 3**

The auditor is planning for the audit of a car accessories retail business. Inventory is material, and items range in value from $1 to over $500. The nature of the store means that many items are specially ordered with special branding and promotional packaging. Orders are placed six months in advance from overseas suppliers. Large deposits are required to be paid to suppliers when orders are placed. The auditor believes that the account balances for inventory and prepayments are at risk of material misstatement.

Required

(a) Identify the key assertions at risk in relation to inventory and prepayments.

(b) For each assertion in (a), identify a type of evidence that would be persuasive.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2010.

5.26 TYPES AND PERSUASIVENESS OF AUDIT EVIDENCE — ACCOUNTS RECEIVABLE ★ **LO1, 2, 3**

Dinitha is working on the audit of a client's accounts receivable. During the last few weeks she has conducted interviews with the accounts receivable manager, the chief financial officer and staff working in the accounts receivable department. She has also overseen the external confirmations of accounts receivable, 30 per cent of which required the recipient to respond whether or not the amount stated was correct. Dinitha also conducted a review of subsequent cash receipts from the client's customers. She vouched a sample of accounts receivable balances back to the underlying invoices, cash receipts and sales returns, and traced a sample of these documents to the accounts receivable ledger.

Required

(a) List the types of audit evidence gathered by Dinitha and comment on the persuasiveness of each type.
(b) Link each type of evidence to the relevant accounts receivable assertions.

5.27 TYPES AND PERSUASIVENESS OF AUDIT EVIDENCE — ACCOUNTS PAYABLE ★ **LO1, 2, 3**

The audit team is preparing for audit of accounts payable at a continuing client, Springs Ltd. Springs has grown rapidly this year and introduced new products into its business. The new products are purchased from overseas suppliers. Finn is new to the audit team and keen to make an impression. Finn suggests that the team use payable confirmations to gather evidence about the completeness of accounts payable because they provide highly persuasive evidence. Finn has already asked the client for a list of accounts payables from which the sample of suppliers will be selected for the account payable confirmation letters.

Required

Assess Finn's suggestion and explain its strengths and weaknesses.

5.28 BANK RECONCILIATIONS ★ **LO1, 2, 3**

Ali is responsible for preparing bank reconciliation statements at Broad Ltd. Broad Ltd has many bank accounts, including separate accounts for each major branch, imprest accounts for salaries and dividends, and accounts kept in foreign currency for overseas divisions. Ali maintains records including bank statements and weekly bank reconciliations for each account. In addition, there are files containing correspondence with banks about disputed transactions, dishonoured cheques from Broad Ltd's customers and other bank-initiated transactions such as fees and interest.

Required

(a) Comment on the persuasiveness of the evidence in Ali's files for Broad Ltd's financial report audit.
(b) Explain how an auditor would obtain more persuasive evidence for the relevant assertions for the bank accounts at Broad Ltd.

5.29 COMMUNICATION WITH LAWYERS ★ **LO1, 2, 6**

Conversations between the board of directors of Binny Ltd and the engagement partner of the financial audit, Seppe Del Santo, have revealed that Binny uses three legal firms. Ball and Partners performs all legal work related to property transfers, mortgages and planning applications. Brown and Associates handle all employment matters, such as claims for unfair dismissal and complex employment contracts. Zimmerman and Co. are retained for all other matters such as agreements relating to products and suppliers and any international matters.

Required

(a) What type of communication should Seppe and his audit team have with each legal firm? Explain.
(b) What procedures could Seppe perform to discover if any other legal firms have performed work for Binny during the financial year?

5.30 USING THE WORK OF AN EXPERT ★ **LO4**

The audit partner for Kumar Ltd is assessing the resources required to complete the audit. The partner is aware that Kumar Ltd has a material balance in specialised machinery and decides that an expert will be needed to provide evidence for the valuation assertion for the machinery.

Required

Explain what sources the auditor partner could use to gather information about the competence, capabilities and objectivity of an expert.

5.31 MISSTATEMENT RISK FOR DEPRECIATION ★★ LO1, 2, 3

Yellow Aviation is an existing client of PPP Partners. The auditors are aware that the impacts on airlines of the recent terrorist attacks and the global recession have been severe, with predictions of a prolonged downturn. Also, the entry of new competitors in the domestic and international markets has prompted some airlines to heavily discount flights on some routes.

The client's policies include the following:

> *Aircraft maintenance costs policy*
> The standard cost of major airframe and engine maintenance checks is capitalised and depreciated over the shorter of the scheduled usage period to the next major inspection or the remaining life of the aircraft.

Yellow Aviation's latest financial data show the aircraft and engines at cost (including major maintenance costs) to be at a similar level as last year while depreciation costs have decreased by 7 per cent.

Required

(a) What key assertions for the above accounts are likely to be affected?
(b) Explain what evidence would be persuasive in this case.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2010.

5.32 REVENUE ASSERTIONS 1 ★★ LO1, 2, 3

The audit program for the Revenue account for a client has been drafted. The following item appears:

Item	Assertion	Detailed audit procedure
1	Completeness	Select a sample of sales from the sales journal and ensure each sales invoice is supported by an authorised delivery docket and approved customer order.

Required

(a) Does the procedure address the stated assertion? Explain.
(b) If your answer to (a) is no, provide the correct assertion or explain what work would be required to address the assertion.
(c) Explain what type of evidence is obtained by performing the stated procedure. How persuasive is it?

Source: Adapted from the CA Program's *Audit & assurance exam*, July 2010.

5.33 REVENUE ASSERTIONS 2 ★★ LO1, 2, 3

The audit program for the Revenue account for a client has been drafted. The following item appears:

Item	Assertion	Detailed audit procedure
2	Cut-off	Select a sample of sales invoices recorded a few days prior to the year-end and then agree dates on the invoices to the dates on the delivery documents signed by the customer.

Required

(a) Does the procedure address the stated assertion? Explain.
(b) If your answer to (a) is no, provide the correct assertion or explain what work would be required to address the assertion.
(c) Explain what type of evidence is obtained by performing the stated procedure. How persuasive is it?

Source: Adapted from the CA Program's *Audit & assurance exam*, July 2010.

5.34 REVENUE ASSERTIONS 3 ★★ LO1, 2, 3

The audit program for the Revenue account for a client has been drafted. The following item appears:

Item	Assertion	Detailed audit procedure
3	Accuracy	Select a sample of sales from the sales journal and agree the sale price to the authorised price list.

Required

(a) Does the procedure address the stated assertion? Explain.
(b) If your answer to (a) is no, provide the correct assertion or suggest additional work.
(c) Explain what type of evidence is obtained by performing the stated procedure. How persuasive is it?

Source: Adapted from the CA Program's *Audit & assurance exam*, July 2010.

5.35 USING AN EXPERT ★★★ LO4, 5

Sunny Days is a start-up company in the renewable energy sector. The founder of Sunny Days, Fritz Herzberg, has developed cutting-edge technology to convert the energy in the sun's rays to electricity via a novel system of mirrors designed to focus the sun's rays onto tubes containing a patented type of gas, which then heats and expands to drive turbines. KKK Partners has won the contract for the first statutory audit of Sunny Days on the basis of its expertise in the energy sector. However, the lead partner, Ken Kennedy, recognises that the success of the audit is dependent on the correct assessment of the technology being used at Sunny Days. Ken specified in the successful tender documents that the audit will use an external expert to help with valuation of the company's assets.

Fritz Herzberg is very protective of his company's intellectual property and is resistant to Ken's first suggested expert, Manfred Hamburg. Fritz believes that Manfred Hamburg is hostile towards him because they clashed when they both worked for a German company making photovoltaic cells in the 1990s. Fritz has suggested another expert, Lily Beilherz, with whom he has had good working relations over the last 20 years.

Required

(a) Advise Ken Kennedy about the choice of an expert for the audit of Sunny Days. What must he consider when making his choice?
(b) Sunny Days takes over another renewable energy company during the second year of the audit. The new subsidiary is based in another state and has previously been audited by a local audit firm. How should Ken handle the new audit responsibilities brought about by the client's expansion? Explain.

5.36 GATHERING EVIDENCE ★★★ LO1, 2, 6

Max Crowe is a junior auditor who has just started with the team conducting the audit of a new client in the construction industry. Susan Wong is trying to teach Max about the benefits of getting to know the client. Susan is also trying to help Max develop experience in picking up subtle signals about the client's problems and what the client might be trying to hide from the auditor.

Max is getting a little frustrated with the time he is required to spend in training. He can't understand why Susan is spending so much time talking to the client's staff and touring the various construction sites and offices. When Susan is not doing this, she is working on a spreadsheet of the client's previous financial report and unaudited interim data. Max wants to know when they are going to do some 'real' work and start gathering audit evidence. Susan tells Max that they have already started.

Required

(a) Discuss Susan's comment that they have already started the audit. What evidence have they gathered so far?
(b) Explain what work is being done with the spreadsheets of financial data. Give some specific examples for this client. How is this type of work relevant to all stages of the audit?

(c) When Susan is touring the client's premises she is taking notes of equipment and furniture items she sees, especially anything that looks either newly purchased or older and unused. Why might she be doing this? Explain.

5.37 CONSIDERING THE WORK OF OTHER AUDITORS ★★★ **LO5**

MaxSecurity Limited (MaxSecurity) has been an audit client of Smith & Associates (S&A) for the past 15 years. MaxSecurity is based in Wollongong, where it manufactures high-tech armour-plated personnel carriers. MaxSecurity often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialised and MaxSecurity only does business with nations that have a recognised, democratically elected government. MaxSecurity maintains a highly secure environment, given the sensitive and confidential nature of its MaxSecurity vehicle designs and its clients.

Clarke Field has been the engagement partner on the MaxSecurity audit for the last five years. Clarke is a specialist in the defence industry and intends to remain as review partner when the audit is rotated next year to a new partner (Sally Woodrow, who is to be promoted to partner to enable her to sign-off on the audit).

MaxSecurity has a small internal audit department that is headed by an ex-partner of S&A, Rydell Creek. Rydell joined MaxSecurity after leaving S&A six years ago after completing his Chartered Accountants qualifications. Rydell is assisted by three junior internal auditors, all of whom are completing Bachelor of Business studies at Swanston University.

MaxSecurity end of financial year is 30 June.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

Required

Discuss the effect, if any, of ASA 600 on Clarke Field's consideration of MaxSecurity's internal audit department for the financial report audit.

Questions 5.38 and 5.39 are based on the following case.

Chan and Partners Chartered Accountants are a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year, Chan and Partners gained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home
- Total Cancer Specialists Limited (TCSL), a private oncology clinic that specialises in the treatment of cancer.

Year-end for all MSHG entities is 30 June.

You are performing the audit field work for the 2017 year for Shady Oaks Hospital. The field work must be completed in time for the audit report to be signed on 21 August 2017. You have been asked to circulate the receivable confirmations. Shady Oaks Hospital's trade receivables arise from the use of hospital facilities (including the provision of nurses, anaesthetists, operating theatres and supplies) by medical practitioners in private practice. The trade receivables balance was \$3 974 569 as at 30 June 2017 and was considered material.

The hospital's payment terms are 14 days from the date of the invoice. Sixty per cent of the balance is represented by invoices outstanding from five different medical practitioners. The remaining 40 per cent is made up of numerous smaller amounts, most of which have been outstanding for more than 60 days. Any allowance for doubtful debts is taken directly against the trade receivables account and not shown separately.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2008.

5.38 CONFIRMATION EVIDENCE ★★★ **LO2, 3, 6**

Discuss the strength and weaknesses of debtor confirmations as audit evidence for MSHG.

5.39 ADEQUACY OF DOCUMENTATION AND AUDIT EVIDENCE ★★★ LO2, 6

Is it possible for Chan and Partners to use debtor confirmations only as audit evidence?

CASE STUDY — CLOUD 9

PART 1 Inherent risk

In chapter 3, you were required to research the key market forces, as they relate to Cloud 9's operations. The topics you researched included the general and industry-specific economic trends and conditions; the competitive environment; product, customer and supplier information; technological advances and the effect of the internet; and laws and regulatory requirements. The purpose of this research is to identify the inherent risks for this client. The auditor needs to identify which financial report assertions may be affected by these inherent risks. Identifying these risks will help determine the nature of the audit procedures to be performed.

Management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of a financial report. Auditors use assertions for account balances to form a basis for the assessment of risks of material misstatement. That is, assertions are used to identify the types of errors that could occur in transactions that result in the account balance. Consequently, further breaking down the account into these assertions will direct the audit effort to those areas of higher risk. The auditors broadly classify assertions as existence or occurrence; completeness; valuation or allocation; rights and obligations; and presentation and disclosure.

Required

Based on your results from researching the client and its industry for the case study questions in earlier chapters, discuss the inherent risks in the audit of Cloud 9. Identify the associated financial accounts and assertions that would be affected and provide an assessment of 'high', 'medium' or 'low' in relation to the likelihood and materiality of the risk occurring.

PART 2 Other auditors and experts

W&S Partners will need the assistance of auditors in China and the United States and derivatives experts to complete the Cloud 9 audit.

The other auditors will be asked to provide evidence about the inventory shipped to Australia from the production plants in these countries. Although the inventory is shipped FOB (free on board), there have been several occasions where the shipping agent was unable to place the inventory on a ship. In these cases, the inventory is stored in the shipping agent's warehouse until a vessel is made available. Suzie has some concerns about the quality of the warehouses because if the goods are damaged they could become worthless and the value of 'goods in transit' will be overstated.

In addition, Suzie has asked Jo Wadley (the partner) for help in choosing an expert to help with valuation aspects of the audit of the derivatives. Jo has provided her with three names of experts in the field, but she has had no personal experience with any of them. Suzie must make a choice and engage the expert soon in order to be sure that the expert opinion will be received in time to complete the audit.

Answer the following questions based on the information presented for Cloud 9 in the appendix to this text and the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

Required

(a) Explain the procedures for engaging component auditors to perform the work on the inventory in China and the United States.

(b) Advise Suzie on engaging the derivatives expert. Discuss the qualities the expert must possess. What steps must Suzie perform? What should she tell the expert about the engagement? What must the expert provide to Suzie so that she can be sure she has sufficient appropriate evidence about the derivatives? Can the expert do all the work on derivatives, or must Suzie perform any other procedures?

RESEARCH QUESTION

Obtain the latest annual report of a large, multinational Australian company (for example, one of the large banks or mining companies).

Required

(a) What information is given in the annual report about the use of any component auditors, other than the Australian audit firm issuing the audit report (for example, in the auditor remuneration section)? If any other auditors are mentioned, what work do you think these auditors performed?

(b) Is there any information given in the annual report about the auditor's use of an expert? What sort of work would an expert have performed for the audit of your chosen company?

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. d, 2. a, 3. d, 4. a, 5. b, 6. d, 7. c, 8. d, 9. d, 10. b.

NOTES

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ACKNOWLEDGEMENTS

Figures 5.6 and 5.7: © EY Australia.

CHAPTER 6

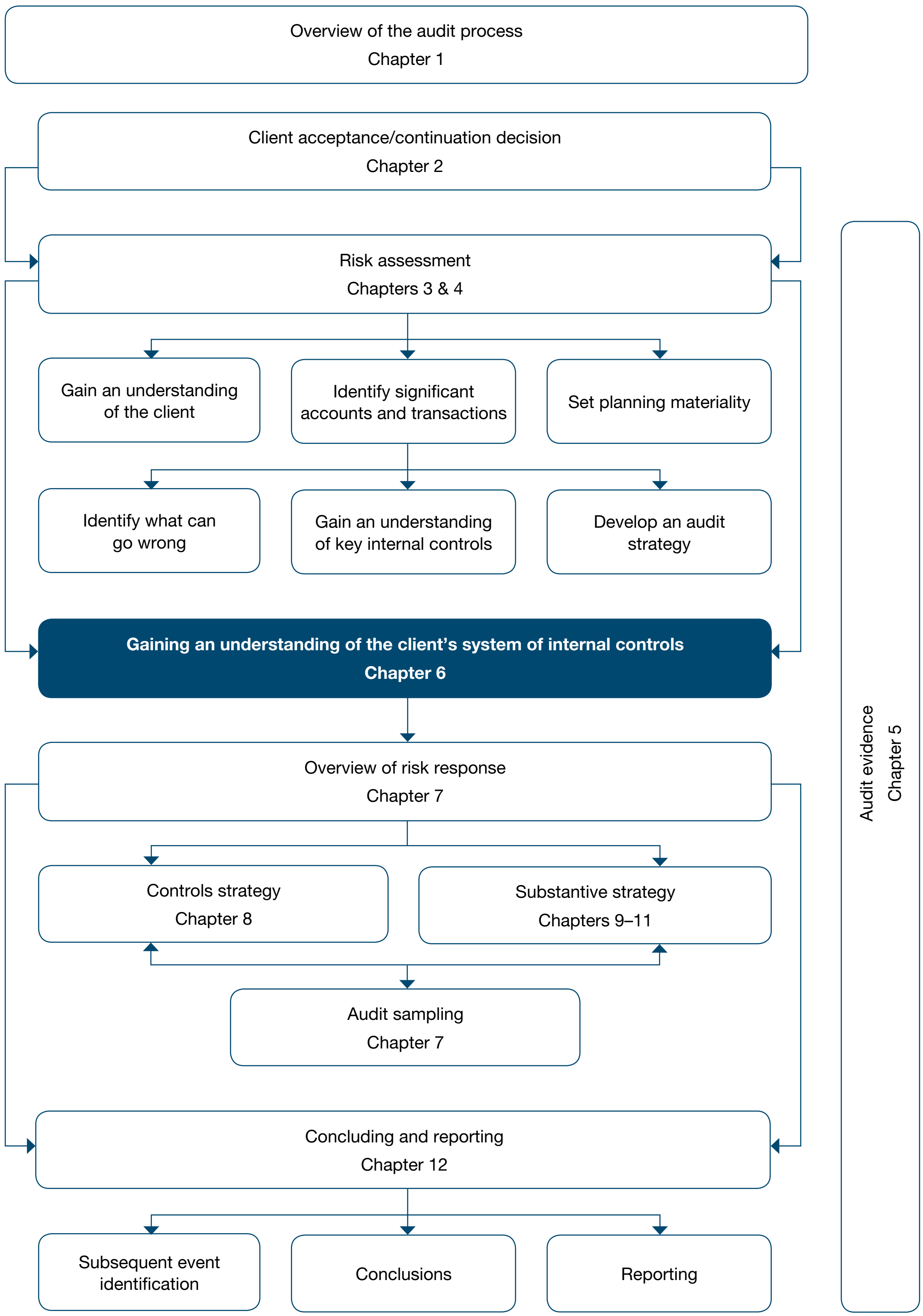
Gaining an understanding of the client's system of internal controls

LEARNING OBJECTIVES

After studying this chapter you should be able to:

6.1 describe internal control
6.2 explain the seven generally accepted objectives of internal control activities
6.3 discriminate between the elements of internal control at the entity level
6.4 describe the elements of internal control at the transaction level
6.5 explain the different techniques used to document internal controls
6.6 explain the importance of identifying strengths and weaknesses in a system of internal controls
6.7 describe how to communicate internal control strengths and weaknesses to those charged with governance.

AUDITING AND ASSURANCE STANDARDS	
AUSTRALIAN	**INTERNATIONAL**
ASA 260 *Communication with Those Charged with Governance*	ISA 260 *Communication with Those Charged with Governance*
ASA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*	ISA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*
ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*	ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*
AUASB Glossary	


Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client's system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

Sharon Gallagher and Josh Thomas are working on the draft of their internal control assessment report for Cloud 9 Pty Ltd (Cloud 9). They met with the Cloud 9 finance director, David Collier, to gain an understanding of the internal controls at the entity level. The interview covered issues such as management integrity, policies and procedures and monitoring of control activities. Sharon asks Josh to write up the results of the interview and make an assessment about the effectiveness of entity-level controls. Does the company demonstrate an environment where potential material misstatements are prevented or detected?

Sharon also wants Josh to document in detail an understanding of the controls at the transaction level. Sharon emphasises to Josh that their description of Cloud 9's system of internal controls is part of the evidence for the audit, and their assessment of the system's strengths and weaknesses will influence the remainder of the planning process. They must understand when, where and how potential material misstatements can occur.

How will Josh complete his tasks?

Audit process in focus

Before an auditor can form an opinion, they must gather evidence, evaluate the evidence and verify it against some form of independent reference. One such independent reference is an internal control framework such as the *Internal Control — Integrated Framework* developed by the Committee of Sponsoring Organisations of the Treadway Commission (COSO). These frameworks describe internal control from a theoretical point of view, with examples of how it could be practically applied to an organisation. Where internal controls put in place by management agree closely to the theoretically desirable and are able to be independently verified as being in existence, the internal control is described as strong. Where they do not agree closely to the theoretically desirable and are not able to be independently verified as being in existence, the internal control is described as weak.

This chapter will assist in understanding the client's system of internal controls as it relates to the audit of the financial report. This involves understanding what is meant by the term internal control, the objectives of the internal controls put in place by management, the components of internal control (particularly at the entity level), and obtaining an understanding of a client's system of internal controls.

This chapter will also discuss the importance of evaluating how the design and implementation of controls will prevent material misstatements from occurring or how they will detect and correct material misstatements after they have occurred, the implications of an absence of internal controls, and a description of how strengths and weaknesses in a system of internal controls are communicated to both management and those charged with governance.

6.1 Internal control defined

LEARNING OBJECTIVE 6.1 Describe internal control.

Why is understanding the internal controls of an organisation important? Because when controls are effective, the organisation is more likely to achieve its strategic and operating objectives. Internal control is a very broad concept and encompasses all of the elements of an organisation — its resources, systems, processes, culture, structure and tasks. When these elements are taken together, they support the organisation to achieve its objectives. For the purposes of this chapter, we will focus on the components of internal control that have a direct impact on the financial reporting, compliance and asset safeguarding of an organisation.

Internal control is defined in the auditing standards as:

> The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the entity's objectives with

regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control. (*AUASB Glossary*, p. 24)

Understanding internal control is important to be able to make a preliminary assessment of control risk. Control risk is a key component of the overall **audit risk** assessment and provides evidence that influences the resulting strategy developed by the auditor. Also, ASA 315 (ISA 315) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* requires the auditor to obtain an understanding of internal control on all audit engagements. This applies to all audits, including where the auditor decides that an entirely substantive approach is the appropriate response to the risks identified.

There are several different frameworks that have been developed around the world that organisations and auditors are able to use for understanding and assessing the internal control framework of an organisation. As mentioned in the beginning of this chapter, one such framework is the *Internal Control — Integrated Framework* developed by COSO. While we will not discuss this framework in particular, the general principles of the framework are consistent with the objectives and components of internal control discussed in more detail in this chapter, and included in ASA 315 (ISA 315).

BEFORE YOU GO ON

- What is an internal control?
- Why is it important to understand (and assess) internal controls?
- Name a generally accepted framework used to describe internal controls.

6.2 Objectives of internal controls

LEARNING OBJECTIVE 6.2 Explain the seven generally accepted objectives of internal control activities.

It is important for the auditor to understand the objectives of internal controls. While the auditor links controls to audit assertions and account balances, the objectives of controls connect the auditor's understanding of why the controls are important and the issues they are designed to prevent. The reason an organisation puts controls in place is to ensure errors in the processing of transactions do not occur, and if they do, that these errors are identified and rectified quickly. Without understanding the intention of management in implementing these controls, it is harder to connect them to our understanding of what can go wrong with the process and how to prevent it from happening.

There are seven generally accepted objectives of internal controls that are used to determine whether an internal control environment as it relates to the recording of transactions and balances is effective. Internal controls are designed and implemented to ensure that transactions are real, recorded, correctly valued, classified, summarised and posted on a timely basis. When the objectives for recording transactions are met, they are also met for the resulting end balances. Some balances are, however, not the result of numerous transactions and instead represent only one transaction. In these cases, the objectives apply equally to that one transaction that results in the balance. The internal control objectives are matched with the relevant assertions as follows.

1. *Real*. There are controls in place to ensure that fictitious or duplicate transactions are not included in the books and records of the organisation (occurrence, rights and obligations, and existence assertions).
2. *Recorded*. There are controls in place that will prevent or detect the omission of transactions from the books and records of the organisation (accuracy, completeness, and valuation and allocation assertions).
3. *Valued*. There are controls in place to ensure that the correct amounts are assigned to the transactions (accuracy, and valuation and allocation assertions).

4. *Classified*. There are controls in place to ensure that transactions are charged and allocated to the correct general ledger account (accuracy, classification, and valuation and allocation assertions).
5. *Summarised*. There are controls in place to ensure that the transactions in the books and records are summarised and totalled correctly (accuracy, and valuation and allocation assertions).
6. *Posted*. There are controls in place to ensure that the accumulated totals in the transaction file are correctly transferred to the general ledger and subsidiary ledgers (accuracy, classification, and valuation and allocation assertions).
7. *Timely*. There are controls in place to ensure that transactions are recorded in the correct accounting period (cut-off and completeness assertions).

The assertion relating to classification and understandability, which is a presentation and disclosure assertion, is not specifically addressed by these internal control objectives. The auditor usually ensures this assertion is met by substantively testing the draft financial report. An example of how this is often done is by using a disclosure checklist. These checklists typically include all of the disclosures required by the accounting standards as well as any other relevant legislation such as the *Corporations Act 2001*. They assist the auditor in ensuring all of the material disclosures required have been made.

When the auditor gains an understanding of the client's system of internal controls and how the client uses internal controls to manage risks in the business, it is important for the auditor to remember each of these objectives. By focusing on each of these objectives the auditor will be able to select the appropriate controls to test to gain the greatest level of assurance possible that the client's system of internal controls is operating effectively.

The concept of testing and assessing controls is discussed in more detail in chapter 8. It is worth mentioning here that when the objectives of internal controls are not met, it is considered to be a weakness in internal control. The auditor then considers whether the weakness has a material impact on their risk assessment for the relevant account balances and transactions. This is discussed in further detail later in this chapter.

Internal control, no matter how effective, can only provide an entity with reasonable assurance in achieving its financial reporting objectives. There are inherent limitations of internal control. These include:

- human error that results in a breakdown in internal control
- ineffective understanding of the purpose of a control
- collusion by two or more individuals to circumvent a control
- a control within a software program being overridden or disabled
- decisions made by management as to the nature and extent of the control it chooses to implement.

An example of a limitation is an internal control that may be designed appropriately but never implemented by management. The control therefore has no ability to mitigate risks. These limitations of internal controls are often mitigated by other controls (often referred to as compensating controls). If there are no other controls mitigating the weaknesses or limitations, the risks are addressed by the auditor performing extensive substantive procedures. This concept is discussed further in chapters 8 and 9.

CLOUD 9

Josh knows that as he writes his report he has to think about the whole system of internal controls at Cloud 9 and how effective it is in helping the company achieve its objectives. However, as the auditor, he has to focus mostly on the controls that relate to the integrity of the company's financial report. Which controls are keeping transactions real, recorded, correctly valued, classified, summarised and posted on a timely basis? Also, which controls are protecting assets and ensuring the company complies with relevant laws and regulations? The better these controls, the more likely W&S Partners can rely on the strength of the controls to reduce the amount of substantive testing in the audit.

BEFORE YOU GO ON

- What are the seven generally accepted objectives of internal controls as related to the recording of transactions?
- Why are internal controls important to an organisation?
- Why are internal controls important to an auditor?

6.3 Entity-level internal controls

LEARNING OBJECTIVE 6.3 Discriminate between the elements of internal control at the entity level.

As set out in ASA 315 (ISA 315), internal control consists of five components:

1. the control environment
2. the entity's risk assessment process
3. the information system, including the related business processes, relevant to financial reporting, and communication
4. control activities
5. monitoring of controls.

These internal control components, when collectively considered, are often referred to as **entity-level controls** as each of them exists at an organisational or entity level rather than at a more detailed transactional level. For example, a control ensuring that sales are recorded in the sales ledger is a transaction-level control. A control such as the internal audit function of a company is an entity-level control. The different types of controls are discussed further in chapter 8.

Gaining an understanding of the entity-level (or entity-wide) internal control components helps in establishing the appropriate level of professional scepticism, gaining an understanding of the client's business and financial report risks, and making assessments of inherent risk, control risk and the combined risk of material misstatement which in turn determines the nature, timing and extent of audit procedures (as discussed in chapters 4, 7, 8 and 9). It helps to inform our decisions (particularly with regard to professional scepticism) even though we do not test these sorts of controls.

The reason we do not test entity-level controls is primarily due to the difficulty in trying to test them. For example, there is rarely audit evidence that a control such as the tone at the top of an organisation is in existence and operating effectively. Also, the reasons controls are put in place is to prevent or detect and rectify an error occurring. Entity-level controls by themselves are not usually sensitive enough to prevent or detect and rectify material errors. Lower-level controls, which are discussed further later in this chapter and chapter 8, are more capable of preventing or detecting and rectifying material errors.

6.3.1 The control environment

The control environment sets the tone of an entity and influences the control consciousness of its people. It is the foundation for all other components of internal control and is often thought of as a combination of the culture, structure and discipline of an organisation. It reflects the overall attitude, awareness and actions of management, the board of directors, any others charged with governance, and owners concerning the importance of controls and the emphasis given to controls in determining the organisation's policies, processes and organisational structure.

The **control environment** also sets the foundation for effective internal control, providing discipline and structure, and includes the following elements.

- *Communication and enforcement of integrity and ethical values.* Integrity and ethical values are essential elements of the control environment, affecting the design, administration and monitoring of key processes. Integrity and ethical behaviour are the products of the organisation's ethical and behavioural standards, how they are communicated, and how they are monitored and enforced in its business activities. They include management's actions to remove or reduce incentives, pressures and opportunities that might prompt personnel to engage in dishonest, illegal or unethical acts. They also include the communication of the organisation's values and behavioural standards to personnel through policy statements and codes of conduct, and the examples set by management.

For example, management may state in its code of conduct that employees are not allowed to accept gifts from suppliers valued above a certain amount and that all offers of gifts (whether accepted or not) are to be reported in a gift register (or similar). Although this does not guarantee that employees will act ethically when it comes to gifts, it does indicate that management communicates standards of behaviour that it expects employees to adhere to. This, coupled with other procedures, may support an effective control environment.

- *Commitment to competence.* Management's commitment to competence refers to considering the skill levels required for particular jobs within the organisation and making sure that staff with the required skills are hired and matched to the right jobs. Among the factors that management may consider are the nature and degree of judgement to be applied to a specific job and the extent of supervision required. Auditors use professional judgement to determine whether they believe management and employees appear to be competent to carry out their assigned roles and receive adequate supervision where required.

  For example, do employees have the knowledge and expertise necessary to understand and execute the requirements of the generally accepted reporting framework (International Financial Reporting Standards (IFRSs) in Australia) that the organisation is required to apply?
- *Participation by those charged with governance.* The organisation's control environment is influenced significantly by its board of directors and others charged with governance of the entity; for example, the audit committee members or the CEO (if they are charged with responsibility for governance as well as being a member of management). Those charged with governance are responsible for overseeing the entity's accounting and financial reporting policies and procedures. As a result, those charged with governance have an obligation to be concerned with the entity's financial reporting to shareholders and the investing public, and to monitor the entity's accounting policies and the internal and independent (external) audit processes.

  In determining the effectiveness of the participation of those charged with governance, in particular the board of directors, auditors consider the board's independence from management, the experience of its members, the extent of its involvement and scrutiny of management's day to day activities, and its interactions with the internal and/or external auditors. For example, if the board has regular and open communications with its auditors, management may be more willing to inform the board of issues arising in the business on a timely basis (to avoid 'surprises').
- *Management's philosophy and operating style.* Obtaining an understanding of management's philosophy and operating style is necessary to identify the factors that influence management's attitudes towards internal control. This understanding affects the auditor's assessment of how management makes judgements and accounting estimates, as well as providing an insight into the competence and motivations of management. The more confidence an auditor gains regarding management's abilities and integrity, the more reliance placed on the information, explanations and representations provided by management. Alternatively, doubts about management's ability and integrity will increase the level of corroborating evidence required for representations made by management. An understanding of management's operating style is therefore a fundamental input into assessing audit risk.
- *Organisational structure.* The client's organisational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled and monitored. Establishing an organisational structure includes considering the key areas of authority and responsibility as well as the appropriateness of lines of reporting.

  The size and complexity of the organisation together with management's business and operating philosophies significantly affect the organisational structure and the need for formal organisation charts, job descriptions and policy statements. In addition to the formal organisational structure, an informal structure may also exist that affects the control environment. An auditor will gain an understanding of their client's organisational structure and the suitability of its policies and procedures in light of its size and complexity.

The information technology (IT) environment is also an important aspect of the auditor's view of the organisational structure. Consideration needs to be given to whether the IT deployed by the entity allows clear assignment of responsibilities. This should include the assignment of authorisation to initiate and/or change transactions and programs as well as ensuring there is appropriate segregation of duties related to the programming, administration, operation and use of IT. Segregation of duties is explained further in sections 6.3.4 and 6.3.6.

- *Assignment of authority and responsibility.* Assignment of authority and responsibility includes how authority and responsibility for operating activities are assigned, and how reporting relationships and authorisation hierarchies are established. It includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. It also includes policies and communications directed towards ensuring all employees understand the organisation's objectives, know how their individual roles and actions contribute to those objectives, and recognise how they will be held accountable for their actions.
- *Human resource policies and practices.* Human resource policies and practices relate to hiring, inducting, training, evaluating, counselling, promoting and compensating employees. As discussed above, the competence and integrity of an entity's employees are essential elements of its control environment. The organisation's ability to recruit and retain competent and responsible employees is therefore dependent to a large extent on its human resource policies and practices.

  For example, standards are often set for hiring qualified individuals, focusing on educational background, prior work experience, past accomplishments and evidence of a cultural fit with the employer organisation (values and ethics). These standards show the organisation's commitment to employing only competent and trustworthy people. Often role descriptions illustrate the expected levels of performance and behaviour.

When gaining an understanding of the control environment, the auditor considers each of these areas and their interrelationships. In particular, the auditor needs to understand whether there are any significant deficiencies in any one area, as these deficiencies may have an impact on the effectiveness of the other elements. For example, management may establish a formal code of conduct but then act in a manner that condones breaches of that code.

The assessment of internal controls, as well as the impact of weaknesses in or exceptions to internal controls, is discussed in more detail in chapter 8.

CLOUD 9

During the interview Josh and Sharon held with David Collier, they learned a lot about the tone at the top at Cloud 9. Top-level management at the company is bound by a code of conduct based on a similar document adopted by the parent company, Cloud 9 Inc. The parent company has been affected by legislative changes in the United States and has adopted a very strict approach to management integrity. Cloud 9's board members and senior managers attend training and awareness sessions on the code at least annually. In addition, there has been a rigorous process of embedding the code's main points throughout the company's policies and procedures, most of which have been rewritten in the previous two years.

A copy of the company's code of conduct and the policies and procedures are included in the audit working papers. Josh also writes a description of the company's efforts to communicate its approach to management integrity in the report. He assesses the control environment at Cloud 9 as likely to be effective.

PROFESSIONAL ENVIRONMENT

Human risks

Why do controls fail? Once a computer is programmed to do something, it will keep doing exactly what you tell it. Will employees do exactly what they are told, every time? A perfect control is no match for the employee who doesn't know, or doesn't care, how to operate the control.[1] In an article explaining the human side of risk, Jackson urges internal auditors to take a careful look at the human element of risk by considering how controls are used by employees, and not just concentrate on evaluating the design of control systems within organisations. External auditors also need to recognise that financial reporting misstatement risk does not simply come from an organisation's processes or controls, but from the people behind the processes and controls who might make mistakes or commit improprieties.

Human risks are perennial because they are among the most difficult to define, control and manage.[2] A report conducted by the global accounting firm EY shows that human resource (HR) issues rank among the top five business risks to a company's results.[3] The EY report contains the results from surveying senior finance, accounting, risk and HR executives at 150 Fortune 1000 companies. The executives were asked to rank the HR issues that they perceived as having a high impact and likelihood of occurrence within a global organisation. The top five HR issues were:

1. talent management and succession planning
2. ethics/tone at the top
3. regulatory compliance
4. pay and performance alignment
5. employee training and development.

The executives were also asked about the methods used to monitor these risks. The results show that 41 per cent of executives surveyed admit to reviewing these risks on an ad hoc basis or never.[4] This result reinforces the view that HR issues are not managed effectively enough in many organisations.

One aspect of HR risk that is closely related to financial reporting auditing is the effect of HR policies on promoting and communicating ethical values throughout the organisation and ensuring that the appropriate 'tone at the top' trickles down through the organisation. The EY survey revealed that these issues have become more visible and significant, possibly as a result of adverse publicity about corporate ethics, in recent years. However, although ethics is becoming more significant as a HR risk, the executives responding to the survey rated the likelihood of ethical problems arising throughout the organisation as low. The survey's authors suggest HR executives should pay more attention to the alignment between values espoused by company management in public arenas and actual practices by employees at all levels within the organisation.[5]

6.3.2 The entity's risk assessment process

All entities, regardless of their size, structure, nature or industry, encounter risks at all levels within the organisation. Risks will affect the entity's ability to survive, compete, grow and improve the quality of its products, services and people. It is not possible to reduce these risks to zero; however, management (in conjunction with those charged with governance) needs to determine how much risk is acceptable to the organisation. Some organisations have a risk committee, which is responsible for ensuring that all of these risks are identified, managed and reported to the board of directors.

The entity's risk assessment process is its process for identifying and responding to business risks. For financial reporting purposes, the entity's **risk assessment process** includes how management identifies risks relevant to the preparation of a financial report that gives a true and fair view in accordance with the entity's applicable financial reporting framework. For identified risks, management estimates their significance, assesses the likelihood of their occurrence and decides upon actions to manage them.

Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to initiate, record, process and report financial data consistent with the assertions of management in the financial report. For example, changes to the legislation that an entity reports within (such as the change from local accounting standards to IFRSs as required by the Corporations Act) is an externally created risk relevant to the entity's financial reporting.

An organisation's risk assessment process is different to the auditor's consideration of risk. The purpose of the entity's risk assessment process is to identify, analyse and manage the risks that affect its ability to achieve its operational effectiveness. In an audit, the purpose is to assess the combined **inherent**, **control** and **detection risks** to evaluate the likelihood that material misstatements could occur in the financial report.

An entity's risk assessment for financial reporting purposes is its identification, analysis and management of the risks relevant to the preparation of the financial report that is fairly presented in compliance with the accounting framework (for example, IFRSs). Once risks are identified, management will ordinarily initiate plans, programs or other actions to address the risks. Alternatively, management may decide to accept the risk without addressing it. Usually this decision is made on the basis of the cost versus the benefit of managing the risk.

Risks can arise or change as a result of many changes to the organisation and the environment it operates within. These include changes in the operating environment, new personnel, new technology, rapid growth, business restructures and new accounting pronouncements. It is important for the auditor to understand the risks identified by the entity as this will assist the auditor in considering where (and if) a material misstatement in the financial report might exist. The overall potential for risks to have a material impact on the financial report is increased when management appears willing to accept unusually high risks in making business decisions, enter into major commitments without sufficient consideration of the risks, and fail to closely monitor and control the risks associated with commitments entered into.

CLOUD 9

In their interview, Josh and Sharon asked David Collier about Cloud 9's risk assessment process. They want to know which risks management has identified so that they can consider whether those risks could cause a material misstatement in the accounts. They also want to know about the company's methods of responding to the identified risks. David Collier tells them that Cloud 9's management continually monitor its competitors' activities. It also considers the risk of interruption to supplies because of shipping problems and labour disputes at production plants or transport companies.

Other examples of risks that could have a major impact on the accounts are the use of forward exchange contracts to control the risks caused by purchasing in foreign currencies. They are also very aware of risks associated with the just-in-time inventories system, which has had some problems lately, and have planned some changes to deal with those problems.

Management is monitoring the risks of the new sponsorship arrangement with Rugby League teams in Australia and New Zealand, plus the risks arising from existing sponsorship of the soccer team because there has been a lot of adverse publicity about footballers' behaviour over the past year. Such adverse publicity could impact negatively on sales. Cloud 9's management ensures that the football teams keep the company's management informed of players' activities, where appropriate.

Josh concludes from the interview and his review of documents including company plans, board minutes, and significant contracts and agreements that Cloud 9 has a potentially effective system of risk assessment because it actively searches out and considers potential risks to the business, and has developed action plans to deal with each risk, depending on its likely occurrence.

6.3.3 Information systems and communication

The role of information systems is to capture and exchange the information needed to conduct, manage and control an entity's operations. The quality of information and communication affects management's ability to make appropriate decisions in controlling the organisation's activities and to prepare reliable financial reports. Information and communication involves capturing and providing information to management and employees so that they can carry out their responsibilities, including providing an understanding of individual roles and responsibilities as they relate to internal controls over financial reporting.

Information is needed at all levels of the entity to run the business, and to assist in the achievement of financial reporting, operating and compliance objectives. An array of information is used. Financial information, for instance, is used not only in developing financial reports for external dissemination; it may also be used for operational decisions, such as monitoring performance and allocating resources. Similarly, operating information (for example, airborne particle emissions and personnel data) may be needed to achieve compliance and financial reporting objectives, as well as operating objectives. However, certain operating information (for example, purchases and sales data) is essential for developing financial reports. As such, information developed from internal and external sources, both financial and non-financial, is relevant to all three objectives.

Information is identified, captured, processed and reported by information systems. Information systems may be computerised, manual or a combination thereof. The term 'information systems' is frequently used in the context of processing internally generated data relating to transactions (for example, sales) and internal operating activities (for example, production processes). However, information systems as they relate to internal controls are much broader. That is, information systems also deal with information about external events, activities and conditions.

Auditors are most interested in the information systems that are relevant to the financial reporting objective; that is, the systems responsible for initiating and recording transactions, balances and events that will ultimately be reflected in the financial report. These systems consist of the procedures, whether automated or manual, and records established to initiate, authorise, record, process and report transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities and equity. They include the client's asset safeguarding controls and the process for authorising transactions, including adequate segregation of incompatible duties. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

The information systems that are relevant to the financial reporting objective encompass methods that ensure transactions and disclosures are real, recorded, valued, classified, summarised and posted on a timely basis (refer to section 6.2 for discussion of the seven generally accepted objectives of internal controls).

Communication is the process by which information is provided to those that need it on a timely basis. For example, a monthly management reporting package contains information about the company's financial performance and is used by many companies as the primary way of communicating this information to executives and directors.

CLOUD 9

Josh is an expert on information systems and, based on the interview with David Collier, which covered the information systems at a high level, he can conclude that the entity-level controls in this area are likely to be effective. Josh will gather further information in an interview with Cloud 9's financial controller, Carla Johnson. Based on this second interview and a review of the company's documents, he will write a description of his understanding of the processes used in each of the major transaction cycles.

6.3.4 Control activities

Control activities are policies and procedures that help make sure management's directives are carried out. They help guarantee that necessary actions are taken to address risks affecting the achievement of the organisation's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organisational and functional levels. Generally, control activities that may be relevant to an audit may be categorised as policies and procedures pertaining to the following.

- *Performance reviews (sometimes referred to as 'performance indicators').* These control activities include reviews of actual performance versus budgets, forecasts and prior-period performance and relating different sets of data (operating or financial) to one another, together with analyses of the relationships and investigative and corrective actions. They also include reviews of functional or activity performance, such as, at a bank, a consumer loan manager's review of reports by branch, region and loan type for loan approvals and collections. By investigating unexpected results or unusual trends, management identifies circumstances where the underlying activity objectives are in danger of not being achieved.
- *Information processing.* A variety of controls are performed to check accuracy, completeness and authorisation of transactions within information processing environments. Information processing controls can be manual; automated (that is, application); manual controls that depend on an automated process (that is, IT-dependent manual); or IT general controls (ITGCs). These concepts are discussed further in chapter 8.
- *Physical controls.* These activities encompass the physical security of assets, including adequate safeguards over access to assets and records (such as secured facilities and authorisation for access to computer programs and data files) and periodic counting and comparison with amounts shown on control records. The extent to which physical controls intended to prevent theft of assets are relevant to the success of the business and the reliability of the financial report preparation, and therefore the audit, depends on the circumstances, such as if assets are highly susceptible to misappropriation.
- *Segregation of incompatible duties.* The concept that no one employee or group of employees should be in a position both to perpetrate and to hide errors or fraud in the normal course of their duties. In general, the principle duties that are incompatible and should be segregated are:
  - authorisation or approval of transactions affecting assets
  - custody of assets
  - recording or reporting of transactions.

  In addition, a control over the processing of a transaction should not be performed by the same person that is responsible for actually recording or reporting the transaction.

  Assigning different people the responsibilities of authorising transactions, recording transactions and maintaining custody of assets reduces the opportunity for an individual to both carry out and hide errors (whether intentional or not) or fraud in the normal course of his or her duties. Adequate segregation of duties is an important consideration in determining whether a client's controls are effective, as it reduces the likelihood that errors (intentional or not) will remain undetected. When IT is used in an information system, segregation of incompatible duties is often achieved by implementing system-based controls (referred to as logical access controls).

In understanding the client's control activities at the entity level, consideration is given to factors such as:

- the extent to which performance of control activities relies on IT
- whether the necessary policies and procedures exist with respect to each of the entity's activities, including IT security and system development
- the extent to which controls included in the organisation's policies are being applied
- whether management has clear objectives in terms of budget, profit and other financial and operating goals, and whether these objectives are clearly written, communicated throughout the entity and actively monitored
- whether planning and reporting systems are in place to identify variances from planned performance and communicate such variances to the appropriate level of management
- whether the appropriate level of management investigates variances and takes appropriate and timely corrective actions

- to what extent duties are divided or segregated among different people to reduce the risk of errors, fraud or manipulation of results
- whether software is used to control access to data and programs and, if so, the extent to which segregation of incompatible duties is achieved by implementing these software controls
- whether periodic comparisons are made of amounts recorded in the accounting system with physical assets
- whether adequate safeguards are in place to prevent unauthorised access to or destruction of documents, records and assets.

The auditor finds these controls the easiest to test when compared to other types of entity-level controls as their operation is readily verifiable. For example, the controls surrounding the performance of a stocktake can be observed, while management integrity is not observable or easily verified. This concept is covered in more detail in chapter 8.

6.3.5 Monitoring of controls

After establishing and maintaining internal controls, an important responsibility of management is to monitor the controls to assess whether they are operating as intended and modified for changes in conditions on a timely basis. Over time, systems of internal controls change and the way controls are applied may evolve. Also the circumstances for which the system of internal controls was originally designed may change, causing it to be less effective in warning management of risks brought about by new conditions. Accordingly, management needs to determine whether its internal controls continue to be relevant and able to address new risks.

Monitoring is a process of assessing the quality of internal control performance over time, considering whether controls are operating as intended, and making sure controls are modified as appropriate for changes in conditions. It involves assessing the design and implementation of controls on a regular basis and taking necessary corrective actions. This process is accomplished through ongoing activities and separate evaluations, or a combination of the two.

Ongoing monitoring procedures are built into the normal recurring activities of the entity and include regular management and supervisory activities. For example, managers of sales, purchasing and production at divisional and corporate levels should understand the entity's operations and question the accuracy of reports that differ significantly from their knowledge of operations. Monitoring activities may include using information obtained from communications with external parties. For example, customers ordinarily verify and corroborate a client's billing data by paying their invoices or by complaining about overcharging.

Much of the information used in monitoring is produced by the entity's information systems. If management assumes that data used for monitoring is accurate without having a basis for the assumption, errors may exist in the information, potentially leading management to incorrect conclusions from its monitoring activities.

One of the most common monitoring activities is the internal audit function. In many organisations, internal auditors (or personnel performing similar functions) contribute to the monitoring of the client's activities through separate evaluations. They regularly provide information about the functioning of internal controls, focusing considerable attention on the evaluation of the design and implementation of controls. They communicate information about strengths and weaknesses and make recommendations for improving internal control. The importance that a company places on its internal audit function also provides evidence about its overall commitment to internal control.

As will be discussed in chapter 7, when evaluating the effectiveness of the internal audit function, factors to consider include independence, reporting lines, adequacy of staffing, adherence to applicable professional standards, scope of activities, adequacy of work performed and conclusions reached.

The internal audit activities most relevant to the audit include those that provide evidence about the design and effectiveness of internal control or that provide substantive evidence about potential material misstatements in the financial report.

Finally, when gaining an understanding of the client's monitoring processes at the entity level, factors such as the following are ordinarily considered:

- whether periodic evaluations of internal control are made
- the extent to which personnel, in carrying out their regular duties, obtain evidence as to whether the system of internal controls continues to function
- the extent to which communications from external parties corroborate internally generated information, or indicate problems
- whether management implements internal control recommendations made by internal and external auditors
- management's approach to correcting known significant deficiencies on a timely basis
- management's approach to dealing with reports and recommendations from regulators
- the existence of an internal audit function that management uses to assist in its monitoring activities
- evaluations or observations made by the external auditors.

CLOUD 9

In the interview with David Collier, Sharon and Josh ask questions about both the control activities and the monitoring of those activities at Cloud 9. Sharon and Josh are particularly interested in the systems used at the company to make sure that information about management's plans and orders is transmitted throughout the organisation and that there are policies and procedures to ensure that the appropriate actions are taken and reviewed.

In addition to asking David Collier about these matters, Josh reads the policy and procedures manuals and they take a tour of the offices and other facilities. For example, Cloud 9 has a tightly structured system of performance reviews. Managers at each level must report financial and operating performance against budget at regular intervals. Higher level managers are able to access information about activities within their area of responsibility for monitoring purposes through the information system. Although there have been some issues with theft of goods from the retail store, the losses have been contained following the installation of additional security, including cameras. Josh and Sharon have been particularly impressed with the thorough approach to segregation of incompatible duties.

Josh is able to conclude that at an entity level, there is sufficient evidence that these controls are potentially effective. He plans to review the specific controls that affect transaction cycles in more detail so that he can document his understanding of these processes.

6.3.6 Internal control in small entities

In smaller entities there are often limitations surrounding the entity's ability to put effective internal controls in place. This is due to the small number of employees, which in turn impacts the ability of the organisation to segregate duties. Also, it is often not practical for smaller organisations to create an appropriate paper trail of documentation that allows an assessment of internal controls to be made.

However, despite the size limitations of these entities, internal controls still exist. Ordinarily in smaller businesses there is an owner-manager who is heavily involved in the day-to-day running of the business. This can be seen as both a strength and a weakness. It is a strength (assuming the owner-manager is competent) due to the fact that they are so closely involved in the business and day-to-day operations, including the selling of goods and services as well as the close daily cash management of the operations. Therefore, it is unlikely that material errors that might occur would not be detected by the owner-manager. It is also a weakness because that same owner-manager is in a position to be able to override internal controls.

The risk of management override can be reduced by establishing documented policies and procedures. However, if no such procedures or controls are in place, the risk of management override will need to be reduced from an audit perspective by the performance of additional audit procedures (through an increase in substantive procedures).

BEFORE YOU GO ON

- What are the five components of internal control?
- Why is segregation of duties important when understanding internal control?
- How does management's attitude and control consciousness affect the internal control environment of an organisation?

6.4 Transaction-level internal controls

LEARNING OBJECTIVE 6.4 Describe the elements of internal control at the transaction level.

Now that we have discussed entity-level controls, we will briefly overview transaction-level controls. These are discussed in more detail in chapter 8. As explained previously, entity-level internal controls are at the entity-wide or whole-of-organisation level and have the potential to affect all of the processes management puts in place for the entire organisation. This includes controls that may not have a direct impact on the financial report.

As its name suggests, **transaction-level controls** are controls that affect a particular transaction or group of transactions. Transactions in this sense refer to transactions that are ordinarily recorded in the general ledger for the client and span from initiation of the transaction through to the reporting of the transaction in the financial report. Transaction-level controls are those controls that respond to things that can go wrong with transactions. They need to be sensitive enough to either prevent an error occurring, or to detect the error, report it and have it rectified on a timely basis. These controls are referred to as prevent and detect controls and are explained further in chapter 8.

6.4.1 Example transaction flows — sales process

The transaction flow in a typical sales process for a client that sells goods includes processing orders, approving credit, shipping goods, invoicing customers and recording sales and trade receivables. The transaction flows for a client that sells services is the same but instead of shipping goods the client sells/performs the services. This chapter will use sales in the context of a client that sells goods. Example risks and controls that can be put in place relating to sales are in table 6.1.

6.4.2 Example transaction flows — cost of sales process

Typically, manufacturing companies have inventories systems that record the physical movement of inventories and a costing system that accumulates the inventories costs. These systems are integrated with the accounting software to record inventories movements and cost of sales.

The inventories balance (in the balance sheet) can include transactions relating to recording raw material purchases, direct labour and indirect overheads, and cost of sales.

Cost of sales (in the income statement) can include purchasing inventories, adding costs and overheads, reducing the cost of sales for any inventories remaining on hand (verified by a stocktake) and transferring the value of stock on hand to the inventories general ledger in the balance sheet. Example risks and controls that can be put in place relating to cost of sales are shown in table 6.2.

TABLE 6.1 **Sales process example risks and controls**

Transaction	Risks (what can go wrong)	Example control	Key assertion*
Processing orders	Orders are processed to the wrong customer.	Review of orders processed each day by an independent staff member (e.g. salesperson) Three-way match of order, dispatch document and invoice prior to dispatch of goods	Occurrence, accuracy
	Orders are taken from customers with no credit history or credit limit.	Application control that will only allow orders to be processed against existing approved customers with enough unused credit limit	Occurrence, accuracy
	Orders are incorrectly input.	Requirement for acknowledgement of order by customer for any orders placed over $5000 (using system-generated order confirmation reports based on information input into the system)	Accuracy
Approving credit	Credit is approved for customers unable to pay.	Credit committee review and approve all applications for credit over $1000	Accuracy
	Credit limits are set too high or too low.	Credit committee review of credit limits on a quarterly basis	Accuracy
	Credit limits are exceeded.	Application control requires approval for exceeding credit limits (exception report generated, reviewed and approved)	Accuracy
Shipping goods	Products are shipped without shipping documents being generated.	Application control generates picking slip and delivery documentation when order is processed	Accuracy, completeness, cut-off
	Invoices are not raised when goods are shipped.	Monthly reconciliation of picking slips generated with no invoice generated Three-way match of order, dispatch document and invoice Regular stocktakes	Accuracy, completeness
	Goods are shipped to the wrong customer.	Review of delivery address against customer master file by warehouse staff Three-way match of order, dispatch document and invoice	Accuracy, occurrence
Invoicing customers	Invoices are not correct as to the quantities of goods shipped.	Quantities per dispatch document marked as correct when picked by warehouse staff Invoices automatically generated from order and dispatch document	Accuracy
	Invoices are raised twice (or more) for the same order and delivery.	Three-way match of order, dispatch document and invoice	Occurrence, accuracy, completeness
	Wrong unit prices are used on the invoices.	Approved master file automatically used by application as source for invoice pricing	Occurrence, accuracy, completeness
	Quantity times price is incorrectly calculated.	Application programmed to calculate correctly	Occurrence, accuracy, completeness

Transaction	Risks (what can go wrong)	Example control	Key assertion*
	Discounts (such as volume rebates) are incorrectly applied.	All discounts more than $1000 approved by the sales manager	Occurrence, accuracy, completeness
	Invoices do not add correctly.	Application programmed to calculate correctly	Occurrence, accuracy, completeness
	Shipping documents and invoices do not reflect correct transaction dates.	Application cannot be modified as to date of transaction (set by calendar and clock in software)	Accuracy, cut-off
Recording sales and trade receivables	Sales are recorded in the wrong period.	Date recorded is set by date of transaction in software CFO review of all sales above $1000 for last three days of each month	Cut-off
	Sales tax, GST, discounts, rebates and other invoice adjustments are priced to the wrong general ledger account.	Application control (driven by approved chart of accounts) within the accounting software used	Classification
	Sales are not recorded in the sales subsidiary ledger.	Application control within the accounting software used	Accuracy, completeness
	Total recorded sales in the sales subsidiary ledger is not recorded in the general ledger.	Application control within the accounting software used Monthly sales and trade receivables reconciliation between the subsidiary ledgers and general ledger	Accuracy, completeness
	There are duplicate postings.	Monthly sales and trade receivables reconciliation between the subsidiary ledger and general ledger	Accuracy, completeness

* Most assertions may apply. However, this example has focused on the key assertion(s) for each that can go wrong.

TABLE 6.2 Cost of sales process example risks and controls

Transaction	Risks (what can go wrong)	Example control	Key assertion
Purchasing inventories	Purchases are made and not recorded in the general ledger for inventories or payables.	Three-way match between purchase order, delivery document and invoice Supplier statements reconciled monthly	Completeness
	Purchases are recorded in the general ledger but the goods are never received.	Three-way match between purchase order, delivery document and invoice Regular stocktakes	Completeness, occurrence
	Purchases of unwanted goods are made.	All purchase orders above $1000 approved by purchasing manager	Accuracy
	Goods are received that were not ordered.	Three-way match between purchase order, delivery document and invoice	Completeness, occurrence
	Goods are damaged when they are receipted into the warehouse.	Damaged stock rejected by warehouse manager and notified to payables clerk and purchasing officer	Accuracy

TABLE 6.2 (*continued*)

Transaction	Risks (what can go wrong)	Example control	Key assertion
	The wrong price is charged on the purchase invoice by the supplier.	Approved purchase order reconciled to invoice	Accuracy
	The wrong amount is paid against an invoice.	All relevant documentation (invoice and cheque) reviewed and approved by two people Supplier statements reconciled monthly	Accuracy
Recording labour and overhead	The wrong labour costs are added to the cost of individual inventories items.	All standard costs reviewed and approved by the production manager and CFO annually and entered into the stock master file. Any exceptions to the master file generate an exception report that is reviewed and approved by the CFO	Accuracy
	The wrong overhead allocation is added to the costs of individual inventories items.	All standard costs reviewed and approved by the production manager and CFO annually and entered into the stock master file. Any exceptions to the master file generate an exception report that is reviewed and approved by the CFO	Accuracy
Recording inventories on hand	Inventories are recorded in the balance sheet that does not exist (therefore understating cost of sales in the income statement).	Stocktakes performed on a quarterly basis	Valuation of stock and accuracy of cost of sales
	The wrong quantities are recorded during the stocktake.	All stock double counted by independent teams Review performed of all variances greater than 10 per cent or $100	Accuracy
	Goods that have been sold and invoiced are included in the inventories on hand.	All stocktake variances greater than 10 per cent or $100 are reviewed	Accuracy, cut-off

CLOUD 9

Josh will document his understanding of the processes for the various transaction cycles. This document will allow the audit team to identify the points within the accounting process where errors or fraud can occur. These points are more likely where information is changed, there is significant human involvement, or access to systems is not restricted. In essence, it is where something in the process can go wrong. The auditors will concentrate on those points that have a financial report impact.

Once the types of potential material misstatements are understood, the audit team will consider the magnitude and likelihood of the misstatement in the financial report. This will help narrow the risk assessment and determine what audit procedures should be performed. In addition, the audit team considers how errors in each financial report assertion might occur.

This analysis will guide the audit planning for additional substantive testing. Sharon and the audit partner can also decide if there are any material weaknesses that should be included in the management letter.

Josh knows that documenting his understanding of the processes is necessary for the team to identify control strengths that can be relied upon to justify reduced substantive testing. Substantive testing will be reduced if tests of those controls confirm that these design strengths are reflected in actual performance of the control system. Josh thinks he will need to discuss his assessment of control strengths and weaknesses with Sharon before finalising the audit program. He needs her to help him determine if some control weaknesses are compensated for by other strengths. They will also identify the most important controls to test. Some controls are actually redundant; that is, another control exists that performs the same function.

BEFORE YOU GO ON

- What is the difference between entity-level controls and transaction controls?
- Name two risks and corresponding controls to address those risks for sales transactions.
- Name two risks and corresponding controls to address those risks for cost of sales transactions.

6.5 Documenting internal controls

LEARNING OBJECTIVE 6.5 Explain the different techniques used to document internal controls.

Before the auditor tests the internal controls, they need to document their understanding of them. The most common forms of documentation include the following.

- *Narratives*. This is the most common form of documentation, particularly in smaller environments where accounting and internal control activities are simple or where a particular flow of a transaction is relatively simple and straightforward. It involves the auditor describing (in words) each step of the flow of transaction from start to finish (that is, from initiation to reporting in the financial report). Refer to figure 6.1 for an example.

Sales order is received by fax or email. Check customer details against customer account balance to see if they have exceeded their credit limit. If customer has exceeded their limit, refer the sales order to the credit manager (C. Cox) for approval. If approval is denied, refer the order back to the sales manager to discuss with the customer and notify customer. If customer has not exceeded their credit limit or the credit manager (C. Cox) has provided an approval to exceed the limit, process the sale in the sales ledger.

FIGURE 6.1 Example narrative for documenting credit sales process

- *Flowcharts and logic diagrams*. This form of documentation is used in larger and more complex environments. It involves the auditor summarising (in flowcharts/boxes) each step of the flow of a transaction from start to finish (that is, from initiation to reporting in the general ledger). Flowcharts are not often used as they usually take longer to prepare than narratives or checklists. Instead, logic diagrams are more common. They provide a visual perspective of the flow of the transaction and key controls throughout the flow that is often simpler for the reader or reviewer to understand. The key to a good logic diagram is to keep it as simple as possible, with as few words as possible so as not to overload the reader with information. Refer to figure 6.2 for an example.
- *Combinations of narratives and flowcharts*. This form of documenting internal controls is typically a page divided into two sections with the process flowchart on the left-hand side, and the narrative describing each step in the flow on the right-hand side. The flowchart side highlights the key activities from initiation to reporting, while the narrative column contains the details about what happens in the flow of the transaction. Refer to figure 6.3 for an example.

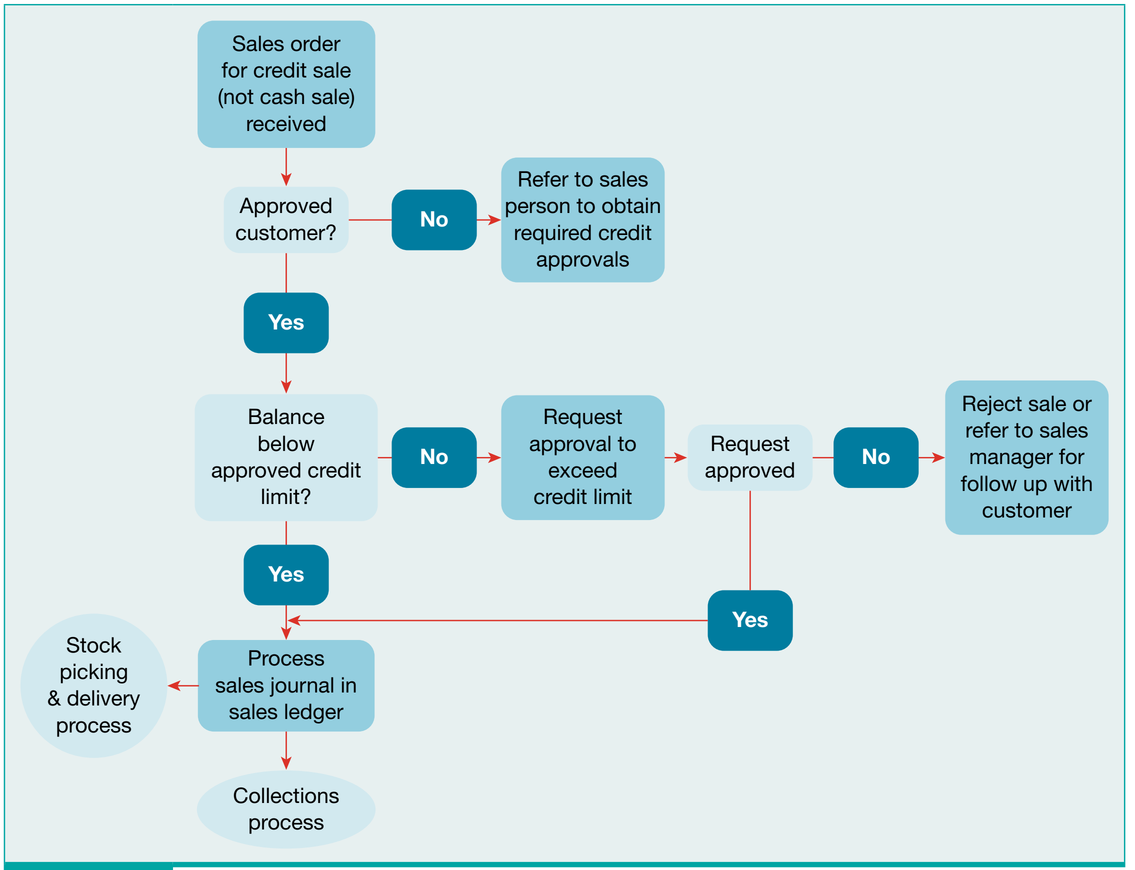
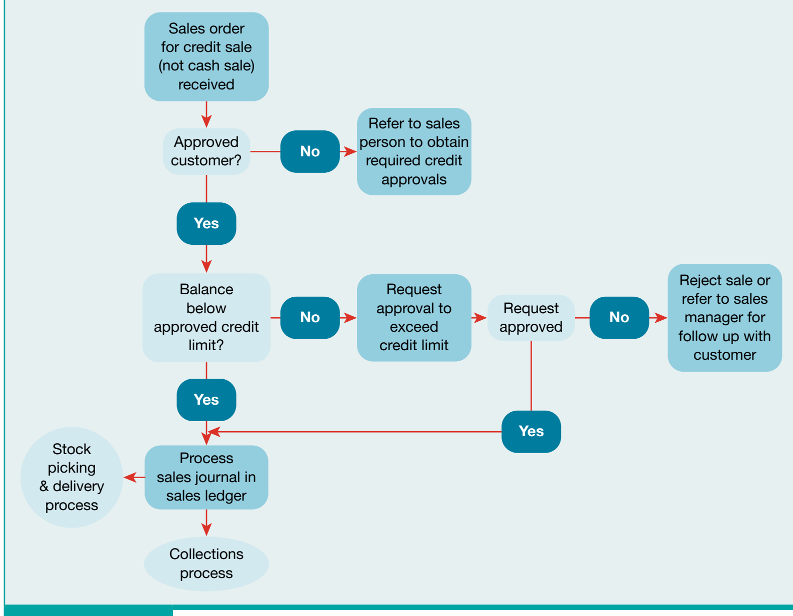


FIGURE 6.2 Example logic diagram for credit sales process



- Sales order is received by fax or email.
- Check customer details against customer account balance to see if they have exceeded their credit limit.
- If customer has exceeded their limit, refer the sales order to the credit manager (C. Cox) for approval. If approval is denied, refer the order back to the sales manager to discuss with the customer and notify customer.
- If customer has not exceeded their credit limit or the credit manager (C. Cox) has provided an approval to exceed the limit, process the sale in the sales ledger.

FIGURE 6.3 Example combination documentation for credit sales process

• *Checklists and preformatted questionnaires*. An internal control checklist or questionnaire is another technique used to systematically identify the most common types of internal control procedures that should be present. This is particularly helpful in industries that the auditor may not personally be familiar with auditing, or when less experienced auditors find it difficult to identify which are the critical controls (for example, when documenting entity-level controls). Refer to figure 6.4 for an example.

Process step	Performed by	IT/reliance on electronic data Yes/No?
Customer places sales order and order is input into sales order program		
Credit and/or credit terms approved		
Order filled and prepared for shipment		
Shipping/delivery documents prepared		
Order shipped/delivered to or picked up by customer		
Sales invoices prepared		
Prices (or deviations from standard prices) approved		
Invoices reviewed for accuracy and mailed/delivered to customers		
Sales journal produced		
Sales journal summarised and posted to general ledger and trade receivables detail		
Provide any other details that are necessary to understand the initiation, processing, recording and reporting of the transactions:		
*Briefly describe the client's **revenue recognition policy**, including **standard billing and collection terms**:*		
*Briefly describe the client's **credit terms** and **credit authorisation procedures**:*		
*Briefly describe the client's procedures for **sales returns and allowances** and the issuance of **credit memos**:*		

FIGURE 6.4 Example checklist for documenting a credit sales process

Source: EY 2010.

Regardless of which of the above approaches is used to document internal controls, the extent of the documentation will increase as the complexity of the client, its systems and its internal controls increases.

CLOUD 9

Josh will prepare a logic diagram or narrative to document his understanding of the different transaction cycles. This will help him understand the stages at which the errors can occur. He will include the entire process from the initiation of the transaction through to recording in the general ledger. Where appropriate, he will link several accounting processes together into one seamless flow of transactions. For example, as a first step he makes a simple diagram of the flow of transactions from initiation of a purchase order through to the cash payment to the supplier (see figure 6.5). The process comprises three smaller processes: initiating a purchase order through to receipting the goods as they arrive; receiving the purchase invoice from the supplier through to entering the invoice in the general ledger; and requesting cash payment and recording the payment to the supplier. In the next step, the flow of transaction diagram will be supplemented with additional details showing details of the document matching and their disposition, or filing.

This is a high level summarised view of how some businesses may document their flow of a particular transaction. Some may also include more detail underlying each step in the flow.

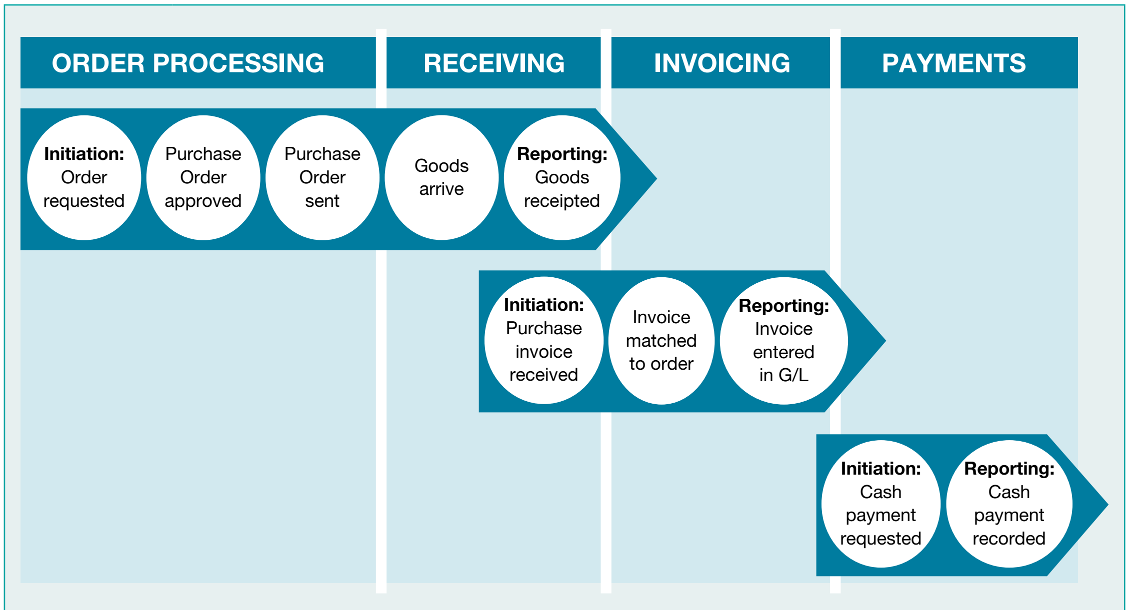


FIGURE 6.5 Cloud 9 flow of transaction — order to payment

BEFORE YOU GO ON

- Explain the different techniques used to document internal controls.
- What is the difference between a narrative and a logic diagram?
- When would it be more appropriate to use a logic diagram instead of a narrative to document internal controls?

6.6 Identifying strengths and weaknesses in a system of internal controls

LEARNING OBJECTIVE 6.6 Explain the importance of identifying strengths and weaknesses in a system of internal controls.

Another important outcome of understanding the system of internal controls that a client puts in place is the ability to make observations, draw conclusions and offer recommendations regarding the strengths and weaknesses observed. While clients will often be interested in obtaining feedback from external auditors as to the relative strengths of their internal controls, focus is ordinarily on the areas of weakness identified. This is because it is the weaknesses that increase the risk of material misstatements being undetected by management's processes and controls, and the areas of weakness are also where the auditor typically performs additional substantive testing to quantify the (potential) material misstatement. The link between these **internal control exceptions** (that is, observations that controls being tested did not operate as intended) and the level of substantive procedures required to address these exceptions is explained further by way of examples in chapter 8.

Some observations made by the auditor will relate to controls that are not directly relevant to the audit. As discussed previously, some controls within the system of internal controls have a financial reporting impact, whereas other controls are implemented to assist the entity in meeting its organisational and compliance objectives. For example, a bank reconciliation is a control that has a financial reporting impact, whereas an approved supplier list is a control that ensures stock is only purchased from reputable sources but has no financial reporting impact. Significant levels of professional judgement are required when deciding whether an internal control observation (individually or in combination with others) is in fact relevant to the audit and should be tested.

ASA 260 (ISA 260) *Communication with Those Charged with Governance* and ASA 265 (ISA 265) *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* require the auditor to provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process, and to promote effective two-way communication between the auditor and those charged with governance. The auditor needs to communicate issues of governance interest as soon as practicable, and at an appropriate level of responsibility, including significant (or material) weaknesses in the design or implementation of internal control. It is for these key reasons that the auditor prepares what is often called a management letter.

BEFORE YOU GO ON

- Why is it important to identify both the strengths and weaknesses in a system of internal controls?
- Does the auditor provide feedback on strengths in internal controls or just weaknesses? Explain.
- What obligations does the auditor have regarding communicating strengths or weaknesses in internal controls?

6.7 Management letters

LEARNING OBJECTIVE 6.7 Describe how to communicate internal control strengths and weaknesses to those charged with governance.

A **management letter** (sometimes referred to as a letter of recommendations) is a deliverable prepared by the audit team and provided to those charged with governance. The management letter discusses internal control weaknesses and other matters discovered during the course of the audit. The purpose of the management letter is to inform the client of the auditor's recommendations for improving its internal controls. An example of a management letter is shown in figure 6.6.

As identified in figure 6.6, the combination of the auditor's experience in auditing various businesses and a thorough understanding gained in conducting an audit, mean the auditor is in the unique position to provide insights regarding the system of internal controls designed and monitored by those charged with governance. It also enables them to provide timely feedback to management on the implementation of internal controls.

Significant **professional judgement** is necessary in deciding whether a weakness identified is significant enough to warrant communicating to management and those charged with governance. When the auditor identifies risks of material misstatement that the entity has not controlled (or has not adequately controlled), or if in the auditor's judgement there is a material weakness in the entity's design or implementation of internal control, they are required to communicate these weaknesses as soon as practicable to those charged with governance. Deciding whether an observation should be reported to those charged with governance is often a matter of consultation and discussion amongst the audit team. As discussed in chapter 2, various cases have demonstrated that in the past some auditors observed material weaknesses but failed to communicate them. As a result of these cases, now auditors often report all matters observed, irrespective of whether they are considered material or not. Some of the most recent and high-profile corporate collapses globally led to the US Public Company Accounting Oversight Board (PCAOB) being created by the US Securities and Exchange Commission, and the Sarbanes–Oxley Act (2002) containing explicit internal control reporting provisions.

EY
Building a better working world

10 February 2017

Ms L Cox-Hancy
Chair, Audit Committee
Cantafa Adventures Pty Ltd
28 Main Street
Brisbane QLD 4000

Dear Ms Cox-Hancy

Internal Control Observations

We have completed our audit of the financial statements of Cantafa Adventures Proprietary Limited and its controlled entities ('Cantafa') for the year ended 31 December 2016.

This management letter includes all control matters and issues arising from our audit findings that we consider appropriate for review by management.

In accordance with Australian Auditing Standards, we have gained an understanding of your internal controls, as relevant to the audit in order to assist in the design of our audit procedures to gather sufficient appropriate evidence to form an opinion on the company's financial report. Our audit procedures do not address all internal control and accounting procedures and are based on selective tests of accounting records and supporting data and have not been designed for the purposes of making detailed recommendations. As a result our procedures would not necessarily disclose all weaknesses in Cantafa's internal control environment, and you should not assume that there are no additional matters that you should be aware of in meeting your responsibilities.

We wish to express our appreciation for the courtesies and co-operation extended to our representatives during the course of their work. If you have any questions or comments, please do not hesitate to call me on (07) 3011 3516.

Yours faithfully

S. Fitzpatrick

Shane Fitzpatrick
Partner

Attachment

Copy to: Jo Langworthy, CFO
Brent Menzies, CEO

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Observations

1.1 Credit Limits for Customers

Issue	
Observation	The Company does not have an established policy to determine credit limits granted to customers. Consequently, the amount owing by TBLR Pty Ltd has been allowed to increase significantly to $2.7m as at 31 December 2016, constituting 24% of the total outstanding accounts receivable balance.
Management response	Management should design and implement a credit control system that includes a careful evaluation of the credit limits given to customers to help minimise the risk of exposure to doubtful accounts. For this control to be effective the credit limits set must be both realistic and compatible with the credit worthiness of the customers and such limits should be checked before additional credit is approved. Management should also review the established credit limits regularly and revise them when necessary. When a special extension of credit terms is necessary, it should be approved by an appropriate member of management independent of the individual granting credit.
Responsibility	Harri Vines, Credit Manager

1.2 Fully Depreciated Assets

Issue	
Observation	There are numerous fully-depreciated assets in the fixed assets register, some of which are no longer in use or held by the Company. As a result property, plant and equipment and the related accumulated depreciation is overstated in the notes to the financial statements.
Management response	Management should periodically perform a physical verification of its fixed assets. Management should review its fixed assets register and reconcile it to the underlying assets to determine whether there are assets that no longer exist or are no longer in use so that the underlying accounting records can be adjusted.
Responsibility	Paul Gardiner, Fixed Assets Manager

FIGURE 6.6 Example management letter

While it is not mandatory to provide feedback regarding internal control weaknesses in writing, the auditor ordinarily prefers to provide their recommendations in the form of a letter or report to avoid any ambiguity or confusion as to what observations, conclusions and recommendations they have made. It also provides a simple way for management to document the actions they have taken in response to the issues raised, and to share these actions (and the progress towards the resolution of the issues) with those charged with governance. It also provides the auditor with valuable insights into management's attitude towards the importance of internal controls by being able to evaluate what management has done in response to the recommendations made in the previous year at the start of each audit. Depending on the size of the engagement and the timing of when control weaknesses are identified relative to the final audit visit, teams will sometimes prepare an interim management letter at the end of planning and interim procedures, with a final management letter issued at the completion of the audit.

CLOUD 9

Josh provides his documented understanding of Cloud 9's system of internal controls and his preliminary assessment of the system's strengths and weaknesses to Jo Wadley, the engagement partner of the audit. The audit team will gather additional evidence about the system of internal controls during the audit, and at the completion of the audit the senior members of the audit team will make a final assessment of Cloud 9's internal controls and write a management letter. Providing a management letter, including recommendations for future changes to the system of internal controls, is an important part of the auditor's role. The management letter not only discharges the audit team's responsibilities to the client, but helps the client improve its systems. In turn, this will likely increase the quality of its financial reporting in the future and improve the efficiency and effectiveness of future financial report audits.

PROFESSIONAL ENVIRONMENT

Reporting on internal controls

Australian companies that either raise capital in the United States or are subsidiaries of US companies are subject to US regulations introduced by the Sarbanes–Oxley Act (2002) (known as SOX). Section 404 of SOX requires US public companies to report on the effectiveness of their internal control over financial reporting. Management is required to assess the effectiveness of internal control. The independent auditor then reports on management's assessment and on the effectiveness of the company's internal controls over financial reporting. The auditor's report on internal controls required by SOX is in addition to the independent auditor's report on the company's financial report.

If one or more material weaknesses exist in the company's internal controls at year-end, the auditor cannot conclude that internal control over financial reporting is effective.[6] The US Public Company Accounting Oversight Board (PCAOB) defines a material weakness as a 'significant control deficiency, or a combination of deficiencies, that results in more than a remote likelihood that material misstatement of the annual or interim financial statements will not be prevented or detected.'[7] In other words, a material weakness does not mean that a material misstatement has occurred or will occur, but that it could occur.

The introduction of SOX in 2002 created additional work for auditors because the understanding of internal controls that is required in order to express an opinion on the financial report is not sufficient for the auditor to be able to offer an opinion on the controls themselves. Auditors of companies affected by SOX, including Australian auditors registered with the PCAOB, had to design and implement new procedures to be able to satisfy the new internal control reporting obligations.[8]

In Australia, ASAE 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* provides general guidance for assurance practitioners who are engaged to provide assurance over internal controls. ASAE 3150 *Assurance Engagements on Controls* (effective from 2016) provides more specific guidance for assurance practitioners who are engaged to provide an 'assurance report on the suitability of the design of controls to achieve identified control objectives, and if applicable, fair presentation of the description of the system, implementation of the controls as designed and/or operating effectiveness of controls as designed' (ASAE 3150, para. 3).

BEFORE YOU GO ON

- Do we always communicate weaknesses in internal controls to those charged with governance? Explain your answer.
- Can the content ordinarily included in a management letter be delivered verbally to those charged with governance? Explain your answer.
- Why is it preferred that most communications with those charged with governance be done in writing?

SUMMARY

6.1 Describe internal control.

Internal control is the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term 'controls' refers to any aspects of one or more of the components of internal control. Controls include entity-level controls and transaction-level controls.

6.2 Explain the seven generally accepted objectives of internal control activities.

Internal controls are designed and implemented to ensure that transactions are real, recorded, correctly valued, classified, summarised and posted on a timely basis.

6.3 Discriminate between the elements of internal control at the entity level.

The elements of internal control at the entity level are the control environment, the entity's risk assessment process, the information system and communications used, how the controls are monitored and how the controls are implemented (including appropriate segregation of duties).

6.4 Describe the elements of internal control at the transaction level.

Transaction-level controls are controls that affect a particular transaction or group of transactions. Transactions in this sense refer to transactions that are ordinarily recorded in the general ledger for the client and span from initiation of the transaction through to the reporting of the transaction in the financial report. Transaction-level controls are those controls that respond to things that can go wrong with transactions.

6.5 Explain the different techniques used to document internal controls.

The most common forms of documentation include narratives, flowcharts, logic diagrams, combinations of narratives and flowcharts, and checklists and preformatted questionnaires.

6.6 Explain the importance of identifying strengths and weaknesses in a system of internal controls.

An important outcome of understanding the system of internal controls that a client puts in place is the ability to make observations, draw conclusions and offer recommendations regarding the strengths and weaknesses observed. ASA 260 (ISA 260) requires auditors to provide those charged with governance with timely observations arising from the audit. This is generally done through a management letter.

6.7 Describe how to communicate internal control strengths and weaknesses to those charged with governance.

A management letter (sometimes also referred to as a letter of recommendations) is a deliverable prepared by the audit team and provided to the client (including those charged with governance). It informs the client of the auditor's recommendations for improving its internal controls.

KEY TERMS

Audit risk The risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated.

Control activities Policies and procedures that help ensure that management directives are carried out. Control activities are a component of internal control.

Control environment The attitudes, awareness and actions of management and those charged with governance concerning the entity's internal control and its importance in the entity.

Control risk The risk that a client's system of internal controls will not prevent or detect a material misstatement.

Detection risk The risk that the auditor's testing procedures will not be effective in detecting a material misstatement.

Entity-level controls The collective assessment of the client's control environment, risk assessment process, information system, control activities and monitoring of controls.

Inherent risk The susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming there are no related controls.

Internal control The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

Internal control exception An observed condition that provides evidence that the control being tested did not operate as intended.

Management letter A document prepared by the audit team and provided to the client that discusses internal control weaknesses and other matters discovered during the course of the audit.

Professional judgement The auditor's professional characteristics such as their expertise, experience, knowledge and training.

Risk assessment process The entity's process for identifying and responding to business risks.

Transaction-level controls Controls that affect a particular transaction or group of transactions.

MULTIPLE-CHOICE QUESTIONS

6.1 Internal control is a process that is *not*: **LO1**
- (a) the responsibility of those charged with governance.
- (b) designed and approved by external auditors after consultation with the internal auditors.
- (c) designed and implemented to address identified business risks that threaten the achievement of the entity's objectives.
- (d) designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

6.2 The objectives of internal controls do *not* include that: **LO2**
- (a) correct amounts are assigned to transactions.
- (b) transactions are recorded in the correct accounting period.
- (c) fictitious transactions are not included in the organisation's records.
- (d) listed companies are able to be more effective and efficient than private companies.

6.3 The control environment: **LO3**
- (a) only applies to listed companies.
- (b) has no relationship with the activities of the board of directors.
- (c) is the economic environment in which the organisation operates.
- (d) is the combination of the culture, structure and discipline of an organisation.

6.4 An entity's risk assessment process: **LO3**
- (a) is established only if the entity is subject to unusually high risk.
- (b) never allows management of an entity to decide to accept a risk without taking any action.
- (c) is designed to help an entity think about risk in the same way that an auditor thinks about risk.
- (d) is the entity's process for identifying and responding to business risks and the results thereof.

6.5 Auditors are interested in an entity's information systems: **LO3**
- (a) only if they are not purely manual systems.
- (b) because they affect managers' ability to maintain accountability for related assets, liabilities and equity.

(c) because management's ability to make appropriate decisions and prepare reliable financial reports is not related to information systems.
(d) all of the above.

6.6 Performance reviews: **LO3**
(a) are part of control activities.
(b) are not relevant to internal controls.
(c) usually do not include financial data only.
(d) are only applicable to the chief executive officer in an organisation.

6.7 Segregation of incompatible duties: **LO3**
(a) is a guarantee that fraud cannot occur.
(b) is the same as performance review by a supervisor.
(c) usually increases the risk of fraud unless a supervisor is subject to a performance review.
(d) occurs when different people authorise transactions, record transactions and maintain custody of assets.

6.8 Internal control in small entities: **LO3**
(a) is likely to be less formal than in a larger entity.
(b) does not have the risk of management override.
(c) is always stronger because the owner-manager can supervise every activity.
(d) always results in an auditor placing a greater emphasis on testing internal controls.

6.9 Documenting internal controls: **LO5**
(a) is not done for smaller clients because of the risk of management override.
(b) is always handled through the use of checklists and preformatted questionnaires.
(c) can be handled with a combination of narratives and flowcharts or logic diagrams.
(d) is done after internal controls are tested so that the results can be included in the documentation.

6.10 A management letter: **LO6, 7**
(a) is written by management to the auditor at the start of the audit.
(b) lists only the material weaknesses discovered during the audit.
(c) contains recommendations for improving internal control and discusses other issues discovered during the course of the audit.
(d) all of the above.

REVIEW QUESTIONS

6.11 What is internal control? Why is an auditor interested in a client's internal control? **LO1**

6.12 Explain each of the seven generally accepted objectives of internal control activities. **LO2**

6.13 If an auditor does not intend to rely on internal controls in the audit, does the auditor need to obtain an understanding of the client's internal control? Explain. **LO3**

6.14 Explain the difference between entity-level controls and transaction-level controls. Is an auditor interested in both? **LO3, 4**

6.15 Discuss the contention that the control environment is the most important part of a system of internal controls because it provides the foundation for the entire system. **LO3**

6.16 Why would an auditor be interested in a client's control monitoring processes? **LO3**

6.17 What sort of risks would an entity's risk assessment process consider? Give some examples for a retailer. Which of these risks would be relevant to financial reporting? Explain. **LO3**

6.18 Explain the importance of segregation of incompatible duties. What sort of duties would be segregated within the sales process? Why? **LO4**

6.19 In the sales transaction process, a key control affecting the accuracy assertion for sales is 'Credit committee review and approve all applications for credit over $1000'. Explain the impact of this control on the valuation assertion for sales receivable (debtors). **LO4**

6.20 Discuss the role of internal audit in an entity's system of internal controls. Is internal audit an essential element of a control system? Explain. **LO3**

6.21 Several approaches to internal control documentation are discussed in the chapter. Assess the advantages and disadvantages of each. How would documentation assist the auditor to identify strengths and weaknesses of an entity's system of internal controls? **LO5**

6.22 Why do auditors prepare management letters? **LO6, 7**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

6.23 UNDERSTANDING CLIENT CONTROLS ★ **LO1**

Abbott & Partners audit firm has audited Pretty Valley Shire council for two years, performing both a statutory audit of the financial reports and a compliance audit for the government department in charge of local councils' landfill waste disposal sites. In all previous control testing, no exceptions were detected. The junior auditor on the engagement has suggested that no work on internal controls is required because last year's evidence will be sufficient.

Required

Explain why the junior auditor's suggestion is not appropriate.

Source: Adapted from the CA Program's *Audit & assurance exam*, March 2010.

6.24 IMPORTANCE OF INTERNAL CONTROL ★ **LO1**

Elecnet is an electricity distribution company based in a large capital city. Its business is to manage the electricity assets, including poles, wires and other equipment, that are used to deliver electricity to more than 500 000 retail and business customers in the city. Pole, wire and substation maintenance and improvements are a large part of the company's operations and teams of highly trained technicians are used for both planned work and emergency response activities. Emergency response is required when storms or fires bring down power lines, the power must be turned off at the direction of police, or the electricity supply fails for any reason.

Each team comprises several vehicles (vans and trucks) and uses additional heavy equipment, such as cherry pickers, cranes and diggers, as required. Each vehicle carries a core set of specialised parts and tools and additional items are obtained as required from the stores, located in a large warehouse in the northern suburbs. The warehouse is staffed on a 24-hour basis to assist night maintenance (designed to minimise disruption to business customers) and emergency response.

Required

(a) Make a list of the potential problems that could occur in Elecnet's maintenance and improvements program.

(b) Suggest ways that good internal control over parts, equipment and labour could help Elecnet avoid these problems.

6.25 CONTROL ENVIRONMENT ★ **LO3**

Cheetah Airways became a client of an audit firm for the first time this year. Soon after taking the engagement in September last year, Cheetah Airways was under investigation by the Australian Competition and Consumer Commission (ACCC) for allegedly fixing prices on some routes in collusion with another airline. The two airlines made an illegal arrangement to not compete with each other so that they both benefited by sharing the business and maintaining prices that would allow them to make profits. After the ACCC investigation became public, several of Cheetah Airways' key corporate customers decided that they did not wish to associate themselves with the airline and severed their exclusive travel dealings with Cheetah Airways.

Required

How does the above information affect your understanding of the control system at Cheetah Airways?

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2010.

6.26 EXPENSE TRANSACTION RISK ★ **LO4**

Bear Transport's accounting policy for maintenance on its fleet of cargo planes is to capitalise the cost of major airframe and engine maintenance checks and depreciate over the shorter of the scheduled usage period to the next major inspection or the remaining life of the aircraft. The latest data shows the aircraft and engines at cost (including major maintenance costs) to be at a similar level as last year while depreciation costs have decreased by 5 per cent.

Required

Discuss the risk of misstatement for depreciation costs. What could go wrong?

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2010.

6.27 SEGREGATION OF DUTIES IN A SMALL BUSINESS ★ **LO3**

North State Computers has premises in the main street of a large regional city. The business is owned by Bob and Mary Winters, who purchased it three years ago. Mary has an extensive background in IT and has a talent for diagnosing and solving problems with computers that are brought in for repair. Bob also has an IT background and oversees the sales and administration staff. There are three staff in the business: a computer technician who assists Mary, a part-timer who helps with sales and a junior trainee, Cara, who does other tasks such as banking. Cara is also responsible for issuing invoices and statements to clients who have a service contract with the business. These clients are generally other businesses that ask Mary to visit their premises for routine and emergency repairs and that purchase software and hardware from the business.

Bob and Mary have worked very hard over the last three years but they have cash-flow problems. Their bank manager has requested a meeting to discuss the business's growing overdraft. The bank manager asks Bob and Mary to prepare for the meeting by analysing their accounts receivable and customer receipts. Bob and Mary review the accounts receivable ledger and find that it is not up to date. They also discover that client statements have not been issued for four months. They are also unable to identify from the cash receipts journal which clients have paid their accounts.

Required

(a) Discuss the attitude and control consciousness of North State Computers' management.

(b) Which duties should be segregated in this business? Recommend an appropriate allocation of duties for the staff at North State Computers.

6.28 CONTROL ENVIRONMENT ★★ **LO3**

Red Minerals is being audited by your firm for the first time in 2015. In 2010, Red Minerals invested in a mining joint venture in Bangaloo, a country which recently experienced significant currency devaluation. In December 2013, there was a large chemical spill in the area surrounding the main centre of Red Minerals' operations in Bangaloo, and the government is seeking compensation and asking for restoration work to be done. The story has been covered in the Australian press. In a review of documents you discover that in 2014, there was a raid on the homes of several Red Minerals' employees, following a tip-off to police. The tip-off alleged that over several years, four members of Red Minerals mechanical staff had been stealing small tools from Red Minerals and re-selling them. To date, four members of Red Minerals' staff have been charged with fraud and theft. You are aware that the Chief Operations Officer (COO) of Red Minerals resigned at the start of 2015 and a suitable replacement has not yet been found.

Required

Discuss the impact of the background material for Red Minerals on your likely assessment of entity-wide controls at Red Minerals.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2010.

6.29 REVENUE FRAUD RISK ★★ **LO4**

Leopard Airways is a new client of your audit firm. Its accounting policy for revenue is to credit to revenue received in advance, and subsequently transfer to revenue in the income statement when passengers or freight are uplifted, or when tours and travel air tickets and land content are utilised.

Your review of last year's financial statements indicates revenue from passengers represents 80 per cent of total revenue, but that this year there is a six per cent fall in revenue from passengers and an 11 per cent decrease in revenue from passengers in advance.

You have read articles in the financial press which suggest an increased incidence of fraud due to the global financial crisis, and that the majority of these frauds are committed by company directors and senior managers.

Required

Explain why the revenue in income statements is at significant risk of fraudulent financial reporting by management.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2010.

6.30 OBJECTIVES OF INTERNAL CONTROL ★★ **LO2**

Donna MacIntosh runs Emerald Spa, a business providing women-only hairdressing, beauty, relaxation massage and counselling services in a small tourist town. Ninety per cent of the clients using the beauty and massage services at Emerald Spa are weekend visitors to the town, but 80 per cent of the hairdressing and counselling clients are locals. The masseuse and counsellor have formal qualifications and are registered with the medical authorities, allowing clients to claim the cost of the service with their private health insurer if an appropriate receipt is provided when the client pays.

Emerald Spa has just opened another branch of the business in a town 100 kilometres away and there are plans for a third branch to be opened next year. Donna has been very busy establishing each new branch and relies on staff in each office to run the day-to-day operations, including ordering supplies and banking receipts. In addition, the branch manager organises the staff and authorises their time sheets. Donna makes the payments for rent, power, salaries and large items of expenditure such as furniture purchases.

Required

(a) Give examples of transactions that would occur at Emerald Spa.

(b) Explain what could go wrong with these transactions if the system of internal controls could not meet any of the seven generally accepted objectives of internal controls.

6.31 CONTROL ENVIRONMENT AT A LARGE COMPANY ★★ **LO3**

International Bank is experiencing bad publicity surrounding huge fraud losses in its foreign currency department. Accusations are being made in the press that the rogue trader blamed for the losses was operating outside the official guidelines with the tacit approval of senior management in the department because of the large profits made by this trader in previous years. The press claims that it was common knowledge in the foreign currency department that strict policies and procedures surrounding the size of trades and the processes for balancing out trades at the end of each day were not to be followed if the trader had verbally informed his supervisor of the trade. The press is also suggesting that the problems are not confined to the foreign currency department and that poor attitudes are prevalent throughout all commercial departments at International Bank.

Required

Discuss the control environment at International Bank assuming the press reports are correct. Which parts appear to be most deficient?

6.32 SEGREGATION OF DUTIES AND DOCUMENTATION ★★ **LO3, 4, 5**

Lisa Curtis is documenting the purchasing and cash payments processes at Hardies Wholesaling. Hardies Wholesaling imports garden and landscaping items such as pots, furniture, fountains, mirrors and sculpture from suppliers in South-East Asia. All items are non-perishable and made from materials such as stone, concrete, metal and wood, and are distributed to retailers throughout the country.

Purchases are denominated in US dollars, which the company acquires under forward exchange contracts. The purchasing department initiates a purchase order when stock levels reach reorder points or sales staff notify the department of large customer orders that need to be specially filled. The purchase order is approved and sent to suppliers selected from an approved supplier list. Goods are transported from South-East Asia by ship and are delivered by truck to Hardies Wholesaling central warehouse. A receiving report is generated by the receiving department and forwarded to the accounts department for matching with the copy of the original purchase order and the supplier's invoice. When the package of documents is completed, the purchase order and invoice are entered into the general ledger. The cash payments department raises a voucher to request payment of the invoice according to the supplier's payment terms. The payment is approved and the cash payment is made.

Required

(a) Create a flowchart or logic diagram to represent the flow of transactions from the raising of a purchase order to cash payment.
(b) Which duties in the above process should be segregated?

Questions 6.33 and 6.34 are based on the following case.

Dolphin Surf & Leisure Holidays Pty Ltd (Dolphin) is a resort company based on the Great Barrier Reef. Its operations include boating, surfing, diving and other leisure activities, a backpackers' hostel, a family hotel and a five-star resort. Justin and Sarah Morris own the majority of the shares in the Morris Group which controls Dolphin. Justin is the chairman of the board of directors of both Dolphin and the Morris Group, and Sarah is a director of both companies as well as the CFO of Dolphin.

Justin and Sarah have a fairly laid back management style. They trust their workers to work hard for the company and reward them well. The accounts staff, in particular, are very loyal to the company. Justin tells you that some accounts staff enjoy their jobs so much they have never taken any annual leave, and hardly any workers ever take sick leave. Justin and Sarah have not bothered much in the past with formal procedures and policies, but they have requested the accounts staff to start documenting the more common procedures. They do not conduct formal performance reviews; they rely on their staff to tell them when there is a problem.

There are three people currently employed as accounts staff, the most senior of which is Peter Pinn. Peter heads the accounts department and reports directly to Sarah. He is in his fifties and plans to retire in two or three years. Peter prides himself on his ability to delegate most of his work to his two accounts staff, Kristen and Julie. He claims he has to do this because he is very busy developing the policy and procedures manual for the accounting department. The delegated work includes opening mail, processing payments and receipts, banking funds received, performing reconciliations, posting journals and performing the payroll function. Julie is a recent Chartered Accountant graduate. Kristen works part-time — coming into the office on Mondays, Wednesdays and Fridays. Kristen is responsible for posting all journal entries into the accounting system and the payroll function. Julie does the balance of the work, but they often help each other out in busy periods. Kristen authorises Julie's transactions and Julie returns the favour by authorising Kristen's transactions. Together, they usually make the accounts balance.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

6.33 INTERNAL CONTROL COMPONENTS ★★★ **LO3, 4**

(a) Explain how the internal control components are usually adjusted to meet the needs of small entities. What advantages and disadvantages does this bring?
(b) Assess the internal controls at Dolphin. What changes would you recommend?

6.34 COMMUNICATION WITH MANAGEMENT ★★★ **LO7**

Write a management letter to Justin and Sarah Morris.

6.35 COMPONENTS OF INTERNAL CONTROL ★★★ **LO3, 4**

MaxSecurity Limited (MaxSecurity) has been an audit client of Smith & Associates (S&A) for the past 15 years. MaxSecurity is based in Wollongong, where it manufactures high-tech armour-plated personnel carriers. MaxSecurity often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialised and MaxSecurity only does business with nations that have a recognised, democratically elected government. MaxSecurity maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

In September 2016, MaxSecurity installed an off-the-shelf costing system to support the highly sophisticated and cost sensitive nature of its product designs. The new system replaced a system that had been developed in-house as the old system could no longer keep up with the complex and detailed manufacturing costing process that provides tender costings. The old system also had difficulty with the company's broader reporting requirements.

MaxSecurity's IT department, together with the consultants from the software company, implemented the new manufacturing costing system. There were no customised modifications. Key operational staff and the internal audit team from MaxSecurity were significantly engaged in the selection, testing, training and implementation stages.

The manufacturing costing system uses all of the manufacturing unit inputs to calculate and produce a database of all product costs and recommended sales prices. It also integrates with the general ledger each time there are product inventories movements such as purchases, sales, wastage and damaged stock losses.

It is now February 2017 and you are commencing the audit planning for the 30 June 2017 annual financial report audit. You are assigned to assess MaxSecurity's IT controls with particular emphasis on the recent implementation of the new manufacturing costing system.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

Required

Select two (2) components of internal control. Explain how the role of internal and external audit would differ in assessing these components in relation to the new manufacturing costing system.

Questions 6.36 and 6.37 are based on the following case.

Chan & Partners Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year, Chan & Partners gained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home
- Total Cancer Specialists Limited (TCSL), a private oncology clinic that specialises in the treatment of cancer.

Year-end for all MSHG entities is 30 June.

During the 2017 financial year, MSHG released its own range of medical supplies such as bandages and first aid kits, which are sold via direct marketing by a sales team employed by the hospital.

The sales team are remunerated via a base salary and a bonus component which is based upon the dollar value of sales they generate. You recognise that their main motivation is to maximise their bonuses.

On 1 April 2017, Gardens Nursing Home Pty Ltd switched from its 'home grown' patient revenue system to MSHG's equivalent system. MSHG is confident that its 'off the shelf' enterprise system would perform all of the functions that Gardens Nursing Home's home grown system performed.

Gardens Nursing Home's home grown patient revenue system comprised the following.

1. *Billing system* — produces the invoice to charge the patient for services provided such as accommodation, medications and medical services. This software includes a complex formula to calculate the patient bill allowing for government subsidies, pensioner benefits and private medical insurance company benefits plans.
2. *Patient database* — a master file containing personal details about the patient as well as the period of stay, services provided and patient's medical insurance details.

3. *Rates database* — a master file that shows all accommodation billing rates, rebate discounts and government assistance benefits.

At the request of the board, the group's internal audit unit was involved throughout the entire switch-over process. The objective of its engagement, as the board stated, was to 'make sure the switch-over worked without any problems'.

Source: Adapted from the CA Program's *Audit & assurance exam,* March 2009.

6.36 CONTROL ENVIRONMENT ★★★ **LO3, 4**

Discuss the implications of the sales bonus system for the control environment within MSHG. What special factors would management have to have to consider?

6.37 CONTROL RISKS IN NEW IT SYSTEMS ★★★ **LO3, 4**

With reference to the 'control activities' component of internal control, formulate one question that each of internal audit and external audit will ask regarding the switch-over of the patient revenue systems by Gardens Nursing Home.

CASE STUDY — CLOUD 9

Answer the following questions based on the information presented for Cloud 9 in the appendix to this text and the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

Sharon Gallagher and Josh Thomas have assessed the internal controls at Cloud 9 as being effective at an entity level. This means that, at a high level, the company demonstrates an environment where potential material misstatements are prevented or detected.

Required

You have been assigned the task of documenting the understanding of the process for recording sales, trade receivables and cash receipt transactions for wholesale customers. In your absence, Josh met with the Cloud 9 financial controller, Carla Johnson, and received permission to tape the interview, which is provided as a transcript (see the appendix to this text). Using this interview transcript and other information presented in the case, you are asked to:

(a) Prepare a flowchart, logic diagram, or narrative documenting your understanding of the sales to cash receipts process for wholesale sales.
(b) Identify any follow-up questions you would like to ask the client if aspects of the process are not adequately explained. You could address such questions to Carla Johnson or any other employee you deem appropriate.
(c) Identify the potential material misstatement that could occur in the sales to cash receipts process for wholesale sales.
(d) Identify, for the material misstatements in (c), the financial report assertion that is affected.

To answer (c) and (d), draw up a worksheet using the following format. Use as many rows as you need. Use the first three columns to present your findings. (You will complete the fourth column in chapter 8.)

Significant process	Potential material misstatement	Assertions	Transaction level internal controls

RESEARCH QUESTION

Recent reports have warned of climate change impacts on Australian coasts, including a rise in sea levels, more frequent storms, flooding and coastal erosion.[9] Assume you are a member of senior management at a large property development company.

Required

Write a report identifying the main risks to your company that you believe should be considered at the next meeting of the risk assessment committee. Include risks to the company's operations and assets, finances and personnel.

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. b, 2. d, 3. d, 4. d, 5. b, 6. a, 7. d, 8. a, 9. c, 10. c.

NOTES

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CHAPTER 7

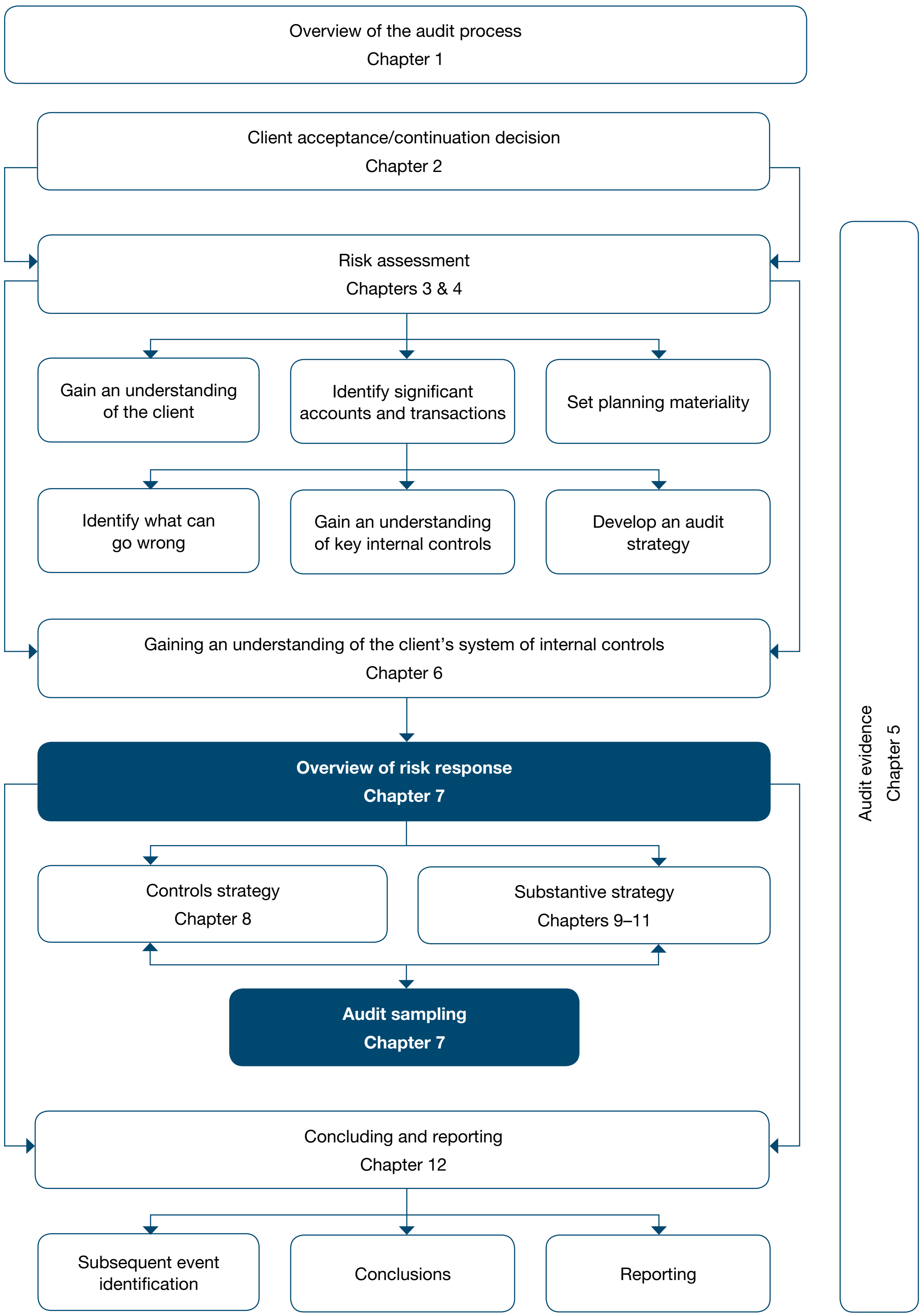
Sampling and overview of the risk response phase of the audit

LEARNING OBJECTIVES

After studying this chapter you should be able to:

7.1 explain how audit sampling is used in an audit
7.2 recognise the difference between sampling and non-sampling risk
7.3 discriminate between statistical and non-statistical sampling
7.4 describe sampling methods
7.5 describe the factors that influence the sample size when testing controls
7.6 explain the factors that influence the sample size when conducting substantive testing
7.7 explain how to evaluate the results of tests conducted on a sample
7.8 discriminate the difference between tests of controls and substantive tests
7.9 explain the factors that affect the nature, timing and extent of audit testing
7.10 explain how auditors arrive at a conclusion based upon the evidence gathered
7.11 illustrate how auditors document the details of evidence gathered in working papers.

AUDITING AND ASSURANCE STANDARDS	
AUSTRALIAN	**INTERNATIONAL**
ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*	ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*
ASA 300 *Planning an Audit of a Financial Report*	ISA 300 *Planning an Audit of Financial Statements*
ASA 330 *The Auditor's Responses to Assessed Risks*	ISA 330 *The Auditor's Responses to Assessed Risks*
ASA 530 *Audit Sampling*	ISA 530 *Audit Sampling*



Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client's system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

The details of the internal control assessment report for Cloud 9 Pty Ltd (Cloud 9), written by Sharon Gallagher and Josh Thomas, is tabled at the next audit planning meeting. The report contains documentation of the internal controls system, and the overall conclusion is that controls are likely to be effective. Both the strengths and weaknesses are identified based on the work done so far. The next step is to plan the required tests, both control tests and substantive tests.

Ian Harper asks Suzie Pickering to coffee. He wants her to explain how they can plan these tests and write a detailed audit program, including instructions on how to select the sample, when the results of one lot of tests will influence the work on other tests. It all seems a bit circular to him and he is finding it difficult to grasp.

Suzie is happy to drink more coffee and meets Ian that afternoon in the staff room. 'The sort of tests we have to do, and when and how we do them, depends on the quality of the client's accounting records. However, before we talk about that, we probably should talk about how we take samples. In most cases, we do not test every transaction or control. We use a system of sampling, conduct the tests on the sample, and then project the results back to the population.' Ian indicates that he understands the idea of sampling — it saves a lot of time and money. 'But do you understand the risks involved in sampling?' Suzie asks.

Audit process in focus

The purpose of this chapter is to provide an overview of audit sampling and to introduce, compare and contrast tests of controls and substantive testing. Audit sampling involves the selection of transactions or accounts within a balance for testing. It is used when the auditor plans on testing less than the entire population of transactions or accounts in a balance available for testing. When selecting a sample it is important that the items chosen for testing are representative of the entire population of transactions and accounts available for testing. Sampling risk is the risk that the sample chosen is unsuitable and, as a consequence, the auditor arrives at an inappropriate conclusion after testing the sample. Non-sampling risk refers to other factors that result in an auditor arriving at an inappropriate conclusion. Both sampling and non-sampling risk are explained in this chapter.

Sampling can be conducted using statistical or non-statistical methods. These terms are explained and the benefits and drawbacks of each group of techniques are discussed in this chapter. We then provide an overview of different techniques that are used to select a sample during an audit.

The sample size chosen will be affected by a range of factors. Those factors will be different if the sample is selected for tests of controls or for substantive procedures. The factors that influence the final sample size when testing controls or conducting substantive tests are explained in this chapter. We then explain how the results of testing are evaluated when a sample is used. It is vital that an appropriate assessment method is used to generalise the findings for a sample to the entire population.

The next section of this chapter provides an overview of the risk response phase of the audit. This phase involves the testing of controls and conducting substantive procedures in line with the auditor's audit strategy, developed during the risk assessment phase of the audit. An overview is provided of the difference between tests of controls and substantive procedures. Once an audit strategy has been developed, an audit program is written detailing the nature, timing and extent of audit procedures to be conducted by audit staff. These terms are defined and explained in this chapter.

A discussion follows on how the auditor arrives at a conclusion regarding the truth and fairness of a financial report. This conclusion is based upon an auditor's understanding of their client, the risks identified during the risk assessment phase of the audit and the evidence gathered throughout the remainder of the audit when conducting detailed testing of controls and substantive testing of transactions and accounts.

Auditors document the details of their controls and substantive testing in their working papers. An auditor's working papers provide proof of audit work completed, procedures used and evidence gathered or sighted. Each accounting firm has its own working paper format and preferences. In this chapter, we provide some examples of a typical audit file and the types of working papers it may contain.

7.1 Audit sampling

LEARNING OBJECTIVE 7.1 Explain how audit sampling is used in an audit.

ASA 530 (ISA 530) *Audit Sampling* provides guidance on **audit sampling**. When creating an **audit program** and designing audit procedures an auditor also decides how to select appropriate items for testing. When an audit procedure is tested on an entire group of transactions (for example, the purchase of machinery) or all items within an account balance (for example, motor vehicles) sampling is not required. However, when there are numerous transactions or items within an account balance available for testing, an auditor must decide how best to select a sample that is representative of the entire population of items available for testing.

As defined previously, audit risk is the risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated. There are two elements to that risk, the risk associated with using a sample for testing, known as sampling risk, and other risks, known as non-sampling risk.

BEFORE YOU GO ON

- What is audit sampling?
- When is it appropriate to use audit sampling?
- How does audit sampling relate to audit risk?

7.2 Sampling and non-sampling risk

LEARNING OBJECTIVE 7.2 Recognise the difference between sampling and non-sampling risk.

Sampling risk is the risk that the sample chosen by the auditor is not representative of the population of transactions or items within an account balance available for testing and, as a consequence, the auditor arrives at an inappropriate conclusion (ASA 530, ISA 530). There are two consequences of sampling risk. There is the risk that the audit will be ineffective and there is the risk that the audit will be inefficient.

7.2.1 Sampling risk and tests of controls

When testing controls, sampling risk is the risk that an auditor relies on their client's system of internal controls when they should not do so (that is, the auditor concludes that their client's internal controls are effective when they are ineffective), and the risk that an auditor concludes that their client's internal controls are less reliable than they really are (that is, the auditor concludes that their client's internal controls are ineffective when they are effective). Table 7.1 provides details of sampling risk when testing controls and the implications of that risk for the audit.

In the top right cell in panel A and the top section in panel B of table 7.1 the auditor has tested their client's system of internal controls and concluded that the system is effective when it is ineffective at preventing and detecting potential material misstatements. Another way of stating this risk is that an auditor has concluded that their client's system of internal controls is *more* effective than it is. As a consequence, the auditor places too much reliance on their client's system of internal controls to identify and rectify material misstatements. This can happen when the items selected for testing the effectiveness of the internal controls are not representative of all items available for testing. For example, a manager is away on vacation for two weeks during the year and another member of the client's personnel acts as manager during their absence. The auditor selects items for testing throughout the year, but the sample does not include transactions processed while the manager was on holiday.

There is a risk that the auditor concludes that the controls that involve the manager's supervision and authorisation are effective throughout the year, when they may not have worked effectively during the two-week holiday period.

TABLE 7.1 Sampling risk when testing controls

Panel A		
	Actual control risk	
Auditor assessed control risk	Low	High
Low	Auditor assessment correct	An increased audit risk
High	An increase in audit effort	Auditor assessment correct

Panel B	
Sampling risk	Implications for the audit
The risk that the auditor concludes that the client's system of internal controls is effective when it is ineffective	An increased audit risk (i.e. there is a risk that the audit will be ineffective)
The risk that the auditor concludes that the client's system of internal controls is ineffective when it is effective	An increase in audit effort when not required (i.e. there is a risk that the audit will be inefficient)

From the audit risk model discussed in chapter 4 we know that when an auditor concludes that their client's system of internal controls is effective at preventing and detecting material misstatements, control risk will be assessed as low and the audit strategy will be to reduce reliance on detailed substantive testing of transactions and balances. By conducting fewer substantive procedures, an auditor increases detection risk, which in turn increases audit risk. This means that there is an increased risk that the auditor's detailed substantive procedures will not detect a material misstatement (that is, there is a risk that the audit will be ineffective).

In the bottom left cell in panel A and the bottom section in panel B of table 7.1 the auditor has tested their client's system of internal controls and concluded that the system is ineffective when it is in fact effective at preventing and detecting potential material misstatements. Another way of stating this risk is that an auditor has concluded that their client's system of internal controls is *less* effective than it is. As a consequence, the auditor does not place sufficient reliance on their client's system of internal controls. This can happen when the items selected for testing the effectiveness of the internal controls are not representative of all items available for testing. For example, a client has a control procedure requiring authorisation of purchases in excess of $200 000. The auditor selected purchase orders from one division of the company. The auditor has found the control to be ineffective because the manager has not signed all purchase orders selected. In this example, the auditor runs the risk of placing less reliance on this control than strictly necessary because they did not select the sample from across all divisions, where the control may be working more effectively.

From the audit risk model we know that when an auditor concludes that their client's system of internal controls is ineffective at preventing and detecting potential material misstatements, control risk will be assessed as high and the audit strategy will be to increase reliance on detailed substantive testing of transactions and balances. By conducting more substantive procedures when control risk is lower than assessed, the audit will be inefficient as more time will be spent conducting substantive procedures than is necessary.

7.2.2 Sampling risk and substantive procedures

When conducting substantive tests, sampling risk is the risk that an auditor concludes that a material misstatement does not exist when it does or an auditor concludes that a material misstatement exists when it does not. Table 7.2 provides details of sampling risk when conducting substantive tests and the implications of that risk for the audit.

TABLE 7.2 Sampling risk when conducting substantive tests

Panel A

	Actual state of a class of transactions or an account balance	
Auditor conclusion	**Not materially misstated**	**Materially misstated**
Not materially misstated	Auditor conclusion correct	An increased audit risk
Materially misstated	An increase in audit effort	Auditor conclusion correct

Panel B

Sampling risk	Implications for the audit
The risk that the auditor concludes that a material misstatement does not exist when it does	An increased audit risk (i.e. there is a risk that the audit will be ineffective)
The risk that the auditor concludes that a material misstatement exists when it does not	An increase in audit effort when not required (i.e. there is a risk that the audit will be inefficient)

In the top right cell in panel A and the top section in panel B of table 7.2 the auditor has conducted substantive procedures on a sample and concluded that there is no material misstatement when there is a material misstatement. As a consequence the auditor will conclude that the financial report is true and fair when it contains a material misstatement (that is, the audit is ineffective). For example, a client has warehouses in four major cities. The auditor has selected a sample of inventory items for testing. The entire sample of inventory selected for testing is located in the one warehouse near the client's head office. The auditor has not tested material inventory items held at the other three warehouses. As a consequence the auditor has not detected a significant error in valuing inventory at one of the warehouses. If the auditor had selected a sample for testing from each warehouse the risk of arriving at an incorrect conclusion would have been reduced, though not eliminated (that is, sampling risk can be reduced though it can never be removed).

In the bottom left cell in panel A and the bottom section in panel B of table 7.2 the auditor has conducted substantive procedures on a sample and concluded that there is a material misstatement when there is no material misstatement. As a consequence the auditor will conduct more extensive testing believing that there is a material misstatement reducing audit efficiency. For example, an error occurred when processing credit sales and a customer was charged twice for the same item by mistake. The auditor detects this error and concludes that if this error was to be repeated throughout the remainder of the population of credit sales, trade receivables would be materially misstated. As a consequence the auditor increases their testing to uncover the cause of the error. If the error is unique and not repeated throughout the population, the audit will be inefficient.

7.2.3 Non-sampling risk

Non-sampling risk is the risk that an auditor arrives at an inappropriate conclusion for a reason unrelated to sampling issues. This can occur when an auditor uses an inappropriate audit procedure, relies too heavily on unreliable evidence or spends too little time testing the accounts most at risk of material misstatement.

When testing controls, non-sampling risk is the risk that an auditor designs tests that are ineffective and do not provide evidence that a control is operating properly. For example, a client uses passwords to restrict access to its computer programs. To test that the passwords are operating effectively, an auditor observes client personnel accessing programs using their passwords. This test is not effective in assessing whether the client's programs prevent access to users with invalid passwords. In another example, an auditor is aware that their client has a new credit policy, which places more restrictions on sales to debtors who are overdue. To test the new policy the auditor reads their client's policy manual, finds the details of the policy change and concludes that the internal control procedure is effective. In this case reading the policy manual is not a test of the control. The auditor would need to select some overdue debtors and check that the new policy had been enforced.

When conducting substantive procedures, there are a number of non-sampling risks. One non-sampling risk is the risk that an auditor relies too heavily on less persuasive evidence. For example, an auditor may rely too heavily on management representations without gathering independent corroborating evidence. Non-sampling risk is also the risk that an auditor spends most of their time testing assertions where the risk of material misstatement is modest and ignores or spends insufficient time testing assertions most at risk of material misstatement. For example, a client sells pearls. There is a significant risk that recorded inventory does not exist, yet the auditor spends more time testing for completeness. In another example, an auditor conducts a debtors' confirmation on thirty of their client's customers. When three immaterial debtors fail to reply, the auditor concludes that the debtors are immaterial and no further work is required in relation to the debtors' confirmation. As the primary assertion tested by confirmations is existence, valuation of individual debtors is not the primary concern. The fact that three debtors did not respond means that further testing for the existence of client debtors may be warranted.

CLOUD 9

Ian is a bit disappointed. 'I thought that if you took a random sample, and did not find any errors, you could conclude that there was definitely no error in the overall population. But you are saying that there is still a risk that the population has errors.'

'That's right,' says Suzie. 'Unless you test every item in the population, you will still have a statistical chance of making the wrong conclusion simply because you took a sample. Also, if you take a sample in a way that is biased, it is difficult to conclude that the sample results say anything at all about the population. That's why it is so important that junior staff don't just take the nearest, or most convenient, box of documents to test. Another big trap is that some part of the accounting period has different conditions, such as a key member of the client's staff is on leave. The auditor has to recognise this and make sure that the relevant period is included in the sample. We know that Cloud 9 opened its new Sydney store on the first of June. Obviously inventory levels will be different around this time, so we have to plan to handle these different conditions with our sampling.'

BEFORE YOU GO ON

- What is sampling risk?
- How does sampling risk relate to tests of controls and substantive testing?
- What is non-sampling risk?

7.3 Statistical and non-statistical sampling

LEARNING OBJECTIVE 7.3 Discriminate between statistical and non-statistical sampling.

According to ASA 530 (ISA 530) **statistical sampling** involves random selection and probability theory to evaluate the results, including sampling risk. Any sample selection method that does not have these characteristics is not statistical sampling; for example, when an auditor uses judgement alone to select a sample for testing. An advantage of statistical sampling is that it allows an auditor to measure sampling risk, that is, the risk that the sample chosen by the auditor is not representative. A disadvantage of statistical sampling is sometimes the cost involved in using this technique.

Non-statistical sampling is easier to use than statistical sampling, requires less staff training, is lower cost and allows an auditor to select a sample that they believe is appropriate using their professional judgement. Most audit firms use a combination of statistical and non-statistical sampling. **Non-statistical sampling** is generally used when an account is considered to be low risk and the auditor has access to adequate corroborating evidence from other sources. Statistical sampling is generally used for high-risk accounts, where limited or no corroborating evidence is available. The next section of this chapter includes a discussion of various statistical and non-statistical sampling techniques.

BEFORE YOU GO ON

- What is statistical sampling?
- What is non-statistical sampling?
- What are the advantages and disadvantages of statistical and non-statistical sampling?

7.4 Sampling methods

LEARNING OBJECTIVE 7.4 Describe sampling methods.

In this section we discuss a range of sampling techniques available to auditors. They include random selection, systematic selection, haphazard selection, block selection and judgement selection.

7.4.1 Random selection

As explained earlier, statistical sampling requires that a sample be selected randomly and the results of the test evaluated using probability theory. **Random selection** requires that the person selecting the sample does not influence the choice of items selected. The resulting sample is then free from bias and each item within the population has an equal chance of being selected for testing. Random number generators can be used to select a sample.

Stratification can be used ahead of random selection to improve audit efficiency. This means that an auditor partitions a population ahead of sampling. After stratifying a population, items can be randomly selected within each stratum. Thus, stratification can be used to ensure the sample includes items that have the characteristics required by the auditor, such as the inclusion of material or risky items in the sample, while remaining a statistical sampling technique, when items are randomly selected. Stratification is explained in more detail in section 7.4.6.

7.4.2 Systematic selection

Systematic selection involves the selection of a sample for testing by dividing the number of items in a population by the sample size, resulting in the sampling interval (n). Once the sampling interval has been determined a starting point is selected, which is an item in the population below the sampling interval, and then the sample is selected by selecting the first item and then every nth item after that.

For example, a client has 600 creditors. The auditor has decided that the sample size when testing creditors is 20. To determine the sampling interval, the following formula is used.

$$\begin{aligned}\text{Sampling interval} &= \frac{\text{Population size}}{\text{Sample size}}\\ &= \frac{600}{20}\\ &= 30\end{aligned}$$

This means that every 30th item will be selected for testing. An item within the first 30 in the list of creditors is selected as the starting point. From then every 30th item is selected for testing. If the first item selected is 15, then the following items will be tested: 15, 45, 75, 105, 135, 165, 195, 225, 255, 285, 315, 345, 375, 405, 435, 465, 495, 525, 555 and 585. If the starting item is selected randomly and the population is not arranged in any particular order, systematic selection can be considered a statistical sampling technique.

The risk in using systematic selection is that items will be listed in such a way that by selecting every *n*th item the auditor is selecting items that are related in some way. For example, if the sampling interval matches a factor inherent to the population being tested the auditor may inadvertently select items that are similar. This can happen when payroll is being tested and the same employee is selected each time. This risk can be reduced by reviewing the items in a population before calculating the sampling interval.

7.4.3 Haphazard selection

Haphazard selection involves the selection of a sample by an auditor without using a methodical technique. While this technique appears to have much in common with random selection, there is a risk that an auditor will avoid selecting some items or ensure other items are included in the sample. For example, an item that is going to be difficult to test because the documentation is held in another location may be purposefully omitted by the auditor, while an item that looks unusual and catches the auditor's eye may be purposefully included. This is a non-statistical technique as human bias may influence the sample selected.

CLOUD 9

'We are going to use haphazard selection for sales invoices and cash receipts at Cloud 9,' Suzie tells Ian. 'We will select our sample from the entire year because we do not expect different conditions in sales made to department stores during different times of the year. Obviously, part of the sampling process includes processes to protect against any potential bias in the sample selection.'

7.4.4 Block selection

Block selection involves the selection of items that are grouped together within the population of items available. This is a non-statistical technique as many populations of items are sorted in a sequence, which makes the selection of groups of items in a block inappropriate. For example, transactions are generally grouped in date order; by using block selection the items selected will not be representative of transactions made throughout the year.

7.4.5 Judgemental selection

Judgemental selection involves the selection of items that an auditor believes should be included in their sample for testing. When testing controls, judgement may be used to ensure that transactions processed when a new computer is installed are included in the sample. When conducting substantive testing, judgement may be used to include in the sample large or unusual items. This is a non-statistical sampling technique. This method of selection is commonly used for low risk accounts.

PROFESSIONAL ENVIRONMENT

Sampling in practice

How do auditors use sampling in practice? Hall et al. conducted a survey of US accountants in public practice, industry and government to find the answer to this question.[1] Although their study was conducted in 1997 and the results are not necessarily representative of today's practices, their discussion on the advantages and disadvantages of statistical and non-statistical sampling and their impact on the risk of an inappropriate audit opinion still applies.

The researchers asked auditors how they determined sample sizes, selected samples and evaluated these samples. The auditors were asked if they used statistical selection techniques (simple random, stratified, systematic/random start and dollar-unit) and non-statistical selection techniques (haphazard, block, systematic/judgement start and directed).

The results showed that auditors use non-statistical selection methods 85 per cent of the time and only 15 per cent of the selections were made using statistical methods. The most common non-statistical sample selection method was haphazard selection. This is a technique where the sample is selected without a method. The choice of items is not supposed to be based on its characteristics, such as colour, size or the convenience of location. However, very few of the auditors reported receiving any training in methods to counter the bias introduced by non-statistical sampling and none reported using any bias reducing techniques. The results suggest that auditors might not fully understand the influence of sample selection bias on their audit conclusions.

The most common statistical sample selection method according to the study is dollar-unit sampling. This is an approach where the unit sampled is not the transaction or document, but the individual dollars making up the transaction or balance. The dollar-unit sampling method means that the auditor samples the dollars in the transactions rather than the transactions themselves. Dollar-unit sampling gives large transactions a greater chance of being sampled than small transactions.

Consider the following example of sales transactions reported by a client.

#1 $2
#2 $2000
#3 $20 000

The auditor wants to take a random sample and inspect the underlying documents. If the unit of sampling is the sales transaction, the $20 000 transaction has the same chance of being selected as the $2 transaction. However, if dollar-unit sampling is used, then every sales dollar has the same chance of being selected. If the sampling unit is $2, the chance of the $20 000 transaction being selected is 10 000 times greater than the $2 transaction. Given that auditors are typically concerned about overstatement of sales, dollar-unit sampling has the advantage of being more likely to select potentially overstated transactions.

7.4.6 Factors to consider when selecting a sample

There are a number of factors to consider when selecting a sample. The factors discussed in this section are common to all sampling methods. When selecting a sample, an auditor will use their judgement and knowledge of their client to make a preliminary assessment of control risk, detection risk and planning materiality, all of which affect the sample size. The lower control risk, the larger the sample size when testing controls. The lower detection risk, the larger the sample size when conducting detailed substantive procedures.

An auditor must take care when selecting the population from which a sample is drawn. This decision is determined by the audit procedure undertaken, which in turn is determined by the assertion being tested. When testing the existence of inventory, it is appropriate to select a sample from the client's inventory listing (that is, the population from which a sample is selected is the client's complete list of inventory), whereas when testing the completeness of inventory, it is appropriate to select a sample of physical inventory (that is, the population from which a sample is selected is the client's physical inventory).

An auditor may decide to stratify the population before selecting a sample from it. Stratification improves audit efficiency by dividing the population into groups and then selecting items from each group. For example, a population may be divided into months of the year. When testing controls, it is important to ensure effectiveness throughout the year. By dividing items into months of the year and selecting from each month, an auditor can efficiently ensure that the whole year is covered by their test. If stratification is not used and the inclusion of items from each month is a priority, the sample size will continue to increase until randomly selected items cover each month of the year. In another example, a population may be divided into different characteristics so that riskier items have an appropriate chance of being selected for testing. Credit sales are riskier than cash sales, so sales may be divided into credit and cash before a sample is selected.

An auditor will use their professional judgement when considering what would be considered an error within the population tested. When testing controls, an auditor will define what represents a deviation from a prescribed control procedure. For example, if a client has a control procedure that requires a manager to authorise purchases greater than \$20 000, a deviation will be evidence of unauthorised purchases greater than \$20 000. When conducting substantive procedures, an auditor will define what represents a misstatement in transactions or account balances. For example, if an auditor conducts receivable confirmations, to test the existence of debtors, a non-reply would be considered a potential error and would require further audit work. If an auditor conducts a test of the accuracy of the depreciation expense by recalculating selected items, if some items are significantly different to the client's depreciation amounts, those differences would be considered potential errors that would require further audit testing.

An auditor will use their professional judgement to determine the **tolerable error** and required level of confidence. The tolerable error is the maximum error an auditor is willing to accept within the population tested (ASA 530, ISA 530). When testing controls this is the tolerable rate of deviation that an auditor is willing to accept before concluding that a control is ineffective. When conducting substantive procedures this concept relates to auditor assessed materiality. If an error is considered material, an auditor will conclude that the account is materially misstated.

The required level of confidence is a function of control risk when testing controls and detection risk when conducting substantive procedures. When control risk is initially assessed as low, based upon an auditor's understanding of their client's system of internal controls, an auditor will require a high level of confidence that the controls are effective before concluding that control risk is low. In this situation an auditor will increase the sample size when testing controls to reduce the risk that the client's system of internal controls is believed to be effective when it is ineffective (refer to the top right cell in panel A and the top section in panel B of table 7.1).

When detection risk is set as low, an auditor will require a high level of confidence that the transactions and accounts are not materially misstated. Recall that by setting a low detection risk, the auditor believes that inherent risk and control risk are high; that is, the transactions and accounts are at risk of material misstatement and the client's internal controls are believed to be ineffective. In this situation the auditor will increase the sample size when conducting substantive tests of transactions and balances to reduce the risk that the auditor concludes that a material misstatement does not exist when it does (refer to the top right cell in panel A and the top section in panel B of table 7.2).

To summarise, before selecting a sample, an auditor will use their professional judgement to assess control and set detection risk, set planning materiality, select an appropriate population for testing, define what is to be considered to be an error within the population to be tested, set the tolerable error rate and set the required level of confidence. Once these parameters are set an auditor will select their sample using a statistical or non-statistical sampling technique.

BEFORE YOU GO ON

- What is the difference between random and haphazard sample selection?
- What is the risk in using systematic sample selection?
- What factors should be considered when selecting a sample?

7.5 Factors that influence the sample size — testing controls

LEARNING OBJECTIVE 7.5 Describe the factors that influence the sample size when testing controls.

There are a number of factors that will influence the sample size when testing controls. These are summarised in table 7.3, which comes from ASA 530 (ISA 530).

TABLE 7.3 **Factors that influence the sample size when testing controls**

Factor	Effect on sample size
1. An increase in the extent to which the auditor's risk assessment takes into account relevant controls	Increase
2. An increase in the tolerable rate of deviation	Decrease
3. An increase in the expected rate of deviation of the population to be tested	Increase
4. An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population	Increase
5. An increase in the number of sampling units in the population	Negligible

Source: Australian Auditing and Assurance Standards Board 2009, ASA 530 (ISA 530) *Audit Sampling*, 'Appendix 2', pp. 21–2.

The first factor listed in table 7.3 is an increase in the extent to which the risk of material misstatement is reduced by the operating effectiveness of controls. If an auditor believes that a control will be effective in reducing an identified risk of material misstatement, their audit strategy will be to increase testing of that control to ensure it is effective. When concluding that a control is effective, an auditor will rely on that control to prevent and detect a material misstatement, and reduce their detailed substantive procedures.

The second factor listed in table 7.3 is an increase in the **rate of deviation** from the prescribed control activity that the auditor is willing to accept. As described previously, an auditor will use their professional judgement to determine the tolerable rate of deviation that is acceptable. There is an inverse relationship between the tolerable rate of deviation and sample size. If an auditor intends to rely on a control to prevent and detect a material misstatement, a lower tolerable error rate will be set and the sample size will be increased to provide the auditor with the evidence required to demonstrate that the control is effective. If an auditor expects to place relatively more reliance on their substantive procedures and reduce their reliance on an internal control, they will increase the tolerable rate of deviation and reduce the sample size when testing the control.

The third factor listed in table 7.3 is an increase in the rate of deviation from the prescribed control activity that the auditor expects to find in the population. If an auditor believes that the rate of deviation has increased when compared to prior audits, they will increase the sample size to accurately evaluate the impact of the changed circumstances. For example, the rate of deviation would increase if the client has new staff, if the client has significantly changed a computer program or if the client has changed their internal control procedures.

The fourth factor listed in table 7.3 is an increase in the auditor's required confidence level. When control risk is assessed as low for a risk factor, an auditor's required level of confidence in the effectiveness of their client's internal control is higher than when control risk is assessed as medium to high. If an auditor is to rely on their client's internal control procedures to prevent or detect an identified material misstatement, their required confidence level in that control increases and they will increase the sample size when testing that control.

The fifth and final factor listed in table 7.3 is an increase in the number of sampling units in the population. When a population is large and fairly homogenous, there is little benefit from continuing to increase the sample size as the results from continued testing should confirm early findings. For example, an auditor may test control procedures surrounding the processing of sales. When all sales are processed using the same procedure, there will be little difference in the sample size if the population of sales was to vary from one year to the next.

BEFORE YOU GO ON

- What are the factors that influence sample size when testing controls?
- What is the relationship between the tolerable rate of deviation and sample size?
- How is the auditor's required confidence level influenced by control risk?

7.6 Factors that influence the sample size — substantive testing

LEARNING OBJECTIVE 7.6 Explain the factors that influence the sample size when conducting substantive testing.

There are a number of factors that will influence the sample size when testing transactions and balances. These are summarised in table 7.4, which comes from ASA 530 (ISA 530).

TABLE 7.4 Factors that influence the sample size when testing transactions and balances

Factor	Effect on sample size
1. An increase in the auditor's assessment of the risk of material misstatement	Increase
2. An increase in the use of other substantive procedures directed at the same assertion	Decrease
3. An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population	Increase
4. An increase in tolerable misstatement	Decrease
5. An increase in the amount of misstatement the auditor expects to find in the population	Increase
6. Stratification of the population when appropriate	Decrease
7. The number of sampling units in the population	Negligible

Source: Australian Auditing and Assurance Standards Board 2009, ASA 530 (ISA 530) *Audit Sampling*, 'Appendix 3', pp. 23–5.

The first factor listed in table 7.4 is an increase in the auditor's assessment of the risk of material misstatement. This risk is influenced by the auditor's assessment of inherent and control risk. The higher the inherent and control risk, the greater the risk that a material misstatement exists in a client's financial report, the more an auditor must rely on their substantive tests of transactions and balances to identify potential material misstatements. When an auditor decides to increase their reliance on their substantive procedures, they will increase the sample size when conducting substantive tests.

The second factor listed in table 7.4 is an increase in the use of other substantive procedures directed towards the same assertion. When testing transactions and balances, an auditor will use a number of audit procedures. The more procedures that are directed to the same audit assertion, the less an auditor will need to rely on the evidence provided by one test alone and the smaller the sample size required. For example, when testing the valuation of inventory, a number of procedures can be used. They include the inspection of inventory on hand for evidence of damage, recalculation of cost multiplied by quantity on hand, tracing of cost to supplier invoices and testing for lower of cost and net realisable value.

The third factor listed in table 7.4 is an increase in the auditor's required confidence level. This factor is also related to the level of inherent and control risk. The greater the inherent and control risk, the lower the detection risk set by the auditor, the greater the confidence level required when conducting substantive tests of transactions and balances. When an auditor requires more confidence from the results of their testing, they will increase the sample size when conducting substantive tests.

The fourth factor listed in table 7.4 is an increase in the total error that the auditor is willing to accept. When an auditor increases the tolerable error rate, they are indicating that they are not relying on that particular test to provide all of the evidence required for a particular assertion. In that case they will reduce the sample size. The tolerable error is equal to or less than the materiality level set for the class of transactions or balances being tested.

The fifth factor listed in table 7.4 is an increase in the amount of error the auditor expects to find in the population. When an auditor believes that there is likely to be a material misstatement in the population of transactions or amounts making up an account balance, they will increase their sample size to gain a better estimate of the actual misstatement in the population. This will occur when an account is at risk of material misstatement such as when it requires estimation (for example, the allowance for doubtful debts), when it requires complex calculations (for example, foreign exchange translations) or when it requires difficult valuation techniques (for example, fair values). This will also occur when the auditor has assessed that control risk is high and the client's control procedures are inadequate.

The sixth factor listed in table 7.4 is stratification of the population. As described previously, stratification of the population will result in more efficient sampling and reduce the sample required. The seventh and final factor listed in table 7.4 is the number of sampling units in the population. As described previously for tests of controls, when a population is large and fairly homogenous, there is little benefit from continuing to increase the sample size as the results from continued testing should confirm early findings.

BEFORE YOU GO ON

- What are the factors that influence sample size when conducting substantive procedures?
- What influences an increase in the auditor's assessment of the risk of material misstatement?
- What could occur to increase the amount of error an auditor expects to find in a population?

7.7 Evaluating sample test results

LEARNING OBJECTIVE 7.7 Explain how to evaluate the results of tests conducted on a sample.

After an auditor has completed their audit testing, the next stage is to evaluate the results. There are numerous methods available to do this. They vary in complexity, with the most complex requiring access to high powered computer software. In this section we outline how sample test results are evaluated in practice, without delving into the complex programs available to aid auditors in some firms. When testing controls, an auditor will consider whether the results of their tests applied to a sample provide evidence that the control tested is effective within the entire population. When conducting tests of transactions and balances, an auditor will consider whether the results of their tests applied to a sample provide evidence that the class of transactions or account balance tested is fairly stated (that is, does not contain a material misstatement).

If an auditor discovers departures from prescribed controls when testing controls, a deviation rate will be calculated. The deviation rate is the proportion of departures within the sample. If the sample is believed to be representative of the entire population, then the deviation rate for the sample should equal the deviation rate for the population. For example, if an auditor finds three departures from a prescribed control when testing a sample of 30 items, the deviation rate is 10 per cent (3/30). If the sample is representative of the population, the auditor will compare this deviation rate with their tolerable rate of deviation. If the rate of deviation exceeds the tolerable rate, the auditor will extend their testing (particularly when the auditor is concerned that their sample may not be representative) and gather further evidence of other controls that may be aimed at reducing the identified risk of material misstatement. If after conducting more testing the auditor finds that the rate of deviation remains consistent with their initial findings and other controls are similarly ineffective, the auditor will conclude that the client's system of internal controls cannot be relied upon to prevent or detect a potential material misstatement and the auditor will reassess control risk and increase their reliance on their substantive tests of the account tested.

If an auditor discovers errors when testing transactions or account balances, the auditor will need to project the error to the population being tested (ASA 530, ISA 530). Firstly, an auditor will consider whether an error is considered to be unique and not likely to be repeated throughout the population being tested. If an error is considered to be unique it will be removed before projecting remaining errors to the population. Secondly, an auditor will consider whether the population was stratified before being sampled. If so, errors are projected within each stratum and then summed together with any unique errors identified. An auditor will consider the impact of **projected errors** on the class of transactions or account balance being tested to determine whether a material misstatement has occurred.

For example, an auditor has conducted substantive testing on an account balance, which has been split into three strata. The results of that test are summarised in table 7.5. The first column contains the stratum number, the second column the error found for each stratum, the third column the dollar value of the sample tested, the fourth column the dollar value of the entire stratum available for testing and the final column the calculation of the projected error for each stratum.

The net total error for the sample is $2649. It would be incorrect to compare that amount to the tolerable error rate as the error in the sample underestimates the error in the entire population. The errors found are projected to the population in the final column in table 7.5, providing a total net error of $5257. That error is compared to the tolerable error rate for that account balance. If the tolerable error rate was set conservatively at $3500, the auditor would conclude that the errors uncovered are material and further work is required. This may involve increasing the sample size and/or conducting other tests aimed at the assertion being tested. If the tolerable error rate was set at $7500, the auditor would conclude that the errors uncovered are not material. As the total net error is close to the tolerable error rate, some additional testing within the sample may be considered to confirm that conclusion.

TABLE 7.5 **Evaluation of results of substantive testing**

Stratum (1)	Error (2)	Sample (3)	Stratum (4)	Projected error (2)/(3)*(4)
1	$1 586	$20 235	$25 732	$ 2 017
2	$ (658)	$ 8 398	$15 367	$(1 204)
3	$1 721	$12 568	$32 456	$ 4 444
Total	$2 649	$41 201	$73 555	$ 5 257

While the techniques used to project errors can be more sophisticated than noted here, they all have in common a need to consider the sampling technique used, the level of precision required and the extent of evidence provided by other audit procedures. As described in the professional environment vignette entitled 'Sampling in practice' appearing earlier in this chapter, audit firms tend to use non-statistical sampling techniques, which require less sophisticated interpretation of results.

CLOUD 9

Suzie concludes the discussion of sampling by assuring Ian that it will not be his task to determine sample sizes and apply judgement to consider the results of the tests — that is a job for Jo Wadley, the partner, and the other senior people on the team. It will, however, be Ian's task to carry out the instructions for applying the instructions very carefully so that he does not inadvertently introduce any bias into the tests.

Suzie returns to Ian's earlier problem. He is confused about how they can proceed with substantive tests and control tests when they seem to be interrelated. How can they determine the appropriate scheduling of control and substantive tests? She starts by asking him a question. 'How likely do you think it is that Cloud 9's trial balance contains errors?' she asks Ian. 'Well that depends.' replies Ian. 'On what?' asks Suzie. 'On whether they made any mistakes, I suppose.' 'Well, how likely is that?' persists Suzie. Ian is even more confused now. He wants to know about control and substantive tests, and Suzie is not telling him.

Suzie tries another approach. 'What can the client do to prevent mistakes getting into their accounts, or detect and correct mistakes that do enter the records?'

BEFORE YOU GO ON

- What will an auditor consider when evaluating test results?
- What is the rate of deviation and when will an auditor calculate this?
- What will an auditor do if the rate of deviation exceeds the tolerable rate?

7.8 Tests of controls and substantive procedures

LEARNING OBJECTIVE 7.8 Discriminate the difference between tests of controls and substantive tests.

A key task during the risk assessment phase of every audit involves the development of an **audit strategy**. As discussed in chapter 4, ASA 300 (ISA 300) *Planning an Audit of a Financial Report* requires that an auditor establish an overall audit strategy. The audit strategy provides the basis for developing a detailed audit program. An audit program includes the audit procedures to be used when testing controls and when conducting detailed substantive audit procedures.

An audit strategy is developed after gaining an understanding of a client's business and its internal control structure. Once an auditor has a thorough knowledge of their client's business and controls they can determine the overall risk of material misstatement, which is the **inherent risk** (the risk a material misstatement could occur) and **control risk** (the risk that a client's system of internal controls will not prevent or detect a material misstatement) combined. The risk of material misstatement affects **audit risk** (the risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated). Figure 7.1 contains an overview of the link between risk of material misstatement and audit strategy. When control risk is assessed as being high (top section of figure 7.1), an auditor will adopt a predominantly substantive approach. This means that the audit strategy is to gain a minimum knowledge of the client's system of internal controls, conduct limited or no **tests of controls** (or **controls testing**) and conduct extensive detailed substantive procedures. When control risk is assessed as medium to low (bottom section of figure 7.1), an auditor will adopt a lower assessed level of control risk approach. This means that the audit strategy is to gain a detailed understanding of their client's system of internal controls, conduct extensive tests of controls and if those controls prove effective, conduct less detailed substantive procedures.

Audit risk = *f*	Inherent risk	Control risk	Detection risk	Audit strategy
	High	High	Low	
		No tests of controls	Increased reliance on substantive tests of transactions and account balances	Predominantly substantive audit strategy
	Low	Low	High	
		Increased reliance on tests of controls	Reduced reliance on substantive tests of transactions and account balances	Lower assessed level of control risk audit strategy

FIGURE 7.1 Risk of material misstatement and audit strategy

CLOUD 9

Ian is starting to understand. Suzie has already explained the idea of inherent, control and detection risk to him, but until now he did not realise the practical implications. He can now answer Suzie's question: he is able to explain that the client is responsible for creating a system of internal controls to stop, or detect, mistakes entering the accounts. A strong system of internal controls means lower control risk. Tests of controls are designed to gather evidence about the system of internal controls' strength, and justify the auditor's decision about how much reliance to place on the system. Greater reliance on a strong system of internal controls will allow the auditor to rely less on substantive procedures. This is the lower assessed level of control risk approach. The other strategy, a predominantly substantive approach, means low (or no) reliance on the system of internal controls and greater reliance on substantive procedures. Now he realises the importance of the report that was provided at the meeting. Josh and Sharon have made a preliminary assessment of Cloud 9's control system. But he is still not clear on what that means for the testing.

7.8.1 Tests of controls

Later in this text we will provide a detailed overview of tests of controls (see chapter 8). The purpose of this brief discussion is to introduce those tests and highlight how they differ from substantive tests. When testing controls, an auditor is interested in assessing the effectiveness of internal controls identified when gaining an understanding of their client's system of internal controls during the risk assessment phase of the audit. When making a preliminary assessment that control risk is medium or low (bottom section of figure 7.1), an auditor is basing that assessment on their knowledge of the inherent risks faced by their client and the suitability of their client's internal controls to mitigate those risks.

Before an auditor can conclude that control risk is medium or low, they test the controls to check their effectiveness. If the controls prove effective the auditor can reduce their reliance on detailed substantive procedures. If the controls prove ineffective, the auditor reassesses control risk as higher than before and increases their reliance on detailed substantive procedures (that is, moves towards the top section of figure 7.1).

Tests of controls are conducted to establish that controls:

- operate effectively, meaning that the rate of deviation from prescribed control procedures are minimised and controls effectively prevent and detect material misstatements
- operate consistently throughout the accounting period.

From chapter 5 we know that the main evidence gathering procedures used by an auditor include inspection, observation, enquiry, confirmation, recalculation, re-performance and analytical procedures. When testing controls, the procedures commonly used include:

- inspection of documents for evidence of authorisation
- inspection of documents for evidence that details included have been checked by appropriate client personnel
- observation of client personnel performing various tasks, such as opening mail and conducting a stocktake
- enquiry of client personnel about how they perform their tasks
- re-performing control procedures to test their effectiveness.

CLOUD 9

Suzie explains that control testing means, for example, that the auditor inspects documents, observes personnel, makes enquiries, re-performs certain controls, or conducts other tests that suit that particular client's systems. Suzie gives examples of the control tests they intend to perform for Cloud 9: read the policies and procedures manuals, check for evidence of supervisors' reviews of cash receipts, observe staff in the shipping department handling despatches, talk to the financial controller about the inventory management system, and re-perform a sample of bank reconciliations.

All these control tests (plus others) have to be scheduled in the audit program. But this is Ian's big problem. They are writing the program now, before they know the results of the control testing. 'What if the test results reveal poor controls?' he asks.

Suzie explains that they have an initial assessment of control system strength and plan their substantive tests based on that assessment. 'Remember,' she adds, 'we have already done some enquiries at a high level, plus we have the results of the analytical procedures. Based on Josh and Sharon's report, we have a pretty good idea of where the problems will arise. However, if our expectations are not met we simply adjust the plan as we go along.'

7.8.2 Substantive procedures

Later in this text we will provide a detailed overview of substantive testing procedures (see chapters 9–11). The purpose of this brief discussion is to introduce those tests and highlight how they differ from tests of controls. The three types of **substantive procedures** include substantive tests of transactions, substantive tests of balances and analytical procedures.

When an auditor assesses inherent and control risk as low for a client and tests of controls confirm their effectiveness (bottom section of figure 7.1), an auditor will reduce the amount of planned detailed substantive procedures. This means that an auditor will rely to some extent on the client's internal control procedures to prevent and detect material misstatements. As a consequence, an auditor can rely more on their analytical procedures, which are more efficient than substantive testing of details, and place greater reliance on the client's accounting records.

When an auditor assesses inherent and control risk as high for a client and decides that the client's internal controls are unlikely to effectively reduce identified inherent risks (top section of figure 7.1), an auditor will adopt a predominantly substantive approach to their testing. This means that an auditor will not place too much reliance on their client's system of internal controls to prevent and detect material misstatements and will instead conduct detailed substantive procedures of their own to reduce audit risk to an acceptably low level. Recall that audit risk is the risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated (ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*; ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*). When control risk is high an auditor will not rely too heavily on their analytical procedures and will instead conduct more time consuming and costly substantive testing of transactions and balances.

When conducting detailed substantive procedures (also called substantive testing or tests of details), an auditor searches for evidence that recorded transactions occurred and relate to the client (**occurrence** assertion), that all transactions have been recorded (**completeness** assertion), that all transactions have been recorded at appropriate carrying amounts (**accuracy** assertion), that all transactions have been recorded in the correct accounting period (**cut-off** assertion) and that all transactions have been recorded in the correct accounts (**classification** assertion). When gathering this evidence, an auditor uses a variety of audit procedures. A few examples are:

- confirmation from the client's bank regarding interest rates charged on amounts borrowed by the client during the accounting period (accuracy assertion)
- recalculating an interest expense using the confirmed interest rates (accuracy assertion)
- inspecting documents to verify the date of transactions around year-end (cut-off assertion)
- inspecting suppliers' invoices to verify amounts purchased (completeness assertion).

When conducting detailed substantive procedures, an auditor searches for evidence that recorded accounts such as assets, liabilities and equity accounts exist (**existence** assertion), that all accounts that should have been recorded have been recorded (completeness assertion), that recorded accounts represent items owned by the client or amounts owed by the client to third parties (**rights and obligations** assertion) and that recorded accounts appear at appropriate carrying amounts (**valuation and**

allocation assertion). When gathering this evidence, an auditor uses a variety of audit procedures. A few examples are:

- confirmation from a selection of debtors of amounts owed to the client (existence assertion)
- recalculating the wages payable amount (valuation and allocation assertion)
- inspecting inventory and counting amounts on hand (existence and completeness assertions)
- inspecting supplier statements for amounts outstanding at year-end (completeness and valuation and allocation assertions)
- inspecting title deeds to verify that property is owned by the client (rights and obligations assertion).

When a client has effective internal controls, an auditor can use analytical procedures when testing transactions and account balances. Analytical procedures can be used to:

- estimate depreciation expense by multiplying the average depreciation rate on a class of assets by the balance at the beginning of the year (accuracy assertion)
- compare the wages expense month by month for this year and last year (completeness and occurrence assertions)
- compare inventory balances for this year and last year (existence, completeness and valuation and allocation assertions)
- compare accounts payable balances for last year and this year (completeness, existence and valuation and allocation assertions)
- discuss unusual fluctuations with client personnel (occurrence, completeness and valuation and allocation assertions)
- estimate revenue for a movie theatre, for example, by multiplying the average price of a ticket, by the number of seats in the theatre, by the average proportion of seats sold per session, by the average number of sessions per week, by the number of weeks per year (occurrence and accuracy assertions).

CLOUD 9

Ian confesses to Suzie that he has a problem understanding the difference between control and substantive tests. 'For example, at Cloud 9 a supervisor is supposed to check and authorise cash receipts deposited to the bank account. Suppose I find that the amount of the bank deposit is correct but the supervisor forgot to sign the authorisation. Is that an error?'

Suzie replies, 'You performed a test of the control that the supervisor authorises the transaction and found an error, or a deviation, from the correct performance of the control. However, you then performed an alternate substantive test and found that there was no error in the actual deposit. You have found evidence to substantiate the accuracy and occurrence assertions for that transaction. We would then consider all the other relevant evidence we have gathered about the controls over cash receipts. For example, how often do we find this type of control deviation for cash deposits? If we find significant problems with the controls, we could adjust our control risk assessment for cash receipts.'

PROFESSIONAL ENVIRONMENT

Data analytics

How will auditing change in the future as auditors try to keep up with big data and the technologies that handle it? Big data is the unstructured, semi-structured and structured data that are characterised as high-volume, high-velocity and high-variety. These sorts of data are produced in vast amounts but only structured data are easily classifiable into rows and columns. An example of the technology that can handle big data is the software behind the suggestions offered on platforms such as LinkedIn to connect with people you may know. These suggestions come from the matching of places you worked or studied, or through connections you might have in common with the suggested person.

The professional environment vignette in chapter 5 considered how financial statement auditors work with IT auditors. Here, we consider how auditing itself might be transformed by information technology. In 2014, the American Institute of Certified Public Accountants (AICPA) released a white paper exploring the issues of big data.[2] The AICPA suggests that the accounting profession will need to make a quantum leap and re-engineer its processes to take advantage of new technologies. In addition, the AICPA suggests that the profession and regulators will have to consider the relevance of auditing standards and modify them where necessary to incorporate the concepts of big data and continuous auditing. Continuous auditing is the process of gathering evidence throughout the year, not waiting until balance date. Not only does continuous auditing mean that the auditor can spread the workload throughout the year, it also means the auditor can use results of continuous auditing to constantly revise audit plans as new information and insights become available. Without change to keep up with new trends, auditing standards could become a hindrance to auditing because they will fail to recognise that new types of evidence can provide insights beyond those gained from traditional techniques.

Murphy and Tysiac suggest that big data could help auditors better understand their clients and improve their audits by identifying anomalies and trends in the data.[3] They suggest that through the appropriate use of technology, the auditor could analyse the whole data set (not just a sample) and identify the items they need to investigate further. The right technology could help auditors perform a comprehensive analysis of their client's general ledger systems and these analyses will be part of the audit evidence set in the future.[4]

Murphy and Tysiac quote one of the authors of the AICPA paper, Miklos Vasarhelyi, who states that potential impacts of big data and data analytics on the accounting profession include:

- changing education requirements to include more data analysis and interpretation skills
- more assurance services being provided by accounting firms as they extend their auditing skills to new data sets (not just financial accounts)
- greater use of big data and data analytics and less reliance on simple spreadsheets
- use of continuous auditing techniques
- updated audit standards.[5]

BEFORE YOU GO ON

- What will be an auditor's strategy when control risk is assessed as high?
- What are the two broad purposes of tests of controls?
- What are the main objectives when conducting substantive tests of account balances?

7.9 Nature, timing and extent of audit testing

LEARNING OBJECTIVE 7.9 Explain the factors that affect the nature, timing and extent of audit testing.

The nature, timing and extent of audit testing are crucial factors in every audit. An auditor uses their professional judgement when determining the nature, timing and extent of audit procedures to use for each client. The audit program details the procedures to be completed by the audit team. The nature, timing and extent of audit procedures used on each audit varies depending on the audit strategy adopted and the type of testing relied upon (that is, tests of controls or detailed substantive procedures) (ASA 330 (ISA 330) *The Auditor's Responses to Assessed Risks*).

7.9.1 Nature of audit testing

The **nature of audit testing** refers to the purpose of the test (that is, to test controls, transactions or account balances) and the procedure used (that is, inspection, observation, enquiry, confirmation, recalculation, re-performance or analytical procedures). The nature of an audit procedure will also depend upon the assertion being tested. The higher the risk of material misstatement, the more reliance placed on substantive procedures, the greater the use of audit procedures that access the most persuasive audit evidence.

As described above, tests of controls are quite different to substantive procedures. Tests of controls are concerned with providing evidence that an internal control procedure exists and is effective. The nature of these controls tests are to re-perform certain procedures, inspect documents for evidence of procedures carried out by client personnel, and observe client personnel performing control procedures. Controls can also be tested by purposefully trying to trip them up. For example, transactions can be created by an auditor to test controls embedded in their client's computer programs. Such transactions (referred to as test data) can include valid and invalid items. Valid data are traced to ensure that appropriate accounts are updated when the transactions are processed. If a client's internal controls are effective, invalid data should be identified and rejected by the program. For example, if a sales program includes a procedure to check the customer number of all debtors entered against an approved customer listing before processing a sale, an auditor could include a sale to a fictitious debtor to test the control is working. If the program processes the sale to a fictitious debtor created by the auditor, the control procedure cannot be relied upon as it has not operated effectively during this instance and there is a risk that some sales have been processed by the client that did not occur (occurrence assertion).

As described above, substantive procedures include detailed tests of transactions, balances and analytical procedures. The lower the risk of material misstatement, the more reliance placed upon more efficient, less costly, analytical procedures. However, an auditor will not place too much reliance on their analytical procedures, as this form of evidence is far less persuasive than detailed testing of balances and transactions, which is time consuming and costly but most effective. For these tests to be effective, it is important that an auditor plans to spend most time testing the assertions most at risk of material misstatement for each transaction class and account balance. For assertions most at risk, an auditor endeavours to gather the most persuasive evidence.

7.9.2 Timing of audit testing

Timing of audit testing refers to the stage of the audit when procedures are performed and the date, such as within or outside the accounting period. Tests of controls are designed to provide evidence that a control was effective throughout the accounting period. As such, tests of controls can be conducted during the interim stage of the audit and then extended to the end of the year when conducting the year-end audit. The interim stage of the audit is the initial visit to a client, before year-end, where planning takes place. It is common for audit planning to commence before year-end to aid in efficiency and to free up time at year-end. After gaining an understanding of the client, assessing the risk of material misstatement and setting a preliminary audit strategy, an auditor can commence tests of controls during the interim audit. Substantive testing of transactions, which also occur throughout the year, can also begin during the interim audit.

For low-risk accounts it is common to conduct more work during the interim audit, testing controls and conducting substantive tests of transactions. If, after conducting these tests, the auditor concludes that control risk matches their initial low- to moderate-level assessment, detection risk will be set as high to medium and less reliance will be placed on detailed substantive testing at year-end. If, after conducting preliminary tests of controls, the auditor concludes that audit risk is higher than initially estimated because, for example, the rate of deviation in controls from the client's prescribed procedures is above the expected rate for a low-risk account, the auditor will reduce detection risk and increase their reliance on detailed substantive testing at year-end.

For high-risk accounts the timing of most audit procedures will be at, or after, year-end. When there is a high risk of material misstatement in the amounts appearing in the financial report, an auditor will spend most time conducting detailed substantive tests of those account balances. Analytical procedures may be used to aid in the identification of those accounts most at risk of material misstatement, but these procedures will not be relied upon as the only audit evidence obtained.

It is necessary for some testing to be conducted around year-end. For example, as inventory counts are generally conducted on, or close to, year-end, audit procedures used to assess the effectiveness of the count can only be conducted around year-end. Some audit procedures are conducted throughout an accounting period (tests of controls and substantive tests of transactions), while others are predominantly conducted at year-end (substantive tests of account balances). The higher the risk of material misstatement, the greater the reliance on testing conducted around year-end.

7.9.3 Extent of audit testing

The **extent of audit testing** refers to the sufficiency (quantity) of audit evidence gathered when testing controls and conducting detailed substantive procedures. When control risk is low (bottom section of figure 7.1), the audit strategy is to increase reliance on tests of controls and reduce reliance on substantive testing of transactions and account balances. This means that the auditor will increase the extent of their testing of controls to gain evidence that their client's system of internal controls is effective in preventing and detecting material misstatements. If that extensive testing confirms the auditor's belief that their client's system of internal controls is indeed effective, the auditor will reduce the extent of substantive testing of transactions and balances and increase the extent of their reliance on more efficient analytical procedures.

When control risk is high (top section of figure 7.1), the audit strategy is to do little or no tests of controls and increase reliance on substantive testing of transactions and account balances. This means that the auditor will not rely on their client's system of internal controls to prevent and detect material misstatements. Instead, the auditor must rely on their own extensive substantive procedures to uncover any material misstatements. In the next section of this chapter we will discuss how an auditor selects an appropriate sample for testing controls and conducting substantive procedures.

CLOUD 9

Suzie emphasises to Ian that the detailed audit program section of the audit plan must specify three things about every test — nature, timing and extent. That is, which tests will be performed, when they will be performed and what period the data belong to, and how many times the tests will be performed. The 'how many' part relates to the size of the sample. The population from which a sample is drawn could be documents, inventory items, people (to talk to or observe), and so on.

Because W&S Partners has been appointed before year-end, it can test interim data and spread the testing over the available time before the audit report deadline. However, timing is not just about convenience. If controls are weak, more tests have to be scheduled around year-end. Control risk has a very pervasive effect on testing because weaker controls mean that the auditor must perform tests that will produce more persuasive evidence and select larger samples.

BEFORE YOU GO ON

- What are the three main categories of substantive procedures?
- What are the two most common types of testing that can be commenced during the interim audit?
- What does the extent of audit testing refer to?

7.10 Drawing conclusions

LEARNING OBJECTIVE 7.10 Explain how auditors arrive at a conclusion based upon the evidence gathered.

Sufficient appropriate audit evidence must be gathered to enable an auditor to draw a conclusion on which to base their opinion regarding the truth and fairness of their client's financial report (ASA 500, ISA 500). The decision of what constitutes sufficient appropriate audit evidence is a matter for professional judgement as it is based upon an auditor's understanding of their client and the significant risks identified when planning the audit and evidence gathered when executing the audit (ASA 315, ISA 315; ASA 330, (ISA 330) *The Auditor's Responses to Assessed Risks*).

During the risk assessment phase on an audit, if an auditor believes that a client has internal controls that potentially can reduce the likelihood of a material misstatement for an identified risk, they will test those controls. This means that their audit strategy will be to gather evidence to establish whether the internal controls are effective. Details of tests of controls will be discussed in chapter 8. Once testing of controls is complete, an auditor will gather further evidence via their substantive testing of transactions and balances.

During the risk assessment phase on an audit, if an auditor decides that a client does not have in place appropriate controls for the identified risk, an auditor will adopt a predominantly substantive approach. The auditor's strategy will be to increase their reliance on evidence gathered via their detailed substantive tests of transactions and account balances. Details of substantive testing will be discussed in chapters 9 to 11.

After gathering all of the evidence required via their tests of controls and substantive testing, auditors will arrive at conclusions for each assertion and each account. Identified misstatements will be brought to the attention of client management and, where necessary, the client's audit committee (or board of directors). Following negotiations between the lead partner on the audit and their client's management and audit committee (or board of directors), the lead partner will form an opinion regarding the truth and fairness of their client's financial report. Chapter 12 includes a detailed discussion of the process used when drawing an overall conclusion at the completion of the audit.

BEFORE YOU GO ON

- How does an auditor decide how much evidence is sufficient?
- What will an auditor do if they believe that a client has internal controls that can reduce the likelihood of a material misstatement?
- What will an auditor do if they decide that a client does not have in place appropriate controls for the identified risk?

7.11 Documentation — audit working papers

LEARNING OBJECTIVE 7.11 Illustrate how auditors document the details of evidence gathered in working papers.

ASA 230 (ISA 230) *Audit Documentation* requires an auditor to document each stage of the audit in their **working papers**, to provide a record of work completed and evidence gathered in forming their audit opinion. That documentation provides evidence of work completed. It details the names of the preparers of that documentation. It details the names of the reviewers of the work performed by the preparers. Documentation is cross referenced between working papers that summarise the components of an account balance and working papers that provide details of the testing of that balance.

An auditor will document each stage of the audit and the procedures used. During the risk assessment phase of an audit, an auditor will document their understanding of their client, the risks identified, analytical procedures used to aid in risk identification, their materiality assessment, their understanding of their client's system of internal controls, their understanding of their client's information technology, related parties identified and any going concern matters. During the risk response phase of the audit, an auditor will document their audit program, details of tests undertaken, copies of significant documents sighted, correspondence with the client's lawyers and bankers, confirmations received from debtors and enquiries of management.

Documentation will vary from client to client. It will depend upon, for example, the audit procedures used, the risks identified, the extent of judgement used, the persuasiveness of the evidence gathered, the nature and extent of exceptions noted and the audit methodology utilised (ASA 230, para. A2; ISA 230, para. A2).

An audit working paper generally includes:

- client name
- period under audit
- title describing the contents of the working paper
- file reference indicating where the working paper fits in the audit file
- initials identifying the preparer of the working paper together with the date the working paper was prepared
- initials identifying the reviewer(s) of the working paper together with the date(s) the working paper was reviewed

- cross-referencing between working papers indicating where further work and evidence is summarised elsewhere.

Working papers are used to document the details of each audit. The two main files held for each client are the permanent file and the current file. The permanent file includes documents that pertain to a client for more than one audit. The current file includes the details of work completed and evidence gathered that relate to the current audit.

7.11.1 Permanent file

The **permanent file** includes client information and documentation that apply to more than one audit. The information included in the permanent file is checked and updated at the commencement of each audit. The permanent file contains the client's head office address, other locations (where relevant) and contact details (telephone, fax and email). Key personnel are detailed and an organisational chart will also often be included in the permanent file. A client's organisational chart includes details of key roles within the organisation (such as the chief executive officer) and the names of the people who undertake those roles. The file may also include the details of the client's bank(s) and lawyer(s).

The permanent file will include copies of long-term contracts and agreements. These documents will be used to calculate interest payable on outstanding long-term loans. The documents will enable the assessment of any lease obligations. Debt covenants will be included in the permanent file. An auditor can check the details of these agreements to assess their client's compliance with covenants. If a client has long-term commitments with debtors and suppliers, an auditor will include the relevant documentation in the permanent file. Key long-term investments will be detailed, including the details of the broker used for these transactions.

The permanent file will include details of the client's board directors and its subcommittees (such as the audit committee). The file will include the minutes of significant meetings held by the client, such as its board of directors meetings. It may include details of bonus and option schemes for senior client staff.

The permanent file will detail a client's principal accounting policies and methodologies. Prior financial reports and audit reports will be included in the permanent file. Details of prior analytical procedures will be included and added to so that the auditor can observe changing trends. Flowcharts and narratives detailing a client's system of internal controls will be included in the permanent file. That description will be amended as required during the risk assessment phase of each audit.

Reports sent to the client during previous audits will be included in the permanent file. For example, management letters that detail weaknesses in internal controls identified by the auditor in previous years will be included and referred to by the auditor. An auditor will read these reports and discuss their contents with their client's management.

CLOUD 9

Cloud 9 Pty Ltd's permanent file contains the basic information about the company (that is, address and key senior staff and their employment contracts) plus the copy of the engagement letter appointing W&S Partners and stating the scope of the audit. Sharon and Suzie have gathered copies of some of the relevant agreements and will add these and more (that is, those relating to leases, sponsorship and loans) to the permanent file.

7.11.2 Current file

The **current file** includes client information and documentation that apply to the current audit. Contents of the current file will vary from client to client, depending on the accounts in the client's financial report and the client's activities. The current file will include the details of all testing and evidence gathered in preparation of the audit report.

The current file will also include correspondence between the auditor and their client, and their client's bankers and lawyers that pertain to the current audit period. Correspondence with other auditors, experts and relevant third parties will be included. The engagement letter will be included in the current file, along with the management letter, detailing weaknesses uncovered in the client's system of internal controls. Representation letters and confirmation letters may also be included in the current file.

The current file will include extracts from the minutes of meetings, such as the board of directors' meetings, which pertain to the current audit. The file will include details of the audit planning process and the audit program. The current file will also include detailed descriptions of evidence gathered, testing conducted and audit procedures performed. It will detail the analytical procedures, tests of controls and detailed substantive testing undertaken, as well as the conclusions drawn at the completion of testing. The current file includes testing of any subsequent events and a copy of the final audit opinion.

Examples of working papers

In this section we provide some examples of working papers. While each accounting firm will have its own way of documenting evidence, to aid understanding, it is worthwhile considering examples of how one firm, in this case EY, prepares its working papers. There are many different ways of preparing working papers; however, most have common elements.

Working papers are prepared and stored electronically. Once the audit is concluded any hard copy working papers are archived in a hard copy file (in the filing room) and soft copy files/working papers are archived to a location that keeps them secure for the required record keeping period (up to 10 years). Working papers are typically locked away so that they cannot be modified. Each audit will have a unique name for ease of identification, which will include the client name and the year-end of the financial report being audited. Each current file created for an audit will be divided into unique sections with each section representing a different element of the audit. Each section comprises a series of working papers that provide evidence of the work conducted on the audit. Working papers generally include details such as the client name, the period under audit, the currency used, a file reference, cross-references to other parts of the audit file, details of the testing conducted, comments/conclusions drawn and details of the preparer (generally a junior member of the audit team for routine audit tasks or a senior for complex audit tasks) and reviewers (seniors, managers and partners).

For the purposes of illustration a series of working papers are presented for a fictional client of EY, New Millennium Ecoproducts. The working paper examples are for the audit period ending 31 December 2017. New Millennium Ecoproducts was created by its founders, brothers Tomas and Charles Delron, avid environmentalists, at the turn of the twenty-first century. The vision for the company is to produce everyday products in a sustainable way, providing an affordable alternative for environmentally conscientious customers. New Millennium operates from three locations and produces a wide range of household products, which it sells to supermarkets and specialty stores.

At the front of every audit file is a copy of the client's trial balance. The trial balance is referenced into the appropriate lead schedule throughout the audit file. At EY, cash and cash equivalents is referenced into the C Lead, inventory accounts is referenced into the F Lead, property plant and equipment is referenced into the K Lead, accounts receivable is referenced into the E Lead and so on.

The first working paper example is the cash and cash equivalents lead schedule (figure 7.2). In the top left corner of the lead schedule the client name, period end and currency unit ($000) are listed. In the top centre of the lead schedule the section identification is provided (C). The reference for this working paper is provided in the top right hand corner (C-Lead) along with details of the working paper preparer and reviewers. General information about the client follows, repeating the information provided in the top corner. Details of the cash and cash equivalents balance follow. For each item listed in the lead schedule the following is noted:

- account number, per the client records
- account name, per the client records

CLIENT: New Millennium Ecoproducts Period-end: 31/12/2017 Currency/unit: $000	C–LEAD	EY Building a better working world **Reference** C-Lead	Prepared by: KM 21/01/2018 Reviewed by: SO 22/01/2018 Reviewed by: MM 24/01/2018

Step 1: **Enter general information (this will automatically populate the banners in each PSP tab).**

CLIENT	New Millennium Ecoproducts
Period-end	31/12/2017
Currency/unit	$000

Step 2: **Lead schedule**

Account No.	Account Name	Pre-adjusted	Adjustments	Adjusted Current Year		Interim	Prior Year		Variance	In %	TM/Ref
		31/12/2017		31/12/2017			31/12/2016				
10100	SOCIETE GENERALE	11 000	0	11 000	**TB**		10 500	**PY**	500	5%	**C02**
10200	BARCLAYS	134	0	134	**TB**		134	**PY**	0	0%	**C02**
10300	DEUTSCH BANK	126	0	126	**TB**		126	**PY**	0	0%	**C02**
10400	CITYGROUP	56	0	56	**TB**		50	**PY**	6	12%	**C02**
10500	Short-term deposits	5 796	0	5 796	**TB**		5 600	**PY**	196	4%	**C05**
	TOTAL Cash and Cash Equivalent	**17 112**	**0**	**17 112**			**16 410**		**702**	**4%**	

Step 3: **Account details, ratios and KPIs**

No specific KPIs, see cashflow statement work for detailed analytical review **A1.1**

Background:

No significant changes in banks or bank accounts from the prior period.
Note: Analytical review on movements in the cashflows has been performed on the cash flow schedule — see **A1.4**

Comments:

Cash and cash equivalent: in line with budget and change consistent with level of activity of the period (see also our review of the statement of cash flow referenced in **A1.4**)
Short-term deposits (CITYGroup): although the balance is very consistent with previous period, inclusion within the cash and cash equivalent is acceptable (refer to **C5**).

FIGURE 7.2 Working paper example: Cash lead schedule

- pre-adjusted balance, any adjustments and the adjusted current year balance per the client's trial balance (TB)
- the prior year balance, per the prior year audit file (PY)
- variance and percentage change, the calculated difference between the prior year and current year balances
- the cross-reference to the working paper where supporting evidence is kept for each balance.

Following the listed balances are details of any analytical procedures that were conducted on the account. In this case the analytical procedures were conducted in the A section of the audit file and the analytical procedures on cash appear on working paper A1.1. The final section of the lead working paper includes background information about the account and comments based upon completed testing.

The second working paper example is the confirmations and related alternative procedures working paper from the accounts receivable (E) section of the audit file (figure 7.3). In the top left hand corner the client name, period end and currency are noted. In the centre top the working paper reference (E02) and title (confirmations and related alternative procedures) are noted along with details of the working paper preparer and reviewers. Next the date of the interim confirmation is noted. In this case the confirmation was conducted for the balance two months prior to year-end. The balance in the accounts receivable account on that date is noted ($9500) and cross referenced to the accounts receivable subsidiary ledger (SL) and another part of the accounts receivable section of the audit file (E03). The date the confirmations were sent is then noted. The first request was sent on 5 November. A second request was sent on 10 December to customers that did not reply to the first request. The table contains details of the customers sent confirmation requests:

- account or invoice number, per the accounts receivable subsidiary ledger (SL)
- customer name, per the accounts receivable subsidiary ledger (SL)
- balance at confirmation date, per the accounts receivable subsidiary ledger (SL)
- the date the auditor received a response from the customer
- the balance outstanding at the confirmation date according to the customer correspondence (filed and cross referenced E02.1, E02.2, E02.3)
- any variance between the client records and the customer correspondence is calculated by the auditor
- then alternative procedures are explained where a customer has not responded or there is a variance
  - the auditor searches the cash receipts journal for evidence that the customer has paid the amount outstanding, which provides evidence that they existed at the confirmation date, and notes the amount received by their client, the date the cash was received and that the amount agrees to a copy of the cheque or remittance advice which indicates that the invoice was paid by the customer subsequent to the confirmation date
  - when the customer has not paid the amount outstanding at the date of confirmation the auditor searches for evidence that the sale occurred. In this case the auditor agrees the amount to shipping reports signed by external carriers which indicates that the item was shipped prior to the confirmation date.

The bottom part of the working paper includes the auditor's comments on any unresolved items after the testing is completed. In this case the auditor concludes that: a payment made by the customer prior to the confirmation date was received by the client just after confirmation date. This timing difference does not affect the existence of a receivable as of the end of October.

The third working paper example is the observation of physical inventories counts working paper from the inventory (F) section of the audit file (figure 7.4). In the top left hand corner the client name, period end and currency are noted. In the centre top the working paper reference (F01.2) and title (observation of physical inventories counts) are noted along with details of the working paper preparer and reviewers. The next section of the working paper notes: who from the audit team attended the inventory count, the location of the inventory count, the date of the inventory count and the inventory balance on the date of the count. The inventory balance on the date of the count is cross referenced to another part of the audit file (F04) where the roll forward of that balance to the year-end balance is carried out. When an inventory count is conducted prior to year-end, the movement in the inventory balance is tested and verified after year-end.

CLIENT: New Millennium Ecoproducts Period-end: 31/12/2017 Currency/unit: $000	**E02 – CONFIRMATIONS AND RELATED ALTERNATIVE PROCEDURES**	**Reference** E02	Prepared by: DM 14/12/2017 Reviewed by: SO 17/12/2017 Reviewed by: MM 19/12/2017

Confirmation/Interim date	31/10/2017	
AR as of confirmation date	9500	**SL/E03**
Date 1st request sent	05/11/2017	
Date 2nd request sent	10/12/2017	

		[A]			[B]		[A–B]	[C]			[D]		[C+D]	
								Alternative procedures in case of no response or variance						
Account or invoice number	Customer name	Amount as of confirmation date	TM/Ref	Date received	Balance per customer as of confirmation date	TM/Ref	Variance	Subsequent cash receipts	Date or source	TM/Ref	Alternative procedures other than subsequent cash receipts	TM/Ref	Total	Comments
123456	Greenwash	2 000	**SL**	28/12/2017	2 000	**E02.1**	–						–	
654321	EcoFriend	545	**SL**				545	400	18/11/2017	✓	145	✗	545	
789789	BigSupa	6 000	**SL**	29/12/2017	6 000	**E02.2**	–						–	
987654	Cleanair	500	**SL**	30/12/2017	450	**E02.3**	50	50	13/12/2017	✓			50	**A**
							–						–	
							–						–	

Key to audit tickmarks:

✓ Agrees to cheque copy/remittance advice which indicates that invoice was paid subsequent to the confirmation date
✗ Agrees to shipping reports signed by external carriers which indicates that item was shipped prior to the confirmation date
SL Agrees to sub ledger – accounts receivables

Comments:

- **A:** OK payment made by customer prior to the confirmation date, but received by the client just after confirmation date. This timing difference does not affect the existence of receivables as of the end of October.

FIGURE 7.3 Working paper example: Confirmations and related alternative procedures

CLIENT: New Millennium Ecoproducts Period-end: 31/12/2017 Currency/unit: $ 000	**F01.2 – OBSERVATION OF PHYSICAL INVENTORIES _ COUNTS**	EY Building a better working world	**Reference** F01.2	Prepared by: KM 30/11/2017 Reviewed by: SO 03/12/2017 Reviewed by: MM 04/12/2017

EY Attendee:	A. Senior
Location of Count:	Location C
Date	30/11/2017
Account balance at the date of physical inventory:	50 000

F04

Section 1: Procedures to complete before and during the physical counts

Comments: Please refer to **F01.3** for the documentation of our work relating to review of the client's procedures and details of observation during the physical counts. No issue noted

Section 2: Review of entity's counts and test of compilation

Test #	Selection number	Item	Description	Measurement in units	[A] Quantity per EY	[B] Quantity per count teams	TM/Ref	[B] – [A] Variance	[C] Final quantity verified with the client	[D] Quantity per inventory compilation	TM/Ref	[D] – [C] Variance	Comments
Count Sheets to Floor													
1	123 453	ABC		Unit	10	10	✓	–		10	✗	–	
2	124 556	DEF		Unit	10	15	✓	5	15	15	✗	–	
3	244 537	GHI		Unit	10	10	✓	–		9	✗	(1)	**A**
4	etc…												
Floor to Count Sheets													
1	245 367	JKL		Unit	10	10	✓	–		10	✗	–	
2	653 452	MNO		Unit	10	15	✓	5	15	15	✗	–	
3	765 342	PQR		Unit	10	10	✓	–		10	✗	–	
4	etc…												

Key to audit tickmarks:

✓ Agrees to count sheet
✗ Agrees to inventory compilation

Comments:

- In two instances, our counts differed from the client's. After further investigation, we agreed with the client's original counts.
- **A:** after inventory counts, the client further investigated reference 244537 and identified an error in the part number for one of the items and corrected after inventory stock taking. This correction has no impact on total inventory (reference xxx was also modified for the same amount), and we do not need to reconsider the quality of the client's counts.

FIGURE 7.4 Working paper example: Observation of physical inventories counts

Ahead of attending the inventory count, the audit team will review and comment on the client's procedures for conducting their count. The details of that review are cross referenced in the working paper to the location of that documentation in the audit file (F01.3). Next are the details of the inventory selected for testing by the auditor. The number of items selected and the nature of the items selected will depend upon the audit strategy. The working paper example includes details of three inventory items selected for testing of existence (count sheets to floor) and three items selected for testing of completeness (floor to count sheets). For each inventory item selected the auditor notes in the working paper the test number, which reflects the number of inventory items selected for testing, the selection number, item and description of the inventory, mode of measurement (in this case units but could be a weight or length depending on the nature of the inventory being counted), the quantity counted by the auditor, the quantity counted by the client per the client count sheet, any variance in the counts, the verified count after reconciling the auditor and client counts, the quantity per the inventory compilation at the conclusion of the count agreed by the auditor to the client inventory compilation, any variance between the quantity per the compilation and the quantity per the final verified amount and finally comments by the auditor on the variances.

CLOUD 9

The first major item in the current file for Cloud 9 is the audit plan with the detailed audit program. The current file also contains documentation for every test performed during the audit. Ian and the other junior staff are still struggling with how to correctly complete the papers. They often forget to complete all the relevant fields and Sharon, Suzie and Josh are continually sending papers back to them with requests to clarify some of their comments. However, embedding the working papers in Excel has made life easier than in the past when everything was paper based, because an error message will be generated if certain key fields are not completed.

BEFORE YOU GO ON

- What is a current file?
- What is a permanent file?
- What will an auditor document during the risk assessment phase of the audit?

SUMMARY

7.1 Explain how audit sampling is used in an audit.

When creating an audit program and designing audit procedures an auditor also decides how to select appropriate items for testing. When there are numerous transactions or items within an account balance available for testing, an auditor must decide how best to select a sample that is representative of the entire population of items available for testing.

7.2 Recognise the difference between sampling and non-sampling risk.

Sampling risk is the risk that the sample chosen by the auditor is not representative of the population of transactions or items within an account balance available for testing and, as a consequence, the auditor arrives at an inappropriate conclusion. Non-sampling risk is the risk that an auditor arrives at an inappropriate conclusion for a reason unrelated to sampling issues, such as an auditor using an inappropriate audit procedure.

7.3 Discriminate between statistical and non-statistical sampling.

Statistical sampling involves random selection and probability theory to evaluate the results. Non-statistical sampling is any sample selection method that does not have these characteristics.

7.4 Describe sampling methods.

Sampling methods include random selection, systematic selection, haphazard selection, block selection and judgement selection.

7.5 Describe the factors that influence the sample size when testing controls.

When testing controls, the factors that influence the sample size include the extent to which the risk of material misstatement is reduced by the operating effectiveness of controls, the rate of deviation from the prescribed control activity that the auditor is willing to accept, the rate of deviation from the prescribed control activity that the auditor expects to find in the population, the auditor's required confidence level and the number of sampling units in the population.

7.6 Explain the factors that influence the sample size when conducting substantive testing.

When conducting substantive testing of transactions and balances, the factors that influence the sample size include the auditor's assessment of the risk of material misstatement, the use of other substantive procedures directed at the same assertion, the auditor's required confidence level, the tolerable error, the amount of error the auditor expects to find in the population, whether the population is stratified and the number of sampling units in the population.

7.7 Explain how to evaluate the results of tests conducted on a sample.

When testing controls the auditor will compare the rate of deviation with the tolerable rate of deviation and determine whether they believe that the control tested is effective in preventing and/or detecting a material misstatement. When testing transactions and balances the error in the sample will be projected to the population and then compared to the tolerable error rate. The auditor will then determine whether the class of transactions or account balance appears to be materially misstated.

7.8 Discriminate the difference between tests of controls and substantive tests.

The purpose of tests of controls is to assess the effectiveness of a client's system of internal controls throughout the accounting period being audited. The purpose of substantive testing is to gather direct evidence that the financial report is free from material misstatement.

7.9 Explain the factors that affect the nature, timing and extent of audit testing.

The nature of audit testing refers to the purpose of the test and the procedure used. The timing of audit testing refers to the stage of the audit when procedures are performed and the date, such as within or outside the accounting period, that audit evidence relates to. The extent of audit testing refers to the amount of audit evidence gathered when testing controls and conducting detailed substantive procedures.

7.10 Explain how auditors arrive at a conclusion based upon the evidence gathered.

The final audit procedure is to assess the evidence gathered throughout the audit and draw a conclusion on the truth and fairness of a client's financial report.

7.11 Illustrate how auditors document the details of evidence gathered in working papers.

Audit evidence is documented in an auditor's working papers. Audit working papers include the client's name, the period under audit, a title describing the contents of the working paper, a file reference indicating where the working paper fits in the audit file, the initials identifying the preparer of the working paper together with the date the working paper was prepared, the initials identifying the reviewer(s) of the working paper together with the date(s) the working paper was reviewed, and cross-referencing between working papers indicating where further work and evidence is summarised elsewhere. Working papers are stored in either the permanent file or the current file. The permanent file includes client information and documentation that apply to more than one audit. The current file includes client information and documentation that apply to the current audit.

KEY TERMS

Accuracy Amounts and other data relating to recorded transactions and events have been recorded appropriately.

Audit program Details the audit procedures to be used when testing controls and when conducting detailed substantive audit procedures.

Audit risk The risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated.

Audit sampling The application of audit procedures to less than 100 per cent of items within a population.

Audit strategy The determination of the amount of time spent testing the client's internal controls and conducting detailed testing of transactions and account balances.

Block selection The selection of items that are grouped together within the population of items available.

Classification Transactions and events have been recorded in the proper accounts.

Completeness All transactions, events, assets, liabilities, and equity items that should have been recorded have been recorded.

Control risk The risk that a client's system of internal controls will not prevent or detect a material misstatement.

Current file Contains client information that is relevant for the duration of one audit.

Cut-off Transactions and events have been recorded in the correct accounting period.

Existence Recorded assets, liabilities and equity interests exist.

Extent of audit testing The amount of audit evidence gathered when testing controls and conducting detailed substantive procedures.

Haphazard selection The selection of a sample without use of a methodical technique.

Inherent risk The susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming there are no related controls.

Judgemental selection The selection of items that an auditor believes should be included in their sample for testing.

Nature of audit testing The purpose of the test and the procedure used.

Non-sampling risk The risk that the auditor reaches an inappropriate conclusion for any reason not related to sampling risk.

Non-statistical sampling Any sample selection method that does not have the characteristics of statistical sampling.

Occurrence Transactions and events that have been recorded have occurred and pertain to the entity.
Permanent file Contains client information that is relevant for more than one audit.
Projected error Extrapolation of the errors detected when testing a sample to the population from which the sample was drawn.
Random selection Where a sample is selected free from bias and each item in a population has an equal chance of selection.
Rate of deviation When testing controls, the proportion of items tested that did not conform to the client's prescribed control procedure.
Rights and obligations The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
Sampling risk The risk that the sample chosen by the auditor is not representative of the population available for testing and, as a consequence, the auditor arrives at an inappropriate conclusion.
Statistical sampling An approach to sampling where random selection is used to select a sample and probability theory is used to evaluate the sample results.
Stratification The process of dividing a population into groups of sampling units with similar characteristics.
Substantive procedures Audit procedures designed to detect material misstatements at the assertion level.
Systematic selection The selection of a sample for testing by dividing the number of items in a population by the sample size, giving sampling interval (n) and then selecting every nth item in the population.
Test of controls (controls testing) The audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.
Timing of audit testing The stage of the audit when procedures are performed and the date, such as within or outside the accounting period, that audit evidence relates to.
Tolerable error The maximum error an auditor is willing to accept within the population tested.
Valuation and allocation Assets, liabilities and equity interests are included in the financial report at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.
Working papers Paper or electronic documentation of the audit created by the audit team as evidence of the work completed.

MULTIPLE-CHOICE QUESTIONS

7.1 A detailed audit program: **LO1**
(a) is based on the overall audit strategy.
(b) contains a description of the control testing procedures.
(c) lists the audit procedures to be used in substantive testing.
(d) all of the above.

7.2 When testing internal controls the auditor: **LO5**
(a) is interested in assessing the effectiveness of controls.
(b) gathers evidence about the balances of the main accounts.
(c) does not have to have any prior knowledge of the client's inherent risks and how the controls address that risk.
(d) all of the above.

7.3 Deviations: **LO8**
(a) occur when controls do not operate as intended.
(b) are caused by auditors choosing incorrect audit procedures.

(c) are errors that affect account balances by a material amount.
(d) are relevant only when they occur consistently throughout the accounting period.

7.4 The difference between statistical and non-statistical sampling is that: **LO3**
(a) non-statistical sampling leads to non-sampling risk and statistical sampling does not.
(b) non-statistical sampling is when the sample is used for control testing not for substantive testing.
(c) statistical samples are chosen using random selection from a larger population and are subject to sampling risk.
(d) statistical sampling is when the sample is taken from a larger population and the whole population is not used for the test.

7.5 When an auditor selects items for a sample on the basis of the auditor's belief that they should be included, this is an example of which selection method? **LO4**
(a) Block
(b) Random
(c) Systematic
(d) Judgemental

7.6 If preliminary testing of controls reveals that the rate of deviation in controls is above the expected rate, the effects on the auditor's (i) assessment of detection risk and (ii) reliance on detailed substantive testing at year-end are: **LO9**
(a) (i) increase and (ii) increase.
(b) (i) increase and (ii) decrease.
(c) (i) reduce and (ii) increase.
(d) (i) reduce and (ii) decrease.

7.7 Sampling risk: **LO2**
(a) can be eliminated by taking a random sample.
(b) applies only to samples for substantive testing.
(c) is the problem that the results of the test will be misinterpreted by the auditor.
(d) is the risk that the sample chosen by the auditor is not representative of the population of transactions.

7.8 Non-sampling risk: **LO2**
(a) occurs only if you test every member of the population.
(b) does not occur if an auditor relies on unreliable evidence.
(c) applies only to samples taken for the purposes of control testing.
(d) is the risk that an auditor arrives at an inappropriate conclusion for a reason unrelated to sampling issues.

7.9 Tolerable error: **LO5**
(a) relates only to control testing.
(b) is positively related to sample size.
(c) is an amount prescribed by ASA 530.
(d) is the maximum error an auditor is willing to accept within the population.

7.10 The working papers for a client contain both a permanent and a current file. The difference between the two files is that: **LO10**
(a) the permanent file must be sent to ASIC and the current file is not.
(b) the permanent file is kept by the audit partner in charge and cannot be altered after the first audit engagement is completed, but the current file can be updated.
(c) the permanent file includes documents that relate to the client and are relevant for more than one audit, and the current file includes the details of work completed and evidence gathered that relate to the current audit.
(d) all of the above.

REVIEW QUESTIONS

7.11 Why do auditors use sampling? Explain the advantages and disadvantages of using sampling instead of testing every item in the population. **LO1**

7.12 Explain the difference between the two types of sampling risk for controls: the risk that the auditor concludes that the client's system of internal controls is effective when it is ineffective and the risk that the auditor concludes that the client's system of internal controls is ineffective when it is effective. What are the errors' different implications for the audit? Which is the more serious risk? Explain. **LO2**

7.13 Explain the difference between the two types of sampling risk for substantive testing: the risk that the auditor concludes that a material misstatement does not exist when it does and the risk that the auditor concludes that a material misstatement exists when it does not. What are the errors' different implications for the audit? Which is the more serious risk? Explain. **LO2**

7.14 Why does non-sampling risk exist for all types of tests in all audits? Explain. **LO2**

7.15 Describe the main non-statistical sampling methods. What are the advantages of non-statistical sampling? **LO3, 4**

7.16 Explain the relationship between the sample size for controls testing and each of the following factors: (1) the likely effectiveness of a control, (2) the acceptable rate of deviation, (3) the expected rate of deviation, (4) the required level of confidence in the effectiveness of the client's system of internal controls and (5) the number of units in the population. **LO5**

7.17 How does stratification of the population reduce the required sample size? Give an example of substantive testing where stratification would be appropriate. **LO6**

7.18 What action does an auditor take if the rate of deviation found when testing internal controls is greater than the tolerable rate of deviation? **LO7**

7.19 Explain the difference between tests of controls and substantive procedures. **LO8**

7.20 How are the results of tests of controls related to decisions about the nature, timing and extent of substantive procedures? **LO9**

7.21 Why are audit tests more likely to be conducted at or after year-end for high-risk clients than for low-risk clients? Explain. **LO9**

7.22 Review the examples of working papers provided in the chapter. What advantages are there for the auditor in writing working papers in spreadsheets and word documents? **LO10**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

7.23 SAMPLING ★ **LO1, 2, 3, 4**

Thanh is working on the plan for an audit of a manufacturing firm and is considering the section of the plan relating to substantive testing of purchase invoices. Thanh has to decide how to select the sample.

Required

Describe the population(s) that would be relevant to Thanh's sample selection.

7.24 RESULTS OF CONTROL TESTING ★ **LO5, 7**

The controls at a retail store were assessed by the lead auditor as being effective and the auditor intended to rely on the operative effectiveness of controls around payroll in determining the nature, timing and extent of substantive procedures. There is no evidence of fraud.

The control activities include controls that ensure that part-time staff are paid at the correct rate.

The results of testing the relevant control are: sample size 40, tolerable deviation rate 5 per cent, exceptions noted: one instance of part-time staff paid an incorrect hourly rate.

Required

(a) What is a 'tolerable deviation rate'?
(b) Explain why the 'exceptions' are evidence that the control did not work effectively in these cases.
(c) Explain in general terms what impact the control test results would have on the nature, timing and extent of substantive testing.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2010.

7.25 CONTROL TESTING IN PREVIOUS YEAR ★ **LO9**

Julie is a junior auditor on the audit team for Wonderful Wildlife Parks Ltd (WWP). The same audit firm has been WWP's auditor for the past two years. During this time, the auditors have completed both the financial audit and the compliance audit for the Department of Tourism, stating that the business has adhered to the Wildlife Park Regulations. WWP has requested that the auditors undertake both audit engagements again for the current year. In each of the previous two years, the audit team has tested all of WWP's internal controls relevant to ensuring compliance with the Regulations. There have been no exceptions detected in this testing of controls in the past two years. A combined approach is also planned for the current year.

Julie suggests that, since there were no exceptions detected in previous years, no work on internal controls is required because last year's evidence will be sufficient.

Required

Explain why Julie's suggestion is not appropriate.

Source: Adapted from the CA Program's *Audit & assurance exam*, March 2011.

7.26 TESTING ACCOUNTS RECEIVABLE ★ **LO8, 9**

Jenny Sharp has been appointed as senior audit manager of the accounts receivable area in the statutory audit of Holiday Cruises, a company operating leisure cruises from ports on the eastern seaboard of Australia. Holiday Cruises sells cruises to individuals (via its website) and to travel agents for resale to customers. All cruises are paid in advance, with a 10 per cent deposit on booking and the remainder collected at least four weeks prior to sailing. Travel agents collect money from their customers, deduct their commission and forward the remainder to the cruise company before the deadline. Jenny has made a preliminary assessment that the client is low risk and plans to conduct extensive testing of controls in the accounts receivable area to support her assessment.

Required

(a) What is Jenny's objective in testing of controls over accounts receivable?
(b) List some procedures Jenny could use to achieve her objective.
(c) Assuming Jenny achieves her objective, discuss the implications for the nature, timing and extent of substantive testing of accounts receivable.

7.27 AUDITING LOW-VALUE ASSETS ★ **LO8, 9**

CFMUU is a regional credit union with 10 branches across the state. CFMUU leases its premises and buys furniture, such as waiting-area chairs and back-office desks, through a central asset purchasing department. All computer assets are acquired on finance leases. The furniture in the waiting area has a life of four years and repairs are common because of constant use. Back-office furniture items have a life of seven years and are often relocated as branches are refurbished or relocated at the expiration of the premises lease. CFMUU has adopted a 'green' office policy over the last three years and refurbishment and recycling of furniture is encouraged. Where furniture is replaced, suppliers with 'green' credentials are preferred. In these cases, old furniture is returned to the supplier as a trade-in on new furniture, even when the market value of these items is virtually zero.

Required

Make a list of audit procedures that could be used for substantive testing of furniture at CFMUU. Explain which assertion each procedure is testing.

7.28 SAMPLING AND NON-SAMPLING RISK FOR CONTROL TESTING ★★ LO1, 2, 9

Frank Brown is auditing cash payments for Woldi, a large supermarket. Woldi deals with several very large corporate suppliers who expect payment by electronic funds transfer within three business days of delivery. Other large suppliers will accept cheques or electronic funds transfer on terms of 14 days, and small suppliers receive cheques with payment terms of 30 days. Other regular large cash payments include wages (weekly by electronic funds transfer from a wages imprest account), utilities (electricity accounts are paid monthly by cheque), cleaning (paid monthly by cheque) and rent (paid monthly by electronic funds transfer). In addition, there are irregular payments for items such as maintenance, fixtures purchase and lease, and vehicle running costs.

All cash payments are processed in the central office after the required set of documents has been assembled and checked by two junior accounts staff. Payments are authorised by a senior accountant and electronic funds transfer authorities and cheques are countersigned by the chief accountant (except if he is on leave when another member of the accounts staff performs this task). Journals and ledgers are maintained by staff not involved in cash payment processing.

Frank needs to test controls over cash payments and has planned to make extensive use of sampling.

Required

(a) What population(s) would be relevant to Frank's control testing?
(b) Explain the potential implications of sampling risk for the audit of cash payments.
(c) What possible non-sampling risks exist in this case?

7.29 SAMPLING METHODS ★★ LO1, 2, 3, 4

Bob Downe is auditing Red Gum Home Furniture (RGHF), a manufacturer and retailer of boutique home furniture. RGHF was founded 25 years ago by a husband and wife team and has grown rapidly in the last five years as solid, environmentally friendly, wooden furniture has grown in popularity. However, although RGHF's owners have attempted to expand the administration department to keep pace with the growth in sales, some systems are not operating as effectively as they should. This is partly due to difficulty in attracting and retaining accounts staff with appropriate experience and skills.

RGHF's owners have recently realised that they need to increase pay and improve conditions for accounts staff to avoid regular periods without sufficient qualified staff, particularly for sales invoice processing. The staff shortages have resulted in sluggish performance in processing invoices, sending out customer statements, and collecting cash from account customers. In addition, there have been numerous mistakes in processing sales invoices, some of which have been discovered after customer complaints.

Bob is selecting a sample of sales invoices for substantive testing. All documents relating to sales invoices for the last five years are stored in boxes in the shed behind the office. The shed is very small and the boxes are stacked on top of each other because the shelves are full. Due to the damp conditions some labels have peeled from the boxes, so it is not clear which boxes relate to the current year.

Required

(a) Describe the population(s) that would be relevant to Bob's sample selection.
(b) Which sample selection methods would be appropriate for choosing sales invoices for substantive testing at RGHF? Explain the factors that would influence your choice.

7.30 DETERMINING SAMPLE SIZE FOR CONTROL TESTING ★★ LO4

Alice Pang is planning the control testing of the accounts payable function in the hardware retailer Koch and Gilbert. Alice is attempting to determine the appropriate sample size for her tests and is writing a report to the engagement partner of the audit justifying her choices. She has had the opportunity to talk to management at Koch and Gilbert and tour the facilities. She has also reviewed the working papers from the previous audits and identified factors that have changed from previous years. She notes that the number of accounts payable has increased by 50 per cent since last year because Koch and Gilbert has changed some of its suppliers from large corporate wholesalers to dealing directly with manufacturers.

Overall, Alice believes that the controls in accounts payable are likely to be operating more effectively than in previous years, and she expects a reduction in control deviations. This situation is likely because of the appointment of an additional staff member in the accounts payable department three months after the start of the financial year. However, she is recommending that a lower rate of deviation would be acceptable this year because of the increased importance of accounts payable to Koch and Gilbert's solvency situation in the current economic climate. In addition, she is recommending that substantive testing of accounts payable be more extensive than in past years.

Required

Explain how the factors mentioned above would affect the sample size for control testing of accounts payable.

7.31 EVALUATING SUBSTANTIVE TESTING RESULTS ★★ **LO5, 6**

The results of substantive testing of sales invoices at Country Electronics are as follows.

Stratum	Error found	Sample total value	Stratum total value	Projected error
1	$ 7 930	$101 170	$128 660	
2	$ 3 290	$ 41 990	$ 76 830	
3	$ 8 600	$ 62 840	$162 280	
Total	$19 820	$206 000	$367 770	

The three strata correspond to different departments and the overall tolerable error is set at $40 000.

Required

(a) Project the errors for each stratum and calculate the total projected error. Is the projected error material? What difference would it make if the tolerable error was set at $50 000 or $30 000? Explain.

(b) Discuss the implications for the substantive testing if it was discovered that for three months of the financial year the permanent staff member in the department corresponding to stratum 3 was on long service leave.

7.32 DOCUMENTATION ★★ **LO10, 11**

Jennifer Jones is reading the documents prepared by the members of the team working on the audit of receivables for a large client. Jennifer is the senior manager assisting the engagement partner, Ruby Rogers. Jennifer and Ruby have worked together on many audits and Jennifer knows the types of questions that Ruby will ask about the working papers if they are not up to the standard required by ASA 230. Jennifer is trying to make sure that all documents are up to the required standard before Ruby sees them tomorrow.

Jennifer is particularly concerned about the documents relating to the receivable confirmations. This is because the audit assistant who wrote up the confirmation results recommended that no further work was required. On review of the results, Jennifer discovered that the audit assistant had incorrectly treated 'no reply' results as acceptable for a positive confirmation, when they are acceptable only for a negative confirmation. Jennifer had ordered further work be done to follow up these 'no reply' results.

Required

(a) What is the minimum standard that the audit documentation must meet?

(b) How would you treat the corrections made to the audit assistant's recommendations and the additional work on receivable confirmations in the working papers? Explain. Refer to both ASA 505 and ASA 230 in your answer.

Questions 7.33 and 7.34 are based on the following case.

Fabrication Holdings Ltd (FH) has been a client of K&F for many years. You are an audit senior and have been assigned to the FH audit for the first time for the financial year ending 30 June 2017. During

March 2017 you are completing the audit planning for the property, plant and equipment (PPE) account class, which is one of FH's most material balances. You are also aware that FH has made a large investment in a new manufacturing process to place itself in a more competitive position. Your analytical procedures indicate an increase in acquisitions of PPE.

You are testing the appropriateness of the depreciation rate assigned to PPE, and whether it is consistent with the present condition and expected use of the assets over their remaining life. You have sampled 35 PPE items, with a total dollar value of $1 145 000. The results show that for the sample items some depreciation rates were too low and/or the remaining useful life of the equipment was overstated by management. Together, these issues produce an error in the sample of $68 500. FH has a profit before tax for the current year of $1 875 000, and a PPE account balance at the end of the year of $11 345 000.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

7.33 SAMPLING METHODS AND RISK ★★★ **LO1, 2, 3, 9**

Discuss the appropriate method of sampling PPE for the planned tests of depreciation. Define the population. What assertions are most at risk?

7.34 PROJECTING ERRORS FOR PPE ★★★ **LO7, 10**

What conclusion would you draw about 'valuation and allocation' of PPE from the above information? Justify your conclusion.

7.35 DOCUMENTING THE AUDIT ★★★ **LO11**

Dolphin Surf & Leisure Holidays Pty Ltd (Dolphin) is a resort company based on the Great Barrier Reef. Its operations include boating, surfing, diving and other leisure activities, a backpackers' hostel, a family hotel and a five-star resort. Justin and Sarah Morris own the majority of the shares in the Morris Group which controls Dolphin. Justin is the chairman of the board of directors of both Dolphin and the Morris Group, and Sarah is a director of both companies as well as the CFO of Dolphin.

While performing the Dolphin audit you discover that the XXXX Travel Agency, which specialises in group travel to Queensland, has an account with Dolphin. The review of the ageing of the accounts receivable balance shows that XXXX Travel Agency's balance is large and material and is now more than 60 days overdue. However, no allowance has been made for the outstanding debt. You consult Dolphin's accounts staff, Julie and Kristen, about the account and they mention that there are rumours that the XXXX Travel Agency is suffering financial difficulties.

You have recently completed the Audit & Assurance section of the Chartered Accountants Program and are aware that ASA 230 has specific requirements about documenting audit work. In particular, paragraph 9 states:

> In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
> (a) The identifying characteristics of the specific items or matters tested;
> (b) Who performed the audit work and the date such work was completed; and
> (c) Who reviewed the audit work performed and the date and extent of such review.

In addition, paragraph 10 states:

> The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

Required

Explain how you would apply the mandatory requirements of the above paragraphs of ASA 230 in relation to the potential bad debt.

Questions 7.36 and 7.37 are based on the following case.

Chan & Partners Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year, Chan & Partners gained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home
- Total Cancer Specialists Limited (TCSL), a private oncology clinic that specialises in the treatment of cancer.

Year-end for all MSHG entities is 30 June.

During the 2017 financial year, Shady Oaks released its own range of medical supplies such as bandages and first aid kits, which are sold via direct marketing by a sales team employed by the hospital. The sales team are remunerated via a base salary and a bonus component which is based upon the dollar value of sales they generate. You recognise that their main motivation is to maximise their bonuses. You select a sample of payments received by the hospital post year-end and trace back to the general ledger and customer account balance.

In addition, you are reviewing the results of a number of tests in relation to accounts payable at Gardens Nursing Home, as follows.

Test	Result	Conclusion
1	A number of suppliers were selected from the list of trade creditors at year-end and balances traced to supplier invoices and goods received notes to ensure goods were received prior to the year-end. For two creditors out of 15 tested the balance was only marginally overstated.	Accepted as no material errors located.
2	Selected a number of suppliers' invoices and checked that the pricing and discount terms have been reviewed and authorised by the purchase manager. Three out of 20 invoices tested had not been authorised and incorrect discounts were recorded for these invoices. A follow-up of the three samples with deviations did not highlight a pattern or specific reason for the errors.	Accepted as the errors in discounts claimed were immaterial.

Source: Adapted from the CA Program's *Audit & assurance exam,* December 2008.

7.36 SUBSTANTIVE TESTING AND ASSERTIONS ★★★ — LO6, 8, 9

(a) Identify the key account balance at risk because of the sales team remuneration at Shady Oaks. Also identify and explain the key assertion at risk.

(b) Identify the key account balance and key assertion being tested with the substantive procedure. Given the bonus structure in place for the sales team, justify your answer.

7.37 SUBSTANTIVE TESTING VERSUS CONTROL TESTING ★★★ — LO6, 8

For each of the test results for Gardens Nursing Home:

(a) Identify whether this is a test of controls or a substantive test of detail.

(b) Determine the key assertion addressed by the test procedure.

(c) Explain why the conclusion reached is appropriate or inappropriate.

(d) Outline the key additional procedure that you believe needs to be performed.

CASE STUDY — CLOUD 9

Answer the following questions based on the information for Cloud 9 presented in the appendix to this text and the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

(*continued*)

Required

Consider the effects on Cloud 9's accounts and business of opening additional retail stores and introducing additional products (workboots).

(a) Describe how this business change would affect audit risk.

(b) What changes would you expect to see in inventory transactions and balances? Be specific in your answer.

(c) Which inventory balance and transaction assertions would be most affected? Explain.

(d) Describe the population(s) and suggest a sampling approach for controls and substantive testing for inventory.

RESEARCH QUESTION

McKesson & Robbins was a company at the centre of a famous fraud in the United States in the 1930s.

Required

(a) Research the facts of the McKesson & Robbins fraud and write a short description of the case.

(b) Make a list of the defects in the company's system of internal controls that are relevant to the fraud and suggest audit tests that would have revealed these problems.

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. d, 2. a, 3. a, 4. c, 5. d, 6. c, 7. d, 8. d, 9. d, 10. c.

NOTES

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2. American Institute of Certified Public Accountants 2014, *White paper: Reimagining auditing in a wired world*, AICPA, New York.
3. Murphy, ML & Tysiac, K 2015, 'Data analytics helps auditors gain deep insight', *Journal of Accountancy*, 14 April, www.journalofaccountancy.com/issues/2015/apr/data-analytics-for-auditors.html.
4. ibid.
5. ibid.

ACKNOWLEDGEMENTS

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CHAPTER 8

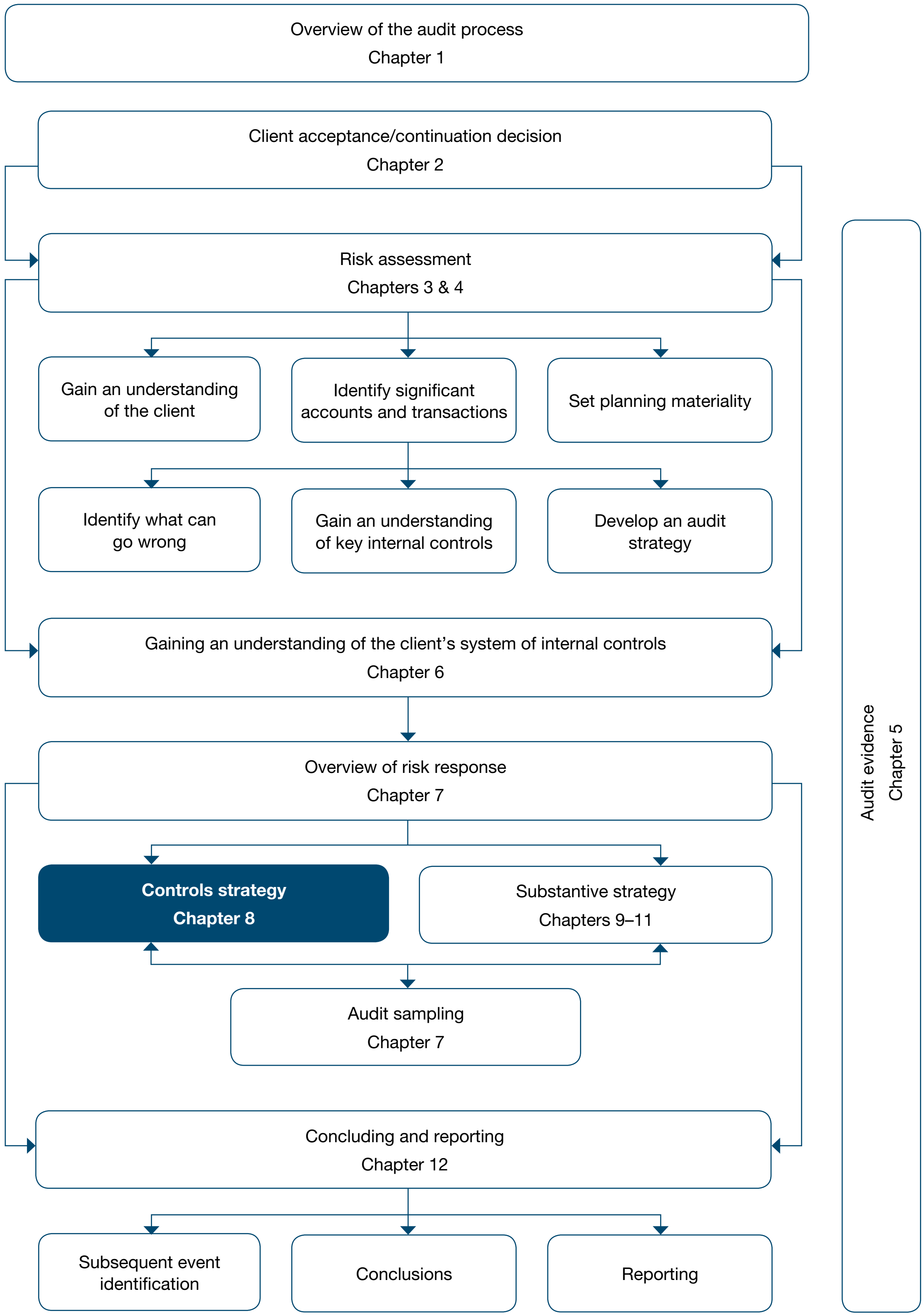
Execution of the audit — testing of controls

LEARNING OBJECTIVES

After studying this chapter you should be able to:

- **8.1** explain the different types of controls
- **8.2** compare the different techniques for testing controls
- **8.3** describe how to select and design tests of controls
- **8.4** compare and contrast the results of testing of controls
- **8.5** describe how to document tests of controls.

AUDITING AND ASSURANCE STANDARDS	
AUSTRALIAN	**INTERNATIONAL**
ASA 230 *Audit Documentation*	ISA 230 *Audit Documentation*
ASA 260 *Communication with Those Charged with Governance*	ISA 260 *Communication with Those Charged with Governance*
ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*	ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*


Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client's system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

Cloud 9 Pty Ltd (Cloud 9) has effective internal controls at the entity level. Sharon Gallagher, the audit manager, believes that when considered at a high level, the company has an environment where potential misstatements are prevented or detected. Sharon has instructed the audit team to turn its attention to considering the controls at the transaction level.

Josh and his group begin by documenting the various accounting processes at Cloud 9. For each process, they identify the potential misstatements that could occur. In other words, they make a list of possible problems for major areas of the accounts. These possible problems are commonly referred to within the audit firm as WCGWs ('what can go wrongs'). Then, for each WCGW, they identify the financial report assertion that would be affected.

Weijing Fei, a new member of Josh's group, needs some help. Josh has asked her to identify the controls that Cloud 9 uses to either prevent or detect the types of misstatements they have identified so far. Weijing does not understand the difference between prevent and detect controls. Also, Josh tells Weijing that he needs the results of her work so that he can design the control testing for Cloud 9. He wants to focus the testing on the critical controls. Weijing is confused. She thought a lower assessed control risk approach to an audit required the auditors to test all the controls.

How can they justify testing only some controls? Which are the critical controls?

Audit process in focus

As discussed in chapter 4, assessing audit risk involves assessing the inherent and control risk and then setting detection risk for each significant account and assertion. The assessment of control risk is performed on the client's system of internal controls (see chapters 4 and 6). The auditor is interested in whether their client has controls in place that are designed to minimise the risk of material misstatement for each significant account and related significant assertion. Controls are set at the entity level as well as at the transaction level. Entity-level controls have been described in detail in chapter 6. While it is important to understand (and document) the entity-level controls in an organisation, they are very rarely, if ever, sensitive enough to prevent or detect material misstatements from happening. Further, they are often the types of controls that are very difficult to test or to obtain evidence of them being in place. For example, we could test the effectiveness of an internal audit function, but would find it very difficult to test the 'tone' of management. It is for these reasons that entity-level controls are rarely tested. Instead, the auditor focuses on testing controls that are operating at a much lower level and have the best chance of preventing things going wrong with transactions, or detecting when they have gone wrong. These are referred to as transaction-level controls.

When control risk is assessed as low, the auditor has determined that there are controls in place that they will test. This will provide evidence that the controls put in place by the organisation are designed and implemented properly to prevent material misstatements from occurring, or to detect that they have occurred and to then correct the misstatement in a timely manner. That is, when control risk has been assessed as low, it is appropriate to test controls. This will then reduce the need to perform significant amounts of substantive testing. That is, as control risk decreases, detection risk increases and therefore the amount of substantive testing decreases. When the control risk is assessed as low, the audit strategy is to test those controls and reduce the need to perform significant amounts of detailed substantive testing.

When the auditor decides to include controls testing in their audit strategy, they select those controls that will provide the most efficient and effective audit (that is, provide the assurance required that the controls are working). Also they test only those controls they believe are critical to their opinion. That is, they select those controls that are extensive and sensitive enough to provide reasonable assurance that the controls operated effectively throughout the period of reliance (that is, the reporting period).

Deciding which controls to test will be influenced by the type of control, the frequency with which the control is performed and the level of assurance the auditor wants to gain from the control being designed and implemented effectively.

There are many techniques available to test the controls identified when planning the audit, and in this chapter we will provide an overview of several of the more typical testing techniques. This overview will include examples of the extent of controls testing to perform (depending on the type of control being tested) and how this extent of testing will influence the level of assurance we obtain towards the overall audit conclusion (opinion).

Finally, we will discuss what the auditor's response should be to any exceptions or errors found in their testing of controls as well as how to document the results of their testing. In the discussion of the results we will also include examples of how these impact on the overall risk assessment and the resulting substantive audit procedures performed.

8.1 Types of controls

LEARNING OBJECTIVE 8.1 Explain the different types of controls.

As described above and in chapter 6, there are two types of internal **controls**: **entity-level controls** and **transaction-level controls**. This chapter will focus on transaction-level controls. Transaction-level controls relate to one of the five components of entity-level **internal control** as set out in ASA 315 (ISA 315) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* (that is, the control environment, the client's risk assessment process, information and communication, **control activities** and monitoring). Transaction-level controls are implemented by businesses to reduce the risk of misstatement due to error or fraud as well as to ensure that processes are operating effectively in areas where management may not have the level of personal oversight they would have if the business was smaller. Controls can include any procedure used and relied upon by the client to prevent errors from occurring during the processing of transactions, or to detect and correct errors that may occur in these transactions.

Controls have two main objectives: to prevent or detect misstatements in the financial report, or to support the automated parts of the business in the functioning of the controls in place. Prevent controls (also referred to as preventative controls) are those applied to each transaction that stop fraud or errors from occurring. Detect controls (also referred to as detecting controls) are those applied after transactions have been processed to identify whether any fraud or errors have occurred. These concepts will be explained in more detail in section 8.1.1.

Controls are classified as one of four types:

1. manual
2. automated (otherwise known as application controls)
3. information technology (IT) general controls (ITGCs) (the overall controls put in place to manage changes to applications and programs, as well as to limit access to those applications to only appropriate users of the IT applications)
4. a combination of control types referred to as IT-dependent manual controls.

Figure 8.1 illustrates the types of controls and how they interrelate. As the figure also shows, each type of control has the potential to be a prevent or a detect control. Each of these control types is discussed in more detail in section 8.1.1.

The reason controls are classified is to assist the auditor in understanding the type of risks each control addresses, how the control addresses those risks, and the potential audit evidence that a control provides. Also, the classification assists in considering the nature, timing and extent of the tests of controls and in determining the skills needed to perform the tests. It is not important what these controls are labelled; what is important is whether the control can be tested, is effective and can be relied upon to provide audit evidence.

8.1.1 Prevent and detect controls

Tests of controls (or **controls testing**) are the audit procedures performed to test the operating effectiveness of controls in preventing or detecting and correcting material misstatements at the assertion level.

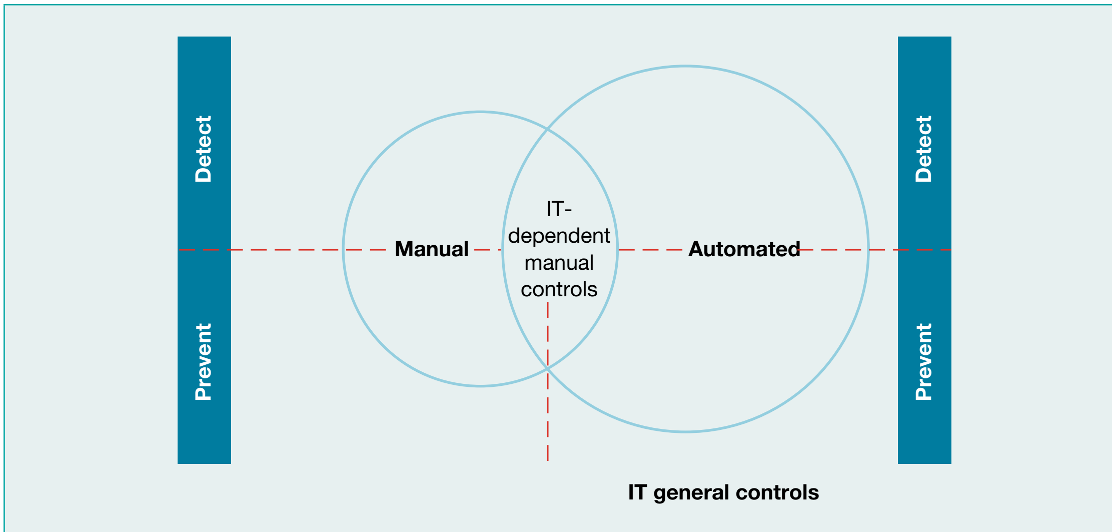


FIGURE 8.1 Types of controls

Prevent controls

Prevent controls can be applied to each transaction during normal processing to avoid errors occurring. Preventing errors during processing is an important objective of every accounting system. To be effective, controls over transactions should ideally include both prevent and detect controls. This is because without the underlying prevent controls, detect controls may not be sufficiently sensitive to identify and correct misstatements. This concept is discussed further in the detect controls section below.

When designing controls, consideration is given to what can go wrong with the transaction (the risk of material misstatement), which would result in an error. These are sometimes referred to as **WCGWs** (what can go wrongs). Effective controls should prevent the WCGWs from occurring (prevent controls), or, if they do occur, ensure that the errors are detected and corrected as quickly as possible (detect controls).

Table 8.1 shows examples of prevent controls and some of the WCGWs each control is designed to prevent.

TABLE 8.1 **Examples of prevent controls**

WCGW	Assertion	Prevent control
Sales occur that are not recoverable.	Occurrence, accuracy	The computer program will not allow a sale to be processed if a customer has exceeded its credit limit.
Fictitious employees are paid.	Occurrence	Amounts are not able to be paid to employees without first matching a valid tax file number to the employee master file.
Sales are recorded at an incorrect value.	Accuracy	Sales invoices are automatically priced using the information in the price master file.
Transactions are classified and coded to incorrect accounts.	Classification	The account coding on each purchase order is checked by the computer to a table of valid account numbers, and then various logic tests are performed by the computer.

Prevent controls do not always have physical evidence indicating whether the control was performed, who performed it or how well it was performed. In other cases, there may be evidence that the control was performed, but evidence as to the effectiveness of the control may not be available. For example, the signature of the goods inwards staff member on a delivery docket or a bill of lading indicates that the signer agreed that stock was physically received into the warehouse but it does not guarantee that the person carefully reviewed it or that they agreed the quantities of each item on the delivery docket. The documentation may have been signed based on only a quick glance or without any review at all. Thus, goods may be recorded that do not exist, excess goods may have been received but not be recorded, or the goods received may not match the goods ordered and recorded. Therefore, in this example, the quality of the evidence that the control will prevent one of these errors from occurring does not provide persuasive enough evidence for the auditor to conclude that the control operated effectively throughout the reporting period. This concept is discussed further in the section on techniques for testing controls.

An absence of effective prevent controls increases the risk that errors will occur or fraud may occur and therefore increases the need for controls that are sensitive enough to detect these errors should they occur.

Detect controls

The purpose of detect controls is to discover fraud or errors that may have occurred during transaction processing (in spite of any prevent controls) and to rectify those errors. As discussed earlier, companies put detect controls in place to assist management in ensuring WCGWs do not occur and that the business is functioning as planned through the design and implementation of its business processes.

Generally, detect controls are not applied to each transaction during the normal flow of processing. Instead, they are applied outside the normal flow of individual transactions to groups of transactions that have been fully or partially processed. For example, often when payables are paid, a cheque run is processed to print the cheques but the transaction is not completed to record the debit to the payables account and credit to the cash account. Instead, the transaction is only partially processed and then 'held' by the system. Once the cheques have been signed as approved for payment, the payables clerk will process the rest of the transaction by 'releasing' the payments and recognising the debit to payables and credit to cash.

Detect controls vary from client to client to a greater extent than prevent controls. Detect controls can depend on the nature of the client's business and on the competence, preferences and imagination of the people who perform the controls. Detect controls may be formally established procedures, such as the preparation of a monthly reconciliation and the subsequent follow-up of reconciling or unusual items. Or, they may be procedures that employees regularly perform and typically document even though they are not formally required to do so by the company. For example, the financial accountant may keep a list of standard month-end journals to use as the basis for checking the entries each month as they are made, and following up on any exceptions. Detect controls are often 'unofficial' procedures similar to this example that client personnel perform to make sure that the information for which they are responsible is accurate.

It is important that detect controls:

1. completely and accurately capture all relevant data
2. identify all potentially significant errors
3. are performed on a consistent and regular basis
4. include follow-up and correction on a timely basis for any misstatements or issues detected.

There are many examples of detect controls, including the following.

- Management level reviews are made of actual performance versus budgets, forecasts, prior periods, competitors (if available) and industry averages (if available). Management's actions in analysing and following up on unexpected variances is a detect control. For example, the financial controller may review the monthly results and compare the number of days' sales outstanding to previous periods to ensure any allowance for doubtful debts is reasonable.
- Performance indicators relate different sets of data, operating or financial, to each other. These indicators, together with an analysis of the relationships and the subsequent follow-up of anomalies, are

also control activities. The auditor needs to understand whether the client uses the information for operational purposes only (to assist in making operating decisions), or whether they use it to also follow up on unexpected results in the financial reporting system. If the information is only used for operational purposes, it is unlikely that the auditor will gather a significant amount of audit evidence to assist them in the financial report audit. Performance indicators include, for example, purchase price variances, stock ordered but not yet manufactured and percentage of sales returned compared to total sales orders. By investigating unexpected results or unusual trends, the client may identify issues in the underlying procurement and manufacturing processes.

- Reconciliations are prepared, reconciling or unusual items are then investigated, and issues are resolved or corrections made, if necessary. The performance of reconciliations without following up on reconciling or unusual items is not a control. The control is the follow-up. Typical reconciliations are performed between the general ledger and some other form of external evidence or a subsidiary ledger. For example, the bank reconciliation reconciles the bank statement to the cash recorded in the general ledger. The trade debtors reconciliation reconciles sales recorded in the trade receivables subsidiary ledger (via the sales ledger) to the trade receivables recorded in the general ledger.
- Review of exception reports — reports are automatically produced showing transactions/groups of transactions that fall outside a set of parameters selected by the client. These exceptions are then reviewed and followed up (if necessary). For example, a report may be produced that shows all sales made to a customer who has exceeded its credit limit. The credit manager then follows-up these sales with the salesperson to ensure no further sales are made until the balance is brought below the credit limit. Alternatively, if necessary, a re-evaluation of the customer's credit limit is performed to increase it (if appropriate).

Table 8.2 shows examples of detect controls and some of the WCGWs each control is designed to address.

TABLE 8.2 **Examples of detect controls**

WCGW	Assertion	Detect control
Cash is received but not recorded in the general ledger, payments are made but not recorded, cash receipts or cash payments are not real or not recorded on a timely basis.	Completeness; occurrence; cut-off	Bank reconciliation and follow-up of unexpected outstanding items (e.g. unexpected or large deposits not yet cleared by the bank, cheques presented by the bank but not recorded in the general ledger).
Shipments not billed and recorded, and billings are not related to actual shipments of product.	Completeness; occurrence	The computer performs a daily comparison of quantities shipped to quantities billed. If differences are revealed, a report is generated for review and follow-up by the billing supervisor.
Unrecorded billings and errors in classifying sales or cash receipts.	Completeness; classification	Quarterly reviews of credit balances in accounts receivable to determine their causes.
Among other things, errors in the number of units or unit prices being calculated or applied incorrectly.	Accuracy	The sales manager reviews daily shipments, total sales, and sales per unit shipped.

As illustrated in this section, detect controls are often accompanied by physical evidence such as a monthly reconciliation. This is in direct contrast to prevent controls. Prevent controls are often driven by the programming of the particular software used by the company, and therefore there is no physical evidence of the control.

When assessing detect controls it is not necessary for the auditor to re-perform all of the steps in, for example, preparing a reconciliation to gain sufficient evidence that the control is operating effectively. It is normally enough to examine evidence that the reconciliation was properly completed and that the appropriate reviews and follow-ups were carried out by the client in a timely manner.

Prevent and detect controls compared

There are very few manual prevent controls, instead they tend to be dependent on IT (that is, IT-dependent manual controls). Specialist IT skills may be required to audit IT-dependent manual controls, depending on how sophisticated the client's IT system is. It is important to note, however, that detect controls are only effective and therefore only provide audit assurance when the underlying data and transactions (and therefore prevent controls) can be relied upon. Therefore, it is important to gain an understanding of (and possibly test) the prevent controls in addition to the detect controls to which they relate.

For example, the review and follow-up of a monthly management report that compares actual results to budget results would be ineffective if there was no evidence available to show that the budgeted amounts were the approved amounts and the actual amounts were the total of the transactions recorded in the general ledger. In addition, the auditor needs to obtain evidence that the underlying transactions are captured and recorded properly. This is ordinarily done via the identification and testing of the underlying prevent controls. Also, the monthly comparison needs to be at an information level that is detailed enough to identify material misstatements, and the review and follow-up needs to be performed on a timely basis.

Because detect controls can be applied to groups of transactions rather than on a transaction-by-transaction basis, they are ordinarily performed less frequently than prevent controls. Therefore, a high degree of assurance they operated effectively throughout the period of reliance can be obtained by examining a relatively small amount of evidence.

As noted earlier, this does not mean that the auditor never considers performing tests of individual transactions to be satisfied that a control was in use and functioned as intended. In addition to performing tests of transactions as part of testing prevent controls, the auditor performs tests of transactions as a way of confirming that their understanding of the flow of transactions from initiation to reporting is correct (as described in chapter 4). In computerised environments, prevent controls can often be tested just as effectively and efficiently as detect controls. This is because prevent controls are accompanied by direct evidence as to the effectiveness of their operation (for example, review and follow-up of exception reports) or the auditor is able to re-perform the control to ensure it is operating effectively. This is discussed in more detail in the section on automated controls.

CLOUD 9

Weijing asks Josh about the types of controls that are normally used in a company like Cloud 9. Josh explains that it is useful to start by classifying controls as automated, manual, IT-dependent manual, or IT general controls. However, Weijing's focus should be on considering whether each of these controls prevents an error occurring in the first place, or is designed to detect an error that has already occurred so it can be brought to someone's attention.

Josh gives Weijing an example of a prevent control at Cloud 9. Based on his conversation with Carla Johnson, the financial controller, he has discovered that the computerised credit checking system at Cloud 9 will not allow a sale to be processed if a customer has exceeded its credit limit. This control prevents a customer order becoming a sale unless the client has been assessed as being able to pay the amount. It also helps prevent some clerical errors, such as 10 units being entered incorrectly as 1000 units (because this would usually take a customer's order over the customer's credit limit). This control is designed to operate for every order, but there does not seem to be anything in Cloud 9's system to show if and when it is done, so it is not easy to know if the control is operating effectively.

Josh also gives Weijing an example of a detect control at Cloud 9. Carla Johnson performs a monthly bank reconciliation that is reviewed and approved by David Collier, the financial controller. However, Josh explains to Weijing that he does not know yet if there is any follow-up on unusual items discovered during the reconciliation and review. If this follow-up is being done, then the control should detect errors in the bank account.

8.1.2 Manual and automated controls

In this section we consider manual and automated controls, as well as ITGCs and application controls (subsets of automated controls) and IT-dependent manual controls (which combine the characteristics of manual and automated controls).

Manual controls

Purely manual controls are those that do not rely on the client's IT environment for their operation. An example is a locked stock cage for high dollar-value items to which only a few authorised staff have a key to access. However, manual controls may use IT-produced information from third parties. For example, a client may reconcile the amount of consignment stock that was manually counted during its stocktake to the amounts listed in the third party's computer-generated consignment stock statement.

There are very few, if any, companies that do not use some form of IT to assist in transaction processing, and most controls rely on IT in some way (refer to the section on IT-dependent manual controls). In most situations, purely manual controls are prevent controls, and, therefore, the considerations for an effective prevent control, listed in the prevent controls section, are particularly important.

Automated controls

Controls generally rely on the client's IT applications (or software) in some way. It is important to identify the extent of reliance a control places on IT to determine the effect of IT on the evaluation of controls. The key consideration for relying on automated aspects of controls is to determine whether or not the client has effective ITGCs.

IT general controls (ITGCs)

ITGCs support the ongoing functioning of the automated (programmed) aspects of prevent and detect controls and also provide the auditor with a basis for relying on electronic audit evidence. The auditor needs to identify, understand, walkthrough, test and evaluate the ITGCs that have been implemented for computer applications they plan to rely on, as is done for any other type of control.

Ordinarily, an entity has three types of ITGCs in place.

1. Program change controls — only appropriately authorised, tested and approved changes are made to applications, interfaces, databases and operating systems.
2. Logical access controls — only authorised personnel have access to data and applications and can perform only authorised tasks and functions. For example, the accounts receivable clerk does not have access or authorisation to the cash payments application; the payroll manager may have access to the electronic funds transfer application, but is unable to process any pay runs without the additional approval (and use of passwords) of the financial controller.
3. Other ITGCs (including IT operations) — often difficult to identify in smaller organisations and include controls such as ensuring regular and timely back-ups of data, following up and resolving program faults and errors in a timely manner, following up any deviations from scheduled processing on a timely basis, and planning upgrades to programs and applications on a timely basis.

ITGCs are important because they impact the effectiveness both of application controls and IT-dependent manual controls, as well as potentially affecting the reliability of electronic audit evidence the auditor may wish to rely upon during the audit. For example, if a client relies on an application that records a sale and then automatically records and updates the accounts receivable ledger for that particular customer, the client also relies on its IT program change procedures and security to verify that the program and this specific control is not changed without appropriate approval and testing.

Examples of tests of controls over program changes and access to data files include:

- program change controls — examine documentation for evidence (for example, signatures on the program change forms) that the changes were authorised, tested and approved by appropriate personnel (for example, users, programmers, IT manager)
- access controls — check whether the access control software options in effect are properly approved and whether the options selected are reasonable; test or observe attempts to log on to terminals and

access files using unauthorised user IDs; review the related access violation or exception reports to determine whether all of the attempts are properly recorded.

Application controls

Application controls are the fully automated controls that apply to the processing of individual transactions. They are the controls that are driven by the particular software application being used, hence the name 'application' controls. They include controls such as edit checks, validations, calculations, interfaces and authorisations. Application controls may also be important in enforcing the segregation of incompatible duties, particularly in large organisations.

It is usually difficult in smaller organisations for application controls to be effective unless there are enough employees to make sure that the physical segregation of duties is mirrored by appropriate access restrictions for particular applications.

IT-dependent manual controls

In many situations, the auditor identifies a prevent or detect control that has both manual and automated aspects to it. These are referred to as IT-dependent manual controls. For these controls, consideration is given to both the manual and the automated aspects. For example, management reviews a monthly variance report and follows-up on significant variances. Because management relies on the computer-generated report to identify the variances, the auditor also needs to check that there are controls in place to ensure that the variance report is complete and accurate.

When evaluating the completeness and accuracy of computer-produced information, before the auditor can rely on the information they need to identify the source and the controls that ensure the information is complete and accurate. As illustrated earlier, the client often relies on both application and IT general controls to make sure any computer-produced information is complete and accurate. If they do not test both the application controls and the ITGCs and determine that the controls are effective (as they relate to particular reports or data), the auditor runs the risk of placing undue reliance on reports or data produced by the client's IT system. Auditors need to ensure any evidence they plan to rely upon (even if it is in the form of an internal system-generated report) is accurate, complete and can be relied upon. This testing can either be performed directly on the report in question or, alternatively, testing can be performed on the overall application that produces the report and the relevant ITGCs, which then removes the need to test the actual report.

PROFESSIONAL ENVIRONMENT

COSO internal control framework

All companies benefit from an effective system of internal controls because internal controls help organisations achieve their goals. In addition, companies subject to an external financial report audit can benefit from a more effective system of internal controls because an effective system of internal controls means financial report audits are more efficient and effective.

The Committee of Sponsoring Organizations (COSO) of the Treadway Commission produced an integrated framework on internal control in 1992 following the release of the Treadway Commission's recommendations. The framework provides principles-based guidance for designing and implementing effective internal controls. It is now the most widely used internal control framework in the United States and is adopted by numerous countries and businesses around the world.[1] COSO released an updated *Internal Control — Integrated Framework* in 2013.[2] COSO expects the 2013 framework to help organisations adapt their internal control to changing business conditions, including greater complexity, and to mitigate the risks of operation as well as to increase the quality of decision making.

An example of rapid change in business is the practice of keeping data and files stored on the internet, also known as cloud computing. Another recent COSO publication provides guidance for organisations using cloud computing to meet their technology needs.[3] The focus in the COSO project is to consider the risks and benefits of using cloud computing, and to help management and boards integrate risk management of cloud computing with the organisation's other risk management practices. Among the risks of using cloud computing identified by COSO is the reliance of the organisation on the technical competence and financial viability of the cloud service provider (CSP). That is, the organisation owning the data becomes more reliant on an external party, potentially reducing costs but increasing risk. The risk is greater as the CSP may be located in another legal jurisdiction. The external auditor is obliged to consider the nature of controls over the integrity of the data stored via cloud computing as part of the audit (ASA 402/ISA 402 *Audit Considerations Relating to an Entity Using a Service Organisation*).

BEFORE YOU GO ON

- What are the different types of controls?
- What is the difference between an application control and an IT general control?
- Which type of control, prevent or detect, is usually a more efficient control type to test?

8.2 Techniques for testing controls

LEARNING OBJECTIVE 8.2 Compare the different techniques for testing controls.

Tests of controls include enquiry, observation, inspection of physical evidence and re-performance. Ordinarily, it is a combination of these testing techniques that provides the evidence that the control operated as intended throughout the period the auditor wishes to place reliance on it. Each of the tests is now discussed.

8.2.1 Enquiry

This technique involves the auditor using questioning skills to determine how the control is completed and whether it appears to have been carried out properly and on a timely basis. For example, the auditor may ask the employee who prepares the bank reconciliation how reconciling items are identified, the reasons for them and the procedures in place to ensure that the accounting records are corrected on a timely basis. They may also ask management how it makes sure the reconciliation is prepared correctly and on a timely basis.

8.2.2 Observation

This technique involves the auditor observing the actual control being performed. For example, they may observe the preparation of the bank reconciliation. The limitation with this technique is that the employee may perform the procedures more diligently when they know they are being observed.

8.2.3 Inspection of physical evidence

This technique relies on the auditor testing the physical evidence to verify that a control has been performed properly. For example, the auditor may trace certain of the amounts on the bank reconciliation to the accounting records or to other documents (for example, a bank statement) to gain evidence that the procedures were properly performed. Also, they may read some or all of the reconciliations for other periods and examine the reconciling items to determine whether the reconciliation routinely detected errors and whether those errors appear to have been appropriately dealt with.

8.2.4 Re-performance

This technique involves the auditor re-performing the control to test its effectiveness. For example, the auditor may test the application controls for cash payments to ensure an unauthorised employee is unable to make cash payments (and that the unauthorised attempt to do so is recorded on an exception report).

CLOUD 9

Weijing can see that there are several possible tests they can use to test the bank reconciliation and follow-up controls at Cloud 9. In addition to observing Carla and David perform their duties, the auditors could ask them about the process, with particular reference to the following up of unusual items. The auditors could inspect the completed bank reconciliation, and they could re-perform the process. These latter tests would be the most reliable and will be used if Josh decides the bank reconciliation and follow-up of unusual items is a critical control.

Weijing is less sure about how they could test the credit limit checking that is performed within the inventory and sales management system. However, because the process at Cloud 9 is fully automated, Josh explains that one possible test is to feed dummy data into the system to see if sales over a client's credit limit are rejected. Also, they can use computerised audit techniques to interrogate the client's programs and produce reports to diagnose the performance of that part of the program.

BEFORE YOU GO ON

- When would an auditor most likely perform observation and enquiry procedures on a control?
- Name the four different techniques for testing controls.
- Give an example of when inspection of physical evidence might be used to test a control.

8.3 Selecting and designing tests of controls

LEARNING OBJECTIVE 8.3 Describe how to select and design tests of controls.

Two areas that require a large degree of professional judgement to be applied are deciding which controls should be selected for testing and determining the extent of audit testing to be performed. These areas are explained in the following sections.

8.3.1 Which controls should be selected for testing?

As explained above, controls are put in place to prevent or detect errors occurring (or a WCGW from actually going wrong). When the auditor decides to include controls testing in the approach they select those controls that will provide the most efficient and effective audit evidence (that is, provide the assurance required that the controls are working). To improve efficiency they test only those controls that they believe are critical to their opinion. That is, which controls provide reasonable assurance that the controls operated effectively throughout the period of reliance? Deciding which controls to test will be influenced by the type of controls, frequency of the controls being performed and the level of assurance the auditor wants to gain from the controls being designed and implemented effectively. As a general rule, the best controls to test are those that address the WCGWs the most effectively with the least amount of testing required (efficient testing strategy). If one control addresses multiple WCGWs then it stands to reason that this control would be selected instead of selecting several different controls to obtain the same level of assurance that a WCGW has not occurred.

8.3.2 How much testing does the auditor need to do?

We have discussed the types of controls and will now discuss how much testing is to be performed, which is closely driven by the frequency of the control in question. For example, is the control operating daily, weekly, monthly or for every transaction processed?

When testing controls, either statistically based sampling techniques (as described in chapter 7) or professional judgement can be used to determine the extent of testing. There are a number of factors to consider when deciding the extent of tests of controls to test. The more assurance the auditor wants from the performance of the controls, the more testing they need to do. That is, if they are intending to reduce control risk to the lowest level possible, they perform more testing than if they are planning to obtain only limited assurance from their testing (and reducing control risk by only a limited amount). The factors to consider when deciding the extent of testing include:

- how often the control is performed
- the degree to which the auditor intends to rely on the control as a basis for limiting their substantive tests
- the persuasiveness of the evidence produced by the control
- the need to be satisfied that the control operated as intended throughout the period of reliance. For some controls they may need evidence only as at year-end, whereas for most controls they need evidence that the control operated throughout the year
- the existence of a combination of controls that may reduce the level of assurance that might be needed from any one of the controls
- the relative importance of the 'what could go wrong' questions or statement being considered
- other factors that relate to the likelihood that a control operated as intended. In determining the extent of tests of a control, the auditor considers several other factors that affect the perception of the likelihood that a control operated as intended throughout the period of reliance, including:
  – the competence (and integrity) of the person who performs the control
  – the quality of the control environment such as the potential for management to override the control or for the control to be bypassed
  – changes in the accounting system that may have occurred
  – unexplained changes in related account balances
  – the auditor's prior-period experiences with the engagement.

Even though the above factors may reduce the expectation of errors, the auditor's tests of a control need to be sufficiently extensive to provide reasonable assurance that the control operated effectively throughout the period of reliance.

When the control is applied on a monthly basis, the auditor may decide to test the application of the control in detail for one month and review the remaining eleven months for unusual items. If the control is applied more frequently (say, weekly or daily), the auditor might test more than one application of the control in detail and review a sample of the remaining applications for unusual items.

Tests of prevent controls that are accompanied only by inferential (rather than physical) evidence of their effective operation include, for example, reviewing documents for an initial or signature and re-performing the checking routine itself (for example, if the initial signifies that the price, extensions and additions have been checked, the auditor checks the price, extensions and additions). The extent of such tests is a matter of professional judgement but, generally speaking, large sample sizes are not necessary. Under normal circumstances, a random sample of, say, 25 to 30 items, assuming no control exceptions (deviations) are observed, when combined with the evidence obtained from other audit procedures performed on the related accounts, provides evidence that controls operated as intended (that is, the control was effective). This example sample size has been calculated using audit risk tables and a technique called **attribute sampling**, a sampling technique used to reach a conclusion about a population in terms of a rate (frequency) of occurrence. For instance, a sample of cash payments can be examined for signatures that are required as evidence of proper approvals. The number of missing signatures (exceptions) is then used to estimate the overall rate of exceptions for the entire file of payments. Each sample item provides one of only two possible outcomes: the attribute being tested (for example, a signature, price or recorded balance) is correct or incorrect, present or absent, valid or not valid.

Normally, attribute sampling by itself does not provide a direct estimate of dollar values, such as the dollar amounts of exceptions. That is why attribute sampling is most often used for tests of controls (rather than as a substantive test of account balances). However, by using this sampling technique, the auditor is able to determine with a certain level of confidence (90 per cent or more) that the error rate for **control exceptions** is acceptably low; that is, they may not need to perform additional controls testing to reduce control risk further. If the audit objective is to obtain evidence directly about a dollar amount being examined, the auditor generally uses a different sampling technique (such as systematic selection).

There may be circumstances where more or less testing is carried out. Regardless of the size of the sample, all control exceptions (deviations) (including those that are accompanied by errors) are investigated by the auditor (see section 8.4). The auditor is careful not to dismiss an observed control exception as a random, non-systematic occurrence. Therefore, the detection of one control exception results in the auditor extending the sample size (when the auditor anticipates no further control exceptions will be found), amending their decision to rely on that control and/or considering whether another control is available that can be substituted for the control being tested (often referred to as a compensating control).

CLOUD 9

Talking with Josh about the factors that have to be considered when deciding how much control testing to do helps Weijing appreciate her task. She realises that her previous understanding of a lower assessed level of control risk strategy was too simple. Gathering evidence about the effectiveness of controls in order to reduce the reliance on substantive testing does not mean that the auditor has to test every control in the same way.

Weijing realises that if the evidence that would be produced from testing a control is not very persuasive, there is little point in devoting a lot of effort to testing that control. For example, a prevent control that a supervisor authorises a transaction only produces evidence of the presence or absence of a signature, not evidence of whether the supervisor was performing the task of reviewing the transaction effectively. Obtaining lots of evidence that the supervisor's signature was on the appropriate form will not provide much assurance by itself about the effectiveness of the control.

Also, Weijing is now starting to understand what Josh means by 'critical control'. Josh wants to know which of the controls identified for each assertion are likely to be the most effective at preventing the WCGWs from occurring or detecting them if they do occur. Josh would like to focus testing on these controls and gather sufficient, appropriate evidence to justify reduced substantive testing.

For example, there are usually several controls designed to prevent or detect errors and misstatements in inventory and sales. In the wholesale sales area at Cloud 9 these controls include signed delivery receipts, policies requiring undelivered goods to be returned to the warehouse at night, and use of a locked shipping cage. Other controls include the use of electronic scanners and matching and authorising documents in the dispatch and invoicing process. However, despite all these controls, Josh has also identified from his conversation with Carla Johnson that unless the controls over the inventory management software system are tested thoroughly they will not be able to justify reduced substantive testing. This is because so much of the document matching and authorisation depends on the correct operation of the programs.

Application controls

The auditor may decide to rely on application controls identified and evaluated earlier in the audit. The functioning of the application control is tested to determine whether it can be relied upon as an effective control. The auditor also tests the operating effectiveness of the control over the period of reliance by one or both of the following methods.

1. Focusing on manual follow-up procedures that support the application control. For example, the computer prices the invoices using data in the price master file. The application control is a computer-generated exception report listing all sales orders entered for which there are no prices on the master file. The auditor may choose to focus on how the client follows-up on these exceptions.
2. Testing controls over program changes, and/or access to data files. Here the auditor is testing the ITGCs (as discussed previously). Using the example in (1) above, the auditor may choose to test controls to ensure that all additions, deletions and changes to the pricing master file are approved.

If these testing strategies are not feasible, the auditor can still rely on application controls by testing them throughout the period of reliance. Using the price master file example above, the auditor may choose to select a sample of invoices from throughout the period and compare the prices to the approved price sheet, instead of just testing at a single point in time.

When the client relies on controls over program changes and/or access to data files (ITGCs), it is efficient for the auditor to test these controls as they may support reliance on several other application controls. For example, they may decide to do a system-wide test of access to data files for controls that apply to more than one control objective or application.

Regardless of which testing strategy is selected, the auditor establishes a basis for concluding that the underlying processing of data is complete and accurate. The techniques to test controls over program changes and/or access to data files are similar to those used to test manual controls. They usually involve enquiry, observation and examination of physical evidence. The testing applies to the specific applications of interest (for example, a test of program changes is limited to changes to the sales application only) if it is possible and efficient to do so.

Recognising that application controls operate in a systematic manner, the auditor may be able to limit their testing of those controls to the significant transaction types. For example, a computerised interest calculation may consistently use the same formula (principal multiplied by an interest rate from a rate master file). Or, a computerised edit check will not allow the finalisation of payments greater than \$100 000 without appropriate authorisation. In these examples, the auditor could limit their testing to a 'test of one' per transaction type (that is, test one interest calculation or attempt to process a cheque request in excess of \$100 000) rather than testing a sample using audit risk tables. This test of one may have been performed as part of the walkthrough, which was performed when the auditor gained an understanding of the transaction, the WCGWs and the controls.

Benchmarking

Benchmarking is an audit testing strategy that can be used to carry forward the benefit of certain application controls testing into future audit periods. It can also assist in reducing or eliminating certain substantive audit procedures in the current and following audit periods.

Benchmarking is based on the premise that a computer will continue to perform any given procedure in exactly the same way until such time as the program (or application) is changed. If the auditor can verify that a given program that executes a process or control has not changed since last tested, they may decide not to repeat certain audit procedures in a subsequent period. This period might extend, for example, from interim through to year-end and beyond into future audit periods.

The auditor establishes their benchmark as at a point in time (for example, at an interim date) by performing a test of the application control using normal audit procedures. Then, at a later point in time, they determine that the application has not been changed or modified since they performed their test of the application control. In order to verify that there have been no changes, it may be necessary for the audit team to use a team member with specialist IT assurance skills.

Benchmarking is appropriate when:

- a programmed control can be matched to a defined program within an application (for example, the auditor may be able to benchmark the specific program that performs the invoice extension calculation or interest computation)
- the application is stable (that is, few changes have happened or are expected to happen from period to period)
- a reliable trail of program changes exists (refer to the previous discussion on ITGCs). This record or trail of program changes is used to identify each change that has been made to the application and how these changes might impact the audit approach.

It is a matter of professional judgement as to when it is necessary to re-benchmark an application. Factors to consider in making this assessment are the effectiveness of the ITGCs, the nature and timing of other related tests and the consequences of errors associated with application controls that are benchmarked. In some cases, the auditor may choose to rely on benchmarked controls from year-to-year and, in other instances, they may choose only to rely on benchmarked controls between interim and year-end.

It is worth noting that benchmarking may not be an efficient strategy if the complexity of the application makes it difficult to easily identify and test the function or application the auditor wants to test and rely upon. For example, a warranty provision may be based on a calculation performed by an application, which is reliant on many interrelated applications, and the client is unable to assist the auditor in identifying which application(s) actually performs the calculation. In this situation, it may be more efficient to retest the underlying data or information in the following audit period.

Timing of tests of controls

Tests of controls will usually be carried out at an interim date (that is, before year-end). It is preferable to test entity-level controls and ITGCs early in the audit process because the results of this testing could impact the nature and extent of other procedures the auditor plans to perform. For example, if it is found that the ITGCs are not effective and cannot, therefore, be relied upon, more extensive testing of application controls will need to be performed if the auditor is planning on relying on applications and computer-generated audit evidence.

The auditor updates their evaluation of controls from the time of their interim procedures through to the year-end date. They update their evaluation by identifying changes, if any, in the control environment and in the controls themselves. If changes are identified, consideration is given to the effect of such changes on their evaluation of the controls. This update is often done via enquiry, observation and, in some cases, testing the control again at year-end. In most cases, a client will not have made significant changes in the control environment or controls between completion of the interim work and year-end. When this is the case and the auditor has noted an effective control environment, they satisfy themselves by enquiry and observation that controls continued to function throughout the remainder of the period without the need for significant additional detailed tests of controls.

Summary of extent of testing

Table 8.3 is an example of how many tests of each control might be performed depending on the frequency of the control in question. The selection of how many instances of a control to test is an area of significant judgement. Table 8.3 is an example only and two different auditors are likely to design two different extents of testing. For example, if it is a monthly control and the auditor wants to obtain a more than limited level of assurance from the controls testing, two controls (for example, a monthly bank reconciliation) would be tested from throughout the year. If, however, only a limited level of assurance from the controls testing is required, only one control would be tested from throughout the year. ‘More than limited’ in this example is not the same as reasonable assurance (which is 95 per cent confidence).

TABLE 8.3 Example extent of testing table

Frequency	More than limited assurance from tests of controls	Limited assurance from tests of controls
> 1000 instances	25–40	10–20
Daily	25–40	10–20
Weekly	5	2
Monthly	2	1
Quarterly	2	1
Annually	1	1
Other	Professional judgement	Professional judgement
Application control (effective ITGCs)	1	1
Application control (ineffective ITGCs)	25–30	25–30

A limited level of assurance may be planned for when additional evidence from other testing is already available to the auditor (such as evidence from **substantive procedures** (also called **substantive testing** or **tests of details**), which are audit procedures performed to detect material misstatements at the assertion level), or where it may be an efficient strategy to test some controls and to perform some additional substantive procedures. More than limited assurance may be planned for when there is no additional audit evidence available from other testing, or when it is more efficient to test and rely on controls without performing a significant amount of substantive testing. In order to obtain 'reasonable assurance' and therefore to conclude with 95 per cent confidence that the controls are operating effectively, multiple controls should be tested for each assertion and material balance. This is an area that requires a significant level of professional judgement.

CLOUD 9

Making sure that testing covers the critical controls and provides sufficient, appropriate evidence of the effectiveness of the controls allows the auditor to reduce the control risk of the related financial report assertion. Josh and Weijing have a discussion about how they can design their control tests to be able to conclude that each control:

- operated how it was understood to operate
- was applied throughout the period of intended reliance
- was applied on a timely basis
- encompassed all applicable transactions
- was based on reliable information
- resulted in timely correction of any errors that were identified.

Josh explains that if they can satisfy the above objectives in their design and no exceptions are found when they perform their tests, the control will be deemed to be effective. If any exceptions are found, they need to investigate the circumstances. They need to be careful not to dismiss any exception as a random event, and unlikely to be a symptom of more extensive problems. Further, they may need to perform additional procedures to obtain sufficient assurance, or reduce their reliance on the control. This latter action might require additional testing of another compensating control or increased substantive testing.

BEFORE YOU GO ON

- Name three factors to consider when deciding the extent of testing to be performed.
- When would testing application controls warrant performing a test of more than one?
- Why does the auditor update the interim evaluation of controls at year-end?

8.4 Results of the auditor's testing

LEARNING OBJECTIVE 8.4 Compare and contrast the results of testing of controls.

Before the auditor tests the controls, they should review the internal control documentation (as described in chapter 6). This will ordinarily be in the form of narratives, logic diagrams, flowcharts, checklists, a questionnaire or a combination of these. If the tests of controls confirm the auditor's preliminary evaluation of controls (and control risk), the planned substantive audit procedures are not modified. If the test results do not confirm their preliminary evaluation of controls (and control risk), the auditor revises the overall audit risk assessment for the related account and the planned audit strategy (that is, increases the level of substantive procedures). For example if the tests of controls indicate that certain controls are not as effective as originally believed or have not functioned as prescribed and substitute (compensating) controls are not available or were not effective, the auditor revises their audit risk assessment (increases control risk), reduces or eliminates the intended reliance, and reduces detection risk by designing more extensive substantive audit procedures (which are intended to detect and estimate the effect of errors in the related significant account balances). As mentioned previously, when a control has not performed as it was intended, it is referred to as a control exception (deviation).

Figure 8.2 illustrates the decision tree or thought process an auditor goes through when assessing the results of their controls testing.

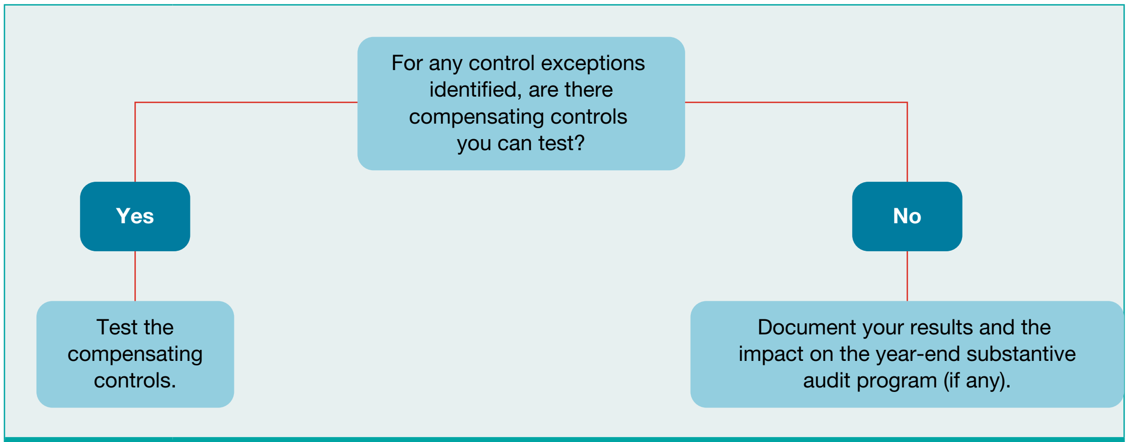


FIGURE 8.2 Results of testing

The auditor needs to investigate any control exceptions (deviations) they identify during their testing to find out, to the extent practical, the causes (for example, whether the exceptions may be indicative of a pattern of similar exceptions), the amounts involved, the financial report accounts affected, and the potential effect on other audit procedures. The auditor is required to document the resolution of any control exceptions (including the impact on the remaining audit approach) and report the control exceptions in a management letter to those charged with governance, as they are considered matters of governance interest in accordance with ASA 260 (ISA 260) *Communication with Those Charged with Governance* (refer to figure 6.6).

If the auditor extends their testing and another control exception is identified, they should change their decision to rely on that control and, if another (compensating) control is not available to be substituted for the control being tested, or it is not considered efficient to continue testing controls, update (and potentially increase) the nature, timing and extent of the planned substantive procedures. That is, the audit strategy is altered and detection risk is reduced.

In trying to determine whether there is a need for additional detailed tests of controls, the following factors are considered.

- *Results of enquiries and observations*. If, during their enquiries or observations later in the audit process, the auditor identifies that significant changes to processes and controls have occurred, their previous tests of controls may no longer provide a basis for relying on those controls. Therefore, they may need to identify and test other controls, perform additional tests of controls or increase the level of substantive testing performed at year-end. Changes to processes or controls are significant only if they have implications for the continued functioning and effectiveness of controls on which the auditor is relying in the first place.
- *Evidence provided by other tests*. Tests of account balances (substantive testing) can often provide evidence about the continued functioning of controls. For example, when the auditor examines vendors' invoices in support of year-end creditors and expense account balances, they learn whether controls relating to the recording of these transactions continue to function. To the extent that their other audit procedures provide evidence of the effectiveness of controls from the date of interim

work to the end of the period under audit, additional tests that otherwise might be necessary can be reduced.

- *Changes in the overall control environment*. An effective entity-level control environment may allow the auditor to limit their tests of controls to enquiry and observation during the period between when they tested the controls (interim) and year-end. If they become aware of adverse changes in the overall control environment of the entity, such as a loss of employees and key management who perform key controls and who provide evidence as to the effectiveness of the overall entity control environment, additional tests of controls may be necessary.

BEFORE YOU GO ON

- What does the auditor do when they identify control exceptions?
- Why does the auditor consider the entity's overall control environment when performing controls testing?
- Why does the auditor always investigate control exceptions?

8.5 Documenting conclusions

LEARNING OBJECTIVE 8.5 Describe how to document tests of controls.

Once controls have been tested, the auditor documents their work in a working paper. In this working paper, the auditor would ordinarily set out the purpose of the tests of the controls identified. This assists in carrying out the testing by reminding the auditor of their overall purpose in testing the controls. If the auditor identifies any exceptions or issues, they are able to decide if there is an impact on their testing strategy by considering whether the control exception means that the control no longer meets the objective of the test. For example, assume that the control selected for testing is a bank reconciliation and the objective of the test is to verify that a review by the financial controller occurred on a timely basis. When performing the testing, however, it was noted that while there was evidence of the review (a signature), there was no date, so timeliness could not be verified. Therefore, the auditor is able to conclude that the control operated but they are not able to conclude as to whether it operated on a timely basis. It would need to be determined whether a compensating control should be tested, or whether the timeliness of the review is not critical to the auditor's ability to rely on the bank reconciliation as audit evidence.

The auditor also documents the test performed, the actual controls selected for testing and the results of the testing. There needs to be enough detail regarding the controls selected to allow another auditor to review the working paper, re-perform the steps (if necessary) and reach the same conclusion as the auditor who prepared the working paper. The results are often set out in a table to make it easier to review and identify quickly what (if any) exceptions were identified during the testing. Prior to an overall conclusion being reached for each section of work performed, the results table also assists the person reviewing the working paper to determine if enough work has been performed and if the right conclusion regarding the controls testing has been reached. The working paper should also include a conclusion specific to whether the test results support the overall purpose of the test. This is the documentation standard that is required by ASA 230 (ISA 230) *Audit Documentation*.

Regardless of how they prepare their working papers and document their results, the extent of the auditor's documentation will increase as the complexity of the client's operations, systems and controls increases. Also, the more complex the client's operations and its internal controls, the more experienced the auditor who performs the work needs to be.

As also illustrated in chapter 7, figure 8.3 is an example of a working paper relating to controls testing.

The first part of figure 8.4 illustrates in a table format the impact of controls testing on the subsequent amount of substantive testing required to be performed. For example, if inherent risk is low and a reasonable level of assurance has been gained from controls testing (that is, controls are operating effectively), potentially only overall analytical review procedures would need to be performed to reduce detection risk (and audit risk) to an acceptable level to be able to make a conclusion about the significant account assertion. If, however, inherent risk is high and no assurance has been obtained from controls testing, extensive substantive procedures designed to estimate the dollar value of any error in the balance would need to be performed.

The second part of figure 8.4 illustrates the same information in a graph format. That is, the higher the level of confidence gained from controls testing, the lower the level of assurance required to be obtained from the substantive procedures in order to form conclusions.

<table>
<tr><th colspan="4">EXAMPLE TEST OF CONTROL WORKING PAPER</th></tr>
<tr><td colspan="2">Client name: CAMTRAC Pty Ltd</td><td colspan="2" rowspan="2">Year-end: 31 December 2016</td></tr>
<tr><td colspan="2">Working paper: Cash controls testing</td></tr>
<tr><td colspan="4">Purpose of test:
The purpose of this test is to verify that the bank reconciliation control was adequately designed and implemented for the 12 months ending 31 December 2016.</td></tr>
<tr><td colspan="4">Work performed:
Selected two bank reconciliations from different months, tied the balance as per the bank statement to the bank statement and bank audit certificate, tied the balance as per the general ledger to the trial balance and vouched all reconciling items between the bank statement and the trial balance greater than $50 000 to supporting documentation to ensure valid reconciling items and that the reconciliation had been performed correctly. Ensured the reconciliation had been prepared and reviewed on a timely basis.</td></tr>
<tr><td colspan="4">Findings/results of testing:
Selected bank reconciliation for the months of April and September 2016. No errors noted in the preparation of the reconciliation. Both were prepared and reviewed within four days of month-end. Considered this to be on a timely basis.</td></tr>
<tr><td colspan="4">Conclusion:
Based on testing performed, the bank reconciliation appears to have been designed, implemented and operating effectively for the 12 months ended 31 December 2016.</td></tr>
<tr><td></td><td>Prepared by:
SEF 13/10/16</td><td>Reviewed by:
FMC 15/10/16</td><td>Index: C1:1</td></tr>
</table>

FIGURE 8.3 Example tests of control working paper

CLOUD 9

Josh and the rest of the audit team have finished testing and assessing the controls at Cloud 9. Where necessary, they performed additional testing to investigate the deviations or exceptions discovered during initial testing. They sent their completed working papers to Sharon Gallagher, the audit manager, and Jo Wadley, the partner. The more senior members of the audit team must review the results of the controls testing and judge whether there is sufficient and appropriate evidence to support the decision to continue to use a lower assessed level of control risk approach to the audit.

Josh has been busy over the last few days answering questions from Sharon and the partner about particular aspects of the controls testing, but it now seems that all problems and issues have been resolved satisfactorily. Although the audit team has been concentrating on controls testing, the plans for substantive testing are well advanced and attention now turns to this phase of the audit.

Inherent risk assessment		Reasonable level of assurance from controls testing	Limited level of assurance from controls testing	No assurance obtained from controls testing
	Low	Few/limited substantive procedures	Some substantive procedures	Considerable testing
	High	Some substantive procedures	Considerable testing	Extensive procedures focused on estimating errors in the balance

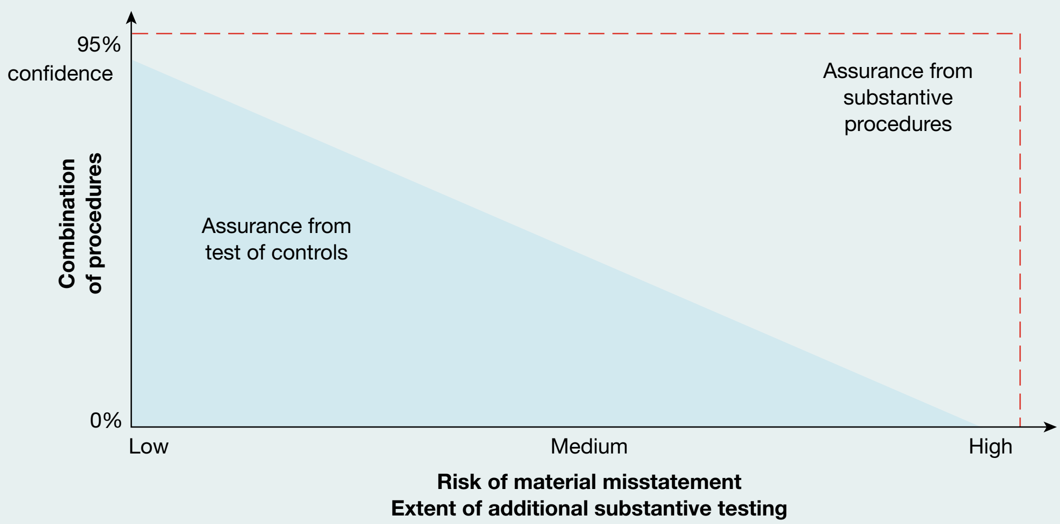


FIGURE 8.4 Impact of controls testing on level of substantive testing

PROFESSIONAL ENVIRONMENT

Audit quality and working papers

Who audits the auditors? The Australian Securities and Investments Commission (ASIC) is required by law (the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*, known as CLERP 9) to inspect audit firms' compliance with audit quality and auditor independence requirements. ASIC is charged with publishing reports on the inspection program to better inform firms, the investing public, companies, audit committees and other interested stakeholders.[4]

Each 12 to 18 months, ASIC publishes the results of its most recent inspection program of Australian audit firms, including smaller firms. Small firms are less likely to have sophisticated systems but are still required to ensure that their working papers contain sufficient evidence to justify their compliance with the mandatory auditing standards. The report dated June 2014 provides the results of their inspections of 107 audit files made during the 2012–13 period.[5]

(*continued*)

ASIC concluded that although audit firms were taking positive steps to improve audit quality, the impact of those steps was yet to be reflected in the risk-based inspection findings. ASIC stated that in 20 per cent of the 454 key audit areas that were reviewed for audit firms of different sizes, the auditors were not obtaining reasonable assurance that the financial report as a whole was free of material misstatement — a similar rate to the previous report (18 per cent). It is important to note that ASIC was not concluding that the financial reports were materially misstated, but that the auditors did not gather sufficient evidence to support their findings. In particular, ASIC stated that auditors were not showing sufficient professional scepticism and were possibly too reliant on the work of experts and other auditors. Many of the deficiencies were related to accounting estimates, such as impairment of assets and accounting policy choices.[6]

BEFORE YOU GO ON

- What level of detail does the auditor need to include in the audit working papers when documenting the results of their controls testing?
- Which auditing standard sets the minimum level of documentation required in the working papers stored in the audit files?
- What is the impact on the extent of required substantive testing if inherent risk is high and no assurance has been obtained from controls testing?

SUMMARY

8.1 Explain the different types of controls.

There are four different types of controls: manual, automated (otherwise known as application controls), IT general controls (ITGCs) or a combination of control types referred to as IT-dependent manual controls. Each of these types can be described as either a prevent control or a detect control. Prevent controls, as the name suggests, prevent errors from occurring. Detect controls detect the error after it has occurred and rectify the error on a timely basis.

8.2 Compare the different techniques for testing controls.

There are four key techniques used for testing controls: enquiry (questions are asked regarding the operation of the control), observation (the operation of the control is observed as occurring), inspection (of physical evidence resulting from the performance of the control) and re-performance (when the auditor re-performs the control to test its effectiveness).

8.3 Describe how to select and design tests of controls.

The selection of which controls to test is a matter of professional judgement. Deciding which controls to test will be influenced by the type of control, the frequency of the control being performed and the level of assurance the auditor plans to gain from the control being designed and implemented effectively. As a general rule, the best controls to test are those that address the WCGWs most effectively with the least amount of testing required.

The extent of testing of controls (that is, how many to test) is also a matter of professional judgement, although there are sampling techniques available (discussed in chapter 6). The extent of testing is impacted by many factors, including how often the control is performed, the degree to which reliance will be placed on the control as part of the audit, the persuasiveness of the evidence produced by the control, the need to be satisfied that the control operated as intended throughout the period of reliance, the existence of a combination of controls that may reduce the level of assurance that might be needed from any one control, the relative importance of the WCGW questions or statements being considered, and any other factors such as the competence of the person carrying out the control, the quality of the control environment and any changes in the accounting system.

8.4 Compare and contrast the results of testing of controls.

If the controls tested are considered to be effective and are able to be relied upon for the purposes of reducing overall audit risk for a particular significant account and assertion, the level of additional substantive testing that is necessary reduces. If the controls tested are considered to be ineffective and are not able to provide any audit evidence that reduces overall audit risk for a particular significant account and assertion, the level of additional substantive testing that is necessary increases.

8.5 Describe how to document tests of controls.

The purpose of the test of controls, selection of controls to test, the results of the controls testing performed and the conclusion regarding the design and implementation of the controls are all documented in a working paper. This working paper is then reviewed by a more experienced auditor to determine if sufficient work was performed and if the appropriate conclusion was reached.

KEY TERMS

Attribute sampling A sampling technique used to reach a conclusion about a population in terms of a rate (frequency) of occurrence.

Control activities Policies and procedures that help ensure that management directives are carried out. Control activities are a component of internal control.

Control exception An observed condition that provides evidence that the control being tested did not operate as intended.

Controls (Refer control activities) the terms internal control, control(s), system of internal controls and components of internal control may be used to refer to the same process.

Entity-level controls The collective assessment of the client's control environment, risk assessment process, information system, control activities and monitoring of controls.

Internal control The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

Substantive procedures (substantive testing or **tests of details)** Audit procedures designed to detect material misstatements at the assertion level.

Tests of controls (controls testing) The audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Transaction-level controls Controls that affect a particular transaction or group of transactions.

WCGWs Where material misstatements due to error or fraud could occur in a flow of transactions or source and preparation of information that affects a relevant financial report assertion.

MULTIPLE-CHOICE QUESTIONS

8.1 Which of the following is not a factor that the auditor considers when deciding which controls to test? **LO1**

(a) The type of control
(b) The risk of detection
(c) The frequency of the control being performed
(d) The level of assurance the auditor wishes to gain

8.2 The purpose of controls is to: **LO1**

(a) detect misstatements in the financial report.
(b) prevent misstatements in the financial report.
(c) support automated parts of a business in the functioning of the controls.
(d) all of the above.

8.3 Which of the following is not a type of control? **LO1**

(a) Manual controls
(b) Automated controls
(c) Substantive controls
(d) IT-dependent manual controls

8.4 Detect controls do not include: **LO1**

(a) reconciliations.
(b) account coding.
(c) performance indicators.
(d) management level reviews.

8.5 ITGCs are important because they: **LO1**

(a) prevent the reliability of electronic audit evidence.
(b) prevent authorised personnel from having access to data and applications.
(c) affect the effectiveness of both application controls and IT-dependent manual controls.
(d) allow client staff to change computer programs without needing to receive authorisation for the change.

8.6 Examples of application controls include: **LO1**

(a) edit checks.
(b) validations.
(c) calculations.
(d) all of the above.

8.7 Inspection of physical evidence is a control test used by auditors. It: **LO2**
(a) is reliant on questioning skills.
(b) relies on testing the physical evidence.
(c) requires the auditor to re-perform the control.
(d) is subject to a limitation because employees may be more diligent when they know they are being observed.

8.8 Which of the following would not require the auditor to increase the level of control testing for a particular control? **LO3**
(a) The control is performed daily instead of monthly.
(b) The WCGW addressed by the control is very important.
(c) There is one control relating to a particular audit objective.
(d) A low degree of reliance is to be placed on the control to limit the amount of substantive testing required.

8.9 A major change in the accounting system has taken place during the year. The effect on control testing is that the auditor: **LO3**
(a) should ensure controls testing is performed for periods both before and after the accounting change became effective.
(b) will not conduct controls testing because obviously the client has thought about making sure the accounting system works well.
(c) can assume the accounting system change was necessary and has improved the client's controls, so should only test the period before the change.
(d) can assume the accounting system change was necessary and has improved the client's controls, so should only test the period following the change.

8.10 Working papers: **LO5**
(a) document the results of the tests but not the purpose of the control selected for testing.
(b) are necessary for the junior auditor to keep track of the daily work but are not important to the overall audit.
(c) document the purpose of the control selected for testing and the conclusion made by the auditor but not the results of the test.
(d) document the purpose of the test of the control identified and the results of the test, including a specific conclusion about whether the test results supported the overall purpose of the test.

REVIEW QUESTIONS

8.11 What is the difference between entity-level controls and transaction-level controls? **LO1**

8.12 Explain the difference between prevent controls and detect controls. Why would it be important for an entity to have both types of controls? **LO1**

8.13 The form completed by casual employees to claim overtime requires a signature from the supervisor before payroll will process the claim. Is this a prevent or detect control? Explain. **LO1**

8.14 A junior employee must prepare a bank reconciliation and submit it to the manager. Is this a prevent or detect control? Explain. **LO1**

8.15 What does 'ITGCs' stand for? Explain their purpose. **LO1**

8.16 What is the difference between observation and inspection of physical evidence? **LO2**

8.17 Does an auditor have to test every control? Explain. **LO3**

8.18 What factors do auditors consider when deciding how much control testing to do? **LO3**

8.19 What is the premise underlying the use of benchmarking? Why is it helpful to the auditor? **LO2**

8.20 Discuss the concepts of nature, timing and extent as they relate to controls testing. **LO3**

8.21 What is the relationship between the results of tests of controls and substantive testing? **LO4**

8.22 Explain the process of documenting the auditor's conclusions. What must be documented? **LO5**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

8.23 PERFORMANCE INDICATORS ★ **LO1**

The audit assistant has been assigned to review performance indicators in the procurement department of Kentucky Kapers, a manufacturing audit client. The assistant reports to you that he has obtained a copy of reports used by the supervisor in the procurement department to assess the performance of the purchasing team. The reports include details of orders processed per day, backlog of orders and time taken to clear the backlog (on a weekly basis), and overtime requests by staff in the department. The assistant also reports that his discussions with the supervisor reveal that the performance indicators are used to manage the department, but are not used for follow-up on unexpected results in the financial reporting system.

Required

Are the performance indicators in the report useful as audit evidence for the financial report audit? Explain.

8.24 CONTROL TESTING RESULTS ★ **LO4**

Washington Cleaning has more than 50 employees and has several contracts to clean offices in the central business district. In order to keep disruption to a minimum, the teams of cleaners do not commence work until after 6 pm each night. In the working papers documenting the control testing results the senior auditor notices that there was one instance of a part-time staff member for Washington Cleaning being paid an incorrect hourly rate.

Required

Explain why the result shows a control exception (deviation).

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2010.

8.25 IT CONTROLS — PASSWORD ★ **LO1**

The client company assigns each new employee a user profile and password for the computer system. The first time the new employee logs onto a company desktop computer, they are automatically forced to change their password. Passwords must be changed every 30 days.

Required

Explain what type of control the above information describes. Discuss its strengths and weaknesses.

Source: Adapted from the CA Program's *Audit & assurance exam*, March 2011.

8.26 IT CONTROLS — SUPPLIERS ★ **LO1**

Within the client's IT system, supplier information is contained in a supplier master file (SMF). Each supplier has a unique supplier code. If the purchasing clerk attempts to place an order from a supplier not in the SMF, the order cannot be processed. To avoid delays in processing orders, the purchasing clerk has access to the supervisor's password, which allows the clerk to allocate a supplier code to new suppliers.

Required

Explain what type of control the above information describes. Discuss its strengths and weaknesses.

Source: Adapted from the CA Program's *Audit & assurance exam*, March 2011.

8.27 INTERNAL CONTROLS FROM PRIOR YEAR ★ **LO1**

The junior auditor on the engagement has suggested that, since there were no exceptions detected in previous years, no work on internal controls is required because last year's evidence will be sufficient. The senior auditor accepts the suggestion because it is a good example of benchmarking.

Required

Explain why the junior auditor's suggestion is not appropriate and outline what work is required.

Source: Adapted from the CA Program's *Audit & assurance exam*, March 2011.

8.28 PREVENT CONTROLS ★★ **LO1**

Nebraska Industries manufactures and wholesales small tools. It sells the tools to a large group of regular customers and makes most sales by telephone to this group. Additionally, it receives orders online by its sales team who sign up new customers within the sales area. In the past, Nebraska Industries has had trouble with customers who do not pay their accounts on time. Despite instructing the sales team not to make sales to customers before their creditworthiness has been assessed, sales are still being made to new customers before their limits have been set and to existing customers beyond their credit limit. Also, the economic recession has started to affect its customers, and Nebraska's management is concerned about the possibility of increasing bad debts.

Required

(a) What sort of prevent control could be used to deal with the problems faced by Nebraska Industries? Explain how the control would work.

(b) Assume the prevent control is implemented, and during this year there have been no sales to customers that have taken any customer beyond its credit limit. What are two possible explanations for this that the auditor must consider?

(c) If an auditor finds two sales transactions during the year that are in excess of a customer's credit limit at the time of the sale, what conclusion would the auditor draw from this evidence? What other evidence could the auditor consider before concluding that the prevent control has failed?

8.29 TESTING BANK RECONCILIATION CONTROLS ★★ **LO1, 2, 3**

You are testing the controls over bank accounts for your audit client, Orleans Ltd. You note that the responsibility for bank reconciliations has changed due to a corporate reorganisation halfway through the current financial year. Both the staff member performing the bank reconciliations and the supervisor have changed. You are able to talk to only the current staff member and supervisor because the other staff took voluntary redundancies and left the client's employment six months ago.

Required

(a) What techniques are available to you to gather evidence about the bank reconciliations? Explain how you would use each technique and comment on the quality of the evidence obtained from each.

(b) When you ask the employees responsible for bank reconciliations about how they perform the reconciliations there is a possibility that they will not tell the whole truth about their performance of the reconciliations. Given this, will you bother to ask them? Explain.

(c) Explain the impact of the staff changes on your controls testing program.

8.30 INVENTORY PROGRAM CONTROLS ★★ **LO1, 3**

Denver Drapers supplies custom-fitted curtains and blinds to retail customers. It has recently expanded to offer a wide variety of home decorating products through its six stores across the state. After some initial problems with stock control it installed a new automated inventory system in April this year. The system replaced another automated system that had been modified so often over the years that the auditor had advised Denver's management that they did not regard it as reliable. That is, the auditor was unable to rely on the old system sufficiently to assess control risk for inventory as anything less than high.

Required

(a) Explain the normal process an auditor would expect to find in the client's systems governing changes to computer programs. Why is an auditor concerned about program changes?

(b) Denver Drapers' financial year-end is 31 December. Does the auditor need to obtain evidence about the performance of the inventory control system from every month in the year or from a sample of months? Explain.

(c) If the auditor conducts tests of the inventory controls at an interim date, is it appropriate to conclude that the controls also relate to the end of period date? Why?

Questions 8.31 and 8.32 are based on the following case.

MaxSecurity Limited (MaxSecurity) has been an audit client of Smith & Associates (S&A) for the past 15 years. MaxSecurity is based in Wollongong, where it manufactures high-tech armour-plated personnel carriers. MaxSecurity often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialised and MaxSecurity only does business with nations that have a recognised, democratically elected government. MaxSecurity maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

In September 2016, MaxSecurity installed an off-the-shelf costing system to support the highly sophisticated and cost-sensitive nature of its product designs. The new system replaced a system that had been developed in-house as the old system could no longer keep up with the complex and detailed manufacturing costing process that provides tender costings. The old system also had difficulty with the company's broader reporting requirements.

MaxSecurity's IT department, together with the consultants from the software company, implemented the new manufacturing costing system. There were no customised modifications. Key operational staff and the internal audit team from MaxSecurity were significantly engaged in the selection, testing, training and implementation stages.

The manufacturing costing system uses all of the manufacturing unit inputs to calculate and produce a database of all product costs and recommended sales prices. It also integrates with the general ledger each time there are product inventory movements such as purchases, sales, wastage and damaged stock losses.

MaxSecurity's end of financial year is 30 June.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

8.31 UNDERSTANDING TYPES OF CONTROLS ★★ **LO1**

In relation to the new manufacturing costing system, describe two automated application controls that MaxSecurity could be using.

8.32 ASSESSING CONTROL TESTING RESULTS ★★ **LO4**

Discuss the implications of finding evidence that the controls identified in question 8.31 are (a) effective, (b) not effective.

8.33 CONTROL TESTING RESULTS AND DOCUMENTATION ★★★ **LO2, 4, 5**

Amy Adams, the audit senior, is reviewing the working papers written by the audit assistant on the audit of Virginia Creepers, a garden nursery and retailer of garden accessories. Amy reads the following description of the results of testing of inventory controls written by the audit assistant:

> Stock controller advises that no changes have been made to the inventory programs during the current financial year. There are no documents on file authorising program changes so I conclude the stock controller's statement is true.
>
> Stock controller also advises that management did not attempt to override any controls relating to inventory. There are no memoranda or emails from management on file instructing the stock controller to go against procedures, so I conclude the stock controller's statement is true.

The audit assistant concludes that the inventory controls have not been changed or overridden during the financial year, so the results of the interim testing of controls can be relied upon.

Required

(a) Examine the statements by the audit assistant. What deficiencies in the testing can you identify?

(b) If the results of testing one control show that the control is not effective, does the auditor have to increase substantive testing? What other options are available to the auditor?

(c) Explain why it is important for the working papers to be completed with sufficient detail for another auditor to understand what has been done. Make a list of the parties who might review the documents.

8.34 TECHNIQUES FOR TESTING COMPUTERISED CONTROLS ★★★ LO1, 3

The sales transactions at Colorado Park, a new audit client, are handled by a software application that is not supported by very detailed documentation. The audit partner requests the team to re-perform some controls to ensure that the software application controls are working as described by Colorado Park's management. The audit software used by the audit team can access the data on the client's files, allowing the use of standard audit procedures.

Required

(a) Give examples of controls over sales transactions that should be part of the software application.

(b) How could the audit team test the controls in the client's sales software application?

8.35 PAYROLL CONTROLS ★★★ LO1, 3

The audit senior on the audit of Frankel Factors is preparing the audit plan for the year ended 30 June 2017. The following notes relate to the payroll application system that went live on 1 January 2017.

1. The new payroll application is more complex than the old system, but its reporting function provides more detail. For example, the new application calculates leave, superannuation, payroll tax and work cover expenses, as well as the corresponding accruals.
2. Due to the brief time available to implement the new system, the previous application ceased operation on 31 December 2016 and the new application went live on 1 January 2017 without running parallel with the previous application. Staff training and testing of the new application was limited.
3. Access to the master files is restricted to the payroll supervisor and her deputy. Access to transaction files is restricted to payroll staff who are responsible for the processing of fortnightly and monthly pay.

   Prior to the introduction of the new payroll application system, the payroll master and transaction files were kept in a separate database from the general ledger application. At the end of each month, the IT staff imported transaction data from the database into the general ledger. Management decided to upgrade the existing accounting system due to the frequent problems encountered by IT staff when importing data into the general ledger.

Required

(a) Based on the information above, explain two relevant concerns you may have about the payroll application's integration with the general ledger application.

(b) Describe one IT application control that would ensure the accuracy of the salaries and wages expenses transaction.

(c) Describe one IT application control that would ensure the occurrence of the salaries and wages expenses transaction.

(d) Design and describe in detail appropriate tests of control that you would use to satisfy yourself about the effectiveness of these internal controls.

Source: Adapted from the CA Program's *Audit & assurance exam,* July 2010.

Questions 8.36 and 8.37 are based on the following case.

Chan & Partners Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year, Chan and Partners gained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home

- Total Cancer Specialists Limited (TCSL), a private oncology clinic that specialises in the treatment of cancer.

Year-end for all MSHG entities is 30 June.

You are an audit senior on the Shady Oaks Hospital engagement. Your initial review of the business has highlighted the following significant risks.

1. Payroll expense. Shady Oaks employs, in addition to its full-time staff, a significant number of casual nursing, cleaning and administrative staff. Overtime is often worked on weekends and night shifts due to a shortage of staff. Payment at overtime rates for standard weekend and night shifts has been a common occurrence.
2. Accounts payable. Shady Oaks also has a large number of suppliers for various medical supplies and drugs. Paying the supplier twice for the same purchase has been a continuing problem.

8.36 PREVENT AND DETECT CONTROLS ★★★ **LO1**

For each of the accounts for Shady Oaks (1 and 2 above) identified to be a significant risk:

(a) determine the key assertion at risk

(b) describe a practical prevent internal control that would directly address the risk

(c) describe a practical detect internal control that Shady Oaks could implement in relation to the risk.

You may wish to present your answer in the form of a table as follows.

Account at risk	a. Key assertion at risk	b. Prevent internal control	c. Detect internal control
1. Payroll expense: overpayment of overtime			
2. Accounts payable: payments made twice to the same supplier			

In addition your business risk assessment procedures indicate there is a risk that payments to suppliers are made prior to goods being received. As part of your evaluation of the potential mitigating internal controls you note that accounting staff perform the following procedures.

1. A pre-numbered cheque requisition is prepared for all payments.
2. The details on the supplier's invoice are matched to the appropriate receiving report.
3. The details on the supplier's invoice and receiving report are matched to an authorised purchase order.
4. The cheque requisition is stapled to the authorised purchase order, receiving report and supplier's invoice and forwarded to the appropriate senior staff member for review and authorisation.
5. The authorised cheque requisition, together with the supporting documents, is passed to accounts payable for payment.

8.37 PREVENT CONTROLS ★★★ **LO1, 3**

(a) Identify the key assertion at risk for payables in relation to payments made prior to receipt of goods.

(b) For the control procedures (1) to (5) above for payables:

   i. Identify the key preventative internal control that directly addresses the risk of payments being made by Shady Oaks to its suppliers before the goods are received.

   ii. Outline how your choice of the internal control in (i) will prevent payment to suppliers prior to receipt of goods.

   iii. Design and describe in detail an appropriate test of control that you would use to satisfy yourself about the effectiveness of this internal control.

Source: Adapted from the CA Program's *Audit & assurance exam,* December 2008 and March 2009.

CASE STUDY — CLOUD 9

Answer the following questions based on the information presented for Cloud 9 in the appendix to this text and the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

Effective internal controls at the transaction level are designed to prevent or detect material misstatements that could occur within the flow of transactions. In the case study assignment in chapter 6, you were required to identify potential misstatements and affected financial report assertions within the wholesales sales to cash receipts process.

Required

(a) Use your worksheet from the case study assignment in chapter 6 to complete this part of the assignment. In column four, include the transaction-level internal controls Cloud 9 has implemented to prevent and/or detect potential errors.

(b) In designing the audit strategy, auditors should consider the effectiveness of the client's internal control structure, thereby determining the control risk. An auditor should perform a preliminary assessment of control risk to give confidence to take a controls-based approach to the audit strategy. A controls-based strategy is one in which the internal controls of a significant process are tested and proven to be effective and, therefore, can be relied upon to reduce the level of substantive testing needed.

If internal controls are tested and proven to be operating effectively, the auditor can reduce the control risk of the related financial report assertion. This method of testing and proving controls can reduce the substantive procedures to be performed or allow substantive testing to be performed prior to year-end.

When designing control tests, consider whether there will be sufficient evidence that the control:

- operated how it was understood to operate
- was applied throughout the period of intended reliance
- was applied on a timely basis
- encompassed all applicable transactions
- was based on reliable information
- resulted in timely correction of any errors that were identified.

Based on the preliminary assessment of Cloud 9's control environment obtained in earlier procedures, the audit team has decided to test controls over the sales to cash receipts process. It is expected that there will be no deficiencies in the transaction-level internal controls.

Josh has partially completed the testing for selected controls over the sales/receivables and cash receipts processes. He has asked you to complete the testing for him. All information has been provided by the client (refer to the appendix to this text). Document your findings on the workpapers Josh has started (see tables 8.4 and 8.5 below) and then conclude with your assessment on the overall effectiveness of the controls tested.

Aim: To test selected controls over the sales and receivables process.
Sample: We haphazardly selected 25 sales invoices from the entire year.
Complete the following audit procedures:

- Match the quantities and products ordered on the invoices to the dispatch notes. If they match, mark all matching lines on both documents with the letter 'A'.
- Check the dispatch notes for a signature by the customer. If a signature is present, mark the signature with a 'B'.
- Check the invoice contains a passcode entered by the supervisor. If a passcode is present, mark the code with a 'C'.

Aim: To test selected controls over the cash receipts process.
Sample: We haphazardly selected 25 working days from the entire year in order to test the reconciliation of daily bank receipts to trade receivables.

Match the total amount of the bank receipts to the accounts receivable postings. If the amounts match, mark with a 'D' on both documents.

(*continued*)

TABLE 8.4 Cloud 9 controls testing — sales/receivables process as at 31 December 2016

	Sales invoice #	Date	Customer name	Sale amount (excl. GST)	Invoice matches dispatch note (A)	Customer signature present (B)	Dispatch note #	Shipping supervisor authorisation (B)
1	324874	14/01/2016	David Jones – Bondi Junction	645.87	✔	✔	D00324874	✔
2	325048	23/01/2016	Rin Tin Limited	17 750.00	✔	✔	D00325048	✔
3	325324	7/02/2016	Rebel Sport – World Square	905.46	✔	✔	D00325324	✔
4	325542	16/02/2016	Rebel Sport – Sunshine Coast	517.32	✔	✔	D00325542	✔
5	325987	2/03/2016	Myer – Adelaide	675.28	✔	✔	D00325987	✔
6	326067	10/03/2016	Dick's Sports – Coffs Harbour	367.96	✔	✔	D00326067	✔
7	326845	8/04/2016	Peacock Prospecting Limited	10 220.00	✔	✔	D00326845	✔
8	327111	27/04/2016	Running Shop – Manly	457.24	✔	✔	D00327111	✔
20								
21								
22								
23								
24								
25								

Note: For the purposes of this case study, sample tests 9 to 19 have been removed. There were no exceptions noted in the results.

TABLE 8.5 Cloud 9 controls testing — cash receipts process as at 31 December 2016

	Date	Total posted to trade receivables	Total bank deposit	Evidence of review (D)
1	8/01/2016	12 548.45	12 548.45	✔
2	18/01/2016	299 587.37	299 587.37	✔
3	15/02/2016	17 486.82	17 486.82	✔
4	27/02/2016	27 456.24	27 456.24	✔
5	11/03/2016	15 836.08	15 836.08	✔
6	19/03/2016	8 012.74	8 012.74	✔
7	4/04/2016	48 753.91	48 753.91	✔
8	22/04/2016	89 687.45	89 687.45	✔
20				
21				
22				
23				
24				
25				

Note: For the purposes of this case study, sample tests 9 to 19 have been removed. There were no exceptions noted in the results.

RESEARCH QUESTION

Explain the differences between an audit of internal controls as required by section 404 of the US Sarbanes–Oxley Act 2002 and the testing of internal controls for the purposes of expressing an opinion on the financial report as mandated by ASA 315 (ISA 315). Refer to the standard and legislation in your answer.

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. b, 2. d, 3. c, 4. b, 5. c, 6. d, 7. b, 8. d, 9. a, 10. d.

NOTES

1. Committee of Sponsoring Organizations of the Treadway Commission (COSO) 2010, www.coso.org.
2. Committee of Sponsoring Organizations of the Treadway Commission (COSO) 2013, *Internal control — integrated framework*, www.coso.org/IC.htm.
3. Crowe Horwath LLP, Chang, W, Leung, E, & Pili, H 2012, *Enterprise risk management for cloud computing*, June, COSO, www.coso.org.
4. Australian Securities and Investments Commission 2014, *Audit inspection program report for 2012–13*, ASIC, www.asic.gov.au.
5. Australian Securities and Investments Commission (ASIC) 2014, *14–140MR ASICs audit inspection findings for 2012–13, ASIC,* www.asic.gov.au.
6. ibid.

CHAPTER 9

Execution of the audit — performing substantive procedures

LEARNING OBJECTIVES

After studying this chapter you should be able to:

9.1 describe substantive audit procedures

9.2 explain the link between the audit risk model and the nature, timing and extent of substantive procedures

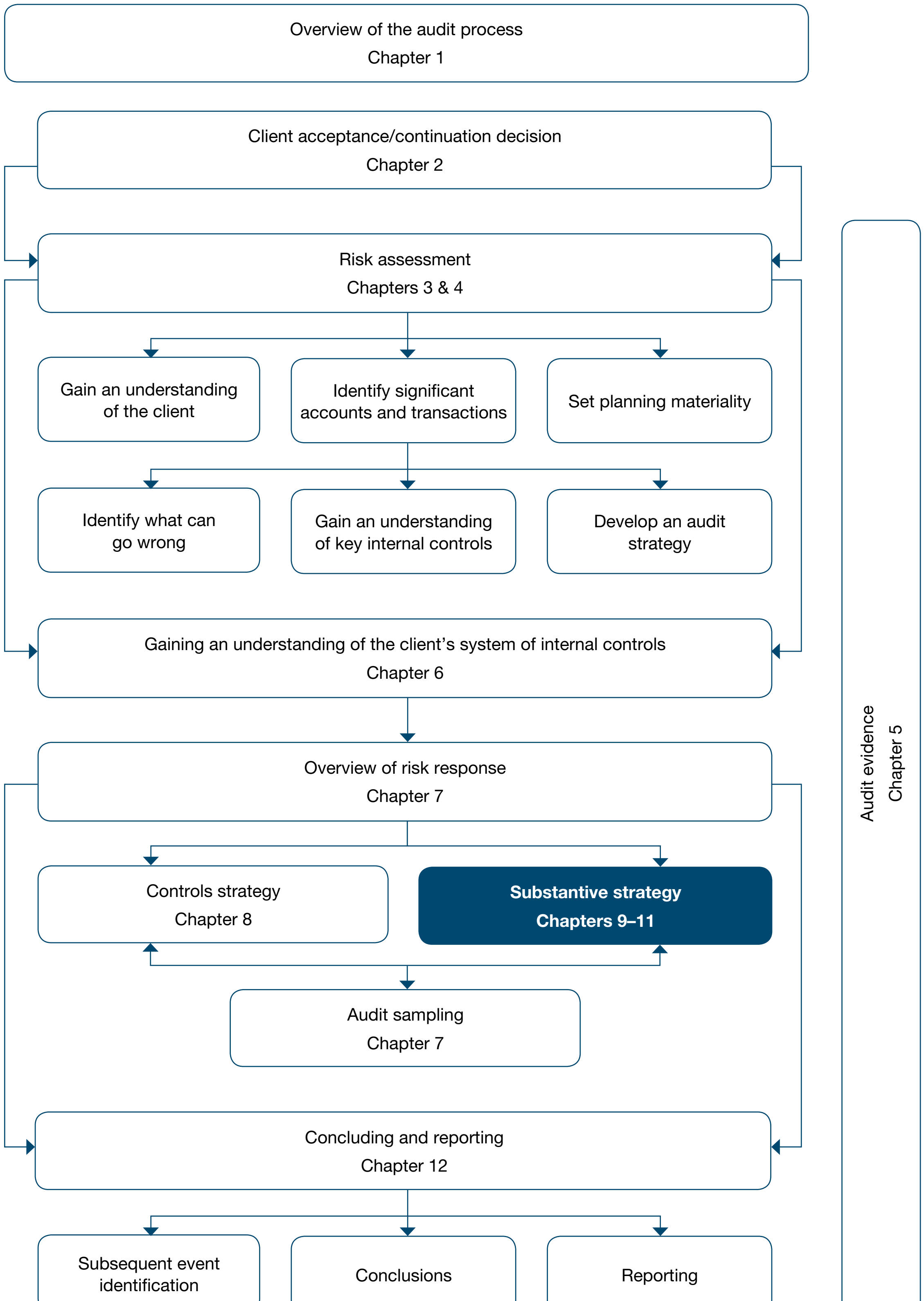
9.3 produce examples of different substantive audit procedures

9.4 discriminate between the various levels of audit evidence obtained when performing substantive procedures

9.5 explain the documentation of the conclusions reached as a result of performing substantive procedures.

AUDITING AND ASSURANCE STANDARDS

AUSTRALIAN	INTERNATIONAL
ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*	ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*
ASA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*	ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*
ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*	ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*
ASA 500 *Audit Evidence*	ISA 500 *Audit Evidence*
ASA 501 *Audit Evidence — Specific Considerations for Inventory and Segment Information*	ISA 501 *Audit Evidence — Specific Considerations for Selected Items*
ASA 505 *External Confirmations*	ISA 505 *External Confirmations*
ASA 520 *Analytical Procedures*	ISA 520 *Analytical Procedures*
ASA 530 *Audit Sampling*	ISA 530 *Audit Sampling*


Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client's system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

Suzie Pickering is the clothing and retail industry specialist on the Cloud 9 Pty Ltd (Cloud 9) audit. Suzie is mentoring Ian Harper, a junior member of the audit team, and they are working together on the detailed substantive test program.

Ian remembers that Suzie used analytical procedures in the early planning phase and that Suzie explained to Ian how useful they could also be in the testing phase. Ian suggests that they plan to rely extensively on analytical procedures for Cloud 9's substantive tests. He is very enthusiastic and wants to put analytical procedures in the plan for all transaction cycles and major balances because he believes that analytical procedures will help keep the cost down and help the team bring the audit in on budget. Suzie is more cautious. Although she will definitely plan to use some analytical procedures, she knows they will also need other types of tests. 'Why?' asks Ian. 'How do I know when to only use analytical procedures? What other tests do we need?'

Audit process in focus

Finding an appropriate combination of audit procedures to minimise an engagement's audit risk at an acceptable cost to the auditor is a constant challenge. The purpose of this chapter is to describe the audit execution process often referred to as 'performing substantive procedures'. The overall objective of substantive procedures is to supplement controls testing the auditor may have performed in order to determine that the underlying accounting records are materially correct and reconcile to the financial report that the auditor will ultimately form an opinion on (further discussion on the overall conclusion of the audit is in chapter 12).

The types of substantive procedures discussed in this chapter include analytical procedures, tests of key items, representative sampling, tests of underlying transactions and data, and using computers to assist in performing substantive procedures.

We will explain the link between the audit risk model and the nature, timing and extent of substantive procedures, which then assists in the preparation of the audit program. The chapter will also describe the levels of audit evidence the auditor can obtain from the various substantive procedures they have available to select from, and how to conclude that the overall account balance or disclosure being audited is not materially misstated.

9.1 Overview of substantive procedures

LEARNING OBJECTIVE 9.1 Describe substantive audit procedures.

In this section we discuss the link between audit risk, assertions and substantive procedures, and define substantive procedures in detail.

9.1.1 Substantive procedures and assertions

As discussed in previous chapters, the nature, timing and extent of audit procedures is determined in response to the risk assessment for each **significant account** and assertion using the formula for **audit risk** (or the risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated) and requires the use of **professional judgement**. Figure 9.1 contains the audit risk model introduced in chapter 4.

Inherent risk is the risk of a misstatement occurring irrespective of any controls management may put in place. These risks tend to be driven by the nature of the significant account or business that the client is in. There is no way for the auditor to influence the inherent risk of an account or assertion.

Control risk is assessed as high when there are no internal controls tested or relied upon by the auditor (or they are unable to be tested and relied upon). Control risk is assessed as low when there are good internal controls in place that are designed and implemented effectively to reduce an identified risk and the auditor has been able to test them and verify their operating effectiveness throughout the period subject to audit. Control risk and controls testing were discussed in detail in chapter 8.

$$AR = f\,(IR, CR, DR)$$

where:

AR = Audit risk

IR = Inherent risk

CR = Control risk

DR = Detection risk

FIGURE 9.1 Audit risk model

The combination of inherent risk and control risk (the risk of material misstatement (ASA 200 (ISA 200) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*)) determines the level of **detection risk** (or the risk that the auditor's testing procedures will not detect a material misstatement) the auditor is willing to accept to be able to conclude that the financial report is materially correct. There is an inverse relationship between the auditor's assessed risk of material misstatement and detection risk. For example, if the combined inherent risk and control risk is high (that is, the client is in a high-risk industry and the account has a higher chance of being materially misstated if there are no controls put in place and no controls have been tested), the amount of detection risk the auditor is willing to accept is low and therefore significant substantive procedures are necessary to reduce the detection risk. If the combined inherent risk and control risk are low (that is, the client is in a low-risk industry and the account has a lower chance of being materially misstated if there are no controls put in place and controls have been tested), the amount of detection risk the auditor is willing to accept is high and therefore only a small number of substantive procedures are necessary to reduce the detection risk.

Figure 9.2 shows the link between the assessment of inherent risk and control risk and how it affects the amount of substantive testing required to reduce detection risk to an acceptable level.

			Control risk assessment		
			Low	**Medium**	**High**
			Controls tested extensively and able to be relied upon	Limited controls tested and able to be relied upon	No controls tested and no assurance from controls
Inherent risk assessment	**Low**	Lower risk of material errors if no controls in place	Few substantive procedures required	Some substantive procedures required	Considerable substantive procedures required
	High	Higher risk of material errors if no controls in place	Some substantive procedures required	Considerable substantive procedures required	Extensive substantive procedures required

FIGURE 9.2 Linkage between inherent risk, control risk and detection risk

As discussed in previous chapters, the risk assessments discussed in this section are required to be performed at an assertion level. Chapter 5 introduced and defined each of the audit assertions as outlined in ASA 315 (ISA 315) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*. They are reproduced in table 9.1 and grouped to show the assertions that have common objectives.

Table 9.1 illustrates how the objective of each assertion relates to the particular type of account or disclosure. For example, the auditor needs to verify that sales transactions recorded in the income statement occurred and relate to the entity (the occurrence assertion). Those same sales transactions flow through to the trade receivables balance in the balance sheet, and the auditor needs to verify that the balance of trade receivables as at year-end exists and that the client holds the rights to those receivables (the existence, and rights and obligations assertions). The auditor then needs to verify that the balances then disclosed in the financial report as sales revenue and trade receivables occurred and relate to the entity (the occurrence, and rights and obligations assertions).

TABLE 9.1 Audit assertions

Assertions about classes of transactions and events	Assertions about account balances at year-end	Assertions about presentation and disclosure
Typically income statement accounts	*Typically balance sheet accounts*	*Disclosures made in the financial report*
Occurrence	Existence	Occurrence
	Rights and obligations	Rights and obligations
Completeness	Completeness	Completeness
Cut-off		
Accuracy	Valuation and allocation	Accuracy and valuation
Classification		Classification and understandability

It is clear from this example that testing performed on sales revenue transactions will also provide evidence on trade receivables in the balance sheet and on the financial report disclosures; however, there will still need to be additional testing performed on the trade receivables balance regarding the other assertions not addressed by this example (such as testing the valuation assertion).

Care should be taken not to assume that similar assertions across all three types of assertions are exactly the same. For example, 'classification' in the income statement is not exactly the same as 'classification and understandability' in the financial report. Classification as it relates to transactions requires verification that transactions and events have been recorded in the proper accounts (that is, within the general ledger). Classification and understandability as it relates to the financial report disclosures requires verification that financial information included in the financial report is appropriately presented and described, and disclosures are clearly expressed. This is slightly different to the first audit assertion. The first assertion is focused on the transaction being captured in the correct general ledger account. The second assertion is focused on it being presented, described in the notes and disclosed correctly and clearly in the financial report. Ensuring this audit assertion is met will require the auditor to ensure that the right account(s) in the general ledger are summarised, presented, and described in the notes to the accounts and disclosed in the financial report in accordance with an applicable accounting framework (such as IFRS).

CLOUD 9

Suzie emphasises to Ian that their testing must respond to the risk of material misstatement at the assertion level. For each assertion, the audit team determines the level of detection risk, which is based on the inherent risk assessment and the results of the control testing, which is used to establish the level of control risk. The auditors also have to consider a range of practical factors, such as constraints on timing and the complexity of the client's systems. 'Analytical procedures are always useful, but the decision to use analytical procedures and/or other substantive procedures must consider risk and practical factors,' she says. 'In an audit we have to decide what an acceptable level of detection risk is, and how to achieve it, for every assertion about transactions, account balances and disclosures.'

9.1.2 Definition of substantive procedures

Substantive procedures are designed to obtain direct evidence as to the completeness, accuracy and validity of data, and the reasonableness of the estimates and other information contained in the financial report. Substantive procedures include inspection, observation, enquiry, confirmation, recalculation, re-performance and analytical reviews. These procedures were introduced in chapter 5 and are also referred to as **substantive testing** or **tests of details**.

How much substantive testing is performed and when it is performed are influenced by several factors. The most important factor is the overall risk assessment for the item being tested. This was described in section 9.1.1. Prior to making this assessment, the auditor will have performed planning procedures and controls testing (including testing any controls identified that the auditor intends to place reliance on). The results of these planning and interim procedures allow the auditor to make an overall assessment as to how much detection risk still exists prior to any substantive testing being performed. The auditor then designs what they believe are appropriate substantive audit procedures that will allow material errors and exceptions to be identified and rectified before an overall conclusion is made. These procedures are documented in what is usually referred to as the audit program. The audit program typically includes all of the planning, interim and year-end testing procedures with enough detail to enable the auditor to understand the nature, timing and extent (or scope) of testing required. It details the controls testing (as detailed in chapter 8) as well as the resulting substantive procedures (as detailed in this chapter). Examples of typical substantive procedures for common significant accounts are included in chapters 10 (balance sheet accounts) and 11 (income statement accounts).

There are several other factors (over and above the audit risk assessment) that influence how much (extent) and when (timing) substantive procedures are performed. These include the following.

- The nature of the test (some lend themselves more easily to being performed during the year-end visit as opposed to during the interim audit visit(s)). For example, vouching prepayment amounts to their supporting documentation (the invoices that were paid during the year) is easy to perform prior to year-end; verifying the calculation of the split between the amount to be recognised as a prepayment and the amount to be expensed in the income statement is easiest to perform at or after year-end.
- The level of assurance necessary (reasonable assurance requires more evidence to be obtained from substantive procedures than limited assurance in order to reach a conclusion).
- The type of evidence required (for example, are the procedures designed to provide persuasive, corroborative or minimal audit evidence? These concepts are discussed further in section 9.4).
- The complexity of the client's data capturing systems (the more complex the systems, the more complex and sophisticated the substantive audit procedures may need to be).

It is ordinarily more efficient to test and rely on controls than carry out substantive procedures; however, there are situations when this may not be possible or practicable. In these situations, the auditor will need to perform extensive substantive procedures to provide sufficient audit evidence to reach a conclusion. This is often the case when auditing smaller businesses that do not have appropriate segregation of duties, or may not have internal controls in place for the entire period of reliance.

The types of procedures used to reduce detection risk to an acceptable level consist of key item testing, representative samples, other tests of details and analytical procedures. These are described in more detail in section 9.3.1. When controls are tested and determined to be effective, the auditor would ordinarily address any residual detection risk through the use of substantive analytical procedures. These are described in more detail in section 9.3.2.

It is a matter of professional judgement as to whether the substantive audit procedures start with analytical procedures and are then supplemented with additional procedures as necessary, or whether to begin with tests of details, including key item testing, and to use analytical procedures as the overall procedure performed after sufficient other substantive procedures have been performed.

By using a combination of techniques, the auditor is able to perform substantive procedures that, when coupled with any other audit evidence obtained during the planning and interim phases of the audit, will provide sufficient and appropriate audit evidence to enable the auditor to conclude at the assertion level, significant account level and overall at the financial report level.

It is worth noting that there are certain substantive procedures that are required to be considered. If they are not performed, the standards require documentation to be contained in the audit working papers explaining what alternative procedures were performed to address these required procedures. These are outlined in the auditing standards and include sending bank confirmations, observing stocktakes or inventory counts (ASA 501 (ISA 501) *Audit Evidence — Specific Considerations for Inventory and Segment Information*), confirming receivables balances (ASA 505 (ISA 505) *External Confirmations*), and examining material journal entries and other adjustments of audit importance during the course of preparing the financial report (ASA 240 (ISA 240) *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*).

CLOUD 9

Ian is starting to realise that the standards and professional practice would not allow him to rely exclusively on analytical procedures. Cloud 9 has significant inventory balances and receivables, so the auditors will need to gather persuasive evidence about the existence, valuation, and rights and obligations assertions for these accounts. Procedures such as confirming receivables balances and observing inventory counts are definitely going to be included in the detailed audit program.

Suzie warns Ian that it is not always the size of the account that determines the use of analytical procedures or other procedures. For example, if Cloud 9's trial balance includes an asset representing loans made to its directors, the auditors would need to consider not just the size of the loan to the directors, but also the qualitative characteristics of such an account. Even if the balance of an account representing loans to directors is less than 1 per cent of total assets, because the accounting standard covering related party transactions (AASB 124 (IAS 24) *Related Party Transactions*) creates additional disclosure requirements for these accounts, the significance of the account and the amount of testing required is higher than the monetary balance might initially indicate.

'Auditors also have to be particularly careful in assessing the materiality of any liability balance,' Suzie explains. 'This is because we are usually more worried about understatement than overstatement of liabilities, so the assertion most at risk is completeness, not existence.'

BEFORE YOU GO ON

- Describe why audit assertions are important in the determination of audit risk.
- Define substantive procedures.
- Are there any audits where the auditor would perform no substantive audit procedures? Explain your answer.

9.2 Relationship between risk assessment and the nature, timing and extent of substantive procedures

LEARNING OBJECTIVE 9.2 Explain the link between the audit risk model and the nature, timing and extent of substantive procedures.

The nature of substantive procedures varies from account to account, and ordinarily consists of one or a combination of the following techniques:

- key item testing
- representative sampling
- other tests of transactions/underlying data
- analytical procedures.

These techniques are described in more detail in section 9.3.

The appropriate mix of substantive procedures depends on factors such as the nature of the account balance (that is, balance sheet versus income statement account) and the risk assessment for both the specific account and the client overall (that is, at the account level and at the financial report level).

The nature, timing and extent of substantive procedures are in response to the risk assessments for each of the relevant sources of information affecting a significant account. In the case of an accounting estimate, the auditor may conclude, for example, that the likelihood of material misstatement is lower in measuring the provision for warranty claims but there is a risk that not all such claims are identified. In this case, extensive tests are directed at determining whether all claims have been identified (completeness assertion) while less extensive tests are directed at determining whether the amounts already recognised as claims are appropriate (existence, and valuation and allocation assertions). Risk assessments not only affect the extent of the tests, but can also affect the nature and timing. For example, in the situation described above, it is likely that the auditor would test the completeness of claims at or near year-end; however, the tests of the valuation for individual claims by product type could be carried out prior to year-end.

Similarly, the auditor may have agreed with the client that based on the risk assessment it is appropriate for the client to carry out a physical stocktake prior to year-end (existence assertion). However, it is not appropriate for the auditor to test the client's valuation (pricing) of its stock at that date. Rather, they would perform tests of stock pricing at a date nearer to or at year-end.

Significant professional judgement is therefore required in relating the risk assessment to the nature, timing and extent of the tests in order to hold overall audit risk to an acceptable level.

9.2.1 Timing of substantive procedures

As can be seen from figure 9.3, the timing of substantive procedures is directly influenced by the level of control risk (that is, how much assurance has already been gained from the controls testing performed). Typically substantive testing tends to be performed at or near year-end, with controls testing performed during visits prior to year-end (interim). The timing of substantive procedures is described in more detail in section 9.3.

For accounts that accumulate transactions which, for the most part, will remain in the account balance at year-end, the auditor can normally perform effective procedures prior to year-end. For example, testing additions and disposals to the fixed asset register, or vouching of individually material expense items such as redundancy expenses. Since these transactions accumulate during the year and, for the most part, will remain in the account balance at year-end, the auditor's decision to perform procedures prior to year-end is generally not dependent on the effectiveness of controls or the likelihood of material misstatement. Rather, the timing of such procedures is a matter of convenience and whether it is expected to contribute to audit efficiencies. It is normal for an auditor to perform as much audit testing as possible prior to the client's year-end due to the large number of clients needing their audits completed by the same date. The more work that is performed prior to the year-end visit, the less year-end work that needs to be performed during the audit firm's 'busy season', allowing more flexibility in performing audits.

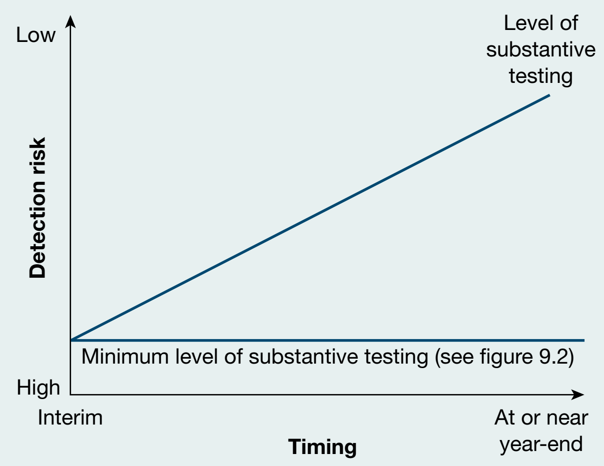


FIGURE 9.3 Timing of substantive procedures

For other accounts, the auditor's ability to perform substantive audit procedures at an interim date is generally dependent on the existence of an effective control environment and the effectiveness of controls. When the control environment is ineffective or there are specific ineffective controls, the auditor considers whether or not it is appropriate to perform substantive procedures at an interim date.

The timing of the substantive procedures is most flexible when controls have been assessed as effective and tested to confirm this assessment. In these circumstances, the substantive procedures may be performed earlier in the year.

Whenever substantive procedures are performed prior to year-end, the auditor performs **roll-forward procedures** to update their audit findings from the time of the interim procedures through to year-end. The nature and extent of these roll-forward procedures are matters of judgement and are responsive to the risk assessment. For example, when the entity's control environment has been assessed as effective, controls have been tested, and no significant changes in the control environment and controls have occurred, limited roll-forward procedures such as analytical procedures or limited testing of intervening transactions may be all that is necessary.

The auditor might also perform substantive procedures prior to year-end because of a client reporting requirement. For example, the auditor may be requested to confirm receivables and observe the counting of inventory prior to year-end to enable the client to close its books promptly.

Performing substantive procedures prior to year-end, in the absence of specific effective controls, may be acceptable when the auditor is able to conclude overall that the client's control environment is effective and the likelihood of errors of audit importance is not high, or when they can perform sufficient procedures both at an interim date and during the intervening period (often referred to as the 'roll-forward period'). The nature of the roll-forward procedures performed is responsive to the risk associated with the absence of controls and the timing of substantive procedures.

CLOUD 9

Suzie asks Ian to consider Cloud 9's warranty provision in its liabilities. What is the likelihood that the provision is understated? Are there any reasons to believe there are unidentified claims, and how would the auditors detect such claims?

Ian does not know of any change in manufacturing conditions that would affect the quality of Cloud 9's product, and thus the obligation under the warranty program. However, there was a new product introduced at the start of the previous year. 'Because sales of the new 'Work on Clouds' workboots are growing, and there are two major customers with another involved in a trial, we should consider any possible effects on the warranty provision. I recommend specific work be done to assess the claims from this product.'

'However, if we remove this product from the analysis, the relationship between the warranty provision and sales is likely to be similar to past years. Because warranties apply to products, the amount of the warranty liability is determined by sales volume and product quality. Therefore, if conditions affecting product quality have not changed, and there is no change to the warranty program, analytical procedures are a useful way of testing the reasonableness of the provision.'

'Finally', Ian concludes, 'relying on analytical procedures to test the warranty provision is more justified if control testing suggests that Cloud 9 has effective controls over warranty claim identification and processing.'

BEFORE YOU GO ON

- Name the four different types of substantive procedures discussed.
- Describe the relationship between the amount of substantive testing to be performed and the timing of the testing.
- When is the timing of substantive procedures most flexible? When are substantive procedures performed in these circumstances?

9.3 Substantive audit procedures

LEARNING OBJECTIVE 9.3 Produce examples of different substantive audit procedures.

In this section we explore the types of substantive procedures, including tests of details and analytical procedures. We also consider using computer assisted audit techniques in performing substantive testing.

9.3.1 Tests of details

Substantive procedures that are not analytical procedures are referred to as 'tests of details' and are predominantly designed to verify a balance or a transaction back to supporting documentation. Testing details of balances is performed on balance sheet accounts and testing the transactions that result in balances is performed on income statements. Often these tests of details are called 'vouching' or 'tracing'. **Vouching** is when a balance or transaction is taken from the underlying accounting records and verified by agreeing the details back to supporting evidence outside of the accounting records of the company (typically the details are agreed to external third-party information such as a supplier invoice or delivery documentation). Because vouching involves testing and verifying information already recorded in the accounting records, the primary purpose of the testing is to ensure the balances or transactions are not overstated (for example, existence and occurrence assertions). **Tracing** is when a source document is traced to the underlying accounting records. Because tracing involves testing and verifying information outside of the accounting records that is not necessarily recorded (for instance, on a source document such as an invoice), the primary purpose of the testing is to ensure the balances are not understated (for example, completeness assertion).

When agreeing a balance or transaction to supporting documentation, consideration needs to be given to the type of evidence that is available. As noted in ASA 500 (ISA 500) *Audit Evidence*, evidence that is external to the client is ordinarily considered more relevant and reliable audit evidence than evidence generated internally by the client. For this reason, where available, appropriate external evidence (or 'third-party' evidence) is preferred when performing these types of tests.

Auditors do not ordinarily audit an entire balance or class of transactions. Auditing requires professional judgement to be applied when determining how much testing to apply to a balance. For this reason, an auditor uses **audit sampling** (ASA 530 (ISA 530) *Audit Sampling*). Audit sampling was defined and described in detail in chapter 7 and is a valid way of performing audit procedures. The auditor is not required (nor are they able) to perform audit procedures on 100 per cent of the balances and disclosures within the financial report. Instead, transactions, balances and disclosures that are more likely to contain material errors are selected. Further, the nature, timing and extent of testing are based on the application of professional judgement in assessing the risks of material misstatement in the financial report.

The three main types of tests of details that are also techniques applied when deciding how much of a balance to test include (1) key item testing, (2) representative sampling and (3) other tests of transactions/underlying data. Each of these is now discussed.

9.3.2 Key item testing

When conducting substantive testing, the auditor uses either a statistical basis or professional judgement to identify and test key items within a balance. Their focus is on selecting the largest transactions within a balance to obtain 'coverage' over the total. That is, by selecting the largest transactions to test, the auditor is able to conclude over the entire balance based on the conclusions they reached by testing the largest transactions within a balance.

For example, an auditor is testing accounts receivable existence via the use of a debtors' circularisation (confirmation). The total receivables are $3 million with two key item trade debtors totalling $2.75 million of the balance. By selecting these two trade debtors and sending confirmation requests to them, assuming they reply, the auditor is able to conclude that because 91.7 per cent of trade receivables exist as at the confirmation date ($2.75 million ÷ $3 million), total trade receivables of $3 million exist as at the confirmation date.

Some audit firms have software that assists in determining whether key items selected will provide enough of a basis to conclude that the audit assertion being tested has been met (within the confines of materiality). These software tools use a variety of approaches in assessing the approach planned, and ordinarily take into consideration the total population (the account balance being audited), the materiality for the audit and what other procedures might be planned that will provide evidence to the auditor about the assertion being tested. The more persuasive the evidence from other procedures, the less coverage these key items need to address. The less persuasive the evidence from other audit procedures, the more coverage is generally necessary from these key items.

Representative sampling

As discussed in chapter 7, after key items have been segregated, there may remain a large population of items that are individually unimportant but significant in total. These populations can consist of either transactions through a point in time (for example, sales) or items within an account balance at a point in time (for example, year-end finished goods stock on hand). If risk assessments indicate the results of key item testing do not provide sufficient evidence for concluding that the population is free from material errors, the auditor obtains additional required evidence by selecting a sample from the remainder of the population (after excluding the key items). When sampling from the remainder of the population, the sample items are selected (either statistically or non-statistically) in such a way that the sample is expected to be representative of that remaining population. This is referred to as representative sampling.

Sampling is a complex area that requires the use of mathematically relevant, statistically valid techniques as well as a high degree of professional judgement in determining the nature, timing and extent of testing.

Another key factor impacting the nature, timing and extent of testing is the ability (or inability) to rely on computer-generated data or reports. When the auditor is unable to rely on the IT general controls or application controls of a client, control risk is assessed as high and the sample size when conducting substantive testing is likely to be larger and will be subject to a higher level of precision or confidence in the test results. When the client has strong controls and these have been tested to provide a basis for reliance, control risk is assessed as low, the sample size when conducting substantive testing is likely to be smaller and the auditor would ordinarily accept a lower level of precision or confidence in the test results.

Other tests of transactions/underlying data

In addition to substantive procedures related to key items and representative sampling, the auditor often performs other tests of transactions or underlying data. Some common examples of these other tests are:

- tests of client prepared schedules
- tests performed at an interim date and then roll-forward procedures performed on the intervening period between the interim date and year-end
- tests of underlying data to be used as part of the analytical procedures (refer to section 9.3.3)
- tests of income statement accounts for account classification
- tests of individual transactions by vouching/agreeing to supporting documentation.

How much testing to perform (the extent of testing) is a matter of professional judgement and needs to be sufficient to allow the auditor to conclude that the underlying data is free from material misstatement (material error). The auditor is essentially trying to perform sufficient testing to conclude that the underlying data being audited is either reasonably accurate or not.

If the auditor identifies errors when performing these tests, they request the client to investigate the reason for the errors. The reason helps the auditor determine the impact these errors may have on their risk assessment and the resultant change to the auditor's planned audit approach (this change is ordinarily to perform additional audit work).

CLOUD 9

During their conversation about Cloud 9's warranty provision Suzie asks Ian about how they would use other substantive procedures to obtain evidence about the completeness assertion for the liability balance. 'For example,' Suzie asks, 'would vouching and tracing be useful and, if so, how would you use them?' Ian is still keen on using analytical procedures, but considers the question carefully. 'I think we would use vouching to get evidence about transactions or balances that are recorded as warranty claims by Cloud 9. We could do this by selecting transactions or items in the balance and obtaining the documentary evidence to support each one. However, it might be more useful to consider tracing because this would allow us to start with the documents and get evidence about how and whether the transactions are recorded in the accounts. If we find a document relevant to a warranty claim has not been recorded in the accounting system, we would be concerned that the liability is understated, or not complete. Additionally, we would like to examine transactions around the balance date and make sure they are recorded in the correct accounting period. This evidence relates to the cut-off assertion, and is part of considering completeness.'

9.3.3 Analytical procedures

The fourth type of substantive procedures, **analytical procedures**, may be used:

- as primary (persuasive) tests of a balance
- as corroborative tests in combination with other procedures
- to provide at least some minimal level of support for the conclusion.

As outlined in ASA 520 (ISA 520) *Analytical Procedures*, properly designed and executed analytical procedures provide an efficient alternative to tests of details of account balances and, in some cases, may provide the most effective test of the appropriateness of account balances (for example, management's estimate of the allowance for doubtful debts or accrual for warranty costs). In other cases, analytical procedures may provide the only method of testing. For example, if the client does not maintain an effective costing system, overheads in the closing stock might be estimated by relating actual overheads for the year to actual direct labour (assuming reliable direct labour reporting and reliable overhead expense records). It is expected that overall analytical procedures at the financial report level will be performed on every audit engagement, irrespective of the audit approach planned for a client.

Therefore, when planning the audit approach, the auditor should consider what analytical procedures are available. The extent to which analytical procedures can reduce the extent of, or eliminate, other substantive procedures will depend upon the risk assessment and the level of assurance provided by the analytical procedures.

9.3.4 Types of analytical procedures

There are a number of techniques that can be used to perform analytical procedures as a substantive test. As discussed in chapter 4, the objective is to select the most appropriate technique (or combination of techniques) to provide the necessary levels of assurance and precision. These techniques or types of analytical procedures include:

- absolute data comparisons (comparing current year to prior year, budgets and forecasts)
- ratio analysis (activity, liquidity, profitability and leverage ratios)
- trend analysis (comparing certain data for several accounting periods)
- preparing common-size financial reports
- break-even analysis
- pattern analysis and regression analysis (sophisticated techniques not often used on audits).

Testing the reliability of underlying data

The biggest risk when performing analytical procedures is that the results will lead the auditor to accept an account balance as materially correct when, in fact, it contains material misstatements. The key way of minimising this risk is to evaluate the relevance of the information used in the analytical procedure and to ensure the auditor is satisfied that the financial and non-financial data they use in the analytical procedure are reliable.

The auditor considers the relevance of the information used in the analytical procedure, such as the following.

- Analytical procedures may not be useful when they are used on a company with significantly diverse operations and geographical segments. Analytical procedures are ordinarily more useful on an individual subsidiary, business segment or location basis than on a consolidated basis.
- The analytical procedure is adversely affected if the industry data is unreliable or is not comparable to the client's data. Industry ratios that are no longer meaningful because of rapidly changing economic conditions may be misleading.
- For entities with operations in inflationary economies, the extent to which increases in, say, costs or prices have been affected by inflation should be considered before performing analytical procedures and relying on the results.
- The comparison of budget to actual results is meaningful only if the client's budget process is well controlled. In some cases it may be necessary to expand the understanding of the process beyond that obtained during the planning phase of the audit (as described earlier).

The auditor also needs to be satisfied when using an analytical procedure that the financial and non-financial data used are reliable, especially when the analytical procedure is used as a persuasive substantive procedure. When using analytical procedures as part of an overall financial report analysis, it is not necessary to test the underlying data, because an overall financial report analysis is performed to increase the understanding of the client's business, provide a basis for developing the scope of the audit, and identify areas requiring further investigation. However, when the analytical procedures are to be persuasive and the primary (and potentially only) substantive test of a balance, it is necessary to test the reliability of the data being used. For example, if the auditor uses an ageing report to support the reasonableness of the allowance for doubtful debts, they ordinarily first test the accuracy of the ageing.

The extent to which the auditor needs to test the underlying data is driven by the extent to which they have been able to test and form a basis for reliance on the controls surrounding the data. Primarily, this means assessing the overall control environment at the company (Is it effective?), the IT general controls (Are they effective?) and the application controls (Have they been tested and can they be relied upon?). The more effective the controls over the data intended to be used in an analytical procedure, the more the analytical procedure can be relied on as a substantive procedure. Conversely, the less effective the client's controls over the data, the less reliable the analytical procedure is likely to be, although it still may be useful in identifying areas for further investigation.

Another factor to consider is that often client-produced non-financial data (such as tonnes of product produced in a particular location) used in analytical procedures are not subject to the same type of controls as the client's financial data. As a result, the auditor may not be able to draw a conclusion about the reliability of the non-financial data without performing tests of that data. On the other hand, if such data is used as a key indicator of performance in running the business, the auditor may take comfort (in the absence of evidence to the contrary) that the client finds the data reliable for such purposes.

In summary, the auditor tests the reliability of underlying data when the analytical procedure is to provide persuasive assurance; they use judgement to determine the need for, and extent of, tests of underlying data when the analytical procedure provides corroborative assurance; and they need not test underlying data when the analytical procedure provides minimal assurance (refer to section 9.4 for discussion of each of these levels of assurance (or evidence)).

Substantive analytical procedures — summary

When performing analytical procedures, the steps the auditor performs can be summarised as follows.

1. Identify the computation, comparison or relationship to be made or to be investigated.
2. Assess the reliability of any data to be used.
3. Estimate the probable balance in the account or the probable outcome of the computation.
4. Make whatever computations are needed using data in the client's records or data from reliable outside sources.
5. Compare the estimated amount with the computed or recorded amount and evaluate whether the difference, if any, is significant.
6. Determine appropriate procedures for investigating the reasons for the difference if it is significant.
7. Perform the procedures.
8. Draw conclusions.

9.3.5 Performing substantive testing using computers

As clients have become more sophisticated and complex over time, the auditor's audit procedures and techniques have needed to respond to these complexities and have also become more sophisticated. One such development is the use of computers to assist the auditor with their testing. This is often referred to as 'computer assisted audit techniques' (CAATs) or 'data analytics'.

There are two main categories of testing using these techniques. The first is where software is used to interrogate and examine client data files. Whenever computers are used to maintain or process accounting data, software can be used to perform procedures such as calculations (for example, the re-adding of a report) and logic tests (for example, sorting or comparing current year amounts with the prior year), and to select and print key items and representative samples for testing.

Using software makes the audit (1) more comprehensive because each item in a file can be examined and subjected to a variety of tests and (2) more efficient because the computer can handle large volumes of data, thereby reducing time-consuming clerical tasks. Using software will also allow the auditor to concentrate on designing the test criteria and on evaluating and interpreting the results, rather than on performing the detailed audit procedures. Software available ranges from large, highly sophisticated products through to basic, electronic spreadsheets and financial reporting packages. Also, the software does not necessarily have to be designed specifically for audit purposes.

The second type of testing technique is software that individual firms have either purchased or developed which is designed to plan, perform and evaluate audit procedures, regardless of whether the client is automated or not.

The main considerations in deciding whether to use this type of testing technique are the completeness of the records and the reliability of the data. As with any audit procedure, the nature and extent of the procedures performed will largely depend on the evaluation of the effectiveness of the client's control environment, IT general controls and application controls.

CLOUD 9

Ian and Suzie continue their discussion about using analytical procedures. Ian is starting to feel more confident and suggests that there are some factors to consider about the Cloud 9 audit that would affect the use of the various procedures. 'We could use all of the usual techniques in the Cloud 9 audit, although we have to be careful in making comparisons across years for a couple of reasons. We have only just taken over the audit, so although prior-year data was audited, we are still building up our level of familiarity with the data and don't really understand all the conditions that applied to the previous years. Also, the changes at Cloud 9, in particular the opening of the new retail stores and the additional borrowing to finance the expansion of the online supply chain that we discovered during our preliminary work, will affect the data, and we will have to think through these effects before using the data in our tests.'

BEFORE YOU GO ON

- Name two common sampling strategies.
- How do the control environment and results of control testing influence the timing of the substantive audit procedures?
- Why is it important to test the reliability of the underlying data used in analytical procedures?

9.4 Levels of evidence

LEARNING OBJECTIVE 9.4 Discriminate between the various levels of audit evidence obtained when performing substantive procedures.

Several different levels of evidence are obtained when performing substantive procedures, depending on the type of substantive procedure performed. Evidence can be persuasive, corroborative, minimal or general. Each of these will now be described in more detail using substantive analytical procedures for illustration purposes. It can be seen from each of these illustrations of the different types of evidence that analytical procedures performed for planning purposes (as outlined in chapter 4) are quite different to those used for substantive testing purposes.

9.4.1 Persuasive

Analytical procedures can be the primary test of a balance (that is, the primary basis for the conclusion) if they provide persuasive evidence. This would be the case when the procedures generate an amount that the auditor believes is a reasonable estimate of what the balance should be, thus enabling them to conclude whether or not the account balance is free from material errors. The effect of classifying an analytical review procedure as persuasive means that no further substantive procedures need to be performed on the related account balance, even in moderate risk situations. Accordingly, careful consideration must be given to the quality of evidence provided by the particular analytical procedure before the auditor concludes that the analytical procedure is persuasive. Table 9.2 includes examples of analytical procedures that may provide persuasive evidence.

TABLE 9.2 **Examples of analytical procedures that provide persuasive evidence**

Evidence	Analytical procedure
Material content of work in progress and finished goods	Relate raw materials put into production and quantities sold to normal yield factors.
Overheads in closing stock	Relate actual overheads for the period to actual direct labour, production volumes or another appropriate measure.
Finished goods stock pricing	Refer to selling prices less selling costs and 'normal' gross margin.
Charges for depreciation	Refer to asset balance, effect of additions and disposals and average depreciation rate.
Payroll expense	Refer to days accrued and average daily payroll or subsequent period's gross payroll.
Commission expense	Refer to commission rates and related sales.
Accruals for commissions or royalties	Refer to terms of agreements and payment dates.
Accrued warranty costs for established products	Refer to applicable payroll and previous year's contribution rate.
Scrap income	Relate standard cost scrap factor to weight of material processed and apply the result to published scrap prices.
Interest expense and related accrual	Refer to the average debt outstanding, weighted average interest rate and payment dates.
Investment income	Relate average amounts invested to an average interest rate or yield.
Total revenue for a school	Relate school fee per each year level by number of students in each respective level.

9.4.2 Corroborative

An analytical procedure provides corroborative evidence if it (1) confirms audit findings from other procedures and (2) supports management representations or otherwise decreases the level of audit scepticism. For example, year-to-year detailed comparisons by product line of stock levels and other key relationships such as turnover, gross margin, percentage composition of materials, labour and overheads provide some evidence as to the reasonableness of the stock balance, but do not provide sufficient evidence by themselves to allow us to conclude that the account is free from material misstatement.

A corroborative analytical procedure includes comparisons of account balances to expectations developed and documented earlier in the audit. These comparisons generally provide corroborative evidence about an account balance and enable the auditor to limit the extent of other procedures in that area. In these cases, the auditor's understanding of the client's business should help confirm the reasonableness of a balance. For example, an auditor expects general administrative expense for the year to be approximately $10 million based on their review of the client's budget and the trend in the relationship of those expenses to sales. If actual general and administrative expenses fall within a reasonable range of the expected balance, a comparison of the recorded balance with the expected balance would provide corroborative evidence about the reasonableness of the balance. In addition, this supports the auditor's plan to reduce or eliminate the extent of other substantive testing of general administrative expenses. However, if an unexpected fluctuation is noted, (for example, general administrative expenses are less than or exceed the auditor's expectation by a material amount) the auditor would expand their other substantive audit procedures to obtain an explanation for the fluctuation and to provide additional evidence to enable them to conclude that the balance is free from material misstatement. For example, they may review a listing of accounts comprising general and administrative expenses for individual account balance fluctuations, and investigate those with significant or unexpected fluctuations. Table 9.3 includes examples of analytical procedures that may provide corroborative evidence.

TABLE 9.3 **Examples of analytical procedures that provide corroborative evidence**

Evidence	Analytical procedure
Cash balances	Compare the listing of cash accounts with those of prior periods and investigate any unexpected changes (e.g. credit balances, unusual large balances, new accounts, closed accounts) or the absence of expected changes.
Trade receivables, sales, going concern	Review the volatility of the customer base (e.g. new customers as a percentage of existing customers) and compare with expectations.
Trade receivables	Compare the current period's receivables as a percentage of net sales with prior-periods' percentages, and consider the reasonableness of the current period's percentage in relation to current economic conditions, credit policies, collectability.
Prepayments	Compare the prepayment account balances with those of prior periods and investigate any unexpected changes (or the absence of expected changes).
Property, plant and equipment	Review the reasonableness of the provision for depreciation by reference to prior-year provision and the effects of acquisitions and disposals.
Sales, commissions expense	Compare sales commissions or bonuses with related sales.
Payroll expense	Compare payroll tax expenses to the annual payroll times the statutory tax rates.

9.4.3 Minimal

Analytical procedures that do not provide persuasive or corroborative evidence contribute minimal support for the conclusion. In deciding whether a particular analytical procedure or combination of procedures provides corroborative evidence or only minimal support for the conclusion, the auditor evaluates both the extent of their analytical procedures and the quality of the evidence they expect to obtain. For example, they may simply compare a current-year overall balance (for example, inventory) to the prior-year balance to help identify potential problems or trends and not to reduce the extent of other substantive procedures. If they do not supplement that comparison with any other analytical procedures (for example, product line comparisons of turnover, gross margin or percentage composition of materials, labour and overhead), they obtain only minimal support for the conclusion. Table 9.4 includes examples of analytical procedures that provide minimal evidence.

TABLE 9.4 **Examples of analytical procedures that provide minimal evidence**

Evidence	Analytical procedure
Cash balances	Review the cash accounts in the general ledger for unusual items.
Trade receivables	Understand the reason for any large credit transactions/balances on the ledger.
Trade receivables	Compare the number and amounts of credit notes issued with those of prior periods.
Property, plant and equipment	Review the property, plant and equipment and related accounts in the general ledger for unusual items.
Trade payables	Compare the number of days purchases in trade payables with prior years.
Equity	Compare the equity account balance with that of prior years and investigate any unexpected changes (or the absence of expected changes).
Payroll expense, cost of sales	Compare the relationship between direct labour costs and number of employees with prior periods.

9.4.4 General

Analytical procedures might provide persuasive evidence in one circumstance but not in another. To illustrate, the risk assessment related to investments might indicate a low likelihood of material misstatement related to recording investment income. If a client has a relatively stable investment portfolio, a comparison of the average amount invested to an average market rate of interest or yield may provide the auditor with persuasive evidence to conclude that the amount of investment income recorded for the year is free from material misstatement. On the other hand, another client's portfolio might be more diversified and turn over quite rapidly. In that case, the auditor may need to expand the analytical review by segmenting the client's portfolio and applying the average yield test to the various segments.

CLOUD 9

Suzie agrees with Ian's assessment of the usefulness of analytical procedures and the possibility of using other techniques for testing the warranty provision at Cloud 9. 'Using analytical procedures as the only substantive procedure is more appropriate if we can find a close relationship between the underlying activity data and the account balance. The weaker or less consistent the relationship between the account balance and the other data, the more likely it is that we will have to perform other substantive procedures in order to obtain sufficient and appropriate evidence.'

Ian has a thought. 'I have just realised that when we are using prior-year data we know it is audited, but the current year's trial balance is as yet unaudited. This means that we need to recognise that there could be errors in those figures. Also, as we do the audit and we find and correct misstatements, we should have another look at our analytical procedures — the change in the underlying data might change our conclusions.'

'That's right,' says Suzie. 'We might also discover a change in conditions, such as operational changes, that could affect our interpretation of the data. We have to be aware of how everything is connected and review our conclusions and decisions as we go through the audit.'

'If we can get persuasive evidence from using analytical procedures we can reduce the reliance on the other substantive tests,' Suzie concludes.

BEFORE YOU GO ON

- What is persuasive audit evidence? Give an example.
- When does an analytical procedure provide corroborative audit evidence?
- When does an analytical procedure provide minimal audit evidence?

9.5 Evaluating and documenting substantive analytical procedures results

LEARNING OBJECTIVE 9.5 Explain the documentation of the conclusions reached as a result of performing substantive procedures.

The understanding of the client's business and industry alerts the auditor when planning the audit to likely fluctuations in the financial data. These fluctuations may be caused by trends, seasonal patterns, cyclical patterns, dependent relationships, specific business decisions taken, or external decisions directly impacting the business. For example, if management and the union representing the workforce have negotiated a 3 per cent pay rise over the next two years, we would expect the analytical procedures performed on average wages and salaries per employee to confirm this increase. Also, if the federal government enacted a law to collect an additional 1 per cent in payroll tax, the auditor would expect the analytical procedure to confirm this increase in payroll tax expense.

The lack of a significant change from one year to the next does not necessarily mean that the auditor can assume that the balance is reasonable. Whether and to what extent they investigate the lack of change in a balance depends on the auditor's understanding of the client's business, the relevant controls and the industry the client operates within.

PROFESSIONAL ENVIRONMENT

Interpreting the results of analytical procedures

Before they can complete an audit, auditors need to evaluate the causes of any unexpected fluctuations in a client's financial report detected by the use of analytical procedures. Auditors have to consider possible causes of the fluctuation, search for additional information about these possible causes, evaluate the alternatives, and decide which possible cause of the fluctuation is the correct one. As part of this process, auditors can make inquiries of management to obtain their explanations of the fluctuation's cause. Management could provide the correct explanation because of their superior knowledge of the situation. However, it is possible that management will give the auditor an incorrect explanation, deliberately or not. The question then arises whether auditors will be inappropriately influenced by management explanations that are not consistent with audit evidence.

In an experiment using 61 Australian auditors from a large accounting firm, Green investigated whether receiving an incorrect management explanation affected auditors' performance in determining the correct explanation for financial data fluctuations.[1] The subjects were required to complete a computerised experimental task involving analytical procedures relating to an error in cost of sales. The subjects in a control group did not receive a management explanation while the other auditors received a management explanation either before or after considering their own alternative explanations.

Green found that only 15 of the 61 auditors selected the correct cause of the data fluctuation, with the remainder either selecting management's explanation or another cause considered as a possibility by the auditor.[2] Although 47 of the auditors actually considered the correct cause, 32 dismissed it in favour of another alternative. The data showed that 14 auditors never even considered the correct cause as a possibility during their investigations.

Overall, Green concluded that receiving an incorrect explanation from management affected the auditors' performance by influencing them to judge it as the correct cause. None of the auditors in the control group, who did not receive the management explanation, judged that explanation to be the correct one. Green suggests that audit firms could consider offering more guidance to auditors to prompt their consideration of more alternatives. In addition, auditor training could focus more on the evaluation of evidence, particularly in relation to management explanations. However, it is possible that in practice more experienced auditors, such as partners, would not be so easily distracted by management's explanations.

CLOUD 9

Ian and Suzie have decided that analytical procedures will not be sufficient for all accounts. For each major transaction cycle and account balance they will also conduct tests of details. For the vouching tests, the auditors will sample transactions and balances in the accounting records and go to the underlying documentation (or physical assets) to confirm the recorded details. For example, for sales recorded as being made prior to the financial year-end, they will examine the invoices and shipping documents to gather evidence on the date, amount and other details of the transactions. If they find a sales invoice with a January date has been included in the sales for the year ended 31 December, they have evidence of a misstatement in the occurrence and cut-off assertions for sales.

They will also trace the details in a sample of documents through to Cloud 9's accounting records. This means that they will start with the documents and then test how that transaction (or asset or liability) is recorded in the client's accounts. For example, if they find a sales invoice with a December date that is *not* included in the sales for the year, they will have evidence of a misstatement in the completeness and cut-off assertions for sales. Suzie advises Ian that the sample sizes and approach to sampling are determined by the results of the controls testing and the resulting expectations for errors.

Suzie also asks Ian to include tests of schedules, such as trade receivables and property, plant and equipment (PPE), in the detailed audit program. Where the risk is low, such as PPE, they will perform these tests at an interim date.

Finally, Suzie informs Ian that the IT audit manager, Mark Batten, is writing the CAAT program.

9.5.1 Evaluating errors identified in testing

As the auditor executes their substantive procedures, they may identify misstatements or errors. When they identify differences they did not expect, they reconsider their evaluation of the effectiveness of controls and overall risk assessments made in planning to determine whether additional procedures need to be performed. When a **misstatement** (either an error (including fraud) or a difference between the auditor's professional judgement and the client's as to whether a balance is correct) is identified, it is captured centrally in the audit working papers. This will then allow the auditor to assess the overall impact of all misstatements at the financial report level during the completion phase of the audit.

As mentioned, there are two key types of misstatements ordinarily identified during the audit procedures: errors (including fraud) and judgemental misstatements. Errors may arise from a one-off event or may systematically arise as the result of a breakdown in controls. The auditor may have identified these as part of controls testing or as part of their substantive testing. Errors do not ordinarily have any element of judgement to them, and are often considered by those charged with governance as 'just wrong' and therefore are often corrected by management irrespective of the size or potential effect on the financial report.

Judgemental misstatements, however, often arise due to a difference in interpretation or application of an accounting policy or standard between the auditor and management, and may also include an error that was extrapolated from a statistically valid sample. These differences tend to be the focus of discussions held with those charged with governance and are often round numbers or a possible error 'range' rather than an exact number.

The identification and resolution of misstatements is one of the auditor's most important responsibilities in an audit and is a critical step in the formulation of their opinion on the fairness of the client's financial report. This is discussed in greater detail in chapter 12.

9.5.2 Concluding and documenting the results of substantive procedures

As discussed earlier, the nature, timing and extent of the audit procedures is influenced by a range of factors, including the type of balance or disclosure being tested, the level of detection risk remaining after the planning procedures and controls testing is complete, and the audit assertion addressed by the test. Once the auditor has determined the nature, timing and extent of the substantive procedures, these are documented in the audit program. This program then serves as the instructions for the audit team members to complete the required testing.

When reaching their conclusion on the results of substantive procedures, the auditor considers the results of all of their testing related to the account balance or disclosure being audited, the responses to inquiries made during the performance of the procedures, and the resolution of any misstatements identified during the audit testing. With respect to all substantive procedures the auditor documents the conclusion statement for each significant account, including the execution of the relevant audit program steps, the results and any significant findings including any misstatements. They also document that the financial report reconciles to the underlying accounting records.

Overall conclusion statements are usually prepared for each audit program step completed, as well as for each significant account and significant assertion. These overall significant account conclusion statements are captured on what are often referred to as 'lead sheets' or 'conclusion working papers'.

CLOUD 9

Suzie asks Ian to set up the working papers for the tests they perform. W&S Partners use electronic working papers and there are pro formas available for Ian to use as a base for the Cloud 9 audit papers.

The priorities for Ian are to ensure that each test is described in sufficient detail in the audit program so the audit staff can perform the test correctly and identify any misstatements. The working papers also have to provide for comments to be included, as the work is completed and by senior staff when they review the test results and form their conclusions on each account's assertions.

PROFESSIONAL ENVIRONMENT

Professional scepticism

The Australian Securities and Investments Commission (ASIC) conducts investigations into audit firms to identify deficiencies or potential deficiencies in audits. The report with the results of ASIC's audit inspections for 2012–13 covers selected audits conducted by 17 audit firms.[3] ASIC concluded that there were 'three broad areas that required improvement by audit firms: (a) the sufficiency and appropriateness of audit evidence obtained by the auditor; (b) the level of professional scepticism exercised by auditors; and (c) ensuring appropriate reliance on the work of experts and other auditors'.[4]

Professional scepticism is defined in paragraph 13(l) in ASA 200 (ISA 200) 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'. The standards require the auditor to critically assess audit evidence and be questioning of whether the evidence is sufficient and appropriate. The AUASB has released a *Bulletin* on the importance of professional scepticism in audit in response to ASIC's concerns about whether professional scepticism is being applied properly in practice, and whether auditors are responding appropriately to unreliable audit evidence and doing enough to corroborate evidence rather than challenge it.[5] Both the AUASB and ASIC are also concerned that working papers are not sufficiently detailed to show how professional scepticism is being applied.

The AUASB *Bulletin* reinforces the concept that auditors are required to investigate further if there is doubt about the reliability of information or indications of possible error or fraud, and excuses will not be accepted: 'the issue of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive'.[6]

Professional scepticism is required throughout the audit, including when planning and performing substantive analytical procedures. Auditors must have a questioning mind when evaluating the reliability of data, and investigating fluctuations or relationships that are inconsistent with expectations. Auditors should document discussions of significant matters, including where they have questioned evidence. They should also document their conclusions on key areas, detailing the evidence and other factors considered in forming their judgements. The documentation should include details of the corroboration of matters considered by the auditor, and also the challenges to the evidence. ASIC inspections show that too often audit working papers provide supporting evidence, but rarely include even the briefest notes on alternatives considered and the auditor's views on those alternatives.[7] The auditor needs to remember that the audit documentation should allow another auditor, not involved with the client or the audit, to reach the same conclusions and be satisfied that alternative explanations were considered and ruled out by the evidence.

BEFORE YOU GO ON

- What is a misstatement?
- What is the difference between an error and a judgemental misstatement?
- What is an audit program?

SUMMARY

9.1 Describe substantive audit procedures.

Substantive audit procedures are procedures designed to obtain direct evidence as to the completeness, accuracy and validity of data, and the reasonableness of the estimates and other information contained in the financial report. Substantive procedures include inspection, observation, enquiry, confirmation, recalculation, re-performance, analyses of many types and analytical reviews.

9.2 Explain the link between the audit risk model and the nature, timing and extent of substantive procedures.

The combination of inherent risk and control risk determines the level of detection risk the auditor is willing to accept and to still be able to conclude that the financial report is materially correct. Detection risk is reduced or increased in direct proportion to the amount of substantive testing performed. There are several factors that influence how much substantive testing is performed including the nature of the test, the level of assurance necessary, the type of evidence required and the complexity of the client's data capturing systems. The timing of substantive procedures is most flexible when controls have been tested and assessed as effective, and can be performed up to six months before year-end. When controls are not tested or are not assessed as effective, the timing of substantive procedures is at or near year-end.

9.3 Produce examples of different substantive audit procedures.

The different types of substantive procedures are key items testing, representative sampling, other tests of transactions/underlying data and analytical procedures. Different analytical procedures include absolute data comparisons, ratio analysis, trend analysis, common-size financial reports, break-even analysis and pattern and regression analysis. Substantive analytical procedures are different to those analytical procedures used during the planning phase of the audit.

9.4 Discriminate between the various levels of audit evidence obtained when performing substantive procedures.

The different levels of audit evidence obtained when performing substantive procedures include persuasive, corroborative, minimal and general audit evidence.

9.5 Explain the documentation of the conclusions reached as a result of performing substantive procedures.

Conclusion statements are documented for each significant account, including the execution of the relevant audit program steps and the results and any significant findings including any misstatements. The auditor also documents that the financial report reconciles to the underlying accounting records. Overall conclusion statements are usually prepared for each audit program step completed as well as for each significant account and significant assertion.

KEY TERMS

Analytical procedures Evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Audit risk The risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated.

Audit sampling The application of audit procedures to less than 100 per cent of items within a population.

Control risk The risk that a client's system of internal controls will not prevent or detect a material misstatement.

Detection risk The risk that the auditor's testing procedures will not be effective in detecting a material misstatement.

Inherent risk The susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming there are no related controls.

Misstatement A difference between the amount, classification, presentation or disclosure of a reported financial report item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Professional judgement The auditor's professional characteristics such as their expertise, experience, knowledge and training.

Roll-forward procedures Procedures performed during the period between an interim date and year-end (the roll-forward period) to provide sufficient and appropriate audit evidence to base conclusions upon as at year-end when substantive procedures are performed at an interim date.

Significant account An account or group of accounts that could contain material misstatements based upon their materiality and/or relationship to identified inherent and financial report risks.

Substantive procedures (substantive testing or **tests of details)** Audit procedures designed to detect material misstatements at the assertion level.

Tracing Tracing a source document to the underlying accounting records.

Vouching Taking a balance or transaction from the underlying accounting records and verifying it by agreeing the details back to supporting evidence outside of the accounting records of the company.

MULTIPLE-CHOICE QUESTIONS

9.1 Designing substantive procedures responds to the risk of: **LO2**
(a) material misstatement at the entity level.
(b) all types of misstatements at the entity level.
(c) material misstatement at the assertion level.
(d) all types of misstatements at the assertion level.

9.2 Which of the following factors influences how much and when substantive procedures are performed? **LO2**
(a) The nature of the test
(b) The type of evidence required
(c) The level of assurance necessary
(d) All of the above

9.3 Which of these statements is true about analytical procedures? **LO2**
(a) They are used to test controls and are not substantive procedures.
(b) They are used at planning and substantive testing stages of the audit.
(c) They are substantive procedures and cannot be used at any other stage of the audit.
(d) They can be used as substantive tests but cannot be used as primary tests of a balance.

9.4 When can we conclude that analytical procedures provide persuasive evidence? **LO4**
(a) Always
(b) Never
(c) Sometimes, if we are able to conclude that no further substantive tests need to be performed on the related account balance
(d) Sometimes, if they do not provide sufficient evidence by themselves to allow us to conclude that the account is free of material errors

9.5 Which of the following conditions make absolute data comparisons relatively less useful? **LO4**
(a) Single location clients
(b) Changes in production methods

(c) Budgets that are carefully prepared
(d) Multiple years of financial data available

9.6 Which of the following statements about the reliability of data used for analytical procedures is correct? **LO4**
(a) Inflation does not affect data reliability.
(b) Data reliability affects the persuasiveness of the evidence from analytical procedures.
(c) Data is more reliable on a consolidated basis than an individual business segment basis.
(d) Data reliability is never affected by the strength of controls over the client's budgetary processes.

9.7 Vouching is: **LO1**
(a) not a useful audit procedure.
(b) not designed to be used as a substantive audit procedure.
(c) agreeing a balance or transaction to supporting documentation.
(d) the main audit procedure used to gather evidence on the completeness assertion.

9.8 The primary advantage of selecting the largest transactions within a balance to test is: **LO3**
(a) that it is an example of random sampling and therefore more reliable than other methods.
(b) that it is more interesting for the auditor because they see the most important transactions in detail.
(c) that the auditor is able to draw a conclusion about the entire balance based on the conclusions they reached by testing the largest transactions.
(d) all of the above.

9.9 Roll-forward procedures: **LO2**
(a) have no effect on audit efficiency.
(b) need to be responsive to the control risk assessment.
(c) are procedures done during the month after year-end.
(d) none of the above.

9.10 Which of the following is a correct statement about misstatements? **LO5**
(a) They are documented in the audit working papers.
(b) They can be categorised as errors or judgemental misstatements.
(c) They must be considered for their effect on the financial report both individually and in aggregate.
(d) All of the above

REVIEW QUESTIONS

9.11 Explain the purpose of substantive testing, and give examples of the main types of substantive tests. **LO1**

9.12 Why would an auditor use observation to gather evidence? What are the strengths and weaknesses of this type of test? **LO1**

9.13 What are analytical procedures? Describe how they can be used as substantive tests in an audit. **LO1**

9.14 What does 'nature' mean in the context of the nature, timing and extent of substantive testing? **LO2**

9.15 Explain how decisions about when and how much substantive testing is performed relate to the overall risk assessment for the item being tested. **LO2**

9.16 Explain 'roll-forward' procedures. When are they appropriate? **LO2**

9.17 Which accounts and/or clients are more suitable for interim substantive testing? **LO2**

9.18 Why is it important to consider the quality of the data used in analytical procedures? How important to this question are client controls over financial data? **LO3**

9.19 Vouching transactions and balances back to supporting documentation would ordinarily provide evidence about which assertions? Which assertions would vouching be least likely to provide evidence about? **LO3**

9.20 Explain the two main types of CAATs. What are the advantages of using software to interrogate and examine client data files? Does using CAATs remove the need to test client control systems? **LO3**

9.21 What conditions must be satisfied before we can regard evidence from analytical procedures as persuasive rather than corroborative or minimal? Why are these conditions important? **LO4**

9.22 Provide an example of (1) an error and (2) a judgemental misstatement that could affect the balance of property, plant and equipment. **LO5**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

9.23 DESIGNING SUBSTANTIVE PROCEDURES ★ **LO1, 2**

Jenny has been asked to join the team responsible for designing the audit program for a new client, Sangekar Industries Ltd (Sangekar), a manufacturing and wholesaling firm. Sangekar recently went 'public' and is now listed on the Australian Securities Exchange. Jenny has worked for the audit firm for a year and received a very high performance rating from her supervisors on last year's audit of Haddin Pty Ltd (Haddin), a firm that provides marketing and other consulting services. Sangekar and Haddin have total revenue of approximately the same amount, so Jenny feels confident that she can apply her knowledge to the new audit. She takes a copy of the audit program for Haddin along to the first meeting, intending to suggest they use it as the basis for the audit program for Sangekar. Jenny thinks that the Sangekar audit program could use the same substantive procedures they used on the Haddin audit.

Required

List some of the problems with Jenny's idea of using Haddin's audit program as a basis for designing substantive procedures for Sangekar.

9.24 SALES CUT-OFF ★ **LO3**

Boris Johnson suggests the following audit procedure should be included in the audit program to gather evidence on the cut-off assertion for the revenue account:

> *Select a sample of sales from the sales journal and agree the dates on the invoices to the dates on the delivery documents signed by the customer.*

Required

Explain how the procedure addresses the assertion. What does it mean if (i) the dates agree, or (ii) the dates do not agree?

Source: Adapted from the CA Program's *Audit & assurance exam*, July 2010.

9.25 SALES JOURNAL AND INVOICES ★ **LO3**

Boris Johnson has another suggestion for the audit program for the revenue account. This time he suggests:

> *Select a sample of sales from the sales journal and agree the details in the journal to the sales invoices, delivery dockets and customer orders.*

Required

Explain which assertion for the revenue account would be addressed by this test.

Source: Adapted from the CA Program's *Audit & assurance exam*, July 2010.

9.26 SALES INVOICES AND JOURNAL ★ **LO3**

Seb Coe and Boris Johnson are discussing the audit program for the revenue account. Seb and Boris disagree about whether they should use procedure A or B below to test the occurrence assertion for the revenue account:

A. Select a sample of sales from the sales journal and agree the details in the journal to the sales invoices, delivery dockets and customer orders.
B. Select a sample of sales invoices, delivery dockets and customer orders and agree the details to the details recorded in the sales journal.

Required

Which test provides evidence about the occurrence assertion? Why? Which assertion does the other test provide evidence about?

Source: Adapted from the CA Program's *Audit & assurance exam*, July 2010.

9.27 PAYROLL TESTING ★ **LO3**

Peter has the task of designing the audit program for the payroll area. There have been no recent changes to the payroll system, or its interface with the general ledger. Among other tests, Peter is considering using the following analytical procedures to gather evidence:

1. Compare payroll tax expenses to the annual payroll times the statutory tax rates.
2. Compare the relationship between direct labour costs and number of employees with prior periods.

Required

(a) Discuss the type of evidence which would be obtained from each of the procedures.
(b) Would your answer be any different if there had been recent changes to the payroll system? Explain.

9.28 SELECTING DEBTORS FOR SUBSTANTIVE TESTING ★★ **LO3**

A theme park business has a website that allows customers to make bookings online. The customers include the general public and local and international travel agents. Travel agents that wish to be able to make bookings on credit must complete an account application form with at least three references. The auditor's tests provide sufficient appropriate audit evidence that credit is granted only after rigorous credit checks. However, large travel agents often settle their accounts between 60 and 90 days (not the required 30 days). Given the amount of business generated from these travel agents, the theme park business allows this practice to continue. The business has 720 travel agents as customers. Forty agents represent 65 per cent of trade debtors.

Required

(a) Discuss which debtors would be selected for further testing.
(b) When would the testing of debtors be carried out?

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2010.

9.29 DATA FOR ANALYTICAL PROCEDURES ★★ **LO3, 4**

Reliable Paper Ltd provides cardboard, paper and plastic packaging materials to a large number of manufacturers and distributors in all states. The cardboard and paper division is a well-established business, but Reliable Paper Ltd has been providing plastic products only since its takeover of Plastic Products Ltd 18 months ago. The takeover doubled Reliable Paper's revenue and caused changes in its management structure — adding another two divisional managers. These new divisional managers are in charge of plastic product sales to different areas of the country — Plastic Eastern and Plastic Western — and they join the Paper Eastern and Paper Western division managers in reporting directly to the CEO.

All internal operating reports are now structured along the four divisional reporting lines, although external financial reports continue to be produced for the whole business. All purchasing and billing systems are fully integrated, although it is possible to extract data along divisional lines, and by state (as before). Reliable Paper purchases bulk supplies of raw plastic and paper and makes boxes, rolls and sheets of these materials to fill customer orders. Production processes in the paper divisions have not changed, and Reliable Paper has made minimal changes to the production processes used by Plastic Products Ltd.

Required

List and discuss the factors that would increase or decrease the reliability of data used in analytical procedures at Reliable Paper Ltd.

9.30 PERSUASIVENESS OF EVIDENCE FROM ANALYTICAL PROCEDURES ★★ LO3, 4

Brian has the task of reviewing the evidence from analytical procedures conducted by the audit assistants on the audit of Smalley Services Ltd. The audit assistants have reported the results of these analytical procedures:

1. Comparison of depreciation expense with the closing balance of each depreciable asset class in property, plant and equipment.
2. Recalculation of sales commission expenses using the standard sales commission rate and total sales.
3. Comparison of payroll expense with previous year payroll.

Required

(a) What questions would Brian ask about each analytical procedure?

(b) If all questions could be answered satisfactorily, explain whether the evidence from each analytical procedure would be persuasive, corroborative, minimal or general. What are the implications of this judgement for further substantive testing?

9.31 TESTS OF DETAILS ★★ LO3, 4

Marty has to audit the sales transactions of Okawa Ltd. Okawa Ltd supplies tools to the mining industry and carries a large number of different makes and models of standard mining tools. Okawa Ltd also designs and manufactures tools for special purposes and for miners operating in difficult conditions. The custom designed tools are made only on the signing of a contract and receipt of a deposit, whereas standard tools are supplied to regular customers on receipt of a telephone order. Okawa Ltd's sales transactions vary from a few dollars to millions of dollars depending on the number of items sold and whether the individual items are large or small tools, and whether the tools are standard items or custom designed.

Marty is instructed to gather evidence about the sales transactions using sampling and vouching. This is explained in detail in the audit program.

Required

(a) What would you expect to see in the audit program given to Marty about (1) the sample selection and (2) the vouching procedures? Explain.

(b) How could Marty use CAATs to help gather the evidence?

9.32 EVALUATING SUBSTANTIVE TESTING RESULTS ★★ LO5

The following items are documented in the audit working papers.

1. Sales transaction included in the year ended June 2017 but evidence from the cut-off procedure suggests that the sale should be dated 1 July 2017 ($550 000).
2. Warranty expenses in the trial balance for the year to June 2017 total $150 000; the provision for warranty claims as at 30 June 2016 was $100 000. Evaluation of correspondence suggests that an additional $200 000 in warranty claims could result from ongoing disputes with customers. No provision for these claims has been made. Management has made a warranty provision for 2017 of $120 000.
3. Redundancy expenses related to reorganisation of head office administration incorrectly charged to rental expenses ($927 440).
4. No expense for impairment of assets has been made by management. A drought-induced recession has adversely affected property values in regional cities where seven branch offices are located (head office and two branch offices are located in the capital city). Total land and buildings in the trial

balance is $20 000 000 and management estimate that the value of these assets is impaired by 10 per cent.

Required

(a) Evaluate each item above and explain whether it is an error or a judgemental misstatement. What action do you recommend for each?

(b) Which accounts would be affected, and how, if an adjustment is made for each item?

9.33 TIMING OF SUBSTANTIVE TESTS ★★★ **LO1, 2, 3, 4**

Melissa is the recently appointed engagement partner of the audit of Brumby Ltd. Melissa has just taken over the audit from Ken Leo, who rotated off the audit after a five-year period as the engagement partner. Ken had a small portfolio of clients and was able to complete most substantive testing for Brumby at year-end. Melissa is unable to do this because she is facing difficulties with two of her other large clients. These clients have just been advised that their financing arrangements with US-based banks may not be renewed, raising doubts about their ability to continue as a going concern. The US banks will make their financing decisions very close to the clients' year-end, forcing Melissa to spend considerable time in this period with these clients.

The financing problems at Melissa's existing clients have created demands on Melissa's audit team that she must resolve. The audit firm cannot provide her with the additional staff she has requested for the year-end period because several other partners' clients are also facing financing difficulties due to the credit crisis in the United States.

The audit firm's ethical rules do not allow Ken to remain as the auditor of Brumby and it is too late to find new partners for any of her other clients, so Melissa must find a way to continue with the audit and still meet all professional and legal standards. So far, the audit team has conducted the preliminary risk assessment for Brumby and early control testing results confirm that Brumby has excellent controls.

Melissa calls a meeting with her senior audit team members to discuss the issue.

Required

Explain how Melissa could vary the timing of the substantive testing at Brumby to help her meet her audit obligations. Specifically:

(a) give examples of substantive procedures that could be performed prior to year-end

(b) explain how Melissa will use roll-forward procedures to complete the audit

(c) explain any other considerations that would affect the timing of substantive procedures for Brumby.

Questions 9.34–9.37 are based on the following case.

Chan & Partners Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year, Chan & Partners gained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home
- Total Cancer Specialists Limited (TCSL), a private oncology clinic that specialises in the treatment of cancer.

Year-end for all MSHG entities is 30 June.

You are a senior auditor working on the Shady Oaks Hospital engagement for the 2017 year and are currently in the planning stage of the audit. In discussions with management you discover that Shady Oaks has recently acquired two new, full body scanning machines. These machines use the latest technology and cost the company more than $10 million each. Although they are more than 50 per cent more likely to detect tumours and other abnormal internal growths, there are new academic studies suggesting there may be potential long-term side effects for patients scanned by these machines. However, because the machines are new the evidence about long-term effects will not be known for many more years. Despite this, there has been some bad press for Shady Oaks highlighting the potential risks to patients.

Shady Oaks charges a premium price for using the scanning machine and there is extremely high demand. To manage the demand Shady Oaks requires that all patients pay for their scans in full at the time of booking, and the payments are immediately recognised as revenue by the hospital. Shady Oaks has taken bookings for four months in advance — although it is only April 2017, the hospital has bookings for July and August 2017.

The Australian Doctors and Hospital Association is currently reviewing the use of the scanning machines and is considering banning their use within Australia until the issue is resolved. A decision is expected on 1 August 2017, and management tell you that they believe there is an 80 per cent chance the scanners will be approved.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2008 and March 2009.

9.34 SUBSTANTIVE TESTING FOR SPECIFIC ASSERTIONS AT RISK ★★★ LO1, 3

(a) Identify two key account balances likely to be affected by the above information.
(b) For each account balance identified in (a) above, identify and explain the key assertions most at risk.
(c) For each assertion identified in (b) above, identify specific substantive tests of detail that would be responsive to the identified risk.

9.35 USING ANALYTICAL PROCEDURES ★★★ LO3, 4

Your assurance services manager has requested you use substantive analytical procedures to calculate Shady Oaks' estimated revenue for patients staying in the hospital, excluding medical procedures and ancillary costs such as medication.

Required

Based on the background provided, describe all the key information required to estimate Shady Oaks' revenue for patients staying in hospital.

9.36 PLANNING SUBSTANTIVE TESTS ★★★ LO2

Inventory of various medical supplies and drugs is a material account on the Shady Oaks Hospital audit engagement. You are planning to adopt a combined audit approach for existence of inventory and place a heavy reliance on preventative control procedures around the physical security of inventory, such as access to the dispensary and the store room being limited to a few authorised staff.

You have just completed your tests of controls in relation to physical security procedures. Your projected error rate based on the results of your already large sample size is higher than the tolerable error. You are satisfied that the sample is representative and the errors occurred throughout the period audited.

Required

(a) Briefly outline the impact of the projected error rate on your planned substantive audit procedures.
(b) Assume that all of the deviations from the internal control procedures tested (that is, errors in the sample) relate to a three-week period when a senior staff member was on annual leave. Discuss how this would affect your planned substantive tests of detail.

9.37 PERSUASIVENESS OF EVIDENCE ★★★ LO4

Review your answers to the previous questions. Comment on the persuasiveness of evidence from each test. Explain any factors that would affect your assessment.

CASE STUDY — CLOUD 9

Answer the following questions based on the information presented for Cloud 9 in the appendix to this text and the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

Required

Using the results of your controls testing in the case study in chapter 8, assess the control risk for the following assertions and write your conclusions in the worksheet below.

Account assertion	Control risk	Explanation
Sales — occurrence		
Sales — completeness		
Trade receivables — existence		
Trade receivables — completeness		
Cash — existence		
Cash — completeness		

RESEARCH QUESTION

Economic conditions and financial markets were significantly affected by the global financial crisis (GFC) in 2008. The GFC had an impact on many businesses in many countries and was one of the largest economic recessions in recent years. Although the GFC's effects may have passed, the risk of smaller economic recessions affecting specific industries remains part of life. Love and Lawson identified a series of specific issues flowing from the GFC that must be considered by financial statement auditors and may affect the procedures used in conducting an audit during economic recessions.[8]

Required

Explain the possible impact of economic recessions on decisions about the nature, timing and extent of substantive testing. Give specific examples of the impact on analytical procedures, and how auditors would adjust their audit programs to ensure overall audit risk remains acceptable.

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. c, 2. d, 3. b, 4. c, 5. b, 6. b, 7. c, 8. c, 9. b, 10. d.

NOTES

1. Green, W 2005, 'Are auditors' analytical procedures judgements affected by receiving management explanations?' *Australian Accounting Review*, vol. 15, no. 3, pp. 67–74.
2. Green 2005, p. 71.
3. Australian Securities and Investments Commission 2014, *Report 397 audit inspection program report for 2012–2013*, p. 4, www.asic.gov.au.
4. ibid., p. 5.
5. Auditing and Assurance Standards Board 2012, 'Professional scepticism in an audit of a financial report' *AUASB Bulletin*, August. p. 1.
6. ibid., p. 2.
7. ibid., p. 4.
8. Love, VJ & Lawson, C 2009, 'Auditing in turbulent economic times', *The CPA Journal*, May, pp. 30–5.

CHAPTER 10

Substantive testing and balance sheet accounts

LEARNING OBJECTIVES

After studying this chapter you should be able to:

10.1 explain the relationship between the risk of material misstatement for a significant account and the extent and timing of substantive procedures

10.2 design and explain how to execute substantive procedures to address audit risk related to cash

10.3 design and explain how to execute substantive procedures to address audit risk related to trade receivables

10.4 design and explain how to execute substantive procedures to address audit risk related to inventory

10.5 design and explain how to execute substantive procedures to address audit risk related to property, plant and equipment

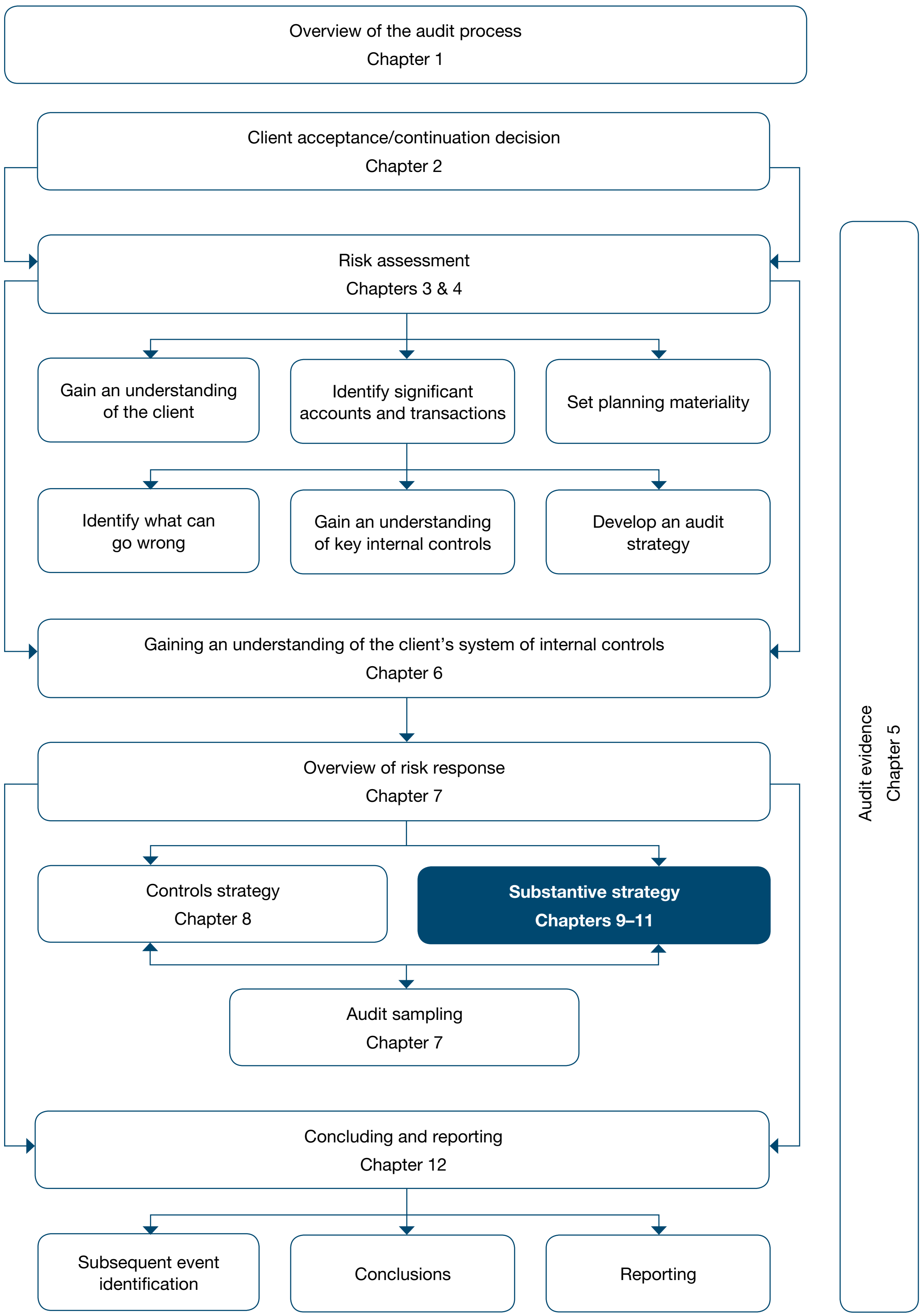
10.6 design and explain how to execute substantive procedures to address audit risk related to payables

10.7 explain how substantive testing is used for other balance sheet accounts

10.8 explain how to assess the results of substantive procedures to determine whether additional substantive tests are necessary.

AUDITING AND ASSURANCE STANDARDS

AUSTRALIAN	**INTERNATIONAL**
ASA 500 *Audit Evidence*	ISA 500 *Audit Evidence*
ASA 501 *Audit Evidence — Specific Considerations for Inventory and Segment Information*	ISA 501 *Audit Evidence — Specific Considerations for Selected Items*
ASA 505 *External Confirmations*	ISA 505 *External Confirmations*
ASA 610 *Using the Work of Internal Auditors*	ISA 610 *Using the Work of Internal Auditors*
AGS 1002 *Bank Confirmation Requests*	
AASB 7 *Financial Instruments: Disclosures*	IFRS 7 *Financial Instruments: Disclosures*
AASB 102 *Inventories*	IAS 2 *Inventories*
AASB 116 *Property, Plant and Equipment*	IAS 16 *Property, Plant and Equipment*



Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client's system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

Suzie and Ian are continuing their work on the substantive audit testing program for the Cloud 9 Pty Ltd (Cloud 9) audit. Suzie has convinced Ian that analytical procedures are not the only substantive tests they will need. They will need to consider how audit risk and other factors have an impact on the appropriateness of analytical procedures for each area of the audit, and include other substantive tests where required.

Today, they are focusing on assets and liability accounts. Significant accounts on Cloud 9's trial balance include cash; trade debtors (included in the receivables balance on the balance sheet); inventory; property, plant and equipment (PPE) (mainly furniture and equipment and leasehold improvements); and several different types of payables and loans. There is also a large balance in derivative financial assets, which is part of financial assets in the balance sheet.

Suzie asks Ian to suggest the key factors that they will have to consider when designing the substantive test program for each of these accounts. What will affect the design decisions? Which tests will they choose to include in the program?

Audit process in focus

Finding an appropriate combination of audit procedures to cover an engagement's audit risk at an acceptable cost is a constant challenge facing most audit teams. This chapter discusses the objectives of substantive testing, the factors that affect the nature, timing and extent of procedures, the processes that affect significant accounts in the balance sheet and illustrative procedures for auditing these significant accounts.

This chapter also illustrates how the type, or nature, of substantive procedures is often the same for each significant account or disclosure, irrespective of the type of business being audited. It is instead the timing and extent of testing that are tailored to each client's circumstances.

10.1 Relationship between risk assessment and substantive procedures

LEARNING OBJECTIVE 10.1 Explain the relationship between the risk of material misstatement for a significant account and the extent and timing of substantive procedures.

This section discusses the extent, timing and other matters to consider when designing **substantive procedures** (also called **substantive testing** or **tests of details**) to detect material misstatements at the assertion level and thereby obtain audit evidence to draw reasonable conclusions on which to base the auditor's opinion (see ASA 500 (ISA 500) *Audit Evidence*).

10.1.1 Extent of substantive procedures

The extent of substantive procedures is determined by the risk assessment for each significant account. Not every account or disclosure is necessarily audited in accordance with the approach outlined in this chapter. Accounts that are clearly trivial or immaterial are usually ignored or only subjected to **analytical procedures**. Professional judgement is required when determining which account balances and disclosures are material to the overall conclusion the auditor forms on the financial report. The **professional judgement** of the auditor is influenced by many factors but mainly by the materiality and nature of the account balance or disclosure.

As discussed in chapter 4, a risk assessment on each significant account or disclosure is performed using the risk assessment determined by the **audit risk** model formula in figure 10.1.

When the assessment of **inherent risk** and **control risk** is high, there are no controls tested or relied upon and therefore the amount of substantive testing required to reduce the detection risk to an acceptable level is significant. When the assessment of inherent and control risk is low, there are lots of controls that have been tested and found to be effective; therefore, the level of substantive procedures required to address the remaining **detection risk** is limited. It then follows that when the assessment of inherent and control risk is medium, there is some audit evidence obtained from **tests of controls** (or **controls testing**) and some from substantive testing.

$$AR = f\ (IR, CR, DR)$$

where:

AR = Audit risk

IR = Inherent risk

CR = Control risk

DR = Detection risk

FIGURE 10.1 Audit risk model

10.1.2 Timing of substantive procedures

Figure 10.2 illustrates the relationship between the timing of substantive procedures and levels of assurance.

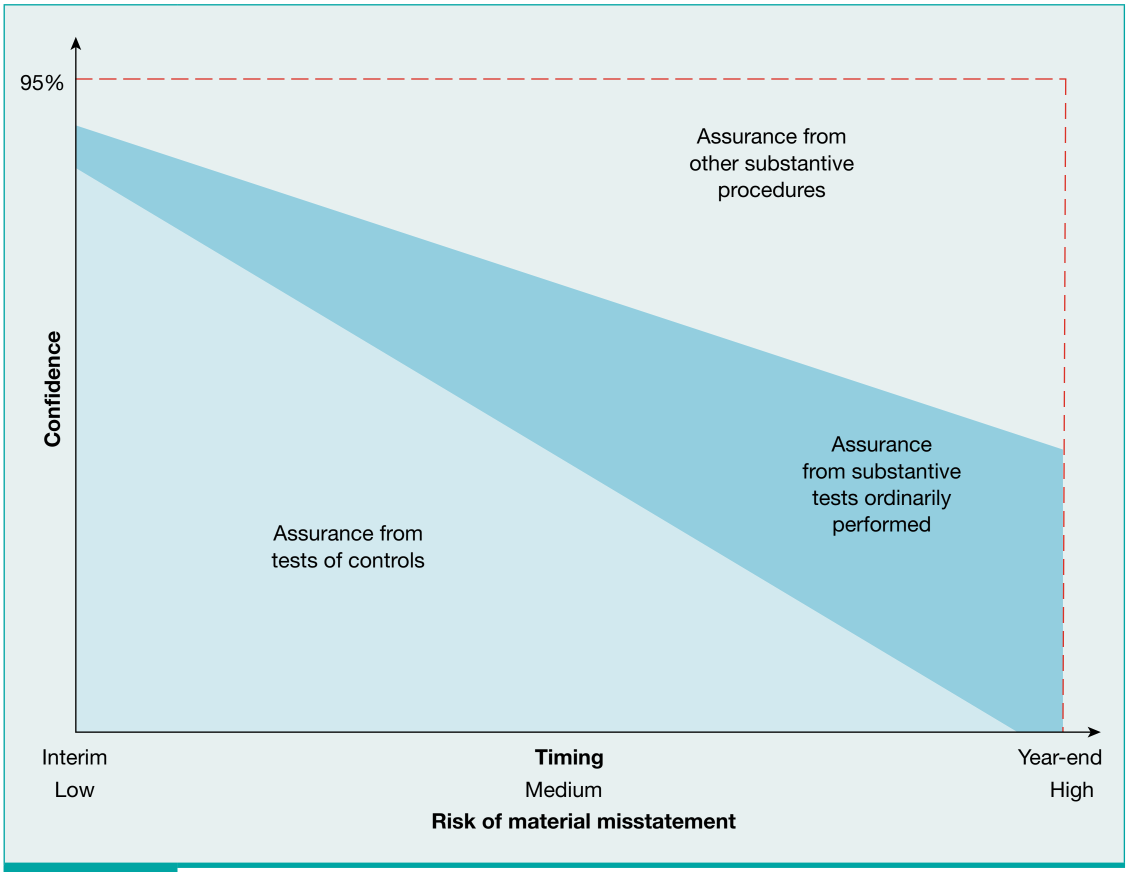


FIGURE 10.2 Timing of substantive procedures

As can be seen from figure 10.2, the timing of substantive testing is dependent on the risk assessment of the **significant account** or disclosure in question. Because most entities are audited at or around the same year-end, the timing of performing audit procedures has a significant impact on the resourcing of audit firms to ensure they are able to complete all of the statutory audits necessary prior to entities' reporting deadlines. As described in previous chapters, the risk assessment of an account affects the timing of the procedures. The higher the detection risk for an account, the lower the amount of work that needs to be performed, and a large part of the audit evidence relating to the account is obtained via controls testing performed before year-end. The lower the detection risk, the higher the amount of work that needs to be performed, with the majority of it being obtained by performing substantive procedures towards or at year-end. Apart from the risk assessment of the significant account, there are additional opportunities for influencing the timing of the work performed. These include auditing events occurring prior to year-end, auditing activity in the period to date, performing general audit procedures prior to year-end, testing provisions prior to year-end and leveraging off the activities of the internal audit function. Each of these will now be discussed.

Auditing events occurring prior to year-end

It is possible (and efficient) to perform audit procedures prior to year-end for balance sheet and income statement accounts that accumulate transactions that, for the most part, will remain in the account balance at year-end. These may include major business acquisitions or disposals and key charges to expense accounts, for example, payroll bonuses or major fixed asset additions/disposals likely to represent significant items at year-end that would ordinarily be audited substantively.

Auditing activity in the period to date

When the year-end test is to audit activity over the entire accounting period (for example, a monthly review of the ageing of trade receivables) it is often possible to understand and test the activity as part of the interim audit visit. The year-end visit will then concentrate on updating these procedures for the period since the interim audit visit.

Performing general audit procedures prior to year-end

On all audit engagements there are a range of audit procedures that always need to be performed. These often involve an accumulation of knowledge throughout the year, for example, a review of board minutes, statutory books and records. Some of these procedures can be performed at an interim date, with an update being performed at year-end.

Testing provisions prior to year-end

Where a provision is based on a system-generated assessment as a basis for the overall calculation, audit teams often take the opportunity to understand and test these processes prior to year-end and bring forward the audit procedures at year-end. This includes familiarisation with the approach taken by management prior to year-end, so that the auditor can begin to develop an expectation of the balances in advance of the year-end visit. As discussed in chapter 4 it is important when performing analytical procedures to have an expectation of the results of the procedure prior to performing it.

Leverage off internal audit

While planning the audit, an understanding of internal audit activities is gained to assess whether any audit procedures may be reduced as a result of these activities. For example, information generated by internal audit may allow a reduction in the overall level of work performed in establishing control risk assessments and can help update the auditor's understanding of controls more efficiently at year-end. ASA 610 (ISA 610) *Using the Work of Internal Auditors* establishes the auditor's responsibilities relating to the work of internal auditors when the auditor determines that the internal audit function is likely to be relevant to the audit.

CLOUD 9

Ian and Suzie have already decided that analytical procedures are to be supplemented with tests of details except where there is low inherent and control risk. If the risk of material misstatement is low, allowable detection risk is high and analytical procedures are likely to provide sufficient and appropriate evidence. When Ian and Suzie decide that tests of details are required, they would perform such tests of details at interim dates if allowable detection risk is relatively high, but closer to year-end date if allowable detection risk is lower.

Ian suggests that because their control testing has shown that internal controls over PPE at Cloud 9 are reasonably effective, tests of details for PPE can be scheduled for interim dates. He suggests that they can inspect physical assets in the balance of furniture and equipment and leasehold improvements prior to the end of the financial year and then vouch recorded acquisitions to the underlying documents and trace documents showing disposals for the period between the interim date and the end of the financial year to the ledger. The main focus of these tests would be on the existence, valuation, and rights and obligations assertions for new assets and the completeness assertion for disposals. Cloud 9's trial balance does not contain a separate maintenance and repairs expense account and Ian is concerned about the possibility that any expenditure has been inappropriately capitalised. He suggests that for PPE, analytical procedures are most useful for depreciation expense testing.

10.1.3 Matters to consider when designing substantive procedures

Some specific issues to consider when designing substantive procedures are discussed in this section, including ensuring substantive procedures respond to specific risks, taking credit for work already undertaken and setting appropriate testing thresholds.

Ensure substantive procedures respond to specific risks

When deciding on the nature of test to perform, it is essential to understand the specific risks driving the risk assessment for that account assertion. For example, one client has significant overseas debtors, which increases the inherent risk for the valuation of receivables. If controls testing indicates that control risk is low for this assertion, substantive testing can be reduced. Another client has a significant number of very small local debtors, which reduces the inherent risk for the valuation of receivables. If controls testing indicates that there are poor controls in place, control risk is high. Both overall risk assessments are the same; however, the audit strategy for each will be different due to the controls risk assessment made.

Take credit for work already undertaken

Before the auditor begins their year-end work, it is important to remember that procedures have already been performed to assess control and inherent risks, and interim substantive procedures also may have been completed. The auditor needs to ensure that they take credit for this work and that the 'mindset' with which they approach their year-end work is appropriate and fully reflects their risk assessment and expectation of the likelihood of material misstatements occurring.

Set appropriate testing thresholds

The threshold for what the auditor considers important will vary depending on the overall risk assessment and the context in which they make the judgement. Thresholds should be challenged in the context of the client and the overall risk assessment, and agreed with the engagement executives to ensure the audit team is performing the right level of testing for each significant account. Determining the extent of testing prior to year-end will allow more time during the year-end visit to focus on performing the required procedures.

CLOUD 9

Ian identifies prepayments as not being a significant account. In the absence of any other indicators suggesting high risk, he recommends that the account balances be substantiated using analytical procedures only. Analytical procedures can be very effective for prepaid rent and insurance because the balance is a mathematical derivation of the contracted amount for rent and insurance.

Accrued expenses on the September trial balance are larger than prepayments, and thus there is a greater risk they are overstated. However, the greater concern is whether the accrued expenses are understated (that is, they are not complete). Some provisions can be confirmed through recalculation (for example, annual leave provision), but others involve more judgement (for example, warranty and loyalty program provisions). He recommends using analytical procedures for both types of liabilities, and additional tests of details for the provisions, including examination of the documents relating to claims. Cloud 9's loyalty program is new and will therefore require the involvement of a senior member of the audit team to test the assumptions used to calculate the liability (some of this work has already been done during the risk assessment phase).

BEFORE YOU GO ON

- Describe two influences on the timing of substantive procedures apart from the risk assessment of the account in question.
- How can internal audit influence the timing of the external auditor's procedures?
- Why is it important to understand the risk of material misstatement for a significant account?

10.2 Substantive testing of cash

LEARNING OBJECTIVE 10.2 Design and explain how to execute substantive procedures to address audit risk related to cash.

When cash is a significant account in an entity's balance sheet, the auditor must ensure sufficient and appropriate audit evidence has been gathered on which to conclude that there are no material misstatements in cash as at year-end. There are three audit assertions that are particularly important to enable the auditor to achieve this objective. These assertions are existence, completeness and classification.

Firstly, existence of cash is usually verified by the receipt of a confirmation from the client's bank. The bank should also confirm whether there are any additional bank accounts, loans, **pledges**, lease facilities or other banking facilities. AGS 1002 *Bank Confirmation Requests* provides further guidance on the enquiry and confirmation methods of obtaining audit evidence about an entity's banking relationships.

The second significant assertion is completeness, with a particular focus on whether the balance completely reflects all cash transactions. Substantive tests usually focus on testing the client's bank reconciliation as well as the cut-off of cash transactions. The auditor tests the bank reconciliation by vouching any differences between cash as per the bank statement and cash as per the general ledger to supporting documentary evidence. The differences between the bank statement and the general ledger are often unpresented cheques, deposits not yet cleared by the bank, bank fees, and sometimes small amounts of interest. Most of these are able to be vouched to a bank statement after year-end evidencing that the cheques have been honoured and the deposits have been recognised by the bank. Any fees or interest the bank charged should be vouched to the general ledger to evidence the client recognising those reconciling items. These tests for the completeness of the cash transactions that affect the bank balance also provide additional evidence about the existence assertion for the bank balance (that is, that the balance of cash in the ledger actually exists and does not represent unpresented cheques or unrecorded fees and interest).

The third significant assertion is classification. Classification is important because of the additional information related to the cash account that is required to be disclosed in the financial report, including unused credit facilities and other information that is part of the statement of cash flow disclosure requirements. Cash testing can also include ensuring that bank covenants (in the client's banking agreement) have not been breached. If the ratios or limits set in these covenants are breached, there are often quite serious consequences for the client, which can include making all loans immediately due and payable (that is, current liabilities).

For certain clients, a fourth audit assertion, rights and obligations, is significant as the client may have pledged assets such as cash, meaning the use of cash by the company is restricted. That is important information not only for the auditor to understand but also for the users of the financial report. Valuation and allocation is not often a significant assertion, although it is very important when the client has cash balances that are held in a foreign currency.

10.2.1 Principal objectives in auditing cash

The principal objectives in auditing cash are described in table 10.1.

TABLE 10.1 Objectives in auditing cash

Objective	Assertion
All cash on the balance sheet is held by the entity or by others (e.g. a bank) for the entity.	Existence (E)
All cash owned by the entity at year-end is included in the balance sheet.	Completeness (C)
Cash is stated at its realisable value.	Valuation and allocation (V&A)
The entity owns, or has legal rights to, all the cash on the balance sheet at year-end. All cash is free from restrictions on use, **liens** or other security interests, or, if not, such restrictions, liens or other security interests are identified.	Rights and obligations (R&O)
Cash is properly classified, described and disclosed in the financial report, including the notes, including disclosures of any of the abovementioned restrictions on use, etc., plus disclosures are made as required by application of an appropriate accounting framework (e.g. International Financial Reporting Standards).	Classification (Cl), classification and understandability (C&U)

It is worth noting that the classification (Cl) assertion and the classification and understandability (C&U) assertion are different. Classification relates to transactions and events that occur throughout the year (for example, how are they recorded in the income statement and whether they are in the right expense account). Classification and understandability relates to presentation and disclosure in the financial report.

10.2.2 Processes affecting cash

Prior to performing tests of details or analytical review procedures, the auditor should assess any audit evidence obtained from the testing they performed at an interim stage on significant transactions, including tests of controls (for example, appropriate approvals of cash payments made). If the auditor has performed controls testing and concluded that the controls are effective and can be relied upon, it is unlikely that any additional tests related to the cash receipts or cash payments processes would be performed. Instead, the auditor would perform the minimum substantive tests ordinarily performed for the cash balance at year-end with no additional process or control related testing required. This is because they have concluded that the controls are effective in ensuring that the 'what could go wrongs' (WCGWs) identified during risk assessment are unlikely to occur.

Table 10.2 illustrates substantive procedures the auditor may perform during their testing of significant transactions related to cash. The two important types of transactions that have an impact on the cash balance are cash receipts and cash payments. These procedures would only be considered when the auditor has been unable to test and rely upon controls (controls are ineffective) or they have decided that it is more efficient to test the transactions making up the balance substantively. There are many tests that would need to be performed over a large proportion of the transactions flowing through these significant accounting processes if a fully substantive approach were to be taken. It is therefore normally more efficient and effective to perform at least some controls testing if possible.

TABLE 10.2 Example substantive tests of transactions — cash

Cash receipts process	Cash payments process
Perform a proof of cash by reconciling activity per the client records to activity per the bank. Also correlate these transactions to the activity in the sales and trade receivables transaction files. This procedure is limited to less complex engagements that have a limited number of transactions. (C, A) Trace remittance advices or lists of cash receipts to entries in the cash receipts transaction file as to date, remitter, amount and account classification. (CI, C) Trace the details of duplicate deposit slips to the entries in the cash receipts transaction file. Investigate abnormal delays in depositing cash receipts. (C)	Account for the numerical sequence of cheques issued during a specified period. (CO, C) Trace paid cheques and supporting documents to the cash payments transaction file as to date, payee, amount and account classification; determine whether supporting documents have been marked to prevent reuse. (C) Vouch entries in the cash payments transaction file to the paid cheques and supporting documents as to date, payee, amount and account classification; determine whether supporting documents have been marked to prevent reuse. (O) Test the account classifications of cash payments. (CI)
Trace the total amounts of daily deposits shown on the bank statement to the totals of the daily cash receipts shown in the cash receipts transaction file. Investigate unusual delays in depositing cash receipts and any splitting of daily cash receipts into separate deposits. (C)	Test the mathematical accuracy of the cash payments transaction file. (V&A)
Trace invoices and other original records of cash sales transactions to recorded cash sales, and vouch recorded cash sales to supporting documents. (C)	Trace the postings of the totals in the cash payments transaction file to the general ledger. (C)
Test the recording of miscellaneous receipts (i.e. receipts not usually recorded in trade receivables, such as scrap or royalties); consider whether the recorded amounts are reasonable. (A)	Trace the posting of individual cash payments from the cash payments transaction file to the appropriate accounts in the general ledger. (CI)
Vouch entries in the cash receipts transaction file (e.g. date, remitter, amount and account classification) to the remittance advices, lists of cash receipts, bank deposit slips and bank statements. (O)	Determine whether the signatures on paid cheques are authorised. (A)
Test the accounting classifications of cash receipts. (CI, V&A)	
Test the mathematical accuracy of the cash receipts transaction file. (A)	

Cash receipts process	Cash payments process
Trace the postings (processing) of the totals in the cash receipts transaction file to the general ledger. (C)	
Test the authorisation of credits, discounts and allowances in the cash receipts transaction file. (O, E)	
Trace the posting of individual cash receipts from the cash receipts transaction file and supporting documents to the trade receivables transaction file. (CI, C)	

E — existence; C — completeness; V&A — valuation and allocation; R&O — rights and obligations; CI — classification; C&U — classification and understandability; CO — cut-off; A — accuracy; O — occurrence

Note that each substantive test illustrated in this chapter addresses a number of audit assertions. This is because many tests of transactions are designed to address multiple assertions in both the balance sheet and the income statement. Only key assertions addressed are specifically identified for the examples in this chapter. Further, note that the assertions are listed as they relate to the process described in the heading. For example, tracing cheques and supporting documents to the cash payments transaction file provides evidence of the completeness assertion for the cash payments process, or cash payments transactions. The test also provides evidence for the existence assertion for the cash balance in the balance sheet. This is because testing for the completeness of transactions that have a negative impact on a balance is also providing evidence that the balance is not overstated by these transactions.

10.2.3 Illustrative procedures for auditing cash

An almost limitless number of substantive procedures can be designed for the testing of account balances. Table 10.3 illustrates example substantive procedures when substantively auditing cash. Some of the procedures are typically always performed irrespective of the risk assessment the auditor reaches for the significant account, while others are selected in response to the risk assessment to address any remaining detection risk that is still evident after controls testing has been performed.

CLOUD 9

Suzie reminds Ian that they have conducted extensive testing of Cloud 9's controls over cash receipts and payments, and many of these tests were dual purpose. This means that the substantive and control tests were done at the same time. While examining the documents, the audit assistant completed tasks designed to detect control deviations and substantive errors. These tests included re-performance of the bank reconciliations, and vouching recorded cash payments and receipts (including transaction approvals and posting) to the underlying documents.

The testing already completed shows that controls over cash are reasonably strong, and they can justify requesting a bank confirmation for an interim date, with a roll-forward to year-end. The bank confirmation will gather evidence about the existence and valuation assertions, plus rights and obligations (that is, it will reveal liens or claims over bank accounts). The roll-forward will include testing the cut-off of cash receipts and payments.

Ian notices that the balance of the savings account at the interim date has declined from the end of the previous year. This is probably due to payment of the costs associated with the new store, trucks and marketing campaign, but it could also be a seasonal fluctuation. They will ask the finance director about the fluctuating cash balance, and compare the account balance and cash flows with budgeted figures.

TABLE 10.3 Example substantive tests of account balances — cash

Example tests typically always performed
Confirm cash held by others (e.g. bank balances and/or overdrafts) and cash on hand, if significant. (E, R&O)
Examine the client's bank reconciliations. When appropriate (e.g. to determine whether receipts or payments are recorded on a timely basis, or to verify the appropriateness of reconciling items) obtain cut-off bank statements either side of the year-end. (C, V&A)
Test cut-off of cash receipts, cash payments and transfers as at year-end. (C, V&A)
Example analytical procedures
Compare the listing of cash accounts with the prior period's and investigate any unexpected changes (e.g. credit balances, unusually large balances, new accounts, closed accounts) or the absence of expected changes. (E, C, V&A, Cl)
Review interest received and/or paid in relation to the average cash balances and/or bank overdrafts. (Occurrence and accuracy of interest income in the income statement)
Example other general procedures
Review the cash accounts in the general ledger for unusual items. (C, V&A)
Review bank confirmations, minutes of meetings, loan agreements and other documents for evidence of restrictions on the use of cash or liens on cash. (C&U)

BEFORE YOU GO ON

- Name two assertions that are ordinarily significant for cash and describe why they are important.
- What is the impact on the level of substantive audit procedures necessary for the cash receipts process if controls are not tested and found to be effective?
- Describe two substantive audit procedures that are always performed for cash.

10.3 Substantive testing of trade receivables

LEARNING OBJECTIVE 10.3 Design and explain how to execute substantive procedures to address audit risk related to trade receivables.

When trade receivables (also referred to as accounts receivable, receivables or debtors) is a significant account in an entity's balance sheet there are two audit assertions that are usually considered most important to ensure the auditor has gained sufficient and appropriate audit evidence on which to conclude that there are no material misstatements in the balance as at year-end. They are the existence and valuation and allocation assertions.

Existence of trade receivables is often verified by sending confirmations to the client's customers. This is referred to as a positive confirmation because the auditor requires a response to the confirmation request from the customer before concluding that the customer (trade receivable) exists. A negative confirmation is generally not used as an audit technique due to the limited level of assurance it provides. It is referred to as a negative confirmation as the auditor requires a response only if the customer disputes the balance included on the confirmation.

There can be confusion as to whether a trade receivables confirmation (as described in ASA 505 (ISA 505) *External Confirmations*) provides assurance over the existence or valuation and allocation (or both) assertions. A positive confirmation really only provides audit evidence as to the existence of the debt. That is, the receivable is real and goods or services were provided to the customer to the value recorded in the trade receivables transaction file. It does not, however, provide any assurance as to whether the client will recover all of the balance. For example, a customer may confirm that a balance is due and payable, but the auditor is unable to determine whether or not the customer has the ability to pay the amount. The best way of ensuring the balance is valued correctly is by the full receipt of the cash by the client.

The second significant assertion is valuation and allocation of trade receivables. As explained previously, the confirmation procedure does not provide assurance over the valuation and allocation assertion; instead, additional tests are required. The most common test is referred to as subsequent receipts. This is when a sample of trade receivables at year-end is vouched to the subsequent receipt of cash from the customer. Additional analytical procedures can also be performed to corroborate the results of the valuation testing. These include tests such as comparing the ageing of trade receivables to the prior period, and calculating the number of days it takes to convert trade receivables to cash for the current and prior period.

Other assertions may also be important in the audit of trade receivables for a client. The classification assertion is important because of the additional information related to trade receivables required to be disclosed in the financial report. This information includes related party disclosures as well as the disclosures required by Australian Accounting Standard AASB 7 (IFRS 7) *Financial Instruments: Disclosures*. For certain clients, rights and obligations are a significant assertion as the client may have restrictions on trade terms as part of its conditions of sale. For example, some clients sell stock that is on consignment from a third party and therefore the stock is not recorded as owned by the client. Completeness is also important; however, the audit procedures to verify that trade receivables are complete are relatively simple and consist of performing cut-off procedures as at year-end. Example cut-off procedures are included in table 10.6.

10.3.1 Principal objectives in auditing trade receivables

The principal objectives in auditing trade receivables are described in table 10.4.

TABLE 10.4 Objectives in auditing trade receivables

Objective	Assertion
All receivables on the balance sheet are real claims of the entity.	Existence (E)
All real claims of the entity for amounts receivable are included on the balance sheet.	Completeness (C)
Receivables are carried at their net realisable (collectable) value (i.e. the gross receivables are properly stated with appropriate allowances provided for uncollectable accounts, discounts, returns, warranties and similar items).	Valuation and allocation (V&A)
The entity owns, or has legal right to, all the receivables on the balance sheet at year-end. All receivables are free from liens, pledges or other security interests or, if not, such liens, pledges or other security interests are identified.	Rights and obligations (R&O)
Receivables are properly classified, described and disclosed in the financial report, including the notes, in conformity with prescribed accounting principles (IFRSs).	Classification (Cl), Classification and understandability (C&U)

10.3.2 Processes affecting trade receivables

Table 10.5 illustrates procedures the auditor may perform during their testing of transactions related to trade receivables. There are three important types of transactions that affect the balance: sales, sales returns and allowances (credit memos) and cash receipts. These procedures would only be considered when the auditor has been unable to test and rely upon controls (controls are ineffective) or has determined that it is more efficient to test the balance substantively. As explained previously, only the key assertions addressed are specifically identified for the examples in the table, and the assertions relate to the processes, not the trade receivables account. Tests that provide evidence for the completeness assertion for transactions that have a negative impact on the balance of receivables provide evidence that the balance of receivables is not overstated (existence assertion).

TABLE 10.5 Example substantive tests of transactions — trade receivables

Sales process	Sales returns and allowances (credit memos) process	Cash receipts process
Account for the numerical sequence of sales invoices, sales orders and shipping documents during a specified period. Reconcile billings with shipping documents for substantial portion of the period. (C, CO)	Trace credit memos and supporting documents to the sales returns and allowances transaction file as to dates, customers, products, quantities, prices and amounts. (O) Account for the numerical sequence of credit memos during a specified period. (C)	Trace remittance advices or lists of cash receipts to the entries in the cash receipts transaction file as to date, remitter, amount and account classification. (C) Trace the details of duplicate deposit slips to the entries in the cash receipts transaction file. Investigate abnormal delays in depositing cash receipts. (C)
Trace the records of products ordered and shipped to the sales records; agree dates, customers, products, quantities, prices and amounts. (O) Trace the posting of individual sales invoices to the sales transaction file and to the trade receivables transaction file. (CI) Vouch recorded sales to the records of products ordered and shipped; agree dates, customer, products, quantities and amounts. (O)	Trace the posting of individual credit memos to the sales returns and allowances transaction file and to the trade receivables transaction file. (CI) Vouch recorded credit memos with the documents supporting returns and allowances as to dates, customers, products, quantities, prices and amounts. (O)	Trace the total amounts of the daily deposits shown on the bank statements to the totals of the daily cash receipts shown in the cash receipts transaction file. Investigate unusual delays in depositing cash receipts and any splitting of daily cash receipts into separate deposits. (C) Vouch entries in the cash receipts transaction file (e.g. date, remitter, amount and account classification) to the remittance advices, lists of cash receipts, duplicate deposit slips and bank statements. (O)
Review the listing of accounts receivable and investigate unusual balances, credit balances and accounts that may not be accounts receivable or may not be properly classified as accounts receivable. (V&A, CI) Investigate large or unusual credit memos issued subsequent to year-end. (V&A) Test the pricing and mathematical accuracy of sales invoices. (A)	Vouch credit postings in the trade receivables transaction file to the cash receipts transaction file or approved credit. (C) Test the authorisation of credits, discounts and allowances shown in the cash receipts transaction file. (A) Test the pricing and mathematical accuracy of credit memos (e.g. trace information to terms and recording of original sales). (A)	Test the accounting classifications of cash receipts. (CI) Test the mathematical accuracy of the cash receipts transaction file. (A) Trace the postings of the totals in the cash receipts transaction file to the general ledger, trade receivables transaction file and other transaction files. (C)

Sales process	Sales returns and allowances (credit memos) process	Cash receipts process
Test the accounting classification of sales transactions. (CI) Review the trade receivables, sales and sales returns and allowances accounts in the general ledger for unusual items. (V&A) Test the mathematical accuracy of the sales transaction file. (A)	Test the cut-off in processing credits and allowances granted to customers by examining credit memos issued and recorded before and after year-end. (CO) Test the timeliness with which credits granted to customers are processed. (A) Test the accounting classification of credit memos. (CI)	Trace the posting of individual cash receipts from the cash receipts ledger and supporting documents to the trade receivables transaction file. (CI, C) Examine the client's bank reconciliations. When appropriate (e.g. to determine whether receipts of payments are recorded on a timely basis, or to verify the appropriateness of reconciling items) obtain cut-off bank statements. (CO)
Trace the accounts receivable to the trade receivables transaction file (detailed customer aged trial balance) and investigate reconciling items. (A) Trace the postings of the totals in the sales transaction file to the general ledger. (C)	Test the mathematical accuracy of the sales returns and allowances transaction file. (A) Trace the postings of the totals in the sales returns and allowances transaction file to the general ledger and trade receivables transaction file. (C)	Test cut-off of cash receipts, disbursements and transfers at year-end. (C)

10.3.3 Illustrative procedures for auditing trade receivables

There is an almost limitless number of substantive procedures that can be designed for the testing of account balances. Table 10.6 illustrates example substantive procedures when auditing trade receivables. Some of the procedures are always performed (irrespective of the risk assessment the auditor reaches for the significant account) while others are selected in response to the risk assessment to address any remaining detection risk that is still evident after controls testing has been performed.

CLOUD 9

Ian suggests that the controls testing over the sales and accounts receivables process and the cash receipts has provided some evidence about receivables. Dual testing has been built into the controls testing program in these areas, which means that additional substantive testing can focus on specific, more risky areas. Debtors confirmations are a key substantive technique that Ian recommends be undertaken at an interim date, with roll-forward to year-end. The roll-forward will include cut-off testing and subsequent receipts testing. Receipts from debtors in the month following year-end provide persuasive evidence about the collectability of receivables at year-end. Senior members of the audit team will be involved in assessing the adequacy of the allowance for doubtful debts.

Suzie suggests that they also consider the derivative financial assets and receivables from the Cloud 9 Inc. parent company when planning substantive tests in this area. The derivatives are related to the forward exchange contracts used to pay for inventory purchases. The forward exchange contracts give rise to both a derivative financial asset and the hedge payable, and reviewing the contracts provides evidence about both accounts. The receivable from the parent gives rise to special disclosure requirements, and therefore is an area of additional risk even though the amount of the asset is not large.

TABLE 10.6 Example substantive tests of account balances — trade receivables

Example tests always performed
Confirm accounts receivable. If accounts are confirmed at an interim date, review the roll-forward of activity from the confirmation date to year-end and compare the level of activity with the prior period. Investigate unusual items; consider confirming (at year-end) significant new accounts and those accounts with significant increases or decreases between the confirmation date and year-end. Examine subsequent cash receipts, shipping records, sales contracts and other evidence to verify the validity of accounts receivable for which replies to confirmation requests were unsatisfactory or were not obtained as part of supporting year-end receivables balances. (E)
Test the cut-off by inspecting the sales transaction file, billings, shipping documents and other supporting documents immediately before and after the cut-off date and determine that the transactions were recorded in the proper period; compare the receivables cut-off to cut-offs in related areas (e.g. sales and inventory). (C)
Evaluate the adequacy of the allowances for doubtful accounts. See the example procedures that may be performed under other general procedures below. (V&A)
Example analytical procedures
Allowances/provision for doubtful debts Compare the aged listing of accounts receivable with the prior period's and note any significant changes (e.g. changes in major customers, in major trade receivables balances overdue). (V&A)
Compare the current period's accounts written off and the allowance for doubtful debts as percentages of accounts receivable and sales with the prior period's percentages. Evaluate the trends in light of current economic conditions and what you know about the client and the industry they operate in. (V&A)
Compare the current year's to the prior year's allowance for doubtful debts as a percentage of receivables and sales. (V&A)
Compare the current period's receivables as a percentage of net sales with the prior period's percentages and consider the reasonableness of the current period's percentage in relation to current economic conditions, credit policies, collectability. (V&A)
Compare the current period's accounts receivable turnover and number of days' sales outstanding with prior amounts and consider the reasonableness of the current period's amounts in relation to current economic conditions, credit policies and collectability. (V&A)
Compare the ageing with the client's and with the industry's collection practices (if known). (V&A)
Compare the current period's sales returns and sales discounts as percentages of sales by product line with prior period percentages. Investigate significant or unusual fluctuations. (V&A)
Compare the number and amounts of sales credit notes issued with those of the prior period. (V&A)
Example other general procedures
Accounts receivable Review evidence or obtain information concerning creditworthiness for large new accounts. (V&A)
Trace the totals of accounts receivable in the trade receivables transaction file to the general ledger control accounts or accounts receivable summary. (V&A, C)
Enquire about management, salespeople or others receiving products without billing or payment. (V&A, C)
For large or unusual sales contracts incomplete at year-end, request confirmation from customers as to pricing, discount, payment and warranty terms. (V&A)
Allowances/provision for doubtful debts Understand and document the rights of return offered to customers under the terms of sales agreements or as a matter of practice. (V&A)

Review analysis of activity in the allowance for uncollectable accounts and bad debts expense accounts during the period. (V&A)
Evaluate the adequacy of the allowance for uncollectable accounts at year-end. (V&A)
Review analysis of activity in the allowances for discounts, returns, warranties and similar items during the period. (V&A)
Evaluate the adequacy of the allowances for discounts, returns, warranties and similar items at year-end. (V&A)
Test the accuracy of the accounts receivable ageing by tracing details to and from the trade receivables transaction file or supporting documentation. Test ageing for clerical accuracy. (V&A)
Evaluate the adequacy of any collateral and guarantees on any receivables balances. (V&A)
Consider requesting confirmation of accounts written off during the period. (V&A)
Review payments received subsequent to year-end or confirmation date. (V&A)
Other Test the timing and amount of year-end revenue recognition by vouching to long-term contracts, service agreements, licence agreements or other appropriate documentation to detect errors and/or estimate amount of incorrect revenue recorded. (E, V&A, CI)
Examine details of accounts receivable from related parties; investigate unusual items as well as significant reductions or increases at year-end; determine that necessary disclosures are made. (C&U)
Review minutes, loan agreements and other documents for evidence of liens, pledges or other security interests in receivables; determine that necessary disclosures are made. (R&O)

PROFESSIONAL ENVIRONMENT

Fraud in trade receivables

A famous case that involves questions about asset values in audited financial reports is WorldCom, a US company that filed for bankruptcy in 2002. WorldCom was a telecommunications company that had grown primarily through acquiring other companies.[1] After WorldCom's collapse commentators questioned the company's financial reporting practices. For example, Eichenwald claimed that when WorldCom acquired new assets as part of a takeover of another company, the assets were immediately written down in value. Eichenwald states that WorldCom 'included in this charge against earnings the cost of company expenses expected in the future. The result was bigger losses in the current quarter but smaller ones in future quarters, so that its profit picture would seem to be improving'.[2]

WorldCom also had some issues with its trade receivables, particularly relating to its acquisition of MCI Communications. Walter Pavlo was a senior manager in billing collections at WorldCom. In January 2001, he was given a 41 month sentence for offences relating to money laundering, wire fraud and obstruction of justice.[3] Walter Pavlo's responsibilities were to bill customers, collect money, post the customer payments and credits, and perform account reconciliations. In a video made for The American Institute of CPAs and the Association of Certified Fraud Examiners, he described the pressure employees of the company were under to grow the business consistently, and the great incentives for growth provided by stock options, which he was given 'by the thousands'.[4]

Pavlo also explained that, initially, the attempts to conceal uncollectable debt felt more like 'a little white lie' that could be fixed up next quarter when more cash was collected. The managers knew exactly where the numbers had to be to meet analysts' expectations each quarter, and worked towards this target. He said that he didn't have the feeling at the time that his actions were unethical. He described 'learning' to find ways to conceal the problems. It was an evolutionary process rather than specific

(*continued*)

instructions to 'fix the books'. However, it was also known at the company that senior executive Bernie Ebbers, subsequently convicted of other offences related to the WorldCom collapse, saw the company's code of ethics as a 'colossal waste of time'.[5]

The auditor for WorldCom was Arthur Andersen, which was facing big problems at the time relating to its audit of Enron. Andersen did not appear to realise the depth of the problems with asset values at WorldCom. Finally, the alarm was raised when an internal auditor, Cynthia Cooper, brought the matter to the attention of WorldCom's audit committee.[6]

BEFORE YOU GO ON

- Name two assertions that are ordinarily significant for trade receivables and describe why they are important.
- What is the impact on the level of substantive audit procedures necessary for the sales process if controls are not tested and found to be effective?
- Describe two substantive audit procedures that are always performed for trade receivables.

10.4 Substantive testing of inventory

LEARNING OBJECTIVE 10.4 Design and explain how to execute substantive procedures to address audit risk related to inventory.

Inventory is often referred to as stock. A stock register is a list of all the items of inventory that a company has. It is used to capture purchases and sales of stock and as the basis to assist in calculating any provision for slow-moving or obsolete stock. A stock register is essentially the transaction file that is reconciled to the general ledger account for inventory. ASA 501 (ISA 501) *Audit Evidence — Specific Considerations for Inventory and Segment Information* contains the requirements for obtaining sufficient appropriate audit evidence relating to inventory. The two key assertions for inventory are existence, and valuation and allocation.

Existence is important because the inventory the company has recorded in its stock listing (which flows into the general ledger and finally into the financial report) needs to actually exist. Auditors test for existence by physically sighting the stock during stocktakes held by the client. Some clients conduct stocktakes once a year, while other clients perform stocktakes on a cyclical basis, counting a small number of items on multiple days throughout the year. The better a company controls its stock, the easier it is to implement cycle counting (to test the perpetual stock records to the physical records) on a regular basis throughout the year. If the controls are not strong, or if it is physically difficult to count the stock, often only an annual stocktake is held (usually close to or on the final day of the reporting period).

It is important to physically sight inventory on a periodic basis as this provides insights into not only whether the items exist in the quantities recorded but also whether there appear to be any items that may be slow-moving, damaged, obsolete, impaired or excess to the client's needs, providing important evidence for the valuation and allocation assertion.

Valuation and allocation is the other significant assertion tested by auditors in relation to inventory as it is important that stock is recorded at the appropriate carrying value (or fair value as it is described and defined by the IFRSs, in particular AASB 102 (IAS 2) *Inventories*). Valuation becomes very important when companies change products, as the decisions made by management and those charged with governance will affect the values that items of inventory should be carried at. For example, if an entity decides to stop making or selling a particular product and instead replace it with a new one, it is likely that the value of the old stock will be affected and may need to be written down to its fair value (or nil).

Typical substantive procedures to test valuation focus on the initial cost recorded (by vouching to supporting invoices), the value recovered for any sales (by vouching to sales invoices), and any provision for impairment calculations for excess, slow-moving or obsolete stock on hand at year-end.

Completeness of inventory is ordinarily not a major issue for most entities as the auditor is typically most concerned with the overstatement of assets, and completeness tests tend to focus on the potential understatement of stock on hand. However, for some clients, it is a significant assertion. For example, for clients selling to retail outlets, the retailer often does not take ownership or title of the goods held in-store until the goods are actually sold. It is not until the sale has occurred that the supplier (our client in this example) is able to recognise the sale. That is important information not only for the auditor to understand but also for the users of the financial report to be aware of, as it gives information about the risks of whether the client is likely to receive the cash (that is, in the example given it is highly dependent on the customer's ability to sell the goods, not on anything the client can necessarily do). It also represents the type of inventory that may be inadvertently omitted from the balance.

Rights and obligations is tested for particular types of rights that attach to the stock held by a client. For example, if stock is owned by the client as soon as it is shipped from the manufacturer, the inventory needs to be recognised as stock before it is actually received into the client's warehouse. Ownership of stock is only subject to a high risk of error at very few, very specific types of companies that purchase or sell stock with specific rights attached to the items (such as in the previous example of inventory being sold to a retailer).

Classification is generally addressed by testing the stock listing. Therefore, verifying the amounts included in the disclosures in the financial report is relatively straightforward, as the disclosures are often found within the listing (that is, the split of total inventory between raw materials, work in progress (WIP) and finished goods).

10.4.1 Principal objectives in auditing inventory

The principal objectives in auditing inventory are described in table 10.7.

TABLE 10.7 **Objectives in auditing inventory**

Objective	Assertion
All inventory on the inventory listing is included in the financial report.	Existence (E)
All inventory is owned by the entity at year-end are included on the balance sheet.	Completeness (C)
Inventory is carried at the lower of cost or market value. The costs and market determinations are appropriate, including adequate provisions for excess, slow-moving, obsolete and damaged goods, and for losses on purchase and sale commitments.	Valuation and allocation (V&A)
The entity owns, or has legal right to, all the inventory on the balance sheet. All inventory is free of liens, pledges and other security interests or, if not, such liens, pledges or other security interests are identified.	Rights and obligations (R&O)
Inventory is properly classified, described and disclosed in the financial report, including the notes, in conformity with prescribed accounting principles (IFRSs).	Classification (Cl), Classification and understandability (C&U)

10.4.2 Processes affecting inventory

Table 10.8 illustrates procedures the auditor may perform during their testing of transactions related to inventory. There are three important types of transactions that affect the inventory balance: purchasing, cash payments and inventory processes. These procedures would only be considered when the auditor has been unable to test and rely upon controls (controls are ineffective) or has determined that it is more efficient to test the balance substantively.

TABLE 10.8 Example substantive tests of transactions — inventory

Purchases process	Cash payments process	Inventory process
Test the records of goods and services ordered by comparing purchase requisitions and purchase orders to vendors' invoices. (O) Test the recording of goods and services received by comparing receiving documents to vendors' invoices. (C) Trace vendors' invoices to the voucher register (or other initial record of entry). (C)	Examine the client's bank reconciliations where appropriate, for example, to determine whether receipts or payments are recorded on a timely basis or to verify the appropriateness of reconciling items. Perform bank reconciliation cut-off procedures. (CO) Account for the numerical sequence of cheques issued during a specific period. (C, CO)	Trace the posting of purchases, production, transfers and shipments of inventory to the perpetual (or other) inventory records. (C, Cl) Trace the recording of acquisitions, transfers, and disposals of inventory to the general ledger accounts. (O, C)
Vouch the records of goods and services purchased to the records of goods and services ordered and received. by comparing the voucher register to vendors' invoices. (O) Test the records of goods and services purchased to the records of goods and services ordered and received by comparing vendors' invoices to purchase orders and requisitions, receiving documents or evidence of receipt of services. (O) Consider the reasonableness of the quantities and the business purposes of the items purchased. (V&A) Test the mathematical accuracy of invoices. (A) Test the timely recording of purchases to the purchase order register. (C)	Trace paid cheques and supporting documents to the cash payments transaction file, compare date, payee, amount and account distribution. Determine whether supporting documents have been marked to prevent reuse. (C) Trace creditor/supplier invoices to the cash payments transaction file. (C) Vouch goods and services ordered (purchase orders and purchase requisitions) to supplier invoices. (O) Vouch evidence of goods received to the supplier invoices. (O) Vouch entries in the cash payments transaction file to the paid cheques and supporting documents, compare date, payee, amount and account distribution. Determine whether supporting documents have been marked to prevent reuse. (C, A) Vouch the cash payments transaction to supplier invoices. (O)	Vouch transactions recorded in the perpetual (or other) inventory records to supporting documentation. (O) Vouch transactions recorded in the general ledger inventory accounts to supporting documentation. (O)

Purchases process	Cash payments process	Inventory process
Trace the posting of individual purchases in the purchases register to the creditors' transaction file accounts as to the proper vendor, invoice number, date and amount. (O) Test the mathematical accuracy of the purchases register. (A) Test the postings of the totals in the voucher register to the general ledger and ledgers. (C)	Examine creditor/supplier invoices, stock or goods receiving reports or other documents supporting the account balances. (E) Compare invoices to purchase orders and purchase requisitions, receipting documents or evidence of receipted services. (C) Consider the reasonableness of the quantities and the business purposes of the items purchased. (V&A) Compare the prices on purchase orders and supplier invoices with those in vendor catalogues. (V&A) Test the mathematical accuracy of invoices. (V&A) Test cut-off of payments and transfers at year-end. (CO) Test the postings of the totals in the cash payments transaction file to the general ledger. (C)	

10.4.3 Illustrative procedures for auditing inventory

As discussed previously, there is an almost limitless number of substantive procedures that can be designed for the testing of account balances, and this is particularly true for inventory. Table 10.9 provides example substantive procedures when auditing inventory. Some of the procedures are typically always performed (irrespective of the risk assessment the auditor reaches for the significant account) while others are selected in response to the risk assessment to address any remaining detect risks that are still evident after controls testing has been performed.

TABLE 10.9 **Example substantive tests of account balances — inventory**

Example tests typically always performed
Observe the counting of physical inventory (stocktake) to establish that: • the client's personnel are complying with the instructions for stocktakes • items belonging to the client, or belonging to others but for which the client is responsible, are accurately counted and recorded • items to be excluded from inventory (no-value items, non-inventory items, items belonging to others) are either subject to satisfactory control and excluded from the counting process or are accurately counted and recorded, including a clear description of their non-inventory status • count tags, sheets or cards are properly controlled.

TABLE 10.9 *(continued)*

Perform tests of the client's counts (from the floor to recorded counts and from recorded counts to the floor); record sufficient information to be able to trace the test counts into the inventory compilation at a later date; record selected information concerning the tags, sheets or cards that are used, partially used, unused and voided.
Inspect shipping, receiving, and transfer documents and the related inventory items, when appropriate, to establish the numbers of the last documents used and other information needed for subsequently verifying cut-off in the accounting records. (E)
Review the physical inventory compilation: • Trace test counts, confirmations and, if necessary, records of the count prepared by the client (e.g. count tags, sheets or cards) to the inventory compilation. Determine that the unit of measure used in the physical inventory compilation is consistent with the unit of measure used during the physical count. • Trace items on the final inventory listing to the physical inventory tags. Determine that the unit of measure used in the physical inventory compilation is consistent with the unit of measure used during the physical count. • Verify that the information gathered during the physical observation regarding the tags, sheets or cards that were used, partially used, unused and voided is accurately reflected in the inventory compilation. • Trace the cut-off information obtained during the physical observation to the accounting records of sales and purchases. (E)
Test the valuation of inventory. Example procedures that may be performed are discussed under Example analytical procedures. (V&A)
Review the reconciliation of the physical inventory compilation with the general ledger account balances and, if applicable, the perpetual inventory records; investigate large and unusual differences; determine that the general ledger accounts and the perpetual records were adjusted to reflect the physical inventory. (V&A)
Example analytical procedures
General Compare the current period's inventory turnover based either on cost or on units sold or produced with the prior period's turnover. (V&A, C)
Compare inventory quantities and/or costs by location, by type and by product with prior period's amounts. (V&A, C)
Compare inventory quantities by product with units sold or used. (V&A)
Compare the current period's gross profit ratios (by month, by location, and by product line) with those of the prior period and/or industry averages. (V&A)
Compare the current year's cost of sales accounts to the prior year's and to the current year's budget (in value or percentages), and investigate any large or unusual fluctuations or the absence of expected fluctuations. (V&A)
Compare the current year's payroll expense accounts to the prior year's and budgets by classification and investigate any large/unusual fluctuations or the absence of expected fluctuations. (V&A)
Compare with the prior period the relationship of payroll expense to cost of sales and sales. (V&A)
Compare budgeted usage of raw materials with the actual usage. (V&A)
Compare production reports with the recorded warehouse receipts of finished products. (V&A)
Compare the relationships of material, direct labour and overhead costs to cost of sales with the prior period. Investigate significant unusual fluctuations or the absence of expected fluctuations. (V&A)
Valuation Compare the average actual unit cost charged to cost of sales during the year by product line with the costs used to price year-end inventory. (V&A)
Compare unit prices for inventory items with those of the prior period and investigate significant changes and/or unusual trends in pricing. (V&A)
Compare the relationship between actual labour and overhead costs to materials put into production with the same relationship in ending inventory. Compare with the prior period. (V&A)
Review product line operating statements and overall profitability to determine if costs are being recovered through selling prices. (V&A)

Obsolete and excess inventory Compare quantities estimated to be sold with forecasts of industry sales. (V&A)
Compare the quantities the entity is committed to purchase and has in hand to the quantities required for future production and/or with forecast sales. (V&A)
Compare inventory quantities with production and storage capacities. (V&A)
Compare current year to the prior year's excess and obsolete reserve, write-offs and related expenses as a percentage of inventory and cost of sales. (V&A)
Compare current year to the prior year's number of days' cost of sales in inventory by inventory category and product line. (V&A)
Compare monthly/annual amounts sold (by product/product line) for current year and prior year. (V&A)
Compare monthly/annual amounts purchased and/or production (by product/product line) for current year and prior year. (V&A)
Compare excess and obsolete experience to patterns in client's industry. (V&A)
Example other general procedures
Determine that the costing method used is consistent with the client's policy and with the method used in the prior year. (V&A)
Review the raw materials, WIP, and finished goods inventory accounts and the cost of sales accounts in the general ledger and subsidiary ledgers for unusual items. (V&A)
Review the nature of items included in non-inventory and cost of sales accounts in the general ledger for amounts that should be included in inventory. (V&A, C)
Verify the calculations of inter and intracompany profits in inventory, and that such profits have been eliminated. (V&A)
Enquire as to the existence of damaged, slow-moving, excess, out-of-style and obsolete inventory and of commitments of additional quantities of similar items. Make note of such items during inventory observations, review of perpetual records, price tests and review of gross margins. (V&A)
Inspect and enquire as to the procedures for identifying obsolete, damaged, excess and slow-moving inventory. Review the values assigned to such items. (V&A)
Investigate any sales and purchase commitments, backorders or sales options to determine whether any losses are likely to be realised in the course of fulfilling the commitments. Verify the reasonableness of the allowances for such unrealised losses. (V&A, R&O)
Review minutes, contracts and other documents for evidence of liens, pledges or other security interests in inventory; determine that the necessary disclosures are made. (R&O)
Review the raw materials, WIP and finished goods inventory accounts not tested in detail for unusual items. (V&A)
Review the reasonableness of the costs applied to the inventory accounts not tested in detail. (V&A)
Investigate significant price variance accounts. High variances may indicate incorrect standard costs. Review for reasonableness the allocation of variances between cost of sales and year-end inventory. (V&A)
Vouch costs of inventory items to current replacement costs per vendor invoices, open purchase orders, current price lists, quotes or published market prices. Consider the effect of lower current cost on materials and purchased-parts content of inventory and on commitments for additional quantities of similar items. (V&A)
Compare costs of WIP and finished goods with selling prices as shown by recent sales invoices, current price lists (adjusted for discounts) and other sources to determine whether there is sufficient margin to cover costs to complete and dispose. (V&A)

TABLE 10.9 *(continued)*

Physical inventory procedures
General procedures Review and determine the adequacy of the instructions and other written materials concerning the counting of inventory and the recording of inventory transactions near the count date. (E)
If the physical inventory is taken on a staggered basis throughout the period, determine the extent of the client's counts during the period; observe one or more of the inventory counts; inspect the recording of the adjustments resulting from the counts to the inventory records; select a sample of items to compare the quantities counted to the quantities recorded in the inventory records; and inspect the recording of the adjustments in the general ledger accounts. (E)
If the physical inventory is taken at an interim date or on a staggered basis during the year, review the roll-forward of activity from the date of the physical inventory to year-end and investigate unusual items; consider counting (at year-end) significant new items and those items with significant increases or decreases between the physical inventory date and year-end. (E)
Review for reasonableness any adjustments to the compiled inventory. (E, V&A)
Procedures for unobserved locations Obtain a copy of the physical inventory compilation and review it for reasonableness (large and/or unusual items). (E, V&A)
Obtain client records of the physical count and review the results and details of any exceptions/problems noted. (E, V&A)
Review the activity in the inventory account since the physical count for reasonableness (large and/or unusual items). (E, V&A)
Vouch activity in the inventory account since the physical count to supporting documents. (E, V&A)
Perform analytical procedures such as comparing current year balance to prior year and budget. (E, V&A)

CLOUD 9

Suzie and Ian spend a considerable amount of time discussing the substantive procedures they will include in the audit program for Cloud 9's inventory. Cloud 9's core business is importing and wholesaling inventory, and an expanding retail store network. The importance of inventory to the business's success means that Cloud 9's senior managers are very aware of the issues surrounding good inventory systems and handling procedures. The audit team has already recognised the importance of these systems by focusing much attention on the controls relating to inventory. However, Suzie and Ian have some concerns about their ability to gather sufficient appropriate evidence about Cloud 9's inventory management system, and they know that if inventory is misstated in the financial reports it is unlikely that the report will provide a true and fair view of the company's financial position and performance.

Suzie and Ian decide that they will gather substantive evidence from the inventory counts at Cloud 9 to add to the evidence gathered from analytical procedures and vouching of inventory transactions. Suzie also decides to take charge of writing the program for gathering evidence on the contracts surrounding the inventory transactions between Cloud 9 and the overseas manufacturers. She wants to be sure that the accounts appropriately reflect the terms of these contracts with respect to transfer of inventory ownership. She asks Ian to take charge of reviewing Cloud 9's procedures for identifying damaged, slow-moving, excess, out-of-style and obsolete inventory.

BEFORE YOU GO ON

- Name two assertions that are ordinarily significant for inventory and describe why they are important.

- What is the impact on the level of substantive audit procedures necessary for the cash payments, purchasing and inventory processes if controls are not tested and found to be effective?
- Describe two substantive audit procedures that are always performed for inventory.

10.5 Substantive testing of property, plant and equipment

LEARNING OBJECTIVE 10.5 Design and explain how to execute substantive procedures to address audit risk related to property, plant and equipment.

The two key significant assertions for property, plant and equipment (PPE) are existence, and valuation and allocation. PPE are often referred to as fixed assets. A fixed asset register is a register or list of all the items of PPE that a company has and is used to capture additions and disposals as well as to calculate the depreciation charges and to track the cost and written down value of each item. The fixed asset register is essentially the transaction file that is reconciled to the general ledger account for fixed assets.

Existence is important because the assets the company has recorded in its fixed assets register (which flows into the general ledger and finally into the financial report) need to actually exist. Auditors usually test for existence by physically sighting the assets listed in the fixed asset register in the first year that a client is audited. In subsequent years, the existence procedures tend to focus on additions to and disposals from the fixed asset register. It is important to physically sight fixed assets on a periodic basis as this provides insights into not only whether the asset exists but also whether there appear to be any assets that may be damaged, obsolete, impaired or excess to the client's needs, providing important evidence for the valuation and allocation assertion.

Valuation and allocation is the other significant assertion tested by auditors in relation to PPE as it is important that assets are recorded at the appropriate carrying value, or fair value as it is described and defined by IFRSs, in particular AASB 116 (IAS 16) *Property, Plant and Equipment*. Valuation also becomes very important when a company changes processes or structures as the decisions made by management and those charged with governance will often have an impact on the values that items of PPE should be carried at. For example, if an entity decides to close down a factory site, it is likely that the value of the fixed assets at that site will be affected and may need to be written down to their fair value (or nil).

Typical substantive procedures to test valuation focus on the initial cost recorded (by vouching to supporting invoices), the value recovered for any disposals (by vouching to cash received or trade-in amounts obtained), and depreciation and impairment calculations for each asset and whether there are any additional write-down or depreciation amounts required for the period. Procedures to test depreciation include performing reasonableness testing of the depreciation charge compared to the cost base of the assets, assessing the useful lives of the assets and comparing these to the depreciation rate used and, in the case of property, having a registered valuation performed.

Completeness is usually not a major issue for most entities as the auditor is typically most concerned with the overstatement of assets, and completeness tests tend to focus on the potential understatement of fixed assets.

The rights and obligations assertion is tested during the first-year audit procedures and then again periodically depending on the type of assets in the fixed asset register. Property is easily verified by reviewing the titles related to each property. Fixed assets also comprise items of equipment, plant and machinery, vehicles and office equipment. Ownership of these items is not subject to a high risk of error unless there are items that are leased (rather than owned). Owned items are able to be verified to either registration papers or original purchase invoices, which will have been tested as part of the valuation assertion. Leased items will be verified to leasing documentation signed by the business when it entered into the lease. While not always specifically testing for rights and obligations, the risk has already been addressed when testing for valuation and allocation.

Classification is generally addressed by testing the fixed asset register. Therefore, verifying the amounts included in the disclosures in the financial report is relatively straightforward, as the disclosures are found within the fixed asset register (the key one being depreciation).

10.5.1 Principal objectives in auditing property, plant and equipment

The principal objectives in auditing PPE are described in table 10.10.

TABLE 10.10 Objectives in auditing PPE

Objective	Assertion
All PPE on the balance sheet (including assets leased under finance leases) are held by the entity or by others for the entity.	Existence (E)
All PPE owned or leased under finance leases by the entity at year-end are included on the balance sheet.	Completeness (C)
PPE are carried at the appropriate amount (taking into account accumulated depreciation, amortisation or impairment). The cost of the plant and equipment is allocated to the appropriate accounting periods in a systematic and rational manner. The written down value of the PPE is expected to be recoverable through future use. PPE assets held for disposal are carried at the appropriate value.	Valuation and allocation (V&A)
The entity owns, or has legal right to, all the PPE on the balance sheet at year-end. All PPE assets are free from liens, pledges, security interests and restrictions or, if not, such liens, pledges, security interests and restrictions are identified and disclosed (if necessary).	Rights and obligations (R&O)
PPE and related accounts are properly classified, described and disclosed in the financial report, including the notes.	Classification (Cl), Classification and understandability (C&U)

10.5.2 Processes affecting property, plant and equipment

Table 10.11 illustrates procedures the auditor may perform during their testing of transactions related to PPE. There are three important types of transactions that affect the balance: cash receipts, cash payments and purchasing. Depreciation is calculated as a monthly or year-end journal and therefore does not form part of these three processes. These procedures would only be considered when the auditor has been unable to test and rely upon controls (controls are ineffective) or has determined that it is more efficient to test the balance substantively.

TABLE 10.11 Example substantive tests of transactions — PPE

Cash receipts, cash payments and purchasing processes
Inspect the cut-off of the additions to PPE, including, when applicable, transfers from construction in progress or work in progress. (CO)
Inspect authorisations and other data supporting retirements, sales and other disposals and recalculate the computations of the resulting gains and losses. Determine that any such assets and the related accumulated depreciation have been removed from the accounts. (E, V&A)
Review the cash receipts transaction file for sales of PPE. (E, V&A)

Trace suppliers' invoices to the initial record of entry (the cost recorded in the fixed asset register). (E, V&A)
Compare repairs and maintenance expense for the period with that of the prior period and against budget, and investigate any unexpected changes (or the absence of expected changes). (E, V&A)
Trace the actual costs of additions to the authorised or estimated amounts; investigate the reasons for any significant differences. (E, V&A)
Examine support for rentals under operating leases and for significant charges to repairs, maintenance and other expense accounts to determine if they should be capitalised as PPE. (E, V&A)
Inspect (sight) selected assets and trace them to the fixed asset register to determine that they were recorded. (E, C)
Verify the physical existence of recorded fixed assets by selecting items from the fixed asset register or from the schedule of additions for the year and inspecting (sighting) the assets. (E)
Vouch the payment made for the acquisition of the fixed asset to the supporting invoices. (V&A)
Consider the reasonableness of the quantities and the business purposes of the items purchased. (V&A)
Agree the details records of PPE and of the related depreciation, amortisation or impairment with the appropriate profit and loss accounts. (V&A)
Inspect the fixed assets register for evidence of mathematical accuracy of the fixed assets register. (V&A)
Trace postings of material additions and disposals to the payments transaction file. (CO, C, V&A)

10.5.3 Illustrative procedures for auditing property, plant and equipment

As previously discussed, there is an almost limitless number of substantive procedures that can be designed for the testing of account balances, in this case, PPE. Table 10.12 provides example substantive procedures when auditing PPE. Some of the procedures are typically always performed (irrespective of the risk assessment the auditor reaches for the significant account) while others are selected in response to the risk assessment to address any remaining detect risks that are still evident after controls testing has been performed.

TABLE 10.12 Example substantive tests of account balances — PPE

Example tests typically always performed
Examine invoices, capital expenditure authorisations, and other data supporting additions and disposals to PPE during the period. (E, V&A)
Review and, when appropriate, examine support for rentals under operating leases and for significant charges to repairs, maintenance and other expense accounts to determine if they should be capitalised as PPE. (V&A, C)
Recalculate computations of depreciation and amortisation to determine if acceptable methods and appropriate lives (or other bases for allocating costs) are being used, and if they are consistent with the methods and lives used in the prior period. (V&A)
Example analytical review procedures
Review the summary of PPE by classification and location that indicates acquisitions or disposals during the period; compare with the prior period and approved capital expenditure budgets. (C&U, V&A)
Review reasonableness of provision for depreciation by reference to prior year provision and the effects of additions and disposals. (V&A, CI, Accuracy of depreciation expense in income statement)

TABLE 10.12 (*continued*)

Example other general procedures
Re-perform calculations of capitalised interest to determine if the appropriate rates, amounts and capitalisation periods have been used. (V&A)
Determine the tax basis of accounting for PPE transactions and verify that any book-tax differences have been accounted for properly. (V&A)
Examine lease agreements to determine whether leases are appropriately classified as finance or operating; determine whether the proper accounting has been performed; determine whether appropriate disclosures have been made. (CI, C&U)
Review the PPE and related accounts in the general ledger for unusual items. (E, V&A)
Ascertain the business reasons for unusual additions or disposals. (V&A)
Inspect evidence of ownership (e.g. deeds, titles, registration papers) or rights to use the PPE (i.e. finance leases). Obtain direct confirmation of ownership if the deeds are held by a custodian. (R&O, E)
Review the minutes, agreements, legal filings and other documents (e.g. bank confirmations and loan agreements) for evidence of liens, pledges, security interests and restrictions on PPE. (R&O)
Review minutes, agreements, capital expenditure budgets and subsequent appropriations for evidence of plans of commitments for future additions, disposals or impairment (including finance leases). (V&A, C)
Physically sight assets. (E)
Inquire as to the existence of, and review detailed records for, major items of PPE that are not in service. Consider the likelihood that PPE will become idle in the foreseeable future (due to a significant drop in production, a change in product lines or technical obsolescence). (V&A)
Determine that PPE that is being held for sale or that is no longer being used is carried at the appropriate amount (fair value after any impairment amount has been recorded). (V&A)
If evidence indicates that the undepreciated cost of major facilities in service (i.e. being used and not held for sale) is not expected to be recovered, determine that such items have been written down to the appropriate amount. (V&A)

CLOUD 9

Ian and Suzie have already discussed their approach to PPE acquisitions and disposals, plus using analytical procedures for depreciation expense testing. Suzie reminds Ian that they need to design substantive procedures to assess asset values. Asset impairments must be recognised under the accounting standards (AASB 136/IAS 36), and the auditors will need to gather evidence about Cloud 9's processes for identifying and recognising asset impairments. Suzie will discuss with Sharon Gallagher, the audit manager, whether they need to obtain expert opinions on asset values.

PROFESSIONAL ENVIRONMENT

Reliability of asset revaluations

Valuation and allocation is a key assertion for PPE assets. When assets are carried at depreciated cost, auditing procedures focus on vouching the initial cost and re-performing depreciation calculations. However, if there is a question about the recoverable value of the asset or the asset has been revalued or carried at fair value instead of cost, the auditor needs to consider the reliability of the asset valuations.

In Australia, upward asset revaluations were very common before the introduction of IFRSs in 2005. The previous accounting standards allowed certain assets to be revalued to their fair value where this exceeded the carrying value based on historical cost. By contrast, upward asset revaluations were not permitted in the United States during this period. The US ban on upward revaluations (downward revaluations are common) is thought to be based on a concern that restated values are not reliable.

Cotter and Richardson examined the Australian data on asset revaluations from 1981 to 1999 to investigate the reliability of asset revaluations performed by independent valuers and company directors under the old accounting standards.[7] The evidence shows that independent valuers are more likely to be used to value property such as land and buildings, and directors are more likely to value investments, plant and equipment, and intangible assets. The authors believe that this pattern is explained by the fact that the values of investments, plant and equipment, and intangible assets are more dependent upon their specific characteristics and situation. This means that a valuer of these assets must have detailed knowledge of the specific circumstances of the current use of the asset. By contrast, land and buildings are widely traded and their values are less dependent on the specific characteristics of the current owner. As a result, directors of the company are more likely than external valuers to understand the value of the investments, plant and equipment, and intangible assets.

Cotter and Richardson also found evidence that where the directors of the company are less independent, they are more likely to use independent valuers to value all assets. Directors are more independent when they are not also executives of the company or associated companies. Cotter and Richardson's evidence implies that directors appear to be aware of the limitations caused by their lack of independence, and that external auditors require independent valuations to be provided in these cases. Finally, Cotter and Richardson found very little evidence of differences in reliability between the two types of valuations. This suggests that directors do not appear to bias their valuations, and that auditors are aware of the limitations of directors' valuations and ensure that they are sufficiently reliable. Overall, the evidence supports the view that directors do not, on average, abuse any flexibility in the system to overstate the value of assets when they perform a revaluation.

BEFORE YOU GO ON

- Name two assertions that are ordinarily significant for PPE and describe why they are important.
- What is the impact on the level of substantive audit procedures necessary for the cash receipts, cash payments and purchasing processes if controls are not tested and found to be effective?
- Describe two substantive audit procedures that are always performed for PPE.

10.6 Substantive testing of payables

LEARNING OBJECTIVE 10.6 Design and explain how to execute substantive procedures to address audit risk related to payables.

The key assertions for payables are completeness, and valuation and allocation. Completeness is critical because, as with any liability account balance, the risk is that the balance is understated. While auditing the balance recorded is relatively simple to do, the bigger risk is that the client has omitted amounts from the balance, and it is therefore understated because it is not complete. The typical procedures performed are often referred to as subsequent payments testing and cut-off testing to search for unrecorded payables.

Subsequent payments testing involves vouching a sample of payments made after year-end to supporting invoices to ensure that if the amount relates to invoices dated prior to year-end, they have been correctly included in payables at that date. If the amount paid relates to invoices after year-end, the testing is to ensure they have been correctly excluded from payables at year-end.

Cut-off testing involves selecting a sample of purchases either side of year-end and verifying that each has been correctly included or excluded from payables based on the invoice date. This testing involves testing a sample of invoices on hand but not yet processed by the client to ensure the client is not 'holding back' invoices that should be recorded in payables at year-end.

Existence and rights and obligations are not usually significant assertions for payables. It is highly unlikely that the client records payables that do not exist or that they do not have the obligation to pay. Classification is important only if there are related party transactions and balances, lease commitments, loan facilities, debt agreements or other forms of finance included within the payables balance.

Payables can include the account referred to as accruals. Accruals are those amounts that the client may not have received the invoice for but for which they know they have incurred an obligation to pay as at year-end. Accruals are tested in the same way as payables, that is, by subsequent payments testing. If the amount has not been paid prior to the audit testing being performed, another test to verify the amount as materially correct is to vouch the accrual amount to the invoices received.

10.6.1 Principal objectives in auditing payables

The principal objectives in auditing payables are described in table 10.13.

TABLE 10.13 Objectives in auditing payables

Objective	Assertion
All accounts payable on the balance sheet are real debts payable to suppliers or other creditors of the entity for goods received or services performed.	Existence (E)
All accounts payable owed by the entity at year-end are included on the balance sheet.	Completeness (C)
Accounts payable are stated at the amounts owed at year-end.	Valuation and allocation (V&A)
The accounts payable on the balance sheet represent obligations of the entity at year-end. The accounts payable are not secured by liens on assets, security interests or other collateral unless otherwise indicated.	Rights and obligations (R&O)
Accounts payable are properly classified, described and disclosed in the financial report, including the notes.	Classification (Cl), Classification and understandability (C&U)

10.6.2 Processes affecting payables

Table 10.14 illustrates procedures the auditor may perform during their testing of transactions related to payables. There are two important types of processes that affect the balance: cash payments and purchasing. These procedures would only be considered when the auditor has been unable to test and rely upon controls (controls are ineffective) or they have determined that it is more efficient to test the balance substantively.

TABLE 10.14 Example substantive tests of transactions — payables

Cash payments process	Purchasing process
Inspect cut-off of cash payments and transfers at year-end. (CO) Account for the numerical sequence of cheques issued during a specified period. (C, CO)	Vouch goods and services ordered (purchase orders) to vendors' invoices. (O) Vouch evidence of goods and services received to vendors' invoices. (O, A) Trace vendors' invoices to the initial record of entry (purchases transaction file). (C)

Cash payments process	Purchasing process
Trace paid cheques and supporting documents with the cash payments transaction file as to date, payee, amount and account classification; determine whether supporting documents have been marked to prevent reuse. (C) Vouch entries in the cash payments transaction file to the paid cheques and supporting documents as to date, payee, amount and account classification; determine whether supporting documents have been marked to prevent reuse. (O) Determine whether the signatures on paid cheques are authorised. (A) Examine payments of balances subsequent to year-end to verify recorded payables. (C) Inspect the account classifications of cash payments for reasonableness. (Cl)	Examine vendors' invoices, shipping documents or other documents supporting the account balances. (O) Vouch the creditors' transaction file to the vendors' invoices. (O) Trace vendors' invoices to purchase orders and purchase requisitions, shipping documents or evidence of receipt of services. (C) Recalculate the mathematical accuracy of invoices. (A) Review the accounts payable account in the general ledger for unusual items. (A) Review the creditors' transaction file and cash payments transaction file for unusual items; investigate any such items observed. (A) Trace the posting of individual purchases in the purchases transaction file to the creditors' transaction file as to the proper creditor, invoice number, date and amount. (C)
Trace the posting of individual cash payments from the cash payments transaction file to the appropriate accounts in the general ledger. (C) Check the mathematical accuracy of the cash payments transaction file. (A) Inspect the postings of the totals in the cash payments transaction file to the general ledger. (C)	Check the mathematical accuracy of the payments transaction file. (A) Compare the posting of the totals in the payments transaction file and creditors' transaction files. (C)

10.6.3 Illustrative procedures for auditing payables

There are many types of substantive procedures that can be designed for testing liability account balances. Table 10.15 provides example substantive procedures when auditing payables. Some of the procedures are typically always performed (irrespective of the risk assessment the auditor reaches for the significant account) while others are selected in response to the risk assessment to address any remaining detection risk that is still evident after controls testing has been performed.

TABLE 10.15 Example substantive tests of account balances — payables

Example tests always performed
Examine the client's bank reconciliations. When appropriate (e.g. to determine whether cash receipts or payments are recorded on a timely basis, or to verify the appropriateness of reconciling items) perform bank reconciliation cut-off procedures. (C)

TABLE 10.15 *(continued)*

Inspect the cut-off by inspecting the payments transaction file, receiving records, suppliers' invoices and other supporting documents immediately before and after the cut-off date and determine that the transactions were recorded in the proper period; compare payables cut-off to cut-off in related areas (e.g. inventory). (C, V&A)
Perform a search for unrecorded liabilities at the stocktake date and/or year-end by selecting subsequent payments, unpaid invoices and invoices on hand but not yet recorded in the transaction file. (C)
Example analytical review procedures
Compare the list of payables with the prior period and investigate any unexpected changes (e.g. changes in major suppliers, in the proportion of debit balances, in the ageing of the accounts) or the absence of expected changes. (C, V&A)
Compare the number of days' purchases in accounts payable with the prior year. (C, V&A)
Example other general procedures
Verify the reasonableness of the account classifications in the payments transaction file by comparing the nature of the goods or services purchased with the descriptions of the accounts. (V&A)
Trace the total of the detailed listing of accounts payable in the creditors' transaction file to the total in the general ledger. (C, V&A)
Identify security interests and assets pledged as collateral for accounts payable by confirmation with creditors and/or by inspecting public records and reviewing minutes and other documents. (R&O, C&U, V&A)
Obtain the listing of accounts payable and vouch the details to the purchase register, creditors' transaction file, creditor statements or other record of detailed accounts; investigate debit balances and other unusual items. (E)
Confirm accounts payable. (E)
Review debit memos and other similar adjustments after year-end. (C, V&A)

CLOUD 9

Ian and Suzie review their plans for substantive testing of liabilities. The controls testing over the payables process, including related cash payments, has revealed reasonably strong controls at Cloud 9. Once again, the dual testing conducted in this area has provided some substantive evidence about the balance of payables (including accruals). The scheduled analytical procedures are particularly useful for accruals, and also provide some evidence about loans (through analysis of interest expense).

The bank confirmations will provide additional evidence about the completeness assertion for liabilities (by potentially revealing information about other loans), and communication with Cloud 9's solicitors will provide evidence about any other undisclosed liabilities, including contingencies. The audit manager will read the company's significant contracts, and the audit senior will review the board meeting minutes for information that could relate to other obligations. Tests relating to warranty, loyalty program, and leave and other employee related provisions are already in the plan, and the hedge payable is the subject of separate tests.

Suzie and Ian include a final step in the substantive testing program for a senior member of the audit team to review the liabilities as a whole for any other issues, including significant disclosures required by the accounting standards.

BEFORE YOU GO ON

- Name two assertions that are ordinarily significant for payables and describe why they are important.
- What is the impact on the level of substantive audit procedures necessary for the cash payments and purchasing processes if controls are not tested and found to be effective?
- Describe two substantive audit procedures that are always performed for payables.

10.7 Special considerations for auditing other balance sheet accounts

LEARNING OBJECTIVE 10.7 Explain how substantive testing is used for other balance sheet accounts.

There are several other common balance sheet account balances that have not been specifically discussed in this chapter, such as prepayments, investments, intercompany, taxation, provisions, leases and equity. Each of these accounts is typically audited substantively (with limited or no controls testing) as they tend to be easier to audit substantively at year-end. For example, prepayments are audited by vouching the balance to the supporting invoices and ensuring the split between what has been expensed and what remains in the balance sheet is correctly calculated.

Investments are able to be vouched either to supporting external documentation, such as investment statements (from a bank), share prices per the stock exchange (for listed investments) or supporting financial reports (for investments in subsidiaries or associates). These sorts of investments (in subsidiaries) are also able to be supported by the testing performed on the subsidiary's trial balance (among other tests), and so may in fact be reliant on controls testing of the subsidiary.

Intercompany balances are vouched to the related entity or to intercompany confirmations. In addition, the auditor needs to ensure that the intercompany balances eliminate on consolidation appropriately.

Taxation balances are generally audited substantively due to the need to verify the underlying tax balance sheet (to determine the deferred tax balances as well as the provision to pay tax and the income tax expense). Also, due to the complexities of taxation law, it is common to have tax specialists as part of the audit team to assist in auditing tax calculations.

Provisions are difficult to audit via controls testing alone, and tend to be heavily reliant on transactions that are subject to management estimation processes. The only exception is payroll related provisions such as the provision for annual leave and long service leave. These balances are reliant on the routine transactions that the payroll system records, which then form the basis for the estimation process (calculation) performed to ensure the provision for leave entitlements is in accordance with the employment contracts, any relevant employment law and accounting standards.

Leases are either finance or operating leases. Finance leases are audited substantively by vouching the lease agreement terms (monthly payments, interest, term of the lease, balloon payments) to the calculation or spreadsheet that the client uses to calculate its finance lease liabilities and commitments. Other than the risk of misstatement, the other risk that the auditor focuses on is the split between current and non-current lease liabilities. Again, this information is obtained from the lease schedule and is easily verified to the terms of the lease agreement. Operating leases are those that are not 'on balance sheet'; instead, they typically relate to leased buildings or premises. This is currently a disclosure item only (not recognised on the balance sheet) and again is typically calculated by the client using a spreadsheet to record the number and amount of remaining lease payments. This is easily vouched to supporting operating lease documentation.

Equity typically does not move much in any given year as it comprises share capital (which only moves when shares are issued or cancelled) and retained earnings (last year's retained earnings plus the current year profit after income tax less any dividends and transfers). Retained earnings is a simple calculation and any shares issued or cancelled are able to be verified to the share register, cancelled share script or the deposit of capital for any new shares issued.

BEFORE YOU GO ON

- Name two types of balance sheet account balances that are typically audited fully substantively. Why is this approach taken?
- How are taxation balances usually audited? Why?
- How are leases usually audited? What (if any) differences are there in auditing finance versus operating leases?

10.8 Assessing the results of substantive procedures

LEARNING OBJECTIVE 10.8 Explain how to assess the results of substantive procedures to determine whether additional substantive tests are necessary.

When performing substantive procedures, the key objective is to determine whether there are material misstatements within the balance being investigated and to quantify the amount of any errors if they exist. When tests performed identify errors or exceptions, the first response is to understand why the exception or error has arisen. Unless the total error in the balance is able to be quantified without performing additional testing, an increase in the sample size may be required to provide additional assurance about quantity of the errors in the population. Additional testing (using the example substantive tests provided above) may also be an appropriate response to confirm and quantify the errors. It is important when errors are identified to continue testing until the error can either be accurately quantified or the balance has been fully tested to an extent that proves a material error can no longer exist within the balance. This concept will be discussed in more detail in chapter 12.

BEFORE YOU GO ON

- What is the key objective in performing substantive procedures?
- What is the first response when testing identifies errors or exceptions?
- Describe the consequences of finding errors or exceptions when performing substantive testing.

SUMMARY

10.1 Explain the relationship between the risk of material misstatement for a significant account and the extent and timing of substantive procedures.

The higher the overall risk of error or misstatement, the higher the level of substantive procedures required, assuming that no controls have been tested or are able to be relied upon. When controls are effective and the overall risk assessment is therefore lower, limited substantive testing is ordinarily required to be performed. The timing of substantive procedures is affected by the detection risk — the lower the detection risk the more work that needs to be done nearer to year-end.

10.2 Design and explain how to execute substantive procedures to address audit risk related to cash.

The most important audit assertions in the audit of cash are existence, completeness and classification. The transactions that form the basis of the cash balance are cash receipts and cash payments, and if controls are tested and found to be effective, it is unlikely that significant additional tests related to these transactions would be performed. The auditor would perform the minimum substantive tests for the cash balance at year-end.

10.3 Design and explain how to execute substantive procedures to address audit risk related to trade receivables.

The most important assertions for the audit of trade receivables are existence and valuation and allocation. Positive confirmations are usually used to test for existence, but they do not provide audit evidence as to the valuation and allocation assertion. Subsequent receipts are the most common procedure to test valuation and allocation, supplemented by analytical procedures such as comparing the ageing of trade receivables to the prior period. The three important transactions that affect the balance of trade receivables are sales, sales returns and allowances, and cash receipts.

10.4 Design and explain how to execute substantive procedures to address audit risk related to inventory.

The two key assertions for inventory are existence, and valuation and allocation. Testing of client stocktakes is an important procedure for gathering evidence about existence, and can help inform tests of valuation and allocation through observation of the condition of inventory. Rights and obligations can be an important assertion where specific rights are attached to the items. Inventory balances are affected by purchases, cash payments and inventory processes.

10.5 Design and explain how to execute substantive procedures to address audit risk related to property, plant and equipment.

Property, plant and equipment (PPE) is also known as fixed assets. Key assertions for PPE are existence, and valuation and allocation. The auditor usually tests for existence by sighting the physical assets and testing additions to and disposals from the fixed asset register. The auditor also considers whether management decisions have affected the values of PPE items. Analytical procedures are useful in testing depreciation expense and rights and obligations are usually tested by reviewing purchase or leasing documentation.

10.6 Design and explain how to execute substantive procedures to address audit risk related to payables.

The key assertions for payables are usually completeness, and valuation and allocation. Completeness is critical because the risk is that the balance is understated, so the auditor usually uses subsequent payments testing and cut-off testing to search for unrecorded payables. The transactions affecting the payables balance are cash payments and purchasing.

10.7 Explain how substantive testing is used for other balance sheet accounts.

Other balance sheet account balances include prepayments, investments, intercompany, taxation, provisions, leases and equity. It is usually easier to test these balances fully substantively, with limited or no controls testing.

10.8 Explain how to assess the results of substantive procedures to determine whether additional substantive tests are necessary.

When procedures performed identify errors or exceptions, it is important to continue testing until either the error can be accurately quantified or the balance has been fully tested to an extent that it proves a material error can no longer exist within the balance.

KEY TERMS

Analytical procedures Evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Audit risk The risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated.

Control risk The risk that a client's system of internal controls will not prevent or detect a material misstatement.

Detection risk The risk that the auditor's testing procedures will not be effective in detecting a material misstatement.

Inherent risk The susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming there are no related controls.

Liens Legal claims of one person upon the property of another person to secure the payment of a debt or the satisfaction of an obligation.

Pledge Something delivered as security for the payment of a debt or the fulfilment of a promise, which is forfeited if there is failure to pay or to fulfil the promise.

Professional judgement The auditor's professional characteristics such as their expertise, experience, knowledge and training.

Significant account An account or group of accounts that could contain material misstatements based upon their materiality and/or relationship to identified inherent and financial report risks.

Substantive procedures (substantive testing or **tests of details)** Audit procedures designed to detect material misstatements at the assertion level.

Tests of controls (controls testing) The audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

MULTIPLE-CHOICE QUESTIONS

10.1 The timing of substantive procedures is influenced by: **LO1**

(a) reviewing processes to generate estimates of provisions.
(b) work done to obtain an understanding of internal audit activities.
(c) interim reviews of activities such as monthly reviews of gross margins.
(d) all of the above.

10.2 A major assertion for the cash account is: **LO2**

(a) existence.
(b) classification.
(c) completeness.
(d) all of the above.

10.3 Valuation and allocation is a significant assertion for cash: **LO2**

(a) never.
(b) always.
(c) when the client has cash balances which are held in a foreign currency.
(d) none of the above.

10.4 Why does an auditor compare remittance advices or lists of cash receipts with entries in the cash receipts transaction file *and* compare entries in the cash receipts transaction file with the remittance advices or lists of cash receipts? **LO2**

(a) Because it gives junior staff training in comparing records.
(b) Because there are usually many thousands of cash receipts in a year.
(c) Because you can't test for existence unless you compare in both directions.
(d) Because the first provides evidence about the completeness of entries in the cash receipts transaction file and the second provides evidence about the existence of cash receipts transaction file entries.

10.5 A debtor's positive confirmation: **LO3**

(a) is not as useful as a negative confirmation.
(b) provides evidence that the debt will be collected.
(c) provides evidence about the existence of the debt.
(d) provides evidence about the classification assertion.

10.6 Auditing cash receipts: **LO3**

(a) can reveal cut-off problems.
(b) can provide evidence about the balance of debtors.
(c) could reveal unusual delays in posting credits to debtors accounts.
(d) all of the above.

10.7 Physical inspection of PPE: **LO5**

(a) provides positive evidence about rights and obligations of PPE.
(b) can reveal insights into whether there are damaged, obsolete, impaired or excess assets.
(c) is a useful technique to gather evidence about the completeness of PPE on the balance sheet.
(d) is always done for every asset every year because PPE is a very significant balance sheet account.

10.8 Additions and disposals of PPE: **LO5**

(a) are usually tested for cut-off.
(b) are usually minor amounts so are not audited.
(c) can be easily audited through analytical procedures so no other tests are required.
(d) none of the above.

10.9 Auditing payables usually focuses most heavily on: **LO6**

(a) existence.
(b) rights and obligations.
(c) existence, and rights and obligations.
(d) completeness, and valuation and allocation.

10.10 Subsequent payments testing is: **LO6**

(a) not required because the client would not pay an invoice that was not properly recorded.
(b) not required because the client would want to make sure that all payables are included as liabilities on the balance sheet.
(c) vouching a sample of payments made after year-end to supporting invoices to ensure that amounts related to invoices dated prior to year-end have been included in payables.
(d) vouching a sample of cash receipts received after year-end to supporting invoices to ensure that amounts related to invoices dated prior to year-end have been included in payables.

REVIEW QUESTIONS

10.11 Explain why an audit team cannot use the same combination of audit procedures for every audit. **LO1**

10.12 What does interim testing mean? Give some examples of substantive tests that can be done before the end of the year. **LO1**

10.13 How can an auditor use results from procedures performed during the control risk assessment phase to affect the nature of substantive testing? **LO1**

10.14 How does the result of controls testing affect auditing of the processes affecting cash and the substantive testing of the cash balance? **LO2**

10.15 How would an auditor test the cut-off of inventory movements at year-end? **LO4**

10.16 Explain the difference between year-end and cyclical stocktakes. What conditions should exist at a client that conducts cyclical stocktakes? **LO4**

10.17 Explain how subsequent receipts tests provide useful evidence about debtors' valuations. **LO4**

10.18 Why is an auditor interested in the repairs and maintenance expense account when auditing the PPE asset account? Explain your answer with reference to the assertions at risk. **LO5**

10.19 Why is an auditor interested in PPE that is not currently being used or could become idle in the near future? **LO5**

10.20 Why would an auditor review directors' board minutes to gather information about assets that could be sold or become idle in the future? **LO5**

10.21 Explain why completeness is a more critical assertion for liabilities than for assets. What procedures are primarily designed to address the completeness assertion for payables? **LO6**

10.22 Explain why gathering evidence about the occurrence assertion for a set of transactions could also provide evidence for the completeness assertion for a balance sheet account. Provide an example. **LO8**

10.23 Explain why provisions are difficult to audit by control testing. **LO7**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

10.24 BANK CONFIRMATIONS ★ **LO1, 2**

The following is a copy of the auditor's working paper for auditing cash at bank balances for the client New Millennium Ecoproducts. It shows the details of the bank confirmation requests.

Required

(a) Find the list of banks from which the auditor has sought bank confirmations. How many banks are listed?

(b) What information would be sought in a bank confirmation? Explain what assertion(s) are relevant to this test, and how the test provides evidence about the assertion(s).

(c) Have any errors or misstatements been revealed by the bank confirmations in this example?

CLIENT: New Millennium Ecoproducts Period-end: 31/12/17 Currency/unit: $000	**C01 – BANK CONFIRMATIONS**	EY Building a better working world **Reference** C01

Confirmation date:	31/12/17

Date 1st request sent:	15/12/17
Date 2nd request sent:	15/01/18

List here the bank accounts where confirmation has been sought

GL Account number	Bank account number	Bank name	TM/Ref	Account type	Balances confirmed?	Commitments confirmed?	Other information confirmed?[a]	TM/Ref	Comments
10100	1 254 895 545	Bendigo and Adelaide Bank	✓	Cheque	Yes	Yes	N/A	**CC01.1**	N/A
10200	5 559 831	Westpac	✓	Term Deposit	Yes	N/A	N/A	**CC01.2**	N/A
10300	8 574 658	National Australia Bank	✓	Cheque	Yes	N/A	N/A	**CC01.3**	N/A
10400	148 743 685	AMP Banking	✓	Cheque	Yes	Yes	N/A	**CC01.4**	N/A

[a] Including derivative products

Key to audit tickmarks:

✓ Agrees to list of bank accounts maintained by client

Comments:

10.25 ACCOUNTS RECEIVABLE CUT-OFF ★ **LO1, 2**

The following is a copy of the auditor's working paper for auditing accounts receivable balances for the client New Millennium Ecoproducts. It shows the details of the cut-off tests.

Required

(a) Find the details of the transactions selected for cut-off tests. Why would these transactions be selected for testing?
(b) Explain how the auditor has used documents to test the details of the transactions. Why are these documents relevant to the tests?
(c) Have any errors or misstatements been revealed by the cut-off tests in this example?

CLIENT: New Millennium Ecoproducts Period-end: 31/12/17 Currency/unit: $000	E04 – ACCOUNTS RECEIVABLE CUTOFF	EY Building a better working world **Reference** E04

1. *Comments relating our review of sales before and after year-end (client's analysis by week, day...)*

Reference of work done:	E04.1

Comments:
✓ No unusual transactions or peak in sales detected.

2. *Specific tests as per audit program*

Customer name	Invoice number	Date in AR ledger	Amount	TM/Ref	Delivery date	TM/Ref	Recorded in the proper period? Yes/No	Comments
Transactions recorded before year-end								
Brighter Bobs	785 553	29/12/2017	25 000	✓	29/12/2017	✗	Yes	
etc…								
Transactions recorded after year-end								
Grey Gums	854 321	01/05/2018	33 000	✓	01/04/2018	✗	Yes	
etc…								

Key to audit tickmarks:
✓ Agrees to invoice
✗ Agrees to shipping document

Comments:
✓ No errors detected

3. *Analytical procedures*

Reference of work done:	E04.2

Comments:
✓ No unusual transaction or peaks in sales detected.

10.26 INVENTORY VALUATION ★ **LO1, 4**

The following is a copy of the auditor's working paper for auditing inventory balances for the client New Millennium Ecoproducts. It shows the details of the net realisable value (NRV) tests.

Required

(a) Why does an auditor test for NRV when auditing inventory?
(b) Find the details of the inventory items selected for NRV testing. What is a 'key item'? Explain how the auditor has decided whether or not the inventory items should be shown at NRV or cost.
(c) Are any inventory items to be written down to NRV in this example? If so, by how much?

CLIENT: New Millennium Ecoproducts Period-end: 31/12/17 Currency/unit: $000	**F07 – NET REALISABLE VALUE TESTING**	**Reference** F07

				[A]	[B]	[B/A = C]		[D]	[E]		[D – E – C]			
Sample number	Item Code	Description	Category	Quantity in stock	Total stock value (Currency unit)	Unit price (Currency unit)	TM/Ref	Selling price per unit (Currency unit)	Distribution costs? (Currency unit)	TM/Ref	Variance	Allowance needed?	Amount (Currency 000)	Comments
Key item														
	700025	switches	Purchased goods	2000	10 000	5	**SL**	33	1	✓	27	No	–	
	etc…													
Representative sample														
1	701442	routers	Purchased goods	25	13 500	540	**SL**	420	1	✓	(121)	Yes	(3025)	**A**
3	800245	fuses	Purchased goods	440	7 000	16	**SL**	28	1	✓	11	No	–	
4	800347	covers	Purchased goods	288	4 200	15	**SL**	45	1	✓	29	No	–	
5	etc…													

Key to audit tickmarks:

✓ Agrees to supporting documentation — sales invoice post year end

✗ Obsolescence reserve is detailed as follows (refer to the review of inventory obsolescence reserve in F08 in GAMx):

Item	Value ($000)	
701442	3	**A**
233999	50	
234567	49	
987239	50	
Total	152	**F-Lead**

Comments:
✓ None (No error detected, exception noted was correctly provided for by the company.)

10.27 PPE ADDITIONS AND DISPOSALS ★ **LO1, 5**

The following is a copy of the auditor's working paper for auditing additions and disposals relevant to the balance of property plant and equipment (PPE) for the client New Millennium Ecoproducts.

CLIENT: New Millennium Ecoproducts Period-end: 31/12/17 Currency/unit: $000 Debit/<Credit>	**K02 – ADDITIONS AND DISPOSALS**	**Reference** K02

Section 1: Additions

Asset Code	Description	Category	Depreciation starting date	TM/Ref	Asset Life (years)	Amount	TM/Ref
700025	Delivery van (15)	Equipment	01/05/17	**c**	10	2750	✓
N/A	CPX 120	Asset under construction	N/A	**c**	N/A	500	✓

Section 2: Disposals

Asset Code	Description	Category	Gross Book Value	Accumulated Depreciation	Net Book Value	Selling Price	TM/Ref	Gain/ (Loss) on Disposal
600662	Delivery van	Equipment	420	280	1400	75		(65)

Key to audit tickmarks:

✓ Agrees to purchase invoice
✗ Agrees to sales invoice and receipt of payment
c OK depreciation starting date appears reasonable

Comments:
✓ No issue from testing of additions
✗ Loss on disposal of item tested is material and does not confirm relevance of depreciation rate used by company.

Required

(a) What assertions are relevant to (i) additions and (ii) disposals of PPE?
(b) Find the details of the additions. Explain the difference between the two items, particularly with respect to depreciation.
(c) Find the details of the disposal. How much was the gain or loss on sale? Why is the auditor interested in the amount of the gain or loss (explain the comment by the auditor about the disposal in the working paper)?

10.28 PAYABLES ★ **LO1, 5**

The following is a copy of the auditor's working paper for auditing accounts payable for the client New Millennium Ecoproducts.

Required

(a) Explain the nature of the test being documented in the working paper.
(b) Compare the information for the current year with the details for the prior year. Do you agree with the auditor's conclusion? Why?

CLIENT: New Millennium Ecoproducts Period-end: 31/12/17 Currency/unit: $000	**N – LEADS**	Building a better working world **Reference** N–Leads

Step 1: **Enter general information.**

CLIENT: New Millennium Ecoproducts
Period-end: 31/12/17
Currency/unit: $000

Step 2: **Lead schedules.**

Account no	Account Name	Pre-adjusted 31/12/2017	Adjustments	Year 31/12/2017		Interim	Prior Year 31/12/2016		Variance	In %	Tm/Ref
20100	Trade payables	–8000	—	–8000	TB		–6500	PY	–1500	23%	NO1
21100	Other payables	–1800	—	–1800	TB		–1600	PY	–200	13%	NO1
F-TOTAL	**TOTAL**	**–9800**	—	**–9800**		0	**–8100**		**–1700**	**21%**	

Step 3: **Account details, ratios, and KPIs**

	31/12/2017	31/12/2016
Average Payment Period = $\dfrac{\text{360 Days – Average A/P}}{\text{Annual Purchases of Goods and Services}}$	31 days	30 days

Expectations about account balances, ratios and KPIs:

✓ Due to the nature of the client's business and the stability of the primary markets in which it operates, we do not expect the accounts payables balance or creditors days to vary year on year.

Comments:

✓ Account details are consistent with previous period and in line with expectations.

10.29 DESIGNING AUDIT PROCEDURES FOR CASH ★ **LO1, 2**

Jackie is designing the audit program for cash for her client, Dexican Services Ltd (Dexican). Dexican is a property management services company. It deals with six major clients and several smaller clients, each with a number of properties for rent in the central business district of the city. Dexican finds tenants, conducts credit checks, negotiates tenancy agreements, and arranges cleaning and maintenance services for each property. Dexican has a staff of 15 and operates from an office in the city. Other than a small petty cash amount, no cash is kept on the premises because rents are directly deposited by the tenants to Dexican's bank account. After the relevant fees are deducted, Dexican remits the rents monthly to the property owners. These transactions pass through a bank account kept solely for this purpose. In addition, Dexican maintains a trust account (for any client moneys held on trust) and a general operating account (for salaries and other expenses).

Required

(a) Advise Jackie about the controls over cash that should be maintained by Dexican.

(b) Assuming these controls are present and operating effectively, suggest the appropriate substantive procedures for Dexican's cash balance.

10.30 VALUATION OF PPE, ADDITIONS AND DISPOSALS ★★ **LO1, 5**

Metalinc NL is a mining company based in Western Australia. Metalinc has 10 open-cut mines, most of which primarily extract iron ore. When the iron ore is extracted a small amount of other minerals is produced as a by-product. Iron ore is sold on forward contracts to companies in other countries. The ore is shipped, unprocessed, in bulk by ship with payment due when the ship leaves the Australian port. Other minerals are sold on the spot market to both domestic and overseas customers.

The world market for minerals is highly dependent on economic conditions. In addition, payment is made by the foreign companies in a foreign currency, usually US dollars. These conditions create major issues for Metalinc in both foreign exchange volatility (which is partially hedged) and sales revenue volatility. When conditions are very adverse, Metalinc 'mothballs' one or more of its mines. Mothballing is a process of closing down all operations except essential maintenance and safety operations; staff are dismissed or transferred to another mine if possible and machinery is left idle.

Machinery is not normally transferred between mines because of the great distances between the mines. This means that depreciation is calculated over the life of the mine if that is shorter than the usual life of the machinery. Some machinery is leased and other machinery is purchased outright. All purchase and disposal or scrapping decisions are made by the board of directors, although authority to make these decisions is granted to the mine manager for smaller value items in accordance with specified company policy.

Required

(a) Explain the implications of 'mothballing' for auditing PPE for mining companies.

(b) Design the audit procedures for PPE for Metalinc NL. Discuss the audit risks and their effect on your approach.

10.31 INVENTORY ★★ **LO1, 4**

Mighty Tools Hardware runs a network of small hardware retail outlets across the state. All sales are made for cash or on credit card and processed through electronic tills. A wide range of goods are stocked by the stores, meaning that the business deals with a large number of suppliers. All goods are purchased on credit with varying terms, depending on the supplier. Invoices are paid by cheque after a package of documents is collated and approved for payment. Ordering of goods and subsequent payments are processed by the central office with delivery direct from supplier to the stores — no central warehouse is used. Mighty Tools uses a perpetual stock system and conducts test counts at regular periods throughout the year.

Required

(a) What controls should exist for inventory movements at the local store level and the central office?

(b) Explain how the stocktake for Mighty Tools Hardware should be audited. What details are most important?

10.32 PAYABLES CUT-OFF TESTING ★★ **LO1, 6**

The accounts payable clerk at Ryan's Meats has been away sick for most of the last three months. During this time, the remaining staff in the accounts department have tried to cover for his absence, as well as continuing to do their own jobs. As a result of this disruption, the audit manager has assessed control risk as high for accounts payable and has adopted a predominantly substantive approach. He has decided to do extensive subsequent payments testing and cut-off testing.

Required

(a) Which assertions are most at risk for accounts payable at Ryan's Meats? Explain.

(b) What is 'subsequent payments' testing? How would you select the transactions to examine?

(c) How does cut-off testing differ from subsequent payments testing?

10.33 SUBSTANTIVE TESTING OF INVENTORY ★★ **LO1, 4**

MaxSecurity Limited (MaxSecurity) has been an audit client of Smith & Associates (S&A) for the past 15 years. MaxSecurity is based in Wollongong, where it manufactures high-tech armour-plated personnel carriers. MaxSecurity often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialised and MaxSecurity only does business with nations that have a recognised, democratically elected government. MaxSecurity maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

In September 2016, MaxSecurity installed an off-the-shelf costing system to support the highly sophisticated and cost-sensitive nature of its product designs. The new system replaced a system that had been developed in-house as the old system could no longer keep up with the complex and detailed manufacturing costing process that provides tender costings. The old system also had difficulty with the company's broader reporting requirements.

The manufacturing costing system uses all of the manufacturing unit inputs to calculate and produce a database of all product costs and recommended sales prices. It also integrates with the general ledger each time there are product inventory movements such as purchases, sales, wastage and damaged stock losses.

MaxSecurity's end of financial year is 30 June.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

Required

(a) What inventory items would you expect to see in MaxSecurity's accounts? How would the cost of each item be calculated?

(b) Suggest some substantive procedures that you would use in the audit of inventory for MaxSecurity. Justify your choices with respect to the risk assessment.

10.34 SUBSTANTIVE TESTING OF PPE ★★ **LO1, 2**

Flinders Ltd has been a client of MRG Partners for many years. You are an audit senior and have been assigned to the Flinders audit for the first time for the financial year end 30 June 2017. During March 2017 you are completing the risk assessment for PPE, which is one of Flinders' most material accounts. You are also aware that Flinders has made a large investment in a new manufacturing process to place itself in a more competitive position. Your analytical procedures indicate an increase in acquisitions of PPE.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

Required

(a) What is the key assertion at risk for the PPE additions? Why is it at risk? Explain.
(b) Identify the relevant substantive tests of details that would be appropriate to address the assertion at risk identified in (a) above.
(c) How would your answers to the previous questions change if the PPE additions have been manufactured in-house by Flinders' engineers and toolmakers, rather than purchased?

10.35 DEBTORS CONFIRMATION ★★★ **LO1, 3**

Albert Enterprises (Albert) is a large importer of goods from China. Albert deals with thousands of suppliers in China and sells the goods to discount stores in Australia. The discount stores include some of the major department store retailers, franchise 'Lo-Cost' chains and independent newsagencies and variety stores. The focus of the business is on cheap, mass-produced items that sell from less than a dollar up to around \$50. Both Albert and the discount retailers operate on a business model of high volumes and low margins. The discount stores sell for cash or on credit card only, but Albert trades on credit. In the past, Albert tried to protect its cash flow by requiring a security deposit from the smaller retailers and refusing to advance credit until a satisfactory credit check was performed on each retailer. In addition, terms of payment were seven days, which meant that the retailer had to pay almost immediately the goods were received.

Albert has faced increasingly stiff competition over the last two years. Some of the Chinese suppliers are negotiating better deals with Albert's competitors, and retailers are also starting to use more than one importer. In an effort to retain business, Albert's management has decided to relax credit terms for retailers. Six months ago, the terms of payment were renegotiated with all larger retailers and some smaller retailers from 7 days to 30 days. In addition, security deposits are no longer required from smaller retailers, although credit checks are still performed.

Required

(a) Explain the potential impact of the change in credit terms on the accounts and the associated risk of material misstatement.
(b) What changes to the audit program for debtors would you recommend this year given the change in credit terms?
(c) How would you select a sample of Albert's debtors for debtors' confirmation letters?

10.36 ACCOUNTS RECEIVABLE TRANSACTION FILE ★★★ **LO1, 3, 8**

Victoria is managing the performance of audit procedures on the trade receivables transaction file. Her main focus is the posting of entries for sales and sales returns to the control account and the individual debtors' accounts. The members of her team have each been given specific tasks which are detailed in the audit program. A predominantly substantive approach is being taken to the audit of trade receivables for this client because, although controls at the company are generally good, the trade receivables area is not significant enough to justify extensive controls testing.

Due to staff shortages this year, Victoria has been assigned a group of inexperienced audit assistants. Therefore, she has to be very careful when evaluating the results of the testing. In some cases, the working papers are not completed with sufficient detail, and in others she has to ask the audit assistants to redo the work.

Required

(a) Help Victoria explain to her audit assistants the reasons why they must account for the numerical sequence of sales invoices, credit (sales returns) memos, sales orders and shipping documents.
(b) One of the audit assistants is checking credit memos. The task is to compare the credit memo and supporting documents with the entries to debtors for sales returns and allowances as to dates, customers, products, quantities, prices and amounts. He checks all memos with dates of up to and including 30 June (year-end) and reports that he finds nothing unusual. Why would Victoria send the assistant back to examine credit memos with July dates? Explain.

(c) Why is it important for Victoria to undertake some procedures herself, such as reviewing the accounts for unusual items, instead of assigning the tasks to the assistants? What types of things would she be looking for when performing these procedures? What other procedures would be best performed by a more senior auditor?

Questions 10.37 and 10.38 are based on the following case.

Chan and Partners Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year, Fellowes and Associates gained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home
- Total Cancer Specialists Limited (TCSL), a private oncology clinic that specialises in the treatment of cancer.

Year-end for all MSHG entities is 30 June.

You are performing the audit field work for the 2017 year for Shady Oaks Hospital. The field work must be completed in time for the audit report to be signed on 21 August 2017. You have been asked to circulate the debtors' confirmations. Shady Oaks Hospital's trade receivables arise from the use of hospital facilities (including the provision of nurses, anaesthetists, operating theatres and supplies) by medical practitioners in private practice. The trade receivables balance was \$3 974 569 as at 30 June 2017 and was considered material.

The hospital's payment terms are 14 days from the date of the invoice. Sixty per cent of the balance is represented by invoices outstanding from five different medical practitioners. The remaining 40 per cent is made up of numerous smaller amounts, most of which have been outstanding for more than 60 days. Any allowance for doubtful debts is taken directly against the trade receivables account and not shown separately.

Source: Adapted from the CA Program's *Audit & assurance exam,* December 2008 and March 2009.

10.37 DEBTORS' CONFIRMATIONS ★★★ — LO2, 3, 4

(a) Explain how you would select the sample of debtors for confirmation.

(b) Only one in four of the debtors' confirmations are returned. Explain the additional audit procedures you could carry out in order to provide sufficient appropriate audit evidence on the trade receivables balance for the existence assertion.

10.38 PAYABLES' CONFIRMATIONS ★★★ — LO1, 2, 7

Assume that you are completing field work on payables for Shady Oaks. The payables relate to purchases of medical and catering supplies, employee related provisions, other accruals, and loans from banks and directors. Each account is individually material.

(a) Would you use payables' confirmations? Explain.

(b) Provide a list of substantive procedures that would address the completeness and valuation assertions for each account.

CASE STUDY — CLOUD 9

Answer the following questions based on the information presented for Cloud 9 in the appendix to this text and the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

Required

(a) Based on your conclusions from the case study questions in previous chapters (particularly chapters 4, 8 and 9), complete the worksheet following to determine the overall risk assessment and the acceptable detection risk.

(b) Based on your overall risk assessment and detection risk estimates, design substantive audit procedures for Cloud 9 Pty Ltd that would address the detection risk for the accounts: trade

(*continued*)

receivables (do not include the allowance for doubtful debts) and cash. When determining testing thresholds for your detail procedures, consider using a percentage of planning materiality that best reflects the relationship to the detection risk; that is if detection risk is high, the percentage of planning materiality should be high.

Account assertion	Inherent risk	Control risk	Overall risk assessment	Detection risk
Trade receivables — existence				
Trade receivables — completeness				
Cash — existence				
Cash — completeness				

RESEARCH QUESTION

Management applies accounting standards in the preparation of financial reports and auditors assess the fair application of those accounting standards. During 2008 and 2009, several changes were made to the IFRSs, which affected the use of fair value for certain assets and liabilities.[8]

Required

Discuss the implications for auditors of these accounting standard changes and the associated questioning of the use of fair values in financial accounting. In particular, you should address the following issues in your answer:

- How do auditors audit fair values?
- Would it be easier for auditors if financial reports contained more or less fair value accounting?
- Are there different implications for auditors when fair values are rising versus when they are falling?

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. d, 2. d, 3. c, 4. d, 5. c, 6. d, 7. b, 8. a, 9. d, 10. c.

NOTES

1. Eichenwald, K 2002, 'For WorldCom, acquisitions were behind its rise and fall', *The New York Times*, 8 August, www.nytimes.com.
2. ibid.
3. American Institute of Certified Public Accountants (AICPA) & Association of Certified Fraud Examiners (ACFE) 2009, *Fraud and the tone at the top* (video), www.acfe.com.
4. ibid.
5. ibid.
6. Pelliam, S & Solomon, D 2002, 'Uncooking the books: how three unlikely sleuths discovered fraud at WorldCom', *The Wall Street Journal*, 30 October.
7. Cotter, J & Richardson, S 2002, 'Reliability of asset revaluations: the impact of appraiser independence', *Review of Accounting Studies,* vol. 7, no. 4, December, pp. 435–57.
8. Gettler, L 2009, 'Standard setters rendered toothless by G20', *The Age*, 15 April, www.theage.com.au; Kessler, G 2008, 'Accounting standards wilt under pressure', *The Washington Post*, 27 December, www.washingtonpost.com; Patterson, C 2009, 'Tweedie: IASB yielded to political pressures', www.nysscpa.org.

ACKNOWLEDGEMENTS

Professional application questions 10.24–28: © EY Australia.

CHAPTER 11

Substantive testing and income statement accounts

LEARNING OBJECTIVES

After studying this chapter you should be able to:

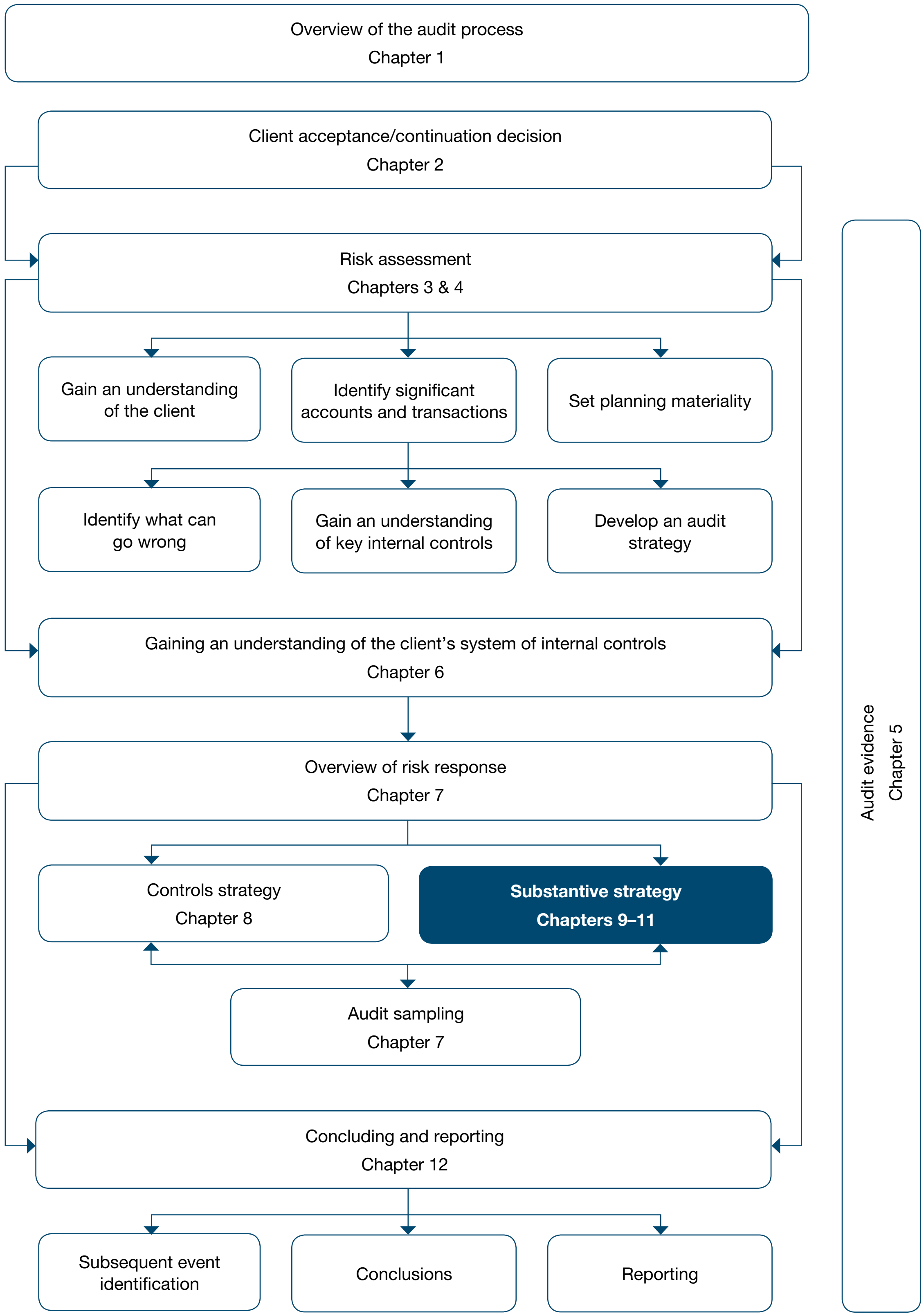
11.1 explain the relationship between the overall risk assessment for a significant account and the extent and timing of substantive procedures, and the differences between auditing income statement and balance sheet accounts

11.2 design and explain how to execute substantive procedures to address audit risk related to revenue

11.3 design and explain how to execute substantive procedures to address audit risk related to cost of sales and other significant expenses

11.4 explain how to assess the results of the substantive procedures to determine whether additional substantive tests are necessary.

AUDITING AND ASSURANCE STANDARDS	
AUSTRALIAN	**INTERNATIONAL**
ASA 330 *The Auditor's Responses to Assessed Risks*	ISA 330 *The Auditor's Responses to Assessed Risks*
ASA 500 *Audit Evidence*	ISA 500 *Audit Evidence*
ASA 520 *Analytical Procedures*	ISA 520 *Analytical Procedures*
ASA 530 *Audit Sampling*	ISA 530 *Audit Sampling*
AASB 138 *Intangible Assets*	IAS 38 *Intangible Assets*


Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client's system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

Suzie Pickering and Ian Harper are continuing their work on the audit program for Cloud 9 Pty Ltd (Cloud 9). The audit program contains the detailed audit procedures that will be completed during the remainder of the fieldwork on the audit. So far they have considered the analytical procedures and other substantive tests for the main asset and liability accounts.

Ian is a bit disappointed that Suzie does not want to rely extensively on analytical procedures when testing the asset and liability accounts, although they are definitely included in the audit program. However, eventually she convinces him that they need to vouch certain asset and liability balances and transactions back to the supporting documentation, as well as do some testing where they trace the documents to the balances and transactions.

'How do you think substantive testing for the revenue and expense accounts differs from the testing for assets and liabilities?' Suzie asks Ian. 'What factors do we have to consider for our audit program at Cloud 9 for these accounts?'

Audit process in focus

As discussed in chapter 10, finding an appropriate combination of audit procedures to cover an engagement's audit risk at an acceptable cost is a challenge for audit teams. This chapter illustrates the differences between substantively auditing balance sheet accounts and income statement accounts. This chapter will also describe the objectives of substantive testing for income statement account balances (including a brief reminder of the factors that affect the nature, timing and extent of procedures), the processes that have an impact on certain significant accounts in the income statement and example procedures for auditing these significant accounts.

This chapter will also illustrate (similarly to chapter 10) how the nature of substantive procedures is often the same for each significant account or disclosure, irrespective of the type of business being audited. It is instead the timing and extent of testing that are tailored to each client's circumstances.

11.1 Relationship between risk assessment and substantive procedures

LEARNING OBJECTIVE 11.1 Explain the relationship between the overall risk assessment for a significant account and the extent and timing of substantive procedures, and the differences between auditing income statement and balance sheet accounts.

This section discusses the extent, timing and other matters to consider when designing **substantive procedures** (also called **substantive testing** or **tests of details**) to detect material misstatements at the assertion level.

11.1.1 Differences between auditing income statement and balance sheet accounts

Typically, substantive procedures for balance sheet accounts, as outlined in chapter 10, include the use of confirmations, vouching of balances back to third-party supporting evidence, and tests for completeness and cut-off of the balances either side of year-end. Many significant accounts in the balance sheet are typically made up of a portion of the income statement transactions, or are one-off transactions within the balance sheet only. For example, a loan balance is ordinarily a one-off transaction where cash was received and a loan payable was created (a balance sheet only transaction). For trade receivables, payables and inventory balances, the account is typically made up of the last 30 to 60 days of sales (trade receivables), purchases (payables and inventory) and expenses (payables).

In contrast, income statement accounts reflect the entire reporting period's transactions (typically 12 months). Therefore, testing the balance sheet substantively will not provide much assurance on the income statement accounts. For example, testing trade receivables at year-end will only give assurance over the last 30 to 60 days of credit sales transactions captured in sales revenue (assuming cash is recovered within 30 to 60 days of sales being recorded). That is, additional testing needs to be performed to ensure that the other 305 to 335 days of transactions that have been captured in sales revenue are complete and accurate, relate to transactions that occurred, have been recorded in the correct period and are classified correctly within the financial report.

It therefore follows that the nature of the tests required to audit income statement accounts is different to those required to audit balance sheet accounts. Instead of using techniques such as confirmations, the auditor will ordinarily use substantive **analytical procedures** (as per ASA 520 (ISA 520) *Analytical Procedures*) coupled with tests of details (such as vouching back to supporting documentation) and verification of expense classification. These analytical procedures allow techniques such as trend analysis and the analysis of relationships compared to expectations to be used to obtain audit assurance over 12 months of transaction flows.

As explained in chapter 10, there are certain substantive procedures that are required to be performed for each material class of transactions, account balance and disclosure (particularly for balance sheet accounts such as trade receivables and inventory). These procedures are required irrespective of the assessed risks of material misstatement or the effectiveness of the control environment (ASA 330 (ISA 330) *The Auditor's Responses to Assessed Risks*). These required procedures are not discussed extensively in this chapter as there are very few required procedures for income statement account balances.

11.1.2 Extent of substantive procedures

As discussed in chapter 10, the extent of substantive procedures is determined primarily in response to the risk assessment for each **significant account** determined by the **audit risk** model formula in figure 11.1.

$$AR = f(IR, CR, DR)$$

where:

AR = Audit risk

IR = Inherent risk

CR = Control risk

DR = Detection risk

FIGURE 11.1 Audit risk model

When the **inherent risk** and **control risk** assessment, or risk of material misstatement, is high, there are no controls tested or relied upon and therefore the amount of substantive testing required to reduce the detection risk to an acceptable level is significant. When the inherent and control risk assessment is low, there are lots of controls that have been tested and found to be effective, therefore allowing reliance to be placed on them to ensure that material misstatements do not occur. Therefore, the level of substantive procedures required to address any remaining **detection risk** is limited. It follows that when the inherent and control risk assessment is medium, there is some audit evidence obtained from **tests of controls** (or **controls testing**) and some from substantive testing.

11.1.3 Timing of substantive procedures

As illustrated in chapter 10, the timing of substantive testing is dependent on the risk assessment of the significant account in question. Apart from the risk assessment of the significant account, there are additional opportunities for influencing the timing of the work performed. These include performing procedures on events that have occurred prior to year-end, performing procedures on activities in the period to date, performing general audit procedures prior to year-end and leveraging off internal audit.

CLOUD 9

Suzie explains to Ian that it is easier to understand financial report auditing if you remember the relationship between transactions and account balances. An account balance is the result of the transactions that have been posted to that account. Assets and liabilities are 'permanent' accounts and revenues and expenses are 'temporary'. This means that asset and liability balances reflect transactions over the life of the account, which could be many accounting periods. However, revenue and expense balances only reflect transactions for the current financial period because they are closed at the end of each year. The work you do auditing the balance of an asset and liability account in one year carries through to the next year. In some cases, an asset or liability balance does not even change during the current year; in this case, the auditor concentrates on substantiating the lack of change. In other cases, there are transactions to substantiate.

The other distinguishing feature of most revenue and expense accounts compared to balance sheet accounts is that they have only one type of transaction posted to them. Some revenue and expense accounts, such as sales and purchases, contain many (perhaps millions) of transactions of the same type. The client usually has good controls over these repetitive transactions, and so we can increase our reliance on controls testing for this part of the audit.

'The good news', she tells Ian, 'is that you can rely extensively on analytical procedures for revenues and expenses if the initial risk assessments suggests, and controls testing provides evidence to support, low inherent and control risk. We use tests of details to supplement the analytical procedures where the risk of material misstatement is higher.'

BEFORE YOU GO ON

- Describe why substantively auditing balance sheet accounts is different to auditing income statement accounts.
- Other than the nature of the test, what else affects the substantive procedures that are designed by auditors?
- According to the audit risk model, when is some audit evidence obtained from tests of controls and some from substantive testing?

11.2 Substantive testing of revenue

LEARNING OBJECTIVE 11.2 Design and explain how to execute substantive procedures to address audit risk related to revenue.

Sales revenue is generally a significant account for an entity (unless it is, for example, a start-up company or a junior explorer in the mining industry). Sales revenue is typically significant due to its size (material), the volume of transactions that flow through the account (high) and the overall high inherent risk associated with revenue. In particular, there is a risk of manipulation of sales revenue (through the use of journals) and of fraud due to the focus that most organisations place on results. That is, an easy way to meet profit targets expected by shareholders, for example, is to manipulate (usually increase) revenue. Because of this increased risk, auditors will either audit the account balance by using only substantive testing techniques (such as tests of details and sophisticated analytical procedures) or by using a controls testing approach supplemented with some substantive procedures including analytical procedures (such as comparing last year's sales revenue by month to the current year's sales revenue and budgeted sales revenue).

There are three audit assertions that are important to ensure the auditor has gained sufficient and appropriate audit evidence for sales revenue. Firstly, occurrence of the sales is important. Testing needs to ensure that the sales recorded in the general ledger are in fact bona fide sales and have 'occurred'. The second significant assertion is accuracy. Substantive tests focus on ensuring that the sales have been recorded at the correct amount (or value) and have not been overstated. The third significant assertion is cut-off. Cut-off is important because there is a risk that an entity will record sales that occur after year-end in the year being audited. The pressure to achieve sales targets and budgets can lead to companies recording sales that occur after year-end in the results prior to year-end. As a result, procedures are designed to test material transactions either side of year-end or all sales in the last period before year-end to ensure that all sales are recorded in the correct period. A simple way of testing which period a sale should be recorded in is to vouch the sale to the delivery documentation for the sale of goods. If the delivery date (out of the client's warehouse and to the customer) is before year-end, it should be included in sales. If the delivery occurred after year-end, it is unlikely it should be recorded as a sale. It is important to understand the client's billing/sales revenue process, as this will influence the testing performed for cut-off and provide an expectation of when sales transactions should be recorded in the trade receivables and sales transaction files. Refer to the professional environment vignette 'How to cheat with revenue' in this chapter for further discussion.

Completeness is generally not a significant assertion as the risk with sales revenue is that the client has overstated the balance. Completeness testing focuses on ensuring all sales revenue that occurred has been recorded to ensure sales revenue has not been understated. Understatement of sales revenue is not a risk for most clients; however, in certain industries and circumstances, this may be a key concern, and may therefore require substantive procedures to be developed to address this risk. For example, sometimes entities that have already achieved their budgeted results (and therefore may have earned substantial bonuses) may defer the recognition of sales until after year-end to give them a 'head start' on meeting the following year's budgeted sales. In this instance, testing is performed to ensure revenue in the current year is not understated. During difficult economic times, however, this risk is low.

Total revenue in the income statement is made up of a number of items. Typically, the two significant revenue accounts are sales revenue (described above) and interest or dividend income (often referred to as 'other income'). When sales revenue is generated from selling services (as opposed to goods) the testing changes in that the auditor typically tests projects to deliver services that, as yet, may not have been fully delivered to the customer. Also, with these sorts of service contracts, progress billings are common, meaning the auditor needs to test that the percentage of completion for the project and the remaining costs to complete the project are accurate to ensure that the service (sales) revenue, related costs and resulting profit are correctly recognised in the right reporting period.

The substantive audit of interest income is performed by a recalculation of expected interest income based on the average cash balances for the year and interest rates in place for the past 12 months. This calculation is then compared to the actual interest income for any significant differences. If there are unexpected or significant differences between the expected interest income and the actual interest income, these are investigated to ensure the amount recorded is materially correct. Dividend income is tested by vouching the dividends back to dividend statements and the bank account (as a cash receipt if the dividend is received prior to year-end).

Other revenue accounts tend to be insignificant or immaterial and therefore only general analytical procedures are usually performed on these balances.

11.2.1 Principal objectives in auditing revenue

The principal objectives in auditing revenue are described in table 11.1.

As described in chapter 10, the classification (Cl) assertion and the classification and understandability (C&U) assertion are different. Classification relates to transactions and events that occur throughout the year (that is, how they are recorded in the income statement and whether they are in the right expense account). Classification and understandability relates to presentation and disclosure in the financial report.

TABLE 11.1 **Objectives in auditing revenue**

Objective	Assertion
All sales included in the income statement represent the exchange of goods or services with customers for cash or other consideration during the period. All other revenues included in the income statement for the period have accrued to the entity at year-end. Revenues applicable for future periods have been deferred.	Occurrence (O)
All sales and other revenues that accrued to the entity during the period are included in the income statement.	Completeness (C)
Sales and other revenues are stated in the income statement at the appropriate amounts.	Accuracy and cut-off (A&CO)
Sales and other revenues are properly classified, described and disclosed in the financial report including the notes.	Classification (Cl), Classification and understandability (C&U)

11.2.2 Processes affecting sales revenue

Prior to performing tests of details or analytical procedures, the auditor should assess any audit evidence obtained from the testing they have performed at an interim stage on the significant processes and flows of transactions, including tests of controls.

Table 11.2 illustrates procedures that may be performed during testing of significant processes related to sales. The two significant accounting processes that affect the sales revenue balance are sales and sales returns and allowances. These procedures would only be considered when the auditor has been unable to test and rely upon controls (controls are ineffective) or has determined that it is more efficient to test the balance substantively. There are many tests that would need to be performed over a large proportion of the transactions flowing through these significant accounting processes if a fully substantive approach were to be taken to a particular account. It is therefore more efficient and effective to perform at least some controls testing if possible.

Note that each example substantive test illustrated in this chapter addresses a number of audit assertions. This is because many tests of transactions are designed to address multiple assertions in both the balance sheet and the income statement. Only key assertions addressed are specifically identified for the examples in this chapter.

TABLE 11.2 **Example substantive tests of transactions — sales**

Sales process	Sales returns and allowances (credit memos) process
Perform a proof of cash by reconciling the activity per the client records to activity per the bank. Correlate activity with the recorded sales for the year and the change in trade receivables balance. (Effectiveness of procedures is limited to less complex engagements.) (O, A) Trace the records of products ordered and shipped to the sales records. Agree dates, customers, products, quantities, prices and amounts. (C, A)	Trace credit memos and supporting documents to the sales returns and allowances transaction file as to dates, customers, products, quantities, prices and amounts. (C) Account for the numerical sequence of credit memos during a specified period. (C) Trace the posting of individual credit memos to the sales returns and allowances transaction file and to the trade receivables transaction file. (C, A)

TABLE 11.2 *(continued)*

Sales process	Sales returns and allowances (credit memos) process
Trace the posting of individual sales invoices to the sales transaction file and to the trade receivables transaction file. (C)	Trace credit memos to the documents supporting returns and allowances as to dates, customers, products, quantities, prices and amounts. (C, A)
Account for the numerical sequence of sales invoices, sales orders and shipping documents during a specific period. (C)	Inspect the authorisation of credits, discounts and allowances. (A)
Trace recorded sales to the records of products shipped. Agree dates, customers, products, quantities, prices and amounts. (O, A)	Recalculate the pricing and mathematical accuracy of credit memos. (A)
Investigate large or unusual credit memos issued subsequent to year-end. (O)	Test the cut-off in processing credits and allowances granted to customers. (CO)
Review the trade receivables, sales and returns and allowances accounts in the general ledger for unusual items. (A)	Test the timeliness with which credits granted to customers are processed. (A)
Review the sales transaction file, the sales returns and allowances transaction file and the cash receipts transaction file for unusual items. Investigate any such items observed. (A)	Test the accounting classification of credit memos. (Cl)
Test the pricing and mathematical accuracy of sales invoices. (A)	Test the mathematical accuracy of the sales returns and allowances transaction file. (A)
Test the accounting classification of sales transactions. (Cl)	Trace the postings of the totals in the sales returns and allowance transaction file to the general ledger and the trade receivables transaction file. (A)
Test the mathematical accuracy of the sales transaction file. (A)	Test and evaluate the procedures for approving customer credit and for collecting passed due accounts. (A)
Trace accounts receivable to the trade receivables transaction file (debtors' trial balance). Investigate reconciling items. (C)	Test and evaluate the procedures for approving credit and allowances granted to customers. (A)
Trace the postings of the sales transaction file to the general ledger and the trade receivables transaction file. (C)	

E — existence; C — completeness; V&A — valuation and allocation; R&O — rights and obligations; CI — classification; C&U — classification and understandability; CO — cut-off; A — accuracy; O — occurrence

11.2.3 Illustrative procedures for auditing revenue

There is an almost limitless number of substantive procedures that can be designed for the testing of account balances. Table 11.3 illustrates example substantive procedures when substantively auditing sales revenue. Some of the procedures are typically always performed (irrespective of the risk assessment the auditor reaches for the significant account), while others are selected in response to the risk assessment to address any remaining detect risks that are still evident after controls testing has been performed.

TABLE 11.3 Example substantive procedures in auditing revenue

Example tests always performed
Compare the monthly income statements to budget and/or prior year and investigate any unexpected fluctuations or absence of expected fluctuations. (C, A, Cl)
Test the cut-off of revenues by inspecting the sales transaction file, billings, shipping documents and other supporting documents immediately before and after the cut-off date and determine that the transactions were recorded in the proper period. Compare the cut-offs of revenue with cut-offs in related areas, for example, accounts receivable and inventory. (CO)
Example analytical procedures
General Review the client's comparison of budgeted and actual revenues by month or by quarter. Corroborate some of the reasons identified by the client for important variations. Investigate any unexpected variations or the absence of expected variations that were not identified by the client. (C, A, Cl)
Sales Compare sales to the current year's budget and to the prior period's actual sales by product line or geographic area. (C, A, Cl)
Compare sales volume to industry output in total or by geographic area (if available). (C, A, Cl)
Compare gross profits with the prior period by product line or geographic area. Compare other operating relationships, both sales and cost of sales, to units shipped with prior periods. (C, A, Cl)
Compare sales for several days prior to and after year-end to the average daily sales for the year. (C, A, Cl)
Compare the current period's sales returns and the allowance for sales returns as percentages of sales by product line with prior period percentages. (A)
Compare the number and amounts of credits issued with those of prior periods. (A)
Review the relationships between sales and cost of sales such as gross margin analysis, comparison of standards and actual costs and reconciliation between cost of sales and outgoing shipments. (C, A, Cl)
Review the relationships between certain types of expenses and sales, for example, freight out to units billed and sales bonuses to sales. (A, Cl)
Other revenue Perform an overall test of revenue, for example, published fee rates for a school times the number of students by classification/year level. (A)
Perform an overall test of interest and dividend income on investments and receivables, for example, by multiplying the average amounts invested by interest rate or dividend yields. (A)
Sales Enquire about management, sales personnel or other parties who may be receiving products without billing or payment. (O, A)
Determine rights of return offered to customers under the terms of sale agreement or as a matter of practice. (O)
Other revenue Obtain detailed analysis of selected revenue accounts and trace the details to the source data. (Cl)
Review the marketable securities and related accounts, for example, interest and dividend income in the general ledger for unusual items. (A)
Recalculate accrued interest and interest earned during the period to average interest rates and cash balances. (A)
Verify interest and dividend income on marketable securities, investments and equity in earnings of investees by calculating interest earned or by referring to published records of dividend paid or to the financial report of investees. (A)

TABLE 11.3 (*continued*)

Inspect authorisations and other data supporting sales and other disposals of property, plant and equipment and recalculate the computations of the resulting gains and losses. (A)
Identify and examine items that may require a separate disclosure in the financial report, including the notes; for example, discontinued operations, segment information and gains or losses on foreign currency transactions. (C&U, V&A)
Review minutes, agreements, union contracts, budgets and plans for evidence of new sources of revenues that may have been earned. Investigate significant items noted. (C, Cl)

CLOUD 9

Ian reviews Cloud 9's trial balance to remind himself of the main revenue accounts. 'The most important revenue accounts are revenue — stores and revenue — wholesale. The stores revenue account is approximately 6 per cent of the wholesale revenue account for the nine months to September, which implies that wholesale revenue is the most crucial to substantiate. However, the stores revenue account is of special interest to the auditors this year because of the opening of new retail stores in Australia and New Zealand. It is possible that controls are not yet working fully in all locations. So this implies greater risk. Another interesting revenue account is the proceeds on disposals, which is over $1.5 million so far this year, but it was zero in the previous year. The remaining revenue accounts are small and include interest from banks, foreign currency gains and "other".'

Suzie agrees. She adds that other relevant key risk areas identified so far in the audit include whether wholesale sales are being billed correctly by the Swift inventory management system; pressure on management to meet increased revenue targets; effects on sales from establishing the loyalty program; and the change in the product mix (due to the introduction of work-boots products). She asks Ian to design the substantive audit procedures for revenue, with a particular focus on the occurrence and accuracy assertions (including a focus on cut-off), and document how each of the risk areas affects both the use of analytical procedures and tests of details.

PROFESSIONAL ENVIRONMENT

How to cheat with revenue

Companies can be tempted to use revenue inflating schemes when they are desperate to meet sales or profit targets. The schemes inflate the current period revenue and profit by bringing forward sales revenue that should be properly recognised in a future period, if at all. One version of these schemes, known as channel stuffing, occurs when the company ships goods to a buyer who is not ready for the purchase.[1] The selling company recognises a sale even though it does not have a valid purchase order from the buyer. Other variations of the schemes are 'parking' and 'bill-and-hold'. Parking occurs when goods are shifted at the end of the period to an intermediary who holds them. The selling company recognises revenue even though the intermediary is simply holding the goods for later return or sale. Bill-and-hold occurs when the sale is recognised even though the goods are still in the selling company's warehouse.

One company that was found to have overstated its profit by using a revenue inflating scheme is Sunbeam, a US appliance-making company. Sunbeam's reported profit for 1997 was a record-breaking US$189 million.[2] However, the US Securities and Exchange Commission (SEC) alleged that US$60 million of the profit was the result of accounting fraud, and Sunbeam was forced to restate its earnings from the fourth quarter of 1996 to the first quarter of 1998.[3] The alleged fraud involved moving merchandise from the company to distributors and retailers, using discounts and other inducements. The problem was that the company appeared to have met its target sales, but the merchandise was either sold at a very heavy discount or likely to be returned to the company because of the terms of the sale.[4]

Other common types of revenue fraud include:

- recording revenue for multiple periods in the period the agreement is signed
- recording sales to customers which are unlikely to pass the credit checks and thus be able to pay for the goods
- recording sales prior to assembly of products
- recording sales for cancelled orders or twice for genuine orders
- overstating percentage of completion for products under construction.[5]

To detect channel stuffing, parking and bill-and-hold, auditors can investigate whether sales are initiated at the request of a customer, or initiated by the selling company. Also, auditors should consider whether a customer has a legitimate business reason for requesting delayed delivery and whether the seller has segregated the goods from other merchandise. Additionally, for these and other potential frauds, auditors can confirm details of contracts with customers, perform cut-off procedures, investigate unusual entries affecting sales, sales returns and discounts before and after the end of the period, investigate deferred revenue accounts and transactions, review credit memos after the year end, and compare sales by product line with prior periods. Attention to these and other tests will help auditors decide whether revenue occurred.

BEFORE YOU GO ON

- Name two assertions that are ordinarily significant for sales revenue and describe why they are important.
- What is the impact on the level of substantive audit procedures necessary for the sales revenue process if controls are not tested and found to be effective?
- Describe one substantive audit procedure typically performed for sales revenue.

11.3 Substantive testing of cost of sales and other significant expenses

LEARNING OBJECTIVE 11.3 Design and explain how to execute substantive procedures to address audit risk related to cost of sales and other significant expenses.

Cost of sales and expenses ('costs and expenses') are generally significant accounts in an entity's income statement and key audit assertions are accuracy, completeness and cut-off. Accuracy is verified by vouching recorded amounts to supporting (third-party) documentation (for example, supplier invoices) or by reference to the significant account that has determined the expense. For example, depreciation is tested as part of the testing of the valuation of property, plant and equipment in the balance sheet. Bad debts expense is ordinarily tested as part of the testing of the valuation of trade receivables. Opening stock is tested as part of inventory valuation testing in the prior year, purchases are tested as part of the testing of inventory and payables, and closing stock is tested as part of inventory valuation at year-end. Purchases tend to be the part of total cost of sales subject to additional testing over and above testing already performed as part of balance sheet testing. Purchases testing is performed most efficiently via the use of controls testing. When this testing is not able to be performed or relied upon, a large number of purchases are vouched back to supplier documentation unless other sophisticated or predictive analytical procedures can be used. For example, a cement supplier who purchases its raw materials (cement) at a contracted price is able to predict the total purchase amount for the year based on total tonnes of cement purchased and movements established in the inventory testing.

The other significant assertion is the combination of two assertions: completeness and cut-off. Completeness and cut-off are important to ensure that the client has not understated its costs and expenses by deferring costs into the period after year-end. There is often an incentive to reach a particular profit result for the period, which may lead to the recognition of purchases or expenses incurred before year-end being deferred to the post year-end period.

Classification may be important because of specific disclosure requirements related to certain costs and expenses. For example, depreciation; loss on sale of property, plant and equipment; superannuation costs; and interest expense (borrowing costs) are all required to be disclosed in accordance with International Financial Reporting Standards (IFRSs).

Occurrence is not typically a significant assertion as the primary objective in testing for occurrence is to ensure that costs and expenses are not overstated. It is unlikely for most entities that there is any incentive to overstate costs and expenses. Should the client, however, be in a situation where there is such an incentive, specific testing to address the risk of occurrence should be performed. Refer to the professional environment vignette ‘Four ways to cheat with expenses’ in this chapter for further discussion.

11.3.1 Principal objectives in auditing costs and expenses

The principal objectives in auditing costs and expenses are described in table 11.4.

TABLE 11.4 Objectives in auditing costs and expenses

Objective	Assertion
All costs and expenses in the income statement are properly supported as charges against the entity in the period. Costs and expenses applicable to future periods are carried forward as inventory, pre-paid expenses, deferred charges or property, plant and equipment.	Occurrence (O)
All costs related to the current period’s revenues and all expenses of the current period are included in the income statement.	Completeness (C)
Costs and expenses are stated in income statement at the appropriate amounts.	Accuracy and cut-off (A&CO)
Costs and expenses are properly classified, described and disclosed in the financial report, including the notes.	Classification (Cl), Classification and understandability (C&U)

11.3.2 Processes affecting costs and expenses

Table 11.5 illustrates procedures the auditor may perform during their testing of significant processes related to costs and expenses. In the case of costs and expenses, there are two important types of transactions that affect the costs and expenses balances: purchases and payroll. These procedures would only be considered when the auditors have been unable to test and rely upon controls (controls are ineffective) or have determined that it is more efficient to test the balance substantively.

TABLE 11.5 Example substantive test of transactions — cost and expenses

Purchases process	Payroll process
Confirm accounts payable (not often performed). (E, V&A) Test the cut-off by inspecting the purchases transaction file, stock receiving records, creditor/supplier invoices and other supporting documents immediately before and after the cut-off date and determine that the transactions were recorded in the proper period. Compare payables cut-off to cut-off in related areas, for example, accounts payable and inventory. (CO)	Compare the payroll at the beginning and end of the period to identify changes in employees and in pay rates. (A) Compare hours paid with the record of hours worked, for example, timecards. (A) Trace the payroll payments to the payroll clearing account. (O, A)

Purchases process	Payroll process
Perform a search for unrecorded liabilities as of the inventory date and/or year-end by selecting subsequent payments, unmatched invoices and stock receiving reports. (C)	Agree the record of hours charged, for example, timecards or job tickets to the payroll transaction file/payroll software used to record and calculate payroll. (C, A)
Trace supplier/creditor invoices to the initial record of entry. (C)	Obtain a list of employees who left during the period from a source other than the payroll department and determine that the former employees were removed from the payroll on a timely basis. (A)
Examine payments of balances subsequent to year-end to verify recorded payables. (C, CO)	Vouch employee data (e.g. name, identification number, department, employee status or group, location, wage rate and deductions) to authorisations on file (e.g. hiring records, personnel files on wage rates and reductions, union contracts and tax file number). (O, A)
Vouch entries in the payables transaction file to the supplier/creditor invoices. (O)	Compare the names, net pay and other data in the payroll transaction file to the amount paid in the pay run (which is then processed through the payroll clearing account). (E, A)
Confirm the account postings within the general ledger of purchases made by comparing the nature of the goods or services purchased with the description of the accounts and the account name that the transaction was posted to. (A, CI)	Recalculate the extensions of wage rates times the hours worked. (A)
Recalculate the mathematical accuracy of the payables transaction file. (A)	Review that the hours on the record of labour performed, for example, timecards, are recorded in the payroll transaction file in the correct period. (CO)
Vouch the posting of items in the payables transaction file to supporting documentation. (O)	Reconcile the accrued payroll balance to the amount in the payroll transaction file for the corresponding balance. (A)
Inspect the postings of the totals in the payables transaction file and trace them to the general ledger. (C)	Examine payments of accrued payroll liabilities and/or payroll disbursements subsequent to the end of the period. (C, CO)
	Inspect the postings of totals in the payroll transaction file and trace them to the general ledger. (C)

11.3.3 Illustrative procedures for auditing costs and expenses

There is an almost limitless number of substantive procedures that can be designed for the testing of account balances. Table 11.6 illustrates example substantive procedures when substantively auditing costs and expenses. Some of the procedures are typically always performed (irrespective of the risk assessment the auditor reaches for the significant account) while others are selected in response to the risk assessment to address any remaining detect risks that are still evident after controls testing has been performed.

TABLE 11.6 Example substantive tests of account balances — costs and expenses

Example tests always performed
Obtain detailed analysis of selected costs and expense accounts and vouch the details to the source data. (O, A)
Compare the current year's expenses to the prior year's actual and the current year's budgeted amount (in absolute dollars and/or as a percentage of sales). Investigate any unexpected changes or absence of expected changes. If expenses are audited at an interim date, review the roll-forward of activity from interim to year-end and compare it to the activity in the equivalent period of the prior year. Investigate any unexpected changes or the absence of expected changes. Consider the need to test interim transactions. (C, A, Cl)
Perform an overall test of payroll expense by comparing the average rates per employee or per hour by group to the prior year or to the union contract, analysing labour variances from standard costs and reviewing the number of employees and year-to-date listing of amount per employee. (C, A, Cl)
Example analytical procedures
Cost of sales Compare the current period's gross profit ratios by month, by location, by product and by geographic area with those of prior periods and with budgeted amounts. Investigate any large or unusual variations or the absence of expected variations. (C, A)
Review the relationship with respect to the flow of goods such as gross profit analysis, comparison of standard and actual costs, and the review of the reconciliation between cost of sales and shipments. (C, A)
Compare the relationships of materials cost, direct labour cost and overhead cost to the cost of sales with prior periods. Investigate significant fluctuations or the absence of expected fluctuations. (C, A)
Compare the relationship of overhead costs in cost of sales to direct labour, hours and/or dollars with prior years. (C, A)
Compare units purchased to units sold. Investigate significant or unusual differences. Ensure that any differences noted are accounted for in the change in inventory during the year. (C, A)
Compare the relationship of direct labour costs to number of employees with prior periods. Investigate significant fluctuations. (C, A)
Compare average production and average compensation per employee with prior years. Investigate significant fluctuations or the absence of expected fluctuations. (C, A)
Expenses Review the client's comparison of budgeted and actual costs and expenses by month or by quarter. Corroborate the reasons identified by the client for important variations. Investigate any unexpected variations or the absence of expected variations not identified by the client. (C, A)
Compare royalty expenses with the related sales. (C, A)
Compare sales commissions or bonuses with the related sales. (C, A)
Compare the current period's relationship of administrative payroll to direct labour with prior years. Investigate any unexpected variations or the absence of expected variations. (C, A)
Compare the current period's relationship of employee benefits to payroll, hours worked or number of employees with prior years. Investigate any unexpected variations or the absence of expected variations. (C, A)
Compare the current period's relationship of superannuation contribution with prior years. Investigate any unexpected variations or the absence of expected variations. (C, A)
Compare the payroll tax expenses to the annual payroll times the statutory tax rate. (C, A)
Perform an overall test of interest expense by multiplying the average debt outstanding by the weighted average interest rate. (C, A)
Compare the current period's depreciation with the prior period and with budgeted amounts and with property, plant and equipment balances. (C, A)

Example other general procedures
Review interim financial reports and investigate fluctuations or the absence of expected changes. (C, A)
Review the expense accounts in the general ledger for unusual items. Investigate any such items observed. (O, C, A)
Review components of significant pre-paid and accrual accounts for reasonableness. If not significant, compare pre-paid expense and accrued liability balances with those of prior periods. Investigate significant fluctuations or the absence of expected fluctuations. (C, A)
Review minutes, agreements, union contracts, budgets and plans for evidence of new types of expenses that may have been incurred. Investigate significant items noted. (C, A)
Identify and examine items that may require separate disclosure in the financial reports including the notes, for example, discontinued operations and segment information. (C, A, Cl, C&U)
Review transaction vouchers on a sample basis for unusual items. Investigate any such items observed. (A)
Review the payables transaction file for unusual items. Investigate significant items noted. (A)
Review the allocation of expenses to cost centres for reasonableness. (A, Cl)
Trace a sample of sales transactions to corresponding commissions or other sales expenses. (A)

CLOUD 9

Ian is not sure how to start identifying the most significant expense accounts. He could rely on the trial balance to identify significant revenue accounts, but he is aware that the biggest risk with expenses is that they are understated on, or even omitted from, the trial balance. Suzie reminds him that the audit team has already done the planning at the entity level. As a part of this process, the team has identified the key risks, processes and accounts.

'For example, we know that certain types of expenses will be incurred by a business that imports, wholesales and retails footwear. Those accounts should be on the trial balance. Do the amounts look reasonable? Also, we know that the business has recently established several new stores, expanded its online supply chain, created new sponsorship programs and introduced new products. Are all those activities reflected in the accounts in the way we expect?'

Ian knows that the controls testing has already produced some evidence about expenses. He suggests they use analytical procedures to focus on the key relationships between the expense accounts and various activity measures (such as employees) and other accounts (such as sales). As part of the controls testing procedures, the audit assistants have vouched expenses, such as purchases, to the underlying documentation. He recommends they perform more tests of details of inventory movements around year-end to gather evidence about cut-off and completeness of expenses. In addition, they will substantiate cash payments during the period following year-end to identify unrecorded liabilities and expenses. Tracing payments to the transaction file posting will help substantiate classification, particularly for items such as maintenance, which is often misclassified as an asset. He also recommends that they include specific procedures wherever there are additional disclosure requirements, such as related party transactions.

PROFESSIONAL ENVIRONMENT

Four ways to cheat with expenses

'Cookie Jar Reserves' are reserves created in good years by debiting expenses and crediting a provision (usually shown as a liability). They reduce accounting profit in the first year and are available for covering up bad results in later years. In bad years, the entry is reversed with a debit to the provision and a credit to expenses. This entry increases accounting profit in the otherwise bad year, potentially avoiding awkward questions from analysts and other financial report users. Auditors need to be alert to overstated expenses to avoid the setting up of these so-called reserves — it is not always true that companies will try to understate expenses.

(*continued*)

Another problem of overstated expenses is 'Big Bath Accounting'. This variation usually occurs when new management takes over a company or when the company is being restructured. Some assets need to be impaired and/or losses recognised on asset disposals, so management take the opportunity to write down everything they can for as much as they can. Managers are motived to do this because investors will hear all the bad news at once, but in future periods lower depreciation expenses and impairment charges will cause profits to rise quickly. Once again, auditors need to test for the validity of expenses — not just assume that management will only ever try to understate them.

Another technique for creating the impression of good performance is to reclassify expenses. Company managers are aware that analysts do not just focus on the bottom line — they also analyse line items. For example, analysts are interested in managers' performance at trading merchandise for high mark-ups. Knowing this, a retailer might try to understate cost of sales by transferring some expenses into general administrative expenses. Reclassifying cost of sales expenses into other line items might get past an auditor because the item is still recorded in the right period for the right amount. Auditors need to be alert to account classification — not just the amount and date of the expense.

Finally, auditors need to pay attention to deferrals. When management claims that a debit should be recorded as an asset instead of as an expense, auditors should ask whether the accounting standard requirements have been met. For example, AASB 138 (IAS 38) *Intangible Assets* requires amounts spent on research to be expensed, and amounts spent on development to be deferred only if the tests about the generation of future economic benefits in the standard are met.

BEFORE YOU GO ON

- Name two assertions that are ordinarily significant for costs and expenses and describe why they are important.
- What is the impact on the level of substantive audit procedures necessary for the purchases process if controls are not tested and found to be effective?
- Describe two substantive audit procedures that are always performed for costs and expenses.

11.4 Assessing the results of substantive procedures

LEARNING OBJECTIVE 11.4 Explain how to assess the results of the substantive procedures to determine whether additional substantive tests are necessary.

In the above description of substantive tests available for ensuring costs and expenses are materially correct, the focus was on cost of sales (also referred to as cost of goods sold) and other significant expenses. As indicated, significant expenses are often those items that have specific disclosure requirements. There may be, however, significant costs or expense accounts other than those discussed in this chapter. These include administration costs, selling expenses, audit fees, advertising and marketing costs, and impairment charges, to name a few. It is important to ensure that appropriate substantive procedures are designed to test all significant accounts. The example substantive procedures in table 11.6 provide a good reference for designing the required procedures for other significant accounts. The nature of the testing is likely to be consistent with the above example procedures, and the auditor then uses their **professional judgement**, knowledge of the client and risk assessment for each significant account to determine the timing and extent of testing.

As noted in chapter 10, when performing substantive testing, the key objective is to determine whether there are material misstatements within the account balance and to quantify the amount of any misstatement if it exists. When tests performed identify errors or exceptions, the first response is to understand why the exception or error has arisen. It may require an increase in the sample size (as per ASA 530 (ISA 530) *Audit Sampling*) to ensure there are no other errors in the balance unless the total error in the balance is able to be quantified without performing additional testing (as per ASA 330 (ISA 330) and ASA 500 (ISA 500) *Audit Evidence*).

Additional testing (using the example substantive tests provided in this chapter) may also be an appropriate response to confirm and quantify the misstatement. This concept will be discussed in more detail in chapter 12.

CLOUD 9

Suzie is very happy with Ian's recommendations. They complete the audit program and send it to the audit manager, who reviews and approves it. Substantive testing begins and the results start to arrive. Suzie, Josh Thomas and Sharon Gallagher meet regularly to discuss progress and respond to the errors and exceptions as they arise. They also begin to prepare for the audit tasks that must be performed close to, or after, the client's year-end. The final phase of Cloud 9's audit is about to begin.

BEFORE YOU GO ON

- Provide three examples of costs or expenses that may be significant accounts in addition to cost of sales, purchases, depreciation and bad debts expense.
- What is the first response when testing identifies errors or exceptions?
- Describe the consequences of finding errors or exceptions when performing substantive testing.

SUMMARY

11.1 Explain the relationship between the overall risk assessment for a significant account and the extent and timing of substantive procedures, and the differences between auditing income statement and balance sheet accounts.

The higher the overall risk of error or misstatement, the higher the level of substantive procedures required, assuming that no controls have been tested or are able to be relied upon. When controls are effective and the overall risk assessment is therefore lower, limited substantive testing is ordinarily required to be performed. Revenue and expense account balances reflect the entire reporting period and auditors typically use substantive analytical procedures coupled with some tests of details.

11.2 Design and explain how to execute substantive procedures to address audit risk related to revenue.

Sales revenue is typically significant due to its size, volume of transactions and high inherent risk. The most important audit assertions for revenue are occurrence, accuracy and cut-off. The two significant accounting processes that have an impact on the sales revenue account balance are sales and sales returns and allowances. It is normally efficient and effective to perform at least some controls testing over these processes.

11.3 Design and explain how to execute substantive procedures to address audit risk related to cost of sales and other significant expenses.

Cost of sales and expenses are generally significant accounts and key audit assertions are accuracy, completeness and cut-off. Typical procedures include vouching recorded amounts to supporting documentation and testing of depreciation expense as part of the testing of property, plant and equipment on the balance sheet. Opening and closing stock are part of inventory testing. Purchases testing is most efficiently tested as part of controls testing. Incentives to achieve particular levels of profit could lead to the recognition of expenses incurred before year-end being deferred into the following period.

11.4 Explain how to assess the results of the substantive procedures to determine whether additional substantive tests are necessary.

When tests performed identify errors or exceptions, it is important to continue testing until the error can either be accurately quantified or the balance has been fully tested to an extent that it proves a material error can no longer exist within the balance.

KEY TERMS

Analytical procedures Evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Audit risk The risk that an auditor expresses an inappropriate audit opinion when a financial report is materially misstated.

Control risk The risk that a client's system of internal controls will not prevent or detect a material misstatement.

Detection risk The risk that the auditor's testing procedures will not be effective in detecting a material misstatement.

Inherent risk The susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming there are no related controls.

Professional judgement The auditor's professional characteristics such as their expertise, experience, knowledge and training.

Significant account An account or group of accounts that could contain material misstatements based upon their materiality and/or relationship to identified inherent and financial report risks.

Substantive procedures (substantive testing or **tests of details)** Audit procedures designed to detect material misstatements at the assertion level.

Tests of controls (controls testing) The audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

MULTIPLE-CHOICE QUESTIONS

11.1 A key difference between auditing balance sheet accounts and income statement accounts is that: **LO1**
(a) balance sheet accounts always have larger totals.
(b) balance sheet accounts are always more significant accounts.
(c) income statement accounts reflect only 12 months of transactions.
(d) income statement accounts rely on audit techniques such as confirmations.

11.2 Sales revenue is a significant account for any entity: **LO2**
(a) except for a start-up company.
(b) because of the overall inherent risk associated with revenue.
(c) because of the high volume of transactions that flow through the account.
(d) all of the above.

11.3 Delivery documentation for the sale of goods: **LO2**
(a) is important because it provides evidence supporting the date of sale.
(b) is not important to audit because the invoice date is always the correct date of sale.
(c) is important because it shows how hard the personnel in the warehouse are working.
(d) is not important because the only thing that matters is whether the debtor pays the account.

11.4 The important assertion(s) for revenue is (are): **LO2**
(a) occurrence because testing needs to ensure that recorded sales are genuine.
(b) never completeness because a company would never want to understate its revenue.
(c) completeness when there could be pressure to defer sales recognition to give the company a head start on meeting next year's target.
(d) both (a) and (c).

11.5 Classification is an important assertion for expenses because: **LO3**
(a) there is often an incentive to overstate expenses.
(b) vouching is a useful audit technique for expenses.
(c) auditing assets gives no evidence about certain expenses.
(d) some expenses are subject to specific disclosure requirements.

11.6 Comparing the relationship of overhead costs in cost of sales to direct labour is an example of which type of auditing technique? **LO3**
(a) Confirmation
(b) Analytical procedures
(c) Vouching to original documents
(d) Tracing posting of original documents to the transaction file

11.7 Which of the following accounts is not an expense account that is ordinarily tested as part of the testing of asset balances? **LO3**
(a) Purchases
(b) Interest received
(c) Bad debts expense
(d) Depreciation expense

11.8 Searching for unrecorded liabilities: **LO3**
(a) is a rarely performed audit procedure.
(b) is always performed by confirming accounts payable.
(c) can be done by examining subsequent payments or unmatched invoices.
(d) is part of testing the mathematical accuracy of the payables transaction file.

11.9 When testing payroll, the auditor: **LO3**
(a) does not examine overtime records as these are always insubstantial.
(b) reviews that the hours on timecards are recorded in the payroll transaction file in the correct period.
(c) uses only the number of employees at the end of the period as the predictor of total payroll expense.
(d) uses the list of employees who left during the period as recorded by the payroll department to check that former employees were removed from the payroll on a timely basis.

11.10 When an audit test reveals an error or exception the auditor should: **LO4**
(a) consider additional testing.
(b) consider increasing the sample size.
(c) try to understand why the error or exception has occurred.
(d) all of the above.

REVIEW QUESTIONS

11.11 How do the key differences between balance sheet accounts and income statement accounts affect the nature, timing and extent of substantive testing of each? **LO1**

11.12 What are the most important assertions for revenue? Do the important assertions differ between sales revenue and other types of revenue? Explain. **LO2**

11.13 Explain the techniques clients might deliberately use to violate the cut-off assertion because of pressure to meet sales targets. How might an auditor detect these actions? **LO2**

11.14 Why is substantive testing of the processes affecting sales revenue usually kept to a minimum? How does the auditor gain sufficient assurance about these processes? **LO2**

11.15 Auditors often use client budgets for revenue and expenses as part of their substantive testing. Explain how and why this is done. **LO2**

11.16 Do analytical procedures use only financial data based on transactions and balances for the current period? Explain using examples. **LO2**

11.17 Which assertions are violated if a client includes labour expense related to manufacturing processes as a general expense instead of as cost of inventory? **LO3**

11.18 Discuss the usefulness of examining subsequent payments as an evidence gathering technique. If an auditor were to use this technique, what would they be looking for? **LO3**

11.19 What is the purpose of examining the records of employees who left the client during the year? Where should the auditor obtain the information about departed employees? **LO3**

11.20 When would a client be more likely to (i) overstate or (ii) understate expenses? **LO3**

11.21 What is an unrecorded liability? Why would an auditor search for them? **LO3**

11.22 Explain the process of 'roll forward'. When is it used? **LO4**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

11.23 DEPRECIATION EXPENSE ★ **LO1, 3**

The following is a copy of the auditor's working paper relating to the testing of depreciation expense for the client New Millennium Ecoproducts.

CLIENT:	New Millennium Ecoproducts	**K04 – DEPRECIATION, DEPLETION AND AMORTISATION**	**Reference** K04
Period-end:	31/12/17		
Currency/unit:	$000		
	Debit/<Credit>		

Section 2: Perform analytical review procedures

Gross Book Values	**Buildings**	**TM/Ref**	**Equipment**	**TM/Ref**	**Total**	
Opening balances	10 000	**K-01**	12 000	**K-01**	22 000	
+ 1/2 Additions-Transfers	–		3 200		3 200	
– 1/2 Disposal	–		(200)		(200)	
– Assets fully depreciated at the beginning of the period	–		–		–	
Total	**10 000**		**15 000**		**25 000**	
Depreciation rate (years) per financial statements	10	✓	20	✓		
Depreciation rate	10%		5%			
Our estimated depreciation expense	**1 000**		**750**	**K-01**	**1 750**	
Actual depreciation expense	1 000	**K-01**	800	~~m~~	1 800	**K-01**
Difference	–		50		50	

Key to audit tickmarks:

✓ Agrees to notes to financial statements

~~m~~ Immaterial

Comments:

- As significant acquisitions were made at the beginning of the period, the depreciation expense is in line with expectations (unexplained difference with our rough estimate being not material).

Required

(a) The opening gross book value balances of the assets are carried forward from the prior period and reconciled to the general ledger (K-01). The auditor then adds half of the amount recorded as additions and subtracts half of the amount recorded as disposals in order to calculate the total balance to be multiplied by the depreciation rate. Why does the auditor use half of these values?

(b) The difference between the estimated depreciation expense and the actual depreciation expense is dismissed as immaterial. Explain why the auditor would reach that conclusion.

11.24 ROLL FORWARD PROCEDURES — ACCOUNTS RECEIVABLE ★ **LO1, 2**

The following is a copy of the auditor's working paper relating to the roll forward procedures for accounts receivable for the client New Millennium Ecoproducts.

CLIENT: New Millennium Ecoproducts Period-end: 31/12/17 Currency/unit: $000	**E03.1-ROLL FORWARD PROCEDURES (rely on controls)**	EY Building a better working world **Reference** E03.1

Additional items/transaction in the roll forward period selected for testing

Item/transaction selected for testing	Date	Amount	TM/Ref	Rationale for testing	Comments
Credit note 2648	01/11/2017	(500)	✓	unusual transaction	accrual for a credit note to customer Brighter Bobs because of defects found in goods supplied, refer invoice 785 553
Other adjustment 254	01/12/2017	250	✓	unusual transaction	reversal of the accrued credit notes as a result of final agreement with customer Grey Gums (A)

Key to audit tickmarks:
✓ agreed to voucher including authorisation from chief accountant
A OK amount corresponds to written agreement dated 12/01/2017

Required

(a) Why are roll forward procedures used when testing accounts receivable and revenue?
(b) The details of the test show that credit note 2648 was highlighted as an unusual transaction. The credit note was used as the basis for a credit to the accounts receivable for Brighter Bobs. Why is an auditor interested in credits to accounts receivable when testing revenue?

11.25 SALES CUT-OFF ★ **LO1, 2**

The following is a copy of the auditor's working paper relating to the cut-off procedures for inventory sales for the client New Millennium Ecoproducts.

Required

(a) Why is an auditor interested in whether inventory movements are recorded for the correct date?
(b) The test described in the working paper focuses on the date of the inventory stocktake and is used to verify inventory balance details. Why is the test also relevant to sales revenue?

CLIENT: New Millennium Ecoproducts Period-end: 31/12/17 Currency/unit: $000	**F05.1-INVENTORY CUT-OFF (Sales)**	**Reference** F05.1

INVENTORIES OUT (SALES):

	Date of shipping document	Reference of shipping document	Customer name	Quantity	Recorded		TM/Ref	Movement recorded in the proper period? Yes/No	Comments
					Before counts	After counts			
GOODS OUT BEFORE STOCKTAKE DATE									
	27/12/2017	SHP3498 123	Brighter Bobs	2 000	X		✓	Yes	
	28/12/2017	SHP3498 156	Grey Gums	2 500	X		✓	Yes	
	29/12/2017	SHP3498 189	Green Bill	3 100	X		✓	Yes	
	30/12/2017	SHP3498 223	Jerry Lights	1 200	X		✓	Yes	
	30/12/2017	SHP3498 456	Mad Monday	1 500	X		✓	Yes	
	etc…								
GOODS OUT AFTER STOCKTAKE DATE									
	01/01/2018	SHP3498 789	Poor Petes	2 200		X	✓	Yes	
	01/01/2018	SHP3498 923	Sorry Stu	3 500		X	✓	Yes	
	02/01/2018	SHP3499 456	Very Well	900		X	✓	Yes	
	03/01/2018	SHP3498 789	Brighter Bobs	8 500		X	✓	Yes	
	04/01/2018	SHP3499 923	Grey Gums	1 000		X	✓	Yes	
	etc…								

Key to audit tickmarks:
✓ Agrees to documentation supporting revenue recognition (e.g. delivery note, shipping reports, sales contracts, ownership transfer condition).

Comments:
- NA

11.26 SEARCH FOR UNRECORDED LIABILITIES ★

LO1, 3

The following is a copy of the auditor's working paper relating to the search for unrecorded liabilities for the client New Millennium Ecoproducts.

CLIENT: New Millennium Ecoproducts Period-end: 31/12/17 Currency/unit: $000	**N04-SEARCH FOR UNRECORDED LIABILITIES**	**Reference** N04

Section 1: Review of subsequent disbursements

Disbursement type (Disbursements after year-end)	Disbursement reference	Disbursement			Invoice details			TM/Ref	Delivery date / Date of service provided	TM/Ref	Accrued at year-end?	TM/Ref	Comments
		Date	Amount	Recipient	Date	Amount	Description						
Wire transfer	455 768	31/01/2018	(1 700)	SYX Ltd	01/12/2018	(1 500)	Gas bill 12/17	✓	2017	✗	Yes	✗✗	
Wire transfer	545 555	31/01/2018	(2 500)	JK9 Ltd	13/01/2018	(2 000)	Consultants' invoices 12/17	✓	2017	✗	Yes	✗✗	
Cheque	666 633	31/01/2018	(2 044)	HHH Ltd	13/01/2018	(2 044)	Flight to London in FY18	✓	2018	✗	N/A	N/A	
etc.													

Section 2: Review of invoices received after year-end

Invoice details			TM/Ref	Delivery date / Date of service provided	TM/Ref	Accrued at year-end?	TM/Ref	Comments
Date	Amount	Description						
05/01/2018	(900)	Switches	✓	2018	✗	N/A	N/A	
03/01/2018	(2 000)	Consultants' invoices 12/17	✓	2017	✗	Yes	✗✗	
04/01/2018	(1 500)	Casual staff 12/2017	✓	2017	✗	Yes	✗✗	
04/01/2018	etc…							

Key to audit tickmarks:
✓ Agrees to Invoice details
✗ Agrees to delivery note / details of service provided
✗✗ Agrees to details of accrued liabilities

Comments:
- No error detected (in addition to the one detected during our cut-off procedures)

Required

(a) Why does an auditor search for unrecorded liabilities?

(b) Explain the test documented in section 1. Does this test reveal any unrecorded liabilities?

(c) Explain the test documented in section 2. Why is 'N/A' recorded in the 'Accrued at year-end?' column?

11.27 ACCOUNTS PAYABLE CUT-OFF ★ **LO1, 3, 4**

The following is a copy of the auditor's working paper relating to the search for accounts payable cut-off testing for the client New Millennium Ecoproducts.

CLIENT: New Millennium Ecoproducts Period-end: 31/12/17 Currency/unit: $000	**N03-ACCOUNTS PAYABLE CUT-OFF**	EY Building a better working world **Reference** N03

Supplier name	Invoice number	Date in AP Ledger	Amount	TM/Ref	Delivery date / Date of service provided	TM/Ref	Recorded in the proper period? Yes/No	Comments
Transactions recorded before year-end								
EXP Ltd	E123456	29/12/2017	(10 000)	SL	29/12/2017	✓	Yes	
etc.	…..							
Transactions recorded after year-end								
GROM Ltd	G987654	01/06/2018	(16 000)	SL	29/12/2017	✓	No	See below
etc.	…..							

Key to audit tickmarks:

✓ Agrees to delivery note / date of service as mentioned on the invoice

SL Agrees to subledger

Comments:

- This transaction (service) was recorded in the wrong period and not included in the accrued expenses as of Year 2017. We expanded our test by completing the following: tests of details of transactions recorded from 01/01/2018 to 10/01/2018. This error seems to be isolated as no additional errors were detected. The error is posted to our summary of audit differences.

Required

(a) Why does an auditor test accounts payable cut-off? Does the test have any implications for the income statement?

(b) Explain the error found by the auditor in the second transaction on the working paper.

(c) Why has the auditor done additional testing (see the comments section)?

11.28 INTERNAL AUDIT AND SUBSTANTIVE TESTING ★★ **LO1, 2**

Jurgen is the engagement partner on the audit of Lynch Brothers, a listed company selling small kitchen appliances. The appliances are made in China and imported and sold to retail outlets by Lynch Brothers.

Lynch Brothers has a small internal audit team that was established after the business had suffered from accusations of 'channel stuffing' five years ago. The internal audit team reports directly to the audit committee, which has four independent directors.

After the problems of five years ago the entire senior management team changed and the company became extremely committed to promoting good corporate ethics. Remuneration packages for all senior staff include incentive payments for achieving targets based on governance indicators, staff satisfaction scores, peer reviews and performance appraisals, as well as sales targets.

Jurgen has audited Lynch Brothers for four years and has been impressed throughout this time with both the quality of the company's accounts and the internal audit team, which is highly qualified and effective.

Required

Explain what approach Jurgen should take to the audit of Lynch Brothers' income statement accounts.

11.29 AUDITING AN INTERNET BUSINESS ★★ **LO1, 2**

Curtley Robinson Friends (CRF) is an internet-based dating agency. Its business model is that anyone can search its website and review for free the profiles of people looking for friends or partners, but if anyone wants to post their profile or a message or make contact with another person they must pay a fee. In addition, it charges advertisers when a user 'hits' the site while their advertisement is displayed and a higher fee if the user follows a link to an advertiser's website.

The problem with this model is that CRF needs profiles on its website to encourage people to visit the site, so it has made some special offers to encourage people to post their profiles. These offers include substantial discounts, even waiving the entire fee for people who meet certain criteria (for example, an attractive female under the age of 35).

Holly, the engagement partner on the audit of CRF, has some doubts about the revenue numbers claimed by CRF in its trial balance. She suspects that some of the profiles are fictitious and the advertising revenue is overstated.

Required

What could Holly do to audit the revenue claimed by CRF?

11.30 SUBSTANTIVE TESTING OF SALES ★★ **LO2**

James is seeking your advice on the selection of substantive procedures for the audit of his client, Rock Ltd. Rock Ltd is a specialist outdoor clothing and equipment retailer and has experienced reasonable growth over the past three years, although this growth has come substantially from the clothing section. Sales of camping and climbing equipment are down significantly so far this year in all stores except Melbourne. Early results from audit testing show that controls over the sales process are reasonably effective, resulting in a low to moderate control risk. James believes he will need to do some substantive testing of sales, but is unsure about which procedures would be most useful. He has access to Rock Ltd's monthly sales budgets for the period and results for the eight months of the year to date.

Required

Write a memo to James explaining the substantive procedures for sales that he could choose from and which would be most useful in these circumstances.

11.31 AUDITING RESEARCH AND DEVELOPMENT EXPENDITURE ★★ **LO1, 3**

Advance Pharma Ltd is developing a new drug for diabetes. The expenditure does not meet the requirements for deferral as an asset and must be expensed in the current period. The amounts involved are material: the trial balance shows salaries for chemists $5 million, depreciation of laboratory equipment $5.5 million, supplies consumed in the laboratory $4.5 million and $9.0 million for the amortisation of related patents. Advance Pharma Ltd expects that further development of the drug will allow commercial production and product sales to commence in another three years.

The main difficulty faced by the auditor is whether the expenditure should be classified as research and development expense or as general administrative expenses. In addition, the auditor is concerned about the accuracy of the amounts claimed by the client.

Required

(a) Explain why the classification of the expenditure is important and needs to be tested.

(b) Suggest to the auditor some techniques for substantiating the expenditure amounts.

11.32 ASSESSING THE RESULTS OF PAYROLL SUBSTANTIVE TESTING ★★ LO3, 4

The human resources department at Countrywide Logistics is responsible for selecting and appointing employees, approving pay rates and promotions, and processing employee terminations. The payroll department is responsible for preparing the weekly wages based on the information from the human resources department and according to hours worked by each employee. Countrywide Logistics has a number of long-term contracts to deliver goods along the eastern seaboard. The company operates a fleet of large trucks and has a number of permanent drivers who are assisted by other drivers on short-term contracts during busy times of the year (such as the three months prior to Christmas). Drivers work long shifts and most of the driving is done at night.

During busy times the human resources department falls behind with processing paperwork related to the short-term contract drivers. In particular, there are constant complaints from the drivers that they have to wait several weeks after they start work for their first pay.

John is testing the payroll process. He discovers that the complaints from the drivers are justified; it takes on average three weeks from the date the driver starts work for the relevant authorisation for the driver's pay to be received by the payroll department. However, he also finds that on average drivers are paid for one additional week after they actually leave the company because the human resources department does not record the termination date accurately. The payroll department tells John that, because of the confusion, no provision is made for accrued wages at year-end.

Required

(a) Based on John's findings, which accounts are likely to be misstated and which assertions are violated?

(b) What tests would you recommend that John perform to substantiate weekly wages expense?

11.33 PURCHASES TESTING ★★★ LO1, 3

Chris Farnon is a veterinary surgeon, specialising in pigs. His customers are pig farmers, large and small, throughout the state. To support his practice he also operates All Creatures Veterinary Supplies Pty Ltd (ACVS), which supplies drugs and other supplies to pig farmers. Most of the drugs can only be sold on a vet's prescription, but the sale of other supplies is unrestricted (although there are safety issues surrounding the storage of some items).

The drugs and other supplies are ordered in bulk from local and overseas suppliers. Most sales are made to farmers on the receipt of a telephoned purchase order. The sales order is taken by a clerk in the office and entered into the computer system. This generates a packing slip for the storeman, who then takes the supplies from the shelves and packages them for delivery. Often there are not sufficient supplies in stock to complete an order so that part of the order is held over until more supplies are obtained.

Purchase orders are initiated by the storeman when stocks are running low. The storeman has to be careful not to hold too much stock because there are strict regulations regarding 'use by' dates for drugs. Sometimes an order of drugs and supplies is not received in full from the suppliers because they are waiting for delivery from the manufacturer. In this case, the storeman makes a note in his diary to follow up and obtain the missing items at a later date.

Clients are often in a hurry to receive their drugs and Chris often takes drugs with him when he visits a farm. When he remembers, Chris leaves a note for the storeman explaining which drugs he has taken. ACVS maintains a perpetual inventory system and the storeman is responsible for periodic stocktakes to confirm the accuracy of the inventory records.

Required

(a) What strengths and weaknesses can you identify in the inventory control system at ACVS?
(b) What substantive procedures would you recommend for purchases given your assessment of the control system?

Questions 11.34 and 11.35 are based on the following case.

MaxSecurity Limited (MaxSecurity) has been an audit client of Smith & Associations (S&A) for the past 15 years. MaxSecurity is based in Wollongong, where it manufactures high-tech armour-plated personnel carriers. MaxSecurity often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialised and MaxSecurity only does business with nations that have a recognised, democratically elected government. MaxSecurity maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

In September 2016, MaxSecurity installed an off-the-shelf costing system to support the highly sophisticated and cost-sensitive nature of its product designs. The new system replaced a system that had been developed in-house as the old system could no longer keep up with the complex and detailed manufacturing costing process that provides tender costings. The old system also had difficulty with the company's broader reporting requirements.

The manufacturing costing system uses all of the manufacturing unit inputs to calculate and produce a database of all product costs and recommended sales prices. It also integrates with the general ledger each time there are product inventory movements such as purchases, sales, wastage and damaged stock losses.

MaxSecurity's end of financial year is 30 June.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2008 and March 2009.

11.34 SUBSTANTIVE PROCEDURES FOR COST OF SALES ★★★ — LO1, 3

(a) What are the principal audit objectives and assertions for MaxSecurity's cost of sales? Explain.
(b) Identify the relevant substantive tests of details that would be appropriate to gather evidence about the assertions in (a) above.

11.35 SUBSTANTIVE TESTING OF INCOME STATEMENT AND BALANCE SHEET ACCOUNTS ★★★ — LO1, 3

Discuss how substantive testing of MaxSecurity's cost of sales expense would relate to substantive testing of the inventory account on its balance sheet.

Questions 11.36 and 11.37 are based on the following case.

Chan and Partners Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year, Chan and Partnersgained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home
- Total Cancer Specialists Limited (TCSL), a private oncology clinic that specialises in the treatment of cancer.

Year-end for all MSHG entities is 30 June.

Shady Oaks Hospital is a private hospital group generating revenue from patients for stays in the hospital and medical practitioners in private practice for use of the hospital facilities and provision of nurses, anaesthetists, operating theatres and supplies.

You are working on the 2017 engagement for Shady Oaks and your assurance services manager has requested you use substantive analytical procedures to calculate Shady Oaks' estimated revenue for patients staying in the hospital, excluding medical procedures and ancillary costs such as medication.

You are also completing the planning of the accounts payable and payments system. Accounting staff perform the following procedures.

- A pre-numbered cheque requisition is prepared for all payments.

- The details on the supplier's invoice are matched to the appropriate receiving report.
- The details on the supplier's invoice and receiving report are matched to an authorised purchase order.
- The cheque requisition is stapled to the authorised purchase order, receiving report and supplier's invoice and forwarded to the appropriate senior staff member for review and authorisation.
- The authorised cheque requisition, together with the supporting documents, is passed to accounts payable for payment.

Your controls testing confirms that the above activities are performed effectively.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2008 and March 2009.

11.36 TESTS OF DETAILS FOR PURCHASES ★★★ **LO3**

Design the tests of details for purchases that you would use to supplement the analytical procedures. Relate each test to the relevant assertion for purchases.

11.37 ANALYTICAL SUBSTANTIVE PROCEDURES FOR REVENUE ★★★ **LO1, 2**

Describe all the key information required to estimate Shady Oaks' revenue for patients staying in the hospital.

CASE STUDY — CLOUD 9

Answer the following questions based on the information presented for Cloud 9 in the appendix to this text and the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

Required

(a) Based on your conclusions from the case study questions in previous chapters (particularly chapters 4, 8, 9 and 10), complete the worksheet below to determine the overall risk assessment and the acceptable detection risk for the sales account.

(b) Design substantive audit procedures for Cloud 9 Pty Ltd that would address the detection risk for the sales account.

Account assertion	Inherent risk	Control risk	Overall risk assessment	Detection risk
Sales — occurrence				
Sales — completeness				

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. c, 2. d, 3. a, 4. d, 5. d, 6. b, 7. b, 8. c, 9. b, 10. d.

NOTES

1. Stallworth, L & Digregorio, D 2004, 'Improper revenue recognition', *Internal Auditor*, vol. 61, no. 3 June, pp. 53–6.
2. Gray, J 2002, 'Hide and seek', *Canadian Business*, vol. 75, no. 6, 1 April, pp. 28–32.
3. ibid.
4. ibid.
5. Perry, L 2010, 'Watch out for fraudulent revenue recognition!' *Accounting Web*, 30 June, www.accountingweb.com.

ACKNOWLEDGEMENTS

Professional application questions 11.23–11.27: © EY Australia.

CHAPTER 12

Completing and reporting on the audit

LEARNING OBJECTIVES

After studying this chapter you should be able to:

12.1 explain the procedures performed as part of the engagement wrap-up, including gathering and evaluating audit evidence

12.2 explain the considerations when assessing the going concern assumption used in the preparation of the financial report

12.3 assess the two types of (material) subsequent events to determine what effect they have on the financial report (if any)

12.4 evaluate misstatements and explain the difference between quantitative and qualitative considerations when evaluating misstatements

12.5 evaluate conclusions obtained during the performance of the audit and explain how these conclusions link to the overall opinion formed on the financial report

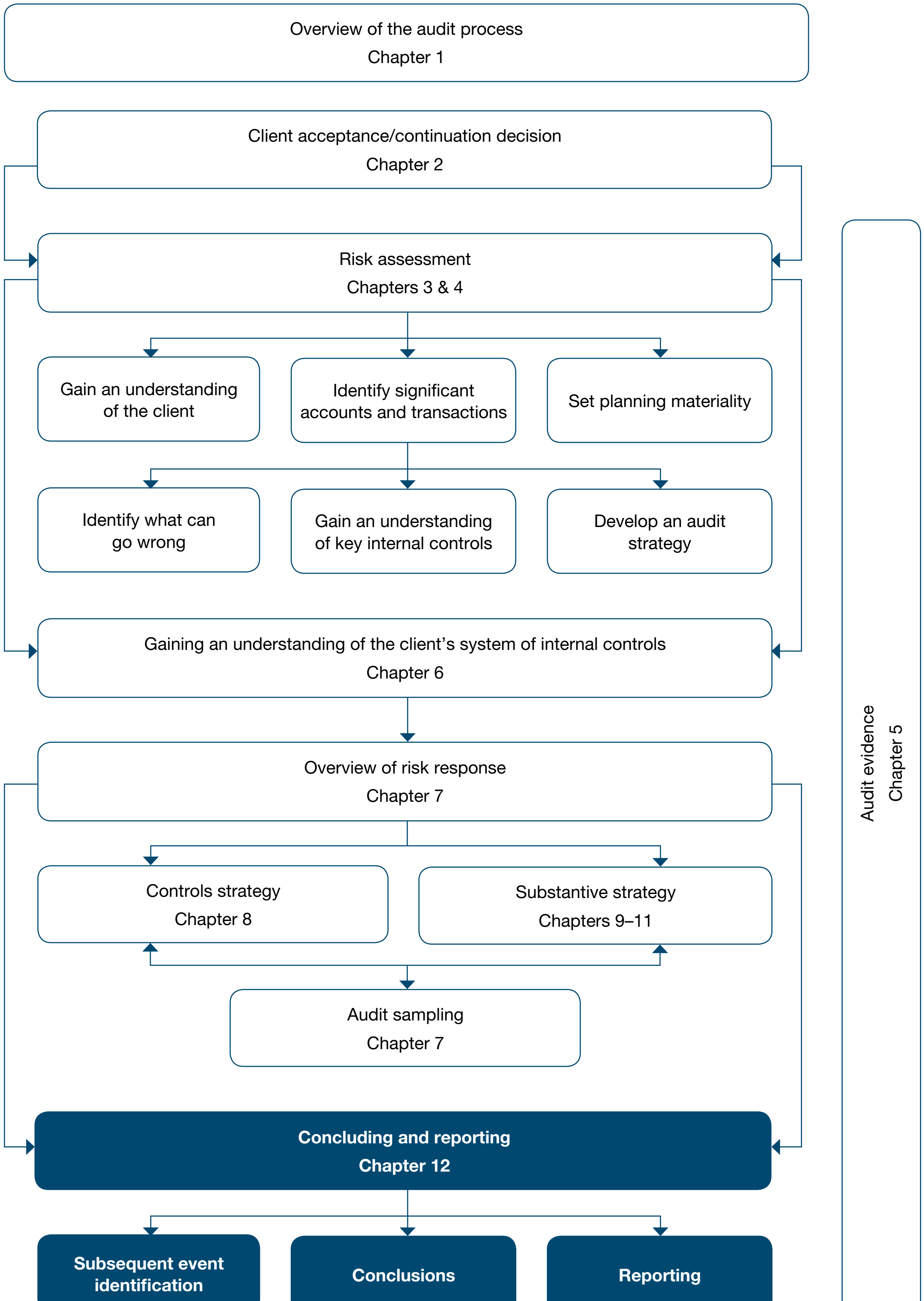
12.6 explain the components of an audit report

12.7 discriminate between the types of modifications to an audit report

12.8 explain why Corporations Act breaches are important to understand

12.9 explain what reporting is required to management and those charged with governance.

AUDITING AND ASSURANCE STANDARDS	
AUSTRALIAN	**INTERNATIONAL**
ASA 230 *Audit Documentation*	ISA 230 *Audit Documentation*
ASA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*	ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*
ASA 250 *Consideration of Laws and Regulations in an Audit of a Financial Report*	ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*
ASA 260 (Revised) *Communication with Those Charged with Governance*	ISA 260 (Revised) *Communication with Those Charged with Governance*
ASA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*	ISA 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*
ASA 320 *Materiality in Planning and Performing an Audit*	ISA 320 *Materiality in Planning and Performing an Audit*
ASA 450 *Evaluation of Misstatements Identified during the Audit*	ISA 450 *Evaluation of Misstatements Identified during the Audit*
ASA 500 *Audit Evidence*	ISA 500 *Audit Evidence*
ASA 560 *Subsequent Events*	ISA 560 *Subsequent Events*
ASA 570 (Revised) *Going Concern*	ISA 570 (Revised) *Going Concern*
ASA 580 *Written Representations*	ISA 580 *Written Representations*
ASA 700 (Revised) *Forming an Opinion and Reporting on a Financial Report*	ISA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*
ASA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*	ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*
ASA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*	ISA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*
ASA 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*	ISA 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
ASA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information*	ISA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information*
ASA 800 (Revised) *Special Considerations — Audits of Financial Reports Prepared in Accordance with Special Purpose Frameworks*	ISA 800 (Revised) *Special Considerations — Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*
ASA 805 (Revised) *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*	ISA 805 (Revised) *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*
ASA 810 *Engagements to Report on Summary Financial Statements*	ISA 810 *Engagements to Report on Summary Financial Statements*
APES 110 *Code of Ethics for Professional Accountants*	*Code of Ethics for Professional Accountants*
AASB 101 *Presentation of Financial Statements*	IAS 1 *Presentation of Financial Statements*
AASB 110 *Events after the Reporting Period*	IAS 10 *Events After the Reporting Period*


Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client's system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

The partner on the Cloud 9 Pty Ltd (Cloud 9) audit, Jo Wadley, has called a meeting with the senior staff (Sharon Gallagher, Josh Thomas, Suzie Pickering and Mark Batten) to discuss the completion of the audit. The partner wants to be sure that all issues are 'in hand' and that she is briefed on all contentious matters so that she can resolve them at the scheduled meetings with Cloud 9's board and management. Meetings with clients at the end of the audit can be quite difficult. Sometimes the audit partner considers qualifying the audit report if the client's management will not adjust the financial report to reflect errors found during the audit.

Sharon, Josh, Suzie and Mark decide to hold a preliminary meeting to prepare for the meeting with the partner. On the agenda are final evidence and misstatements evaluation, going concern procedures and assessment, subsequent events procedures and evidence, overall conclusion and audit opinion, legal issues, and communication with Cloud 9's board.

What issues have arisen with Cloud 9's audit? How can they make sure that the partner is fully prepared for the meeting with the client's management?

Audit process in focus

During the completion phase of the audit a number of steps are performed. Firstly, the auditor evaluates the audit evidence obtained and reviews the documentation to ensure it is of a sufficient quality and quantity. Before drawing an overall conclusion on the audit, the auditor also reassesses the going concern assumption, considers the existence of subsequent events, performs any additional wrap-up procedures, and assesses any misstatements (sometimes referred to as audit differences) identified throughout the audit and the effect they may have on the overall conclusion (and opinion).

The final step in the audit process is to evaluate the conclusions drawn from the audit evidence obtained (which will form the basis for the auditor to form their opinion on the financial report) and to prepare an appropriately worded audit report. At the same time, a management representation letter is obtained from the client and appropriate communication with those charged with governance is prepared. It is also a requirement for the auditor to consider whether the client has breached (or is at risk of breaching) the *Corporations Act 2001*, which may require notification by the auditor to the Australian Securities and Investments Commission (ASIC) under section 311 of the legislation. Consideration of compliance with laws and regulations, in particular the Corporations Act, is made throughout the audit and again as part of the wrap-up and conclusion procedures.

12.1 Engagement wrap-up

LEARNING OBJECTIVE 12.1 Explain the procedures performed as part of the engagement wrap-up, including gathering and evaluating audit evidence.

During the wrap-up of an engagement the auditor finalises any open items before issuing their audit report, including determining if any remaining procedures are to be completed for the audit. Any remaining audit procedures are assigned to team members, including due dates for completion of the open items. This includes determining that the audit team has properly completed and executed the audit procedures that were planned (as described in chapters 3 and 4) and that all relevant matters have been appropriately considered.

The following areas are ordinarily covered during the wrap-up of an engagement.

1. Review planned audit procedures for proper and complete execution.
2. Determine that all necessary matters have been appropriately considered.
3. Revisit open review notes, 'to-do' items and any audit procedures not yet completed. The auditor revisits any open review notes, 'to-do' items and open audit procedures to determine whether they continue to require audit attention, have been resolved to the auditor's satisfaction through other

procedures, or are no longer relevant. At this stage, if additional audit attention is needed, the auditor performs the necessary audit procedures to resolve the items.

4. Determine that all unnecessary documentation, drafts and review notes have been removed from the engagement files. The auditor retains records relevant to the audit, including audit working papers and other documents that form the basis of their audit, memoranda, correspondence, communications, other documents and records (including electronic records) that (1) are created, sent or received in connection with the audit and (2) contain conclusions, opinions, analyses or financial data related to the audit. For open items that are no longer relevant to the audit (or necessary to complete), the auditor documents in their audit working papers that these items are no longer relevant and the reason(s). In some situations, it may be more appropriate to delete references to these items from the working papers altogether. Review notes (or review points) are removed from the file as the working papers are required to stand on their own in terms of the work done and conclusions reached. Having the review notes and responses on a different page or in a different part of the audit file makes it difficult for a reviewer to easily understand the work done and conclusions reached. For this reason, it is standard practice to remove review notes from the file. There are certain circumstances, however, when the only evidence able to be provided of a review having occurred is to leave a marked-up copy in the working paper file. An example of a review note that would be retained is the audit partner's review of the draft financial report. In this situation it may be appropriate to leave the marked-up copy on file. Care should be taken, however, to make sure any items noted on the draft version have been appropriately dealt with or concluded on. ASA 230 (ISA 230) *Audit Documentation* (as well as ASA 315 (ISA 315) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and ASA 330 (ISA 330) *The Auditor's Responses to Assessed Risks*) outlines the various requirements associated with developing, altering and storing audit documentation.
5. For multi-location engagements, determine that all documents requested from other audit teams have been obtained and reviewed.
6. Remove all documents from the working papers that aren't necessary to support the auditor's conclusions.
7. Consider the amount used for materiality. The auditor considers whether the amount they have used for **materiality** (as discussed in chapter 4 and addressed in ASA 320 *Materiality in Planning and Performing an Audit*) when planning the audit and detecting misstatements (rather than evaluating them) is still appropriate as the basis for their conclusion on the fairness of the presentation of the financial report taken as a whole. They consider whether, during the course of their audit, they have identified any factors or conditions about the client or its environment (for example, a significant change in anticipated operating results, numerous unexpected misstatements) that would cause them to determine that a different (lower) amount would have been appropriate in establishing their planning materiality amount. It is important to revisit the amount used for materiality when evaluating misstatements, taking into consideration qualitative as well as quantitative factors.

   When the amount considered material at the end of the audit is significantly lower than at the beginning of the audit (for example, because the basis used for calculating materiality at planning was substantially higher), the auditor considers whether their procedures throughout the audit were sufficient and whether additional audit procedures need to be performed. To avoid possible surprises at the end of an audit, the auditor should reassess the appropriateness of the materiality they set throughout the audit to make sure that sufficient audit procedures are being performed.
8. Reconsider the assessments of internal control at the entity level and the risk of fraud. When planning an audit, the auditor identifies the presence or absence of factors related to the five components of internal control (as discussed in chapter 6) and the risk of fraud and makes their initial assessment of control risk and fraud risk. They then consider throughout the audit whether additional factors or risks are present and whether they need to revise their assessment of control risk at the entity level

and the risk of fraud at the entity level and account level (as discussed in chapter 6). The auditor specifically reconsiders their assessment of control risk at the entity level when they become aware of significant changes in the client's system of internal controls and after they perform tests of controls. Their conclusions about the effectiveness of internal control at the entity level may be affected by control exceptions that they identify when executing their tests of controls.

When the results of their audit tests identify misstatements in the financial report, the auditor considers whether such misstatements may be indicative of fraud. The auditor's consideration of fraud risk, and the results of their audit procedures, may indicate that they need to consider withdrawing from the engagement. For example, the auditor may determine that the fraud is so pervasive in the business that they will be unable to complete their audit procedures, or that the fraud will have such an impact on the client's reputation that they no longer wish to have them as a client. In these rare cases, any decision to withdraw from the engagement is not taken lightly and extensive consultation both internally within the audit firm as well as externally with the regulator (for example, ASIC) will occur before any action is taken. Whether or not the decision is taken to withdraw from the audit engagement depends on (1) whether the evidence suggests that management has been involved in perpetrating the fraud (or there are concerns regarding management's integrity based on how it dealt with the fraud once it was identified) and (2) the diligence and cooperation of management in investigating the circumstances of the fraud and taking appropriate action.

At the conclusion of the audit, the auditor formally reconsiders their assessment of internal control and fraud risk by considering whether the accumulated results of their audit procedures and other observations affect the assessments they made when planning the audit. This evaluation also considers qualitative matters based on the engagement team and audit team executives' **professional judgement**. (Quantitative and qualitative considerations for materiality are discussed in chapter 4.)

9. Revisit the planning documentation to determine that all significant issues identified during the planning phase have been addressed.
10. Perform subsequent events procedures. During the wrap-up of the engagement the auditor performs what is referred to as subsequent events procedures. The objective of subsequent events procedures is to identify those events occurring between year-end (that is, the reporting date) and the date of the audit report, that may require adjustment to or disclosure in the financial report. Subsequent events procedures are normally performed through to and including the date of the auditor's report. Subsequent events are discussed in more detail in section 12.3.
11. Read the other information included in the entity's annual report to consider if there are any material inconsistencies, that is, any material inconsistency between the audited financial report and the other information, and any material inconsistency between the other information and the auditor's knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached. (These requirements can be found in ASA 720 (ISA 720) (Revised) *The Auditor's Responsibilities Relating to Other Information*.) The auditor's work effort on other information applies regardless of whether the other information is obtained prior to or after the date of the auditor's report on the financial report.

12.1.1 Sufficient appropriate audit evidence

As discussed in chapter 1, the objective of an audit is to obtain sufficient appropriate evidence to reduce the risk of material misstatement in the financial report to an acceptably low level.

What constitutes **sufficient appropriate evidence** is ultimately a matter of professional judgement. It will be based on the satisfactory performance of audit procedures designed to address the assessed risk of material misstatement (as discussed in chapters 1, 3 and 4 and addressed in ASA 500 *Audit Evidence*). This includes any additional or modified procedures performed to address changes identified in the original assessment of risk. Some of the factors to consider in evaluating the sufficiency and appropriateness of audit evidence (assuming the tests were appropriate to the type of account and assertions most at risk) include:

- materiality of misstatements
- management responses
- previous experience
- results of audit procedures performed
- quality of information obtained
- persuasiveness of the audit evidence
- whether the evidence obtained supports or contradicts the results of the risk assessment procedures.

If it is not possible to obtain sufficient appropriate audit evidence, the auditor should express a qualified or disclaimer of opinion as described in ASA 705 (ISA 705) *Modifications to the Opinion in the Independent Auditor's Report.*

12.1.2 Evaluating audit evidence

The goal in evaluating audit evidence is to decide, after considering all the relevant data obtained, whether:

1. the assessments of the risk of material misstatement at the assertion level are appropriate
2. sufficient evidence has been obtained to reduce the risk of material misstatement in the financial report, or audit risk, to an acceptably low level.

An audit is an ongoing, cumulative and iterative process of gathering and evaluating evidence. This requires an attitude of professional scepticism to be applied by each member of the audit team, ongoing discussions to take place among the audit team members throughout the engagement and timely modifications being made to planned procedures to reflect any changes to the original risk assessments.

When misstatements or deviations from controls are found in planned procedures, consideration should always be given to:

- the reason for the misstatement or deviation
- the impact on risk assessments and other planned procedures
- the need to modify or perform further audit procedures.

Before evaluating the results of procedures and any misstatements identified, as discussed previously, consideration should be given to whether the materiality levels established during the planning phase need to be revised. A change in materiality could be a result of:

- new information; for example, the bank supplying the company with funding may have decided to refinance the debt during the year and put in place very restrictive covenants relating to certain balances
- a change in the auditor's understanding of the entity and its operations
- new circumstances; for example, an acquisition of a new business or significant customer which materially affects the client's results.

CLOUD 9

Sharon suggests that each member of the team ask themselves whether they believe that sufficient appropriate evidence has been gathered on which to base an audit opinion, given their knowledge and involvement in the audit. Which issues are not satisfactorily resolved? Where do they need to gather additional evidence? Which notes can be closed or removed from the files? Are assessments of control risk and materiality still valid given evidence obtained from substantive procedures?

The team members have performed a final review of the evidence and have identified the major differences that the partner will need to resolve with Cloud 9's management. It appears that the only other major outstanding items are the going concern assessment and subsequent events procedures. Neither of these can be finalised prior to year-end, and certain procedures need to be performed up until the audit report date.

BEFORE YOU GO ON

- Explain why it is important to reassess materiality at the end of the audit.
- What is the goal in evaluating audit evidence?
- Provide three considerations when evaluating the sufficiency and appropriateness of audit evidence.

12.2 Going concern

LEARNING OBJECTIVE 12.2 Explain the considerations when assessing the going concern assumption used in the preparation of the financial report.

As discussed in chapter 3 and ASA 570 (ISA 570) (Revised) *Going Concern*, the going concern assumption is a fundamental principle in the preparation of the financial report. Under the **going concern** assumption, an entity is viewed as continuing in business for the foreseeable future with neither the intention nor the need for liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. As a result, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

Some financial reporting frameworks contain an explicit requirement for management to make an assessment of the entity's ability to continue as a going concern. For example, Australian Accounting Standard AASB 101 (IAS 1) *Presentation of Financial Statements* requires management to make an assessment of an entity's ability to continue as a going concern and when management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern those uncertainties shall be disclosed.

Under other financial reporting frameworks (for example, preparing information in accordance with a joint venture or sale agreement), there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, since the going concern assumption is a fundamental principle in the preparation of a financial report, management has a responsibility to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.

The following factors are relevant when management is assessing the going concern assumption.

- Generally, the further into the future an event is likely to take place, the greater the uncertainty surrounding that event. For that reason, most financial reporting frameworks specify the period management is required to assess all available information when making their going concern assessment. In Australia, this is typically 12 months from the date of the directors' report and audit opinion.
- Any judgement about the future is based on information available at the time at which the judgement is made. Subsequent events can contradict a judgement that was reasonable at the time it was made. Management of clients in industries subject to frequent change face more difficulty when assessing the going concern assumption.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors all affect judgement regarding the outcome of events or conditions.

ASA 570 (ISA 570) (Revised) requires that the auditor considers the appropriateness of management's use of the going concern assumption in the preparation of the financial report. Consideration of management's use of the going concern assumption is based on knowledge of conditions or events obtained through planning and performing the audit. The auditor considers whether their procedures identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern.

They also consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial report. Usually, material uncertainties relate to an entity's inability to meet obligations as they become due without substantial disposals of assets outside the ordinary course of business, restructuring of debt or equity, or major operational improvements.

ASA 570 (ISA 570) (Revised) has a new requirement for the auditor to also challenge the adequacy of disclosures for 'close calls', in view of the applicable financial reporting framework, when events or conditions are identified that may cast significant doubt on an entity's ability to continue as a going concern.

The going concern assumption does not apply to a financial report prepared on a liquidation basis. For example, when owners decide to dissolve the business or bankruptcy proceedings reach a point at which liquidation is probable, they prepare a financial report on a liquidation basis. When a financial report is not prepared on a going concern basis, that fact needs to be disclosed, together with the basis on which the financial report has been prepared and the reason the entity is not considered to be a going concern.

CLOUD 9

Sharon and the team discuss the existence of any issues throwing doubt on the appropriateness of the going concern assumption at Cloud 9. The financial ratios indicate no problems with solvency and the major borrowings are not due to be repaid or refinanced for another four years. In addition, a profit is expected for this financial year. Cloud 9's management is anticipating a profit despite the costs associated with the new stores opening and sponsorship deals. The interim trial balance supports the management's expectations. The team makes a note that these issues have been formally reviewed and they conclude that there are no significant issues casting doubt on the going concern assumption.

BEFORE YOU GO ON

- Provide one consideration management should take into account when assessing the going concern assumption.
- Provide one consideration the auditor should take into account when assessing the going concern assumption.
- Does the going concern assumption always apply to all audits?

12.3 Subsequent events

LEARNING OBJECTIVE 12.3 Assess the two types of (material) subsequent events to determine what effect they have on the financial report (if any).

A financial report is prepared on the basis of conditions existing at year-end (i.e. the reporting date). However, significant events, both favourable and unfavourable, can occur after year-end that, unless reflected in the financial report or suitably disclosed therein, could make the financial report misleading.

There are three key dates that are important when considering subsequent events. Firstly, the date that the financial report is approved. This is the date on which those with the recognised authority assert that they have prepared the entity's complete financial report, including the related notes, and that they have taken responsibility for the financial report. Next is the date of the auditor's report. This is the date the auditor signs the auditor's report on the financial report. The auditor's report is not dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base their opinion on the financial report. Sufficient appropriate audit evidence includes evidence that the entity's complete financial report has been prepared and that those with the recognised authority have asserted that they have taken responsibility for the report. Finally, the date the financial report is issued is the date that the auditor's report and audited financial report are made available to third parties, which may be, in many circumstances, the date that they are filed with a regulatory authority. Each of these terms become important when considering the date field work is completed and are explained further below.

ASA 560 (ISA 560) *Subsequent Events* establishes standards and provides guidance on the auditor's responsibility regarding subsequent events. This standard describes the two types of **subsequent events** that require consideration and evaluation:

1. events that provide additional evidence with respect to conditions that existed at year-end (type 1 subsequent events)
2. events that provide evidence with respect to conditions that developed subsequent to year-end (type 2 subsequent events).

The two types of subsequent events are also defined in AASB 110 (IAS 10) *Events After the Reporting Period*. Each of these is now discussed in more detail.

12.3.1 Type 1 subsequent events — adjusting events

Type 1 subsequent events are events that can affect the estimates inherent in the financial report or indicate that the going concern assumption in relation to the whole or a part of the entity is not appropriate. The financial report is adjusted for any material changes in estimates resulting from these types of events up to the date of the auditor's report. Examples of type 1 subsequent events (that require changes of amounts in the financial report) include:

- the bankruptcy of a customer subsequent to year-end, which would be considered when evaluating the adequacy of the provision for uncollectable trade receivables
- an amount received in respect of an insurance claim that was in the course of negotiation as at year-end
- deterioration in operating results and financial position after year-end that is so significant that it may indicate the going concern assumption is not appropriate to use in the preparation of the financial report.

When, after the date of the auditor's report but before the financial report is issued, the auditor becomes aware of a fact that may materially affect the financial report, the auditor:

1. considers whether the financial report needs changing
2. discusses the matter with the client
3. takes action appropriate in the circumstances.

If the client indicates that it will not change the financial report in a situation where the auditor believes it should be changed, a qualified or adverse opinion is issued. When the auditor's report has been released to the entity (but not released to the public), the auditor would notify **those charged with governance** (generally the board of directors and management) not to issue the financial report and audit report to any third parties. If the financial report has been released or is subsequently released anyway (without being changed), the auditor needs to take action to prevent reliance on the auditor's report. This is usually done by withdrawing the audit report and the company issuing a communication to those third parties in receipt of the report. This is often done by communication with the regulators (the Australian Securities Exchange (ASX) and ASIC) as well as notices on the company website.

Figure 12.1 describes the consequences of a type 1 subsequent event depending on the timing of when the event occurred.

12.3.2 Type 2 subsequent events — non-adjusting events

Type 2 subsequent events are those events that do not result in changes to amounts in the financial report (see figure 12.2). However, these events may be of such significance as to require disclosure in the financial report. Examples of type 2 subsequent events (that do not require adjustment but may require disclosure in the financial report) include:

- the uninsured (or underinsured) loss of plant or inventory as a result of a fire or flood subsequent to year-end
- the purchase of a business
- the issuance of shares or debt securities.

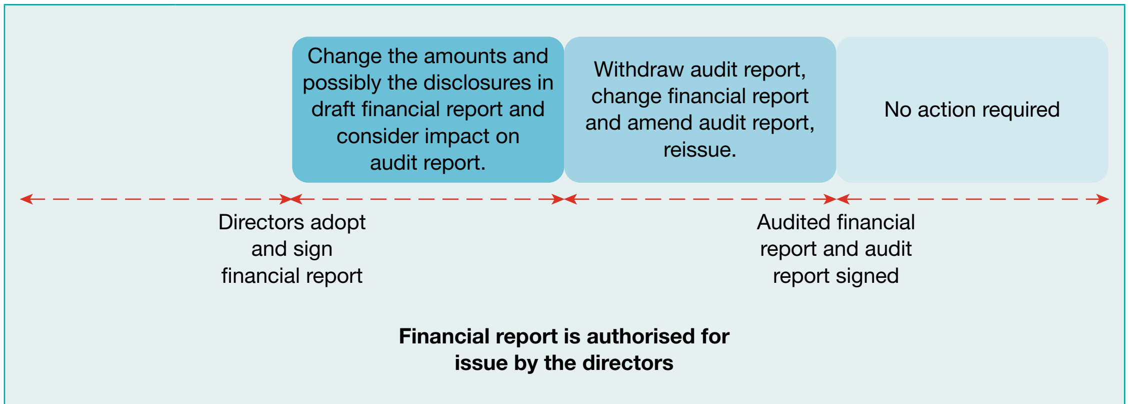


FIGURE 12.1 Type 1 subsequent event consequences

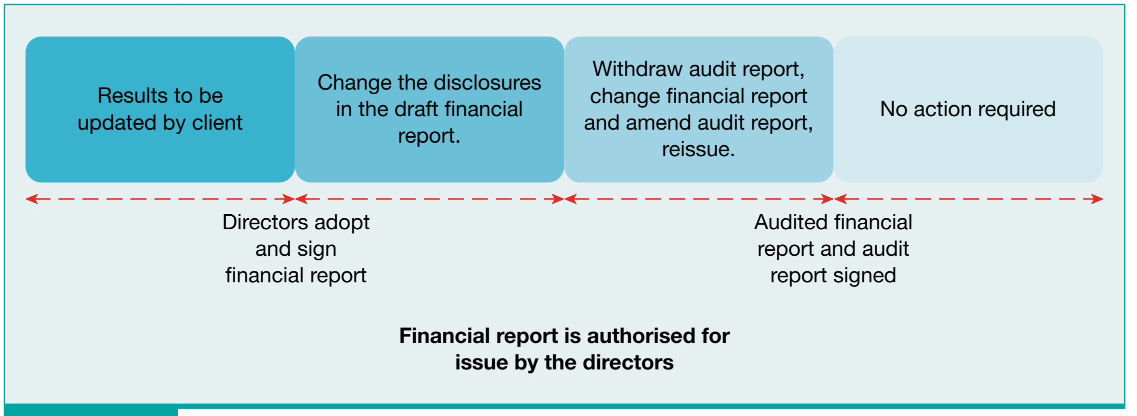


FIGURE 12.2 Type 2 subsequent event consequences

12.3.3 Procedures used when conducting a subsequent events review

The subsequent events review performed for identifying type 1 or type 2 events is different from the usual examination of transactions after year-end (for example, the verification of the cut-off of sales or the collection of trade receivables). The usual examinations of transactions after year-end are performed as part of the substantive tests of certain account balances, primarily to ensure that routine transactions are recorded in the proper period, or to review the appropriateness at year-end of the carrying amounts of assets and the adequacy of provisions for losses or expenses. In contrast, the subsequent events review is concerned only with significant events occurring subsequent to the balance sheet date that may require adjustment to or disclosure in the financial report.

The nature of the specific procedures performed (for the purposes of the subsequent events review) will depend on the individual circumstances of each client and the auditor considering, among other things, the procedures that management has established to identify material subsequent events, the volatility and strength of the client's business, the auditor's understanding and evaluation of the sources of information for significant accounts and sources and preparation of information for significant disclosures, knowledge of the client's business, and the presence of known problems that increase the client's exposure to significant changes in financial position and operations.

The procedures to identify events that may require adjustment of, or disclosure in, the financial report are performed as near as practicable to the date of the auditor's report and include (some or all) of the following.

- Gaining an understanding of, and evaluating, processes that management has established to determine that subsequent events are identified and dealt with.
- Reading minutes of meetings of the board of directors and executive committees held after year-end and inquiring about matters discussed at meetings for which minutes are not available.
- Reading and analysing the latest available interim financial report and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports for events such as changes in accounting principles, significant changes in results or working capital, noncompliance with loan terms, and reviewing sales, receipts, journals and other accounting records relating to transactions that have occurred subsequent to the date of the financial report. The most efficient way to achieve this may be through using electronic tools to search for transactions or relationships between transactions, balances, or non-financial information that are not consistent with the auditor's expectations. The auditor also reviews any analysis that the entity performs.
- Extending any analytical procedures performed during the audit to include the period up to the date of the auditor's report.
- Enquiring, or extending previous oral or written enquiries, of the entity's legal counsel concerning litigation and claims.
- Assessing continued compliance with borrowing limits and loan covenants.
- Enquiring of those charged with governance as to whether any subsequent events have occurred that might affect the financial report.
- Enquiring of management as to whether any subsequent events have occurred that might affect the financial report or (an experienced member of the engagement team) reviewing management reports. Examples of enquiries of management on specific matters include:
  - whether new commitments, borrowings or guarantees have been entered into or any other factors have changed the classification of any liabilities
  - whether sales of assets have occurred or are planned, or any other plans have been made that may affect the carrying value or classification of assets
  - whether the issue of new shares or long-term debt financing instruments or an agreement to merge or liquidate has been made or is planned
  - whether any change of ownership has occurred or is contemplated
  - whether any assets have been seized (or appropriated) by the government or destroyed, for example, by flood or fire
  - whether there have been any developments regarding risk areas and contingencies
  - whether any unusual adjustments have been made since the date of the financial report or are contemplated
  - whether any significant changes in foreign exchange rates have occurred that could affect the entity
  - whether there has been any change in the status of related party transactions, including those entered into subsequent to the date of the financial report
  - whether any significant assessments have been made by tax authorities with respect to tax assessments, fines and penalties
  - the current status of items involving subjective judgement or that were accounted for on the basis of preliminary information, such as provisions for litigation in progress
  - whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the preparation of the financial report; for example, if such events call into question the validity of the going concern assumption
  - sales and profit trends, industry and general economic climate, exceptional bad debt losses, decreases in raw material prices or possible inventory losses, renegotiation of prices under contract, or sales of inventory at a loss.

The auditor obtains written representations (as covered in ASA 580 *Written Representations*) from management as part of the management representation letter (as illustrated in chapter 5) confirming oral representations made in respect of subsequent events and that they are not aware of other relevant subsequent events.

The extent to which the results of these procedures will need reviewing and updating immediately prior to issuing the auditor's report depends on the length of time that has elapsed since the procedures were carried out and the susceptibility of the matters under consideration to change over time.

When, after the financial report has been issued, the auditor becomes aware of a fact that existed at the date of the auditor's report and that, if known at that date, may have caused the auditor to modify the auditor's report, the auditor should:

1. consider whether the financial report needs revision
2. discuss the matter with the client
3. consider whether the actions taken are appropriate in the circumstances. This would include review and approval of the revisions to the financial report including performing any additional audit procedures if necessary, ensuring anyone in receipt of the previously issued financial report and audit report has been informed of the situation and that a new auditor's report has been issued on the revised financial report. The revised audit report should be dated no earlier than the date that the new financial report is approved and should include an emphasis of matter paragraph referring to the note in the financial report that more extensively outlines the reason(s) for the revision to the earlier released financial report.

When management does not take the necessary steps, the auditor would notify those charged with governance (such as the audit committee or board of directors) of the entity that action will be taken by the auditor to prevent future reliance on the auditor's report. As discussed above, this is usually done via communication with regulatory filers (such as the ASX and ASIC) and via the company website.

CLOUD 9

Procedures to search for subsequent events at Cloud 9 are documented in the audit program. These include a review of minutes of board meetings in December, January and February, and analysis of the interim results for these months (including analytical procedures). The partner will also formally ask management about any subsequent events that have come to their attention in the meetings to be held between year-end and the audit report date. The team will also search for additional borrowings or other matters involving significant contracts.

BEFORE YOU GO ON

- Describe the two types of subsequent events that are required to be considered as part of the audit of a financial report.
- Provide two types of subsequent events procedures an auditor may perform to identify a subsequent event.
- What should an auditor do when after the discovery of a subsequent event the client does not take appropriate action?

12.4 Misstatements

LEARNING OBJECTIVE 12.4 Evaluate misstatements and explain the difference between quantitative and qualitative considerations when evaluating misstatements.

As noted in chapters 10 and 11, when performing substantive testing the key objective is to determine whether there are material errors within each account balance and quantify any identified errors. A **misstatement** is a difference between the amount, classification, presentation or disclosure of a reported financial report item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. An **error** is an unintentional misstatement in the financial report, including the omission of an amount or a disclosure. When an error or exception is identified during substantive testing, the first response is to understand why the error or exception has arisen. It may require an increase to the sample size to ensure there are no other errors in the balance (unless the total error in the account balance is able to be quantified without performing additional testing). It is important when errors are identified to continue testing until the error can either be accurately quantified or the balance has been tested to an extent that proves a material error can no longer exist within the balance.

In reaching a conclusion as to whether the misstatements need to be corrected, the auditor evaluates whether the misstatement either causes the financial report to be materially misstated or requires additional disclosure. This evaluation involves considerable professional judgement. Both quantitative and qualitative considerations are taken into account, including:

- the risk of additional misstatements remaining undetected
- the effects of identified misstatements on the client's compliance with covenants under debt or similar agreements
- whether the proposed corrections result from an error or are the result of a **judgemental misstatement** between the client's and the auditor's application of accounting policies
- the turnaround effect on the current year's financial report of uncorrected misstatements identified in the prior year (see section 12.4.2)
- the likelihood that recurring differences, which currently are immaterial, will have a material effect in the future
- the sensitivity of the circumstances surrounding the misstatements, for example, the implications of differences involving fraud and possible illegal acts, or violations of contractual provisions
- the significance of the financial report elements affected by the misstatements
- the significance of the misstatements relative to known user needs, for example, the magnifying effects of the misstatements on the calculation of a purchase price in a transfer of interests (buy/sell agreement)
- the effect of the misstatements on segment information or on another portion of the client's business that has been identified as playing a significant role in the client's operations or profitability
- the effects of offsetting misstatements in different financial report captions (or balance names within the financial report, for example, cash at bank, prepayments, payables).

12.4.1 Current-year misstatements

When misstatements identified during the audit are not corrected by the client, the auditor prepares a working paper (sometimes referred to as a 'Schedule or summary of audit differences') that accumulates these items in order to be able to consider their aggregate effect on the financial report as a whole. The auditor will also consider these misstatements against individual items or balances such as profit before tax or net income, trend of earnings, working capital, shareholders' funds and loan covenants.

When evaluating the materiality of misstatements, the auditor considers the cumulative effect of the misstatements at the end of the current year on pre-tax income and/or net income, working capital and shareholders' equity. The auditor also considers whether the matters underlying the misstatements could cause a material misstatement in future years' financial reports if the client should decide to correct all the misstatements in one year, even though the misstatements are not material to the current year's financial report. This is particularly relevant when the misstatements represent recurring, and generally increasing, differences in particular areas or accounts, such as certain expense accruals.

12.4.2 Prior-year misstatements

Misstatements may not have been corrected by the client in the prior period because they did not cause the financial report for that period to be materially misstated. As described in ASA 450 (ISA 450) *Evaluation of Misstatements Identified during the Audit,* the cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial report.

When these misstatements in the prior year have been identified, they are considered by the auditor to 'turn around' in the following reporting period. For example, if purchases are understated due to a cut-off error in the prior period, the misstatement is considered to 'turn around' in the following period and therefore overstates purchases in that period. Misstatements that are due to such errors (or fraud) are always considered to turn around in the following period, whereas misstatements that arise due to judgemental misstatements between the client and the auditor may not necessarily turn around. Assessing prior-period judgemental misstatements is a complex area that requires a high level of professional judgement and experience, and is considered an advanced auditing concept.

The identification and resolution of misstatements is one of the most important responsibilities in an audit and is a critical step in the formulation of the opinion on the fairness of the client's financial report. Considerable judgement is required when reaching a conclusion on the materiality of unrecorded misstatements, and is influenced by the evaluation of the needs of a reasonable person who will rely on the financial report. This requires the evaluation of the total mix of information available, both quantitative (the dollar amounts of the misstatements relative to the position and results of the entity) and qualitative (other considerations that are not influenced by the dollar amount of the misstatements). This is why the final evaluations and conclusions formed regarding misstatements are always performed by the engagement partner.

12.4.3 Qualitative considerations

Qualitative considerations may cause misstatements of quantitatively immaterial amounts to be considered material to the financial report.

Examples of this are when correcting the misstatement would affect:

- the client's compliance with regulatory requirements or covenants under debt or similar agreements
- the client's compliance with contractual requirements of operating and other agreements
- management's satisfaction of requirements for the award of bonuses or other forms of incentive compensation
- the reported profit by changing it to a loss or vice versa
- individual line items, subtotals or totals by a material amount
- key ratios monitored by analysts or other key users of the financial report.

CLOUD 9

Numerous misstatements have been found during the Cloud 9 audit. Sharon and the team review these items individually as they arise, and collectively at the completion of the audit field work.

For any matters they believe are material, either quantitatively or qualitatively, they will prepare a brief for the partner. The partner needs to understand the nature of the item, including the probable cause of the error and whether it is an indicator of more serious issues in the client's systems. The brief will outline the nature of the evidence gathered and the additional work completed to verify the size and nature of the misstatement, including whether there was an expansion of the sample size and the results of any alternate procedures performed. The brief will make a recommendation and outline why the audit team believes that an adjustment should be made to the client's financial report.

PROFESSIONAL ENVIRONMENT

Forensic accounting

One of the more popular television genres in recent years has been crime with a heavy reliance on forensic science to solve cases (for example, the *CSI* franchise). The programs are so popular there are claims that they have led to a jump in enrolments in forensic science courses. According to an analysis of the demand for forensic accounting courses, interest in forensic accounting has also never been higher, although this is more likely due to the fall-out from high-profile corporate collapses such as Enron and WorldCom than from any television program.[1] Some authors claim that these cases have made boards of directors more aware of their liability for fraud.[2] If a problem is brought to their attention they appear to be more willing to order an investigation, and forensic accountants are called in to do the work.

Another potential cause of the increased interest in forensic accounting is terrorism. Since the tragedy of 9/11, tracing the money trail behind terrorism has been a high priority for security agencies.[3] Forensic accounting expertise is similar to auditing in the sense that both rely on a deep understanding of double-entry accounting plus a large dose of other skills and attributes; in the case of forensic accounting, these include expert knowledge of legal systems and interview techniques. However, at its heart, forensic accounting relies on accounting knowledge because some fraudsters go to great lengths to hide their trail and a knowledge of double-entry bookkeeping is necessary to keep up.[4]

Forensic accountants need to have an eye on how their findings will be used in court. In fact, 'forensic' means something that will be used in, or is suitable to be used in, courts of law. In the past, most forensic accounting work related to appearances in court as expert witnesses for personal injury or divorce cases.[5] Now, forensic accounting practices are focusing more on investigation, fraud risk management, anti-money laundering and computer forensics.[6]

Large accounting firms, such as EY, are now actively offering forensic data analytic services to their clients.[7] Using the power of increasingly sophisticated algorithms, accounting firms are helping their clients proactively search for fraud rather than concentrate on detecting problems after they occur. The patterns contained in data held in corporate databases is being unlocked by these algorithms to expose issues and predict future events. Company managers can be overwhelmed by the amount of data being stored in their systems and accountants are helping them manage, interrogate and analyse the data to create value and prevent losses.

BEFORE YOU GO ON

- What does an auditor do when misstatements identified during the audit are not corrected by the client?
- Why is it important to consider the prior-year unadjusted misstatements?
- Name two qualitative considerations that may be taken into account when assessing misstatements.

12.5 Evaluating the conclusions and forming an opinion

LEARNING OBJECTIVE 12.5 Evaluate conclusions obtained during the performance of the audit and explain how these conclusions link to the overall opinion formed on the financial report.

The final phase of the audit is to assess all of the audit evidence obtained and determine whether it is sufficient and appropriate to reduce the risk of material misstatement in the financial report to an acceptably low level. Forming an opinion on the financial report involves the following four steps.

1. Evaluate the audit evidence obtained.
2. Evaluate the effects of unrecorded misstatements identified and the qualitative aspects of the entity's accounting practices.
3. Evaluate whether the financial report has been properly prepared and presented in accordance with the applicable reporting framework (ordinarily International Financial Reporting Standards (IFRSs)).
4. Evaluate the fair presentation of the financial report.

12.6 Components of the audit report

LEARNING OBJECTIVE 12.6 Explain the components of an audit report.

The format of an audit report for a financial report is governed by ASA 700 (ISA 700) (Revised) *Forming an Opinion and Reporting on a Financial Report.* During 2015, the AUASB issued a new auditing standard, ASA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* (in 2014, the IAASB issued ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report).* While this standard can be applied to the audit or review of any general purpose financial report, it is specifically required that it be applied for audits of listed entities (and in some parts of the world it is required that it be applied to a broader group of audits such as public interest entities).

For audit reports that are not prepared for financial reports but rather are provided on other historical financial information, ASA 800 (ISA 800) (Revised) *Special Considerations — Audits of Financial Reports Prepared in Accordance with Special Purpose Frameworks*, ASA 805 (ISA 805) (Revised) *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement* and ASA 810 (ISA 810) (Revised) *Engagements to Report on Summary Financial Statements* detail the required components of the audit report, which are the same as required by ASA 700 (ISA 700 (Revised).

The way in which auditors report on listed entity audit reports is currently undergoing one of the most significant changes in recent times, which has culminated in the creation of the new auditing standard ASA 701 (ISA 701). Although the layout and some of the content is changing, the most significant change is the introduction of a concept called **key audit matters** (KAMs). KAMs are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. KAMs should be specific to the entity and the audit that was performed in order to provide relevant and meaningful information to users. Therefore, ASA 701 (ISA 701) includes a judgement-based decision-making framework to help auditors determine which matters, from those communicated by those charged with governance, are KAMs. This decision-making framework was developed to focus auditors' attention on areas about which investors and other users have expressed interest — in particular areas of the financial statements that involve the most significant or complex judgements by management and those areas of focus that are in accordance with the risk-based approach in the ASAs (ISAs).

The number of KAMs that will be communicated in the auditor's report may be affected by the complexity of the entity, the nature of the entity's business and environment, and the facts and circumstances of the audit engagement, and it is thought that there will be at least one KAM for an audit of a listed entity. ASA 701 (ISA 701) outlines the required elements that must be included in each KAM. The description of a KAM is required to include a reference to the related disclosures, if any, in the financial statements and must address:

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

The main components of the auditor's report are consistent between listed entity audit reports and other (non-listed) audit reports, and are required by ASA 700 (ISA 700) (Revised) to be in writing. The required components include:

1. title
2. addressee
3. introductory paragraph
   - identifies the entity whose financial report has been audited
   - states that the financial report has been audited
   - identifies the title of each of the statements that comprise the complete financial report
   - refers to the summary of significant accounting policies and other explanatory notes
   - specifies the date and period covered by the financial report
4. management's responsibility for the financial report. Management's responsibility includes establishing and maintaining internal controls relevant to the preparation and fair presentation of a financial report that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances

5. auditor's responsibility for the financial report. The auditor must state that the responsibility of the auditor is to express an opinion on the financial report based on the audit, state that the audit was conducted in accordance with auditing standards (including compliance with relevant ethical requirements), describe the audit and state that the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.
6. auditor's opinion on whether the financial report gives a true and fair view or is presented fairly, in all material respects, in accordance with the applicable financial reporting framework (IFRSs).
7. other matters; for example, in Australia, there is a requirement for all Corporations Act auditors to make a separate independence statement and a statement about the fulfilment of relevant ethical responsibilities. Often a general statement of auditor independence is included in the audit report irrespective of whether the entity is bound by the Corporations Act.
8. other reporting responsibilities; for example, in some cases auditors may be required to report on other matters (such as the remuneration report being prepared in accordance with the Corporations Act)
9. auditor's signature either in the firm's name, the personal name of the auditor or both (depending on the legislative requirements)
10. date of the report
11. auditor's address.

Other key enhancements as a result of the revisions to ASA 700 (ISA 700) (Revised) and the new auditing standard ASA 701 (ISA 701) for all audits include:

- the 'Opinion' section, required to be presented first and followed by the 'Basis for opinion' section
- enhanced auditor reporting on going concern, including
  - a description of the respective responsibilities of management and the auditor for going concern
  - a separate section when a material uncertainty exists and is adequately disclosed, under the heading 'Material uncertainty related to going concern' (previously included in an 'Emphasis of matter' paragraph)
  - a new requirement to challenge the adequacy of financial report disclosures for so-called 'close calls' in view of the applicable financial reporting framework when events or conditions are identified that may cast significant doubt on an entity's ability to continue as a going concern
- affirmative statement about the auditor's independence and fulfilment of relevant ethical responsibilities, and the identification of the relevant ethical requirements applicable within Australia
- enhanced description of the responsibilities of the auditor and key features of an audit, together with the provision that certain components of this description may be presented in an appendix to the auditor's report.

An example audit report is provided in chapter 1.

PROFESSIONAL ENVIRONMENT

Litigation and audit risk in tough economic times

A major problem faced by auditors is whether to express a going concern opinion (GCO) prior to a company failing. If an auditor expresses a GCO too early there is a fear that it may become a 'self-fulfilling prophecy'; that is, if the auditor expresses doubt about the company's ability to continue, then lenders may withdraw credit, increasing the financial pressure on the company and increasing the chances that the company will fail. If the auditor does not issue a GCO then the company may have a better chance of trading its way of out difficulty. A recent study by Geiger, Raghunandan and Riccardi investigated the propensity of auditors to express GCOs prior to the Global Financial Crisis (GFC).[8] They found that, after controlling for other factors related to GCOs, the propensity of auditors to issue a GCO prior to bankruptcy significantly increased after the onset of the GFC. Their results suggest that auditors may have been too reluctant to issue GCOs until the GFC increased the potential for accountants to face legal action for audit failure.

(*continued*)

Prior to the GFC, the auditors may have acquiesced to clients' pleas not to issue a qualified audit report and to give them time to rectify a situation. Professional accounting bodies around the world have issued guidance to their members to help with identifying and dealing with going concern issues linked to the global financial crisis. For example, in 2009 the Australian Auditing and Assurance Standards Board (AUASB) issued a bulletin on auditing considerations in an uncertain economic environment.[9] The bulletin was a response to the GFC and emphasised quality control of the audit, including appropriate direction, supervision and review by the engagement partner, and adequate documentation and communication. The AUASB issued an updated bulletin in 2012 as it became clear that troubled economic times were continuing.[10] The second bulletin reminds auditors to remain alert to issues associated with prolonged economic uncertainty that may individually, or in combination, affect the audit approach.[11] The AUASB stresses the need for professional scepticism and professional judgement in both bulletins. It reminds auditors of the requirements for assessing the appropriateness of the going concern assumption and the reporting options available to the auditor if there is doubt about the ability of the company to continue.

BEFORE YOU GO ON

- Name two factors included in the description of management's responsibility for the financial report as included in the audit report.
- Name five components of an audit report.
- What is the auditor's responsibility for a financial report as stated in the audit report?

12.7 Modifications to the audit report

LEARNING OBJECTIVE 12.7 Discriminate between the types of modifications to an audit report.

In some situations, the auditor's report will require modified wording to emphasise a certain matter or to express a qualified, adverse or disclaimer of opinion (as outlined in ASA 705 (ISA 705) *Modifications to the Opinion in the Independent Auditor's Report* and ASA 706 (ISA 706) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*). This usually happens when:

1. a significant uncertainty exists that should be brought to the reader's attention
2. a limitation of scope of the engagement exists
3. there is a disagreement with those charged with governance regarding the application of accounting policies or the adequacy of financial report disclosures.

12.7.1 Emphasis of matter

An emphasis of matter does not affect the auditor's opinion and usually applies to cases where there is an inconsistency between the directors' report and the financial report, or where the resolution of a matter is dependent on future actions or events not under the direct control of the entity, but that may affect the financial report, and the matter is disclosed in the financial report. The most common emphasis of matter used to be one relating to an entity's ability to continue as a going concern, which may depend on finance arrangements still in negotiation or the financial support of the parent entity. Now, instead of an emphasis of matter relating to going concern, there is a separate section in the audit report (no longer an emphasis of matter section) referring to any material uncertainty related to going concern.

If the document containing the audited financial report (often referred to as the **annual report**, which is issued by the entity (normally annually) and includes the financial report together with the auditor's report thereon) contains information that is materially inconsistent with the financial report (as required to be read by ASA 720 (ISA 720) *The Auditor's Responsibilities Relating to Other Information in Documents Containing an Audited Financial Report*), a request is made to the client to change the document. If the entity refuses to make the change, an emphasis of matter paragraph could be used to describe the material inconsistency. (In extreme cases such as when the information is so extremely different and contradictory to the financial report, it may be more appropriate to issue a disclaimer of opinion instead of adding an emphasis of matter paragraph. This is very rare.)

12.7.2 Limitation of scope

A limitation on the scope of the auditor's work could result from an inability to perform procedures (most common form of scope limitation) or an imposition by the entity (rare). The auditor may not be able to perform procedures believed necessary due to factors such as timing, damage to accounting records, lack of or restricted access to key personnel, accounting records or operating locations; or the absence of adequate accounting records to provide sufficient and appropriate audit evidence upon which to rely. For example, it may not be possible for the auditor to verify the existence of inventory if the client has not held a stocktake, or does not have particularly reliable perpetual inventory records. This would then form the basis for a limitation of scope qualification in the audit report. Where a scope limitation is material to the financial report a qualified opinion or disclaimer of opinion is expressed.

12.7.3 Disagreement with those charged with governance

The auditor may disagree with those charged with governance about matters such as the acceptability of accounting policies selected; the method of their application; or the adequacy of disclosures in the financial report. Where these disagreements are material to the financial report, a qualified or adverse opinion is expressed. Examples of such reports are included in ASA 705 (ISA 705) and ASA 706 (ISA 706). Table 12.1 outlines the circumstances in which a modification would be issued and the type of modification appropriate in the circumstances.

TABLE 12.1 Types of qualified and unqualified audit reports

Nature of matter which does not give rise to a qualification	Unqualified report	
Significant uncertainty — other	Emphasis of matter	
Additional disclosures with which the auditor concurs	Emphasis of matter	
Subsequent event resulting in a new auditor's report on a revised financial report	Emphasis of matter	
Nature of matter giving rise to the qualification	**Auditor's judgement about the pervasiveness of the effects or possible effects on the financial report**	
	Material but not pervasive	**Material and pervasive[a]**
Financial report is materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

[a] Where the circumstances are so material and pervasive that the auditor has been unable to obtain sufficient appropriate audit evidence or where a qualified opinion is inadequate to disclose the misleading or incomplete nature of the financial report.

CLOUD 9

Sharon prepares several versions of a draft audit report for the partner. The partner will discuss the audit report possibilities with Cloud 9's management at their meetings. The draft audit reports vary because the appropriate report depends on the outcome of the discussions between the partner and Cloud 9's management. If management refuses to amend the financial report for the material misstatements found during the audit, the audit report could be qualified. It is possible that a subsequent event could still occur that would require an emphasis of matter. However, there have been no scope limitations or material disagreements with those charged with governance.

BEFORE YOU GO ON

- Provide an example of a common emphasis of matter included in audit reports.
- Does the inclusion of an emphasis of matter paragraph in the audit report result in the audit opinion being qualified?
- Describe one situation in which a limitation of scope may be appropriate in the audit report.

12.8 *Corporations Act 2001* breaches

LEARNING OBJECTIVE 12.8 Explain why Corporations Act breaches are important to understand.

Under section 311 of the *Corporations Act 2001* (the Act) auditors are required to report any actual or suspected contraventions of the Act to ASIC within 28 days of an event. ASIC Regulatory Guide 34 *Auditor's obligations: reporting to ASIC* (RG 34) provides guidance on an auditor's obligation to report breaches of the Act. In RG 34, ASIC advises that the auditor's duty to report under sections 311 and 601HG of the Act is not limited to compliance with financial reporting requirements but extends to any contravention of the Act. While ASIC does not expect auditors to engage in a systematic search for all possible contraventions of the Act, the auditor is expected to be alert to matters that come to their attention that may indicate that there may be such contraventions. Reporting should be done on a timely basis and the auditor should not wait until the conclusion of the audit to report the matter.

RG 34 includes examples of suspected contraventions and how they might be dealt with by the auditor. Contraventions of the Act that are considered significant include:

- insolvent trading
- breaches of accounting standards
- fraud by officers or employees of the entity
- continual late lodgement or non-lodgement of annual statements and financial reports.

RG 34 also provides guidance in determining what constitutes 'reasonable grounds to suspect' a contravention, and when a suspected contravention will not be 'adequately dealt with'. It should be noted that if the suspected contravention will be adequately dealt with by commenting on it in the auditor's report or by bringing it to the attention of the directors, then no reporting to ASIC is required.

BEFORE YOU GO ON

- Name two instances considered to be a breach of the Corporations Act that require notification to ASIC under section 311.
- How quickly after a suspected breach is the auditor required to report to ASIC?
- When is a suspected contravention not required to be reported to ASIC?

12.9 Management representation and communication with those charged with governance

LEARNING OBJECTIVE 12.9 Explain what reporting is required to management and those charged with governance.

Communication with those charged with governance is covered in ASA 260 (ISA 260) (Revised) *Communication with Those Charged with Governance,* which requires that the auditor communicates audit matters of governance interest arising from the audit of a financial report with those charged with governance. Communication with those charged with governance, with management and with third parties, when applicable, is also covered in several other auditing standards. For example, if the auditor has identified a fraud, or has information that indicates the existence of a fraud, they are required to communicate these matters to an appropriate level of management by ASA 240 (ISA 240) (Revised) *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*. Similarly, when the auditor has identified material noncompliance with laws and regulations, they are required to communicate their findings to those charged with governance in accordance with ASA 250 (ISA 250) *Consideration of Laws and Regulations in an Audit of a Financial Report*.

'Governance' is the term used to describe the role of people entrusted with the supervision, control and direction of an entity. Those charged with governance are accountable for ensuring that the entity achieves its objectives, with regard to reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws, and reporting to interested parties. Those charged with governance includes management only when it performs such functions.

'Audit matters of governance interest' are those that arise from the audit of a financial report and, in the auditor's opinion, are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process. Audit matters of governance interest include only those matters that have come to the auditor's attention as a result of the performance of the audit. The auditor is not required to design audit procedures for the specific purpose of identifying matters of governance interest.

12.9.1 Audit matters of governance interest to be communicated

The auditor meets with management and those charged with governance to discuss the results of the audit. The matters that they discuss are those that arise from the audit and that, in the auditor's opinion, are both important and relevant to those charged with governance. As previously stated, the auditor is not required to design audit procedures for the specific purpose of identifying matters of governance interest.

Matters of governance interest that the auditor may wish to discuss with those charged with governance include:

- the general approach and overall scope of the audit, including any expected limitations thereon, or any additional requirements
- the selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial report. The auditor considers the appropriateness of the accounting policies to the particular circumstances of the entity. They judge these against the objectives of relevance, reliability, comparability and understandability, but having regard to the need to balance the different objectives and the cost of providing information with the likely benefit to users of the entity's financial report. They also discuss the appropriateness of accounting estimates and judgements, for example, in relation to provisions, including the consistency of assumptions and degree of prudence reflected in the recorded amounts.
- the potential effect on the financial report of any material risks and exposures, such as pending litigation, that are required to be disclosed in the financial report
- misstatements, whether or not recorded by the entity that have, or could have, a material effect on the entity's financial report
- material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern
- disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial report or the audit report. These communications include consideration of whether the matter has, or has not, been resolved and the significance of the matter.
- expected modifications to the audit report. The auditor discusses any expected modifications to their audit report on the financial report with those charged with governance to confirm that
  - those charged with governance are aware of the proposed modification and the reasons for it before the report is finalised

– there are no disputed facts in respect of the matter(s) giving rise to the proposed modification (or that matters of disagreement are confirmed as such)
– those charged with governance have an opportunity, where appropriate, to provide further information and explanations in respect of the matter(s) giving rise to the proposed modification

- any practical difficulties encountered in performing the audit
- any irregularities or suspected noncompliance with laws and regulations that came to the auditor's attention during the audit
- comments on the design and operation of the internal controls and suggestions for their improvement, particularly if the auditor has identified material weaknesses in internal control during the audit. This is sometimes separately communicated in a management letter as discussed in chapter 6.
- any other matters agreed upon in the terms of the audit engagement.

The auditor also informs those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial report taken as a whole.

12.9.2 Documentation considerations

The auditor retains a copy of the communication with those charged with governance in their working papers, together with details of any responses from management and/or those charged with governance and their intended action(s). If the communication takes the form of a presentation at a meeting or meetings, the auditor files a copy of the presentation material and also gives a copy of the material to management to prevent disputes at a later date. Depending on the nature, sensitivity and significance of the matters communicated, the auditor may decide to confirm oral communications in writing.

As soon as practicable, the auditor should communicate weaknesses in internal controls to management or those charged with governance. The reporting of internal control weaknesses should always be documented; the most common form is a letter (as discussed in chapter 6). However, depending on the circumstances, documentation in the form of a file note (minutes of meetings) may be appropriate to evidence the discussion held on internal control weaknesses.

CLOUD 9

Sharon also prepares a draft letter to be used for communication with those charged with governance at Cloud 9. The letter is incomplete but will be finalised after the completion of subsequent events procedures and the final meetings between the partner and Cloud 9's management.

BEFORE YOU GO ON

- Name five items of governance interest that would be communicated to those charged with governance.
- Is communication with those charged with governance always in the form of a letter?
- If communication is not always in the form of a letter, what other forms of communication could the auditor use?

SUMMARY

12.1 Explain the procedures performed as part of the engagement wrap-up, including gathering and evaluating audit evidence.

During the engagement wrap-up, the auditor reviews planned audit procedures to ensure they are completed, finalises any open items (including review notes and to-do items), ensures all necessary documentation is in the working paper files and removes any unnecessary documentation, reconsiders their assessment of internal control and fraud risk, reconsiders materiality, assesses misstatements and performs subsequent events procedures.

12.2 Explain the considerations when assessing the going concern assumption used in the preparation of the financial report.

The auditor is required to consider whether the going concern assumption is the correct basis upon which the financial report has been prepared. That is, is the entity viewed by the auditor, management and those charged with governance as continuing into the foreseeable future with neither the intention nor the need to liquidate, to cease trading or to seek protection from creditors?

12.3 Assess the two types of (material) subsequent events to determine what effect they have on the financial report (if any).

There are two types of subsequent events. Type 1 subsequent events are those that provide additional evidence with respect to conditions that existed at year-end. These are required to be adjusted for in the financial report. Type 2 subsequent events are those that provide evidence with respect to conditions that developed subsequent to year-end; these are not required to be recorded in the financial report, but are considered for inclusion as a disclosure note.

12.4 Evaluate misstatements and explain the difference between quantitative and qualitative considerations when evaluating misstatements.

Quantitative and qualitative considerations of misstatements include the risk of undetected errors remaining, the effect of the misstatements on compliance with covenants or agreements, whether the misstatements are errors or judgemental misstatements, whether any prior-period unadjusted misstatements exist and could have an impact on the current period's results, the likelihood that these differences may become material in the future, the sensitivity of the misstatements, the significance of the misstatements for the known users of the financial report, the effect of offsetting differences in different financial report captions and the dollar amount (quantity) of the misstatements.

12.5 Evaluate conclusions obtained during the performance of the audit and explain how these conclusions link to the overall opinion formed on the financial report.

An unmodified opinion is issued where there are no material misstatements in the financial report; an unmodified opinion with an emphasis of matter relates to when there is a matter that exists causing an inherent uncertainty that the auditor wishes to highlight in their opinion. Modified opinions are in response to the materiality and pervasiveness of the inherent uncertainty or misstatement and the auditor has either been unable to obtain sufficient appropriate audit evidence or the qualified audit opinion is inadequate in disclosing the misleading or incomplete nature of the financial report.

12.6 Explain the components of an audit report.

The audit report includes a title, addressee, introductory paragraph, management's and the auditor's responsibility for the financial report, audit opinion, other matters including other reporting responsibilities, auditor's signature, date of the report and auditor's address. Audit reports for listed entities also now have a requirement to include key audit matters.

12.7 Discriminate between the types of modifications to an audit report.

The overall conclusion reached at the end of the audit can be unmodified, unmodified with an emphasis of matter, modified with a qualification, modified with an adverse opinion or modified with a disclaimer of opinion.

12.8 Explain why Corporations Act breaches are important to understand.

Breaches (or suspected breaches) of the Corporations Act are required under the Corporations Act to be reported by the auditor to ASIC.

12.9 Explain what reporting is required to both management and those charged with governance.

Reporting to management and those charged with governance is required to include all matters of governance interest identified as a result of the audit procedures performed. These can be provided verbally or in writing, with written communications (or evidence of communications) preferred.

KEY TERMS

Annual report A document issued by an entity, ordinarily on an annual basis, which includes its financial report together with the auditor's report thereon.

Error An unintentional misstatement in the financial report, including the omission of an amount or a disclosure.

Going concern The viability of a company to remain in business for the foreseeable future.

Judgemental misstatement A misstatement that arises as a result of a difference in underlying assumptions or the application of judgement by the client and the auditor. A judgemental misstatement is not the same as an error.

Key audit matters Those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial report of the current period.

Materiality Information that impacts on the decision-making process of users of the financial report.

Misstatement A difference between the amount, classification, presentation or disclosure of a reported financial report item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Professional judgement The auditor's professional characteristics such as their expertise, experience, knowledge and training.

Subsequent events Both events occurring between year-end and the date of the auditor's report, and facts discovered after the date of the auditor's report.

Sufficient appropriate evidence Sufficiency is the quantity and appropriateness is the quality of audit evidence gathered.

Those charged with governance Generally the board of directors and management of an entity.

MULTIPLE-CHOICE QUESTIONS

12.1 At the conclusion of the audit, the wrap-up process involves: **LO1**

(a) revisiting open review notes, to-do items and open audit procedures.
(b) review of proper and complete execution of planned audit procedures.
(c) determination that all necessary matters have been appropriately considered.
(d) all of the above.

12.2 If an auditor finds any misstatements or deviations in planned procedures: **LO4**

(a) the auditor should not revise the risk assessment.
(b) the auditor should continue with procedures as planned.
(c) the auditor should consider the reason for the misstatement or deviation.
(d) the auditor does not have to consider the need to perform further audit procedures.

12.3 The going concern assumption means: **LO2**

(a) assets and liabilities are stated at liquidation values.
(b) the entity is facing difficulties continuing as a going concern.

(c) the auditor is concerned whether the entity is going to change locations.
(d) the entity is viewed as continuing in business for the foreseeable future with no need for liquidation.

12.4 Subsequent events are events subsequent to the: **LO3**
(a) end of the financial year.
(b) appointment of the auditor.
(c) start of the financial year.
(d) going concern assumption.

12.5 Which of the following is an example of a subsequent event? **LO3**
(a) Legal action that was settled in the last month of the financial year
(b) An event that occurred after the start of the year but before the end of the year
(c) An event that provides additional evidence with respect to conditions that existed at year-end
(d) All of the above

12.6 If an auditor becomes aware of a fact that may materially affect the financial report after the date of the auditor's report but before the financial report is issued, the auditor should: **LO3**
(a) discuss the matter with management.
(b) take the action appropriate in the circumstances.
(c) consider whether the financial report needs changing.
(d) all of the above.

12.7 Which is an example of the type of event that provides evidence with respect to conditions that developed subsequent to year-end? **LO3**
(a) Loss of plant as a result of fire or flood after year-end
(b) An amount received in respect of an insurance claim that was in the course of negotiation at year-end
(c) Deterioration in financial results after year-end, which may indicate doubt about the going concern assumption in the preparation of the financial report
(d) Bankruptcy of a customer subsequent to year-end, which would be considered when evaluating the adequacy of the allowance for uncollectable accounts

12.8 Management's responsibility for the financial report includes: **LO6**
(a) selecting internal controls tests.
(b) selecting samples for audit testing.
(c) selecting and applying appropriate accounting policies.
(d) selecting experts to assist with testing asset valuations.

12.9 Emphasis of matter is used without an accompanying qualification of the audit report when: **LO7**
(a) an extreme limitation of the scope of the engagement exists.
(b) a significant uncertainty exists that should be brought to the reader's attention.
(c) there is a disagreement with those charged with governance regarding the selection of accounting policies.
(d) all of the above.

12.10 Communication with those charged with governance: **LO9**
(a) is done at the start of the audit.
(b) is done through the audit report.
(c) requires the auditor to write to the CEO at the conclusion of the audit.
(d) means that the auditor should write to the board of directors about any matters of governance interest arising from the audit of the financial report.

REVIEW QUESTIONS

12.11 What is the process of 'engagement wrap-up'? Why is it important? **LO1**

12.12 What are the auditor's responsibilities with respect to other information in the client's annual report? **LO1**

12.13 What are the auditor's responsibilities for 'going concern'? **LO2**

12.14 Explain the difference between the two types of subsequent events. **LO3**

12.15 Discuss the auditor's responsibility for detecting subsequent events (a) prior to the completion of field work, (b) prior to signing the audit report, and (c) between the date of the audit report and the issuance of the financial report. **LO3**

12.16 What is the difference between current-year misstatements and prior-year misstatements? **LO4**

12.17 List the steps involved in forming a conclusion on the audit. **LO5**

12.18 What are key audit matters? How do these affect the format of the audit report? **LO6**

12.19 What is 'modified wording' in an audit report? What are the different types of modified wording and when are they used? **LO7**

12.20 Explain the difference between limitation of scope and disagreement with those charged with governance. **LO7**

12.21 What are the auditor's responsibilities under the Corporations Act to report breaches of the Act? Who does the auditor report to? **LO8**

12.22 What matters does an auditor communicate at the end of the audit to those charged with governance? Why are these matters important? **LO9**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

12.23 EVENTS AFTER BALANCE DATE ★ **LO3**

Steve Smith is reviewing the results of the review of subsequent cash receipts. There are several receipts listed from customers that were considered doubtful at the end of the year (30 June). Steve is also reviewing evidence that shows that another customer that had a large balance at year-end was unexpectedly declared bankrupt on 10 July.

Required

How should this information be reflected in the financial report?

12.24 GOING CONCERN ★ **LO1**

Martin Stanaway is the partner in charge of the audit for a new client, Western Wonderland (WW). The client engaged Martin's audit firm in November 2017, in preparation for the 2018 audit. From 30 January 2018 onwards, WW has consistently paid its suppliers late, well in excess of the suppliers' agreed credit terms. This has resulted in some suppliers demanding cash on delivery from WW. Martin is also aware from his review of correspondence between WW and its bank that the company has been experiencing cash flow problems since 2016.

Required

Identify any significant events or conditions that individually or collectively may cast significant doubt on WW's ability to continue as a going concern.

Source: Adapted from the CA Program's *Audit & assurance exam,* December 2010.

12.25 EMPHASIS OF MATTER PARAGRAPH ★ **LO2, 7**

Springsteen Ltd is a new audit client for the 2015–16 financial year. Springsteen's financial report for the 2016–17 year, the last with the previous auditor, was prepared on the assumption of a going concern. The auditor's report included a discussion of the going concern issue. The issue identified by the auditor was that Springsteen was due to refinance a material amount of debt shortly after the prior year-end. You are aware that Eastcoast Bank appeared unwilling to extend further finance, and Springsteen had taken no steps to secure other finance. Springsteen did not disclose any information about the debt refinancing matter in its financial report.

Required

Was the opinion in the auditor's report appropriate? Explain.

Source: Adapted from the CA Program's *Audit & assurance exam,* May 2010.

12.26 AUDIT DOCUMENTATION FOR GOING CONCERN ★ **LO1, 2, 5**

It is August 2016 and the first audit for Springsteen Ltd with your audit firm (refer to question 12.25) for the 2015–16 year is almost complete. Prior to reaching your final conclusions, you are reviewing the working papers for the year ended 30 June 2016. The material bank loan with Eastcoast Bank was extended in September 2015 for another 12 months.

Required

Given the history of the bank loan, outline two types of documentation you would expect to see included in the audit file to provide audit evidence that this year's financial report can be prepared on a going concern basis.

Source: Adapted from the CA Program's *Audit & assurance exam,* May 2010.

12.27 AUDIT WRAP-UP ★ **LO1**

Lucy Huang has just finished her first audit assignment. She is now assisting her audit manager, Tom Lucas, wrap-up the engagement. He has asked Lucy to make a list of all open review notes, to-do items and audit procedures, and note for each whether the matter requires more attention, has been resolved (but not yet noted on file), or is no longer relevant because of other events.

Tom has also asked Lucy to go through the files and remove all unnecessary documentation, drafts and review notes. Lucy is very nervous about this task because she believes her inexperience will mean that she will not be able to distinguish 'unnecessary' from 'necessary'. She has heard that in a famous case in the United States an audit firm was prosecuted because it shredded files that should have been kept.

Required

(a) What additional attention would open matters require?
(b) Explain why documents on a client's audit files would be 'unnecessary'. Give examples.

12.28 REPORTING SUBSEQUENT EVENTS ★★ **LO3, 7**

Turnbull Ltd has placed deposits with an overseas supplier totalling \$340 000 for the manufacture of specially branded goods on 14 May 2016. On 27 May 2016 the supplier closed due to civil unrest in the country. Expert opinion obtained on 28 July 2016 stated that it was unlikely that the deposit would be recovered. Turnbull Ltd purchases over \$3 million worth of branded products from this supplier every year. The year-end for the Turnbull Ltd audit is 30 June 2016, and the audit report is due to be signed on 14 August 2016.

Required

(a) Is the event material?
(b) What is the appropriate treatment of this item in the financial report?
(c) What audit report would be appropriate if the directors of Turnbull Ltd refuse to change the financial report?

Source: Adapted from the CA Program's *Audit & assurance exam,* December 2010.

12.29 ASSESSING GOING CONCERN ★★ **LO2, 7**

Melbourne Metal Fabricators (MMF) is a company that makes steel components for the construction industry. It specialises in extreme precision manufacturing where tolerances are measured in distances of less than one millimetre. Its products are used in revolving restaurants, automatic doors and similar construction components. In the past, the majority of its sales have been to international construction companies, particularly in the Middle East. The drop in the price of oil has slowed construction in the Middle East, and the extremely expensive buildings requiring high-precision steel components are becoming less popular. In addition, some of the technology used by MMF has been copied by companies in South-East Asia, resulting in extreme price competition in this section of the construction industry for the first time.

MMF is highly geared. Two years ago the company borrowed a large sum of money to fund the purchase of new premises and the latest laser cutting equipment. The loan is due for renewal three months after year-end. One week before signing the audit report, the bank has still not agreed to renew the loan and MMF's management has commenced negotiations with another bank.

Required

(a) Identify the factors that would raise questions about the going concern assumption for MMF. Are there any mitigating factors?

(b) What reporting options are available to the auditor of MMF? Discuss.

Refer to ASA 570 in your answer.

12.30 SUBSEQUENT EVENTS PROCEDURES ★★ **LO3**

Riley and Rosie are discussing the audit plan for a large manufacturing company. The company has two main manufacturing plants plus several warehouse and distribution centres (one in each state). The company has a large investment in trade receivables and there are additional concerns this year about whether the tough economic conditions have affected the collectability of the debts. The agenda for the board of directors' monthly meeting includes an item to discuss the effect of the economic crisis on customers. The board is also negotiating a takeover with a competing company. The discussions have been ongoing for some time and one month before year-end the board of the other company indicated it would like more progress to be made on this deal.

Riley and Rosie are reviewing the draft plan to ensure that adequate procedures are included to meet their obligations for detecting subsequent events during the period from year-end to the date of signing the audit report. Riley is the engagement partner on the audit and Rosie is an audit manager. Rosie admits to Riley that she has always had trouble distinguishing the two types of subsequent events in AASB 110 and therefore has some trouble applying ASA 560. She also admits to Riley that she has never been involved in an audit where there was a subsequent event arising after the date of the audit report, so she doesn't know what the auditor is supposed to do in these circumstances.

Required

(a) Explain the difference between the two types of subsequent events. Give an example of each and explain the type of adjustment (if any) that would be required to the financial report or each.

(b) List some audit procedures that should be in the audit plan for this company for the detection of subsequent events occurring prior to the date of the audit report.

(c) Explain the auditor's responsibilities for subsequent events that arise after the date of the audit report (either before or after the date the financial report is issued). What is the difference in the auditor's responsibilities between these events and those arising before the date of the audit report?

12.31 REPORTING SUBSEQUENT EVENTS ★★ **LO3**

Brad Jones is reviewing the results of the subsequent events audit procedures. Brad is writing a report for his audit partner based on these results and will be attending a meeting tomorrow with the partner and representatives of the company to discuss them. The issue will be whether the financial report should be amended or additional notes included for these subsequent events.

Many of the items are not material and Brad will recommend that no action be taken with respect to these. However, there are several items that Brad believes are material and should be discussed at the meeting. These are as follows.

- The board is planning to issue shares in a private placement on 15 August.
- The share issue is to fund the purchase of a 60 per cent stake in another company. The negotiations are in the final stages and although the contract is not yet signed it will be signed by 15 August.
- A writ was lodged in the Supreme Court in the week after year-end claiming damages for illness allegedly caused by chemicals used at a subsidiary company's manufacturing plant in the 1990s. This

is the tenth such writ lodged and the client has denied responsibility in all cases because it was unreasonable to believe at that time that these chemicals had adverse health effects. The claimant has new scientific evidence that counters this defence.

The review of subsequent cash receipts has revealed that several of the trade receivables that were considered doubtful have now been paid. However, the audit procedures have shown that a large debtor that was considered safe at 30 June was unexpectedly declared bankrupt on 20 July.

The year end for the company is 30 June and the audit report is due to be signed on 20 August.

Required

For each item above:

(a) What type of subsequent event is it?

(b) What is the appropriate treatment in the financial report?

12.32 AUDIT REPORTS AND OTHER COMMUNICATION AT THE END OF AN AUDIT ★★ **LO5, 7, 9**

Sven Erasmus has had difficulties throughout the audit of Cantwell Catering. The company is a long-standing client of the audit firm and there have been no problems in the past. However, four months into the start of the financial year the company's computer systems failed. Subsequent diagnostic tests revealed that a particularly nasty virus had infected the computer system and corrupted all the processed data. The IT manager called in an IT specialist for advice as soon as the problem was discovered. The specialist installed a new computer system and additional security programs and the IT manager is confident that the problem will not recur.

The processed data had been backed-up and stored in a secure location, but when a restoration was attempted it was discovered that the virus also corrupted the backups. The Cantwell Catering staff tried to reconstruct the computer files based on paper records, but the reconstruction was incomplete because some paper documents had been inadvertently destroyed.

Sven is particularly concerned about sales and trade receivables. Cantwell Catering has many 'one-time' customers as well as several large accounts. The first four months of the year corresponded to the busiest time of the year for the company. Staff attended many corporate and private functions during this time and made numerous sales of catering equipment to wholesale and retail customers. Or, at least they think they did, and they believe that they collected all the accounts. Sven is not so sure. He thinks the chaos caused by the computer virus meant that deliveries were being made in a rush without the completion of the appropriate paperwork, and the attempts to collect accounts were ineffectual as customers took advantage of the situation to claim they had either already paid or had returned goods for credit. Other customers simply 'fell off' the system and were never billed.

Required

(a) Discuss Sven's audit report options and recommend the appropriate wording for the audit report.

(b) What matters would Sven include in the letter to those charged with governance at Cantwell Catering?

12.33 MISSTATEMENTS AND THE AUDIT REPORT ★★★ **LO4, 5, 7**

Meg Lithgow is the engagement partner of the audit of Champion Securities, an investment company. Most of Champion's assets and liabilities are financial and their valuation is critical to the assessment of the company's solvency and profitability. Meg has employed two outside experts to value the financial assets and liabilities because they are extremely complex to value, particularly the energy market derivatives and the instruments traded in foreign markets. In addition, the valuations are highly dependent on market conditions and the specific and detailed requirements of the recently revised accounting standards.

Throughout this year's audit, Meg has had difficulties with the CEO of Champion Securities. He is vehemently opposed to any asset write-downs she has suggested. The CEO has the backing of the chairman of the board and Meg has been unable to get the CEO to listen to her concerns about the valuations of the financial assets and liabilities the company has made. In past years, Meg has had an amicable relationship with both the CEO and the chairman and the audits have run very smoothly. Meg has now realised that this harmonious relationship was mainly due to the boom in the market. It was unlikely that there would be arguments about writing up the value of the company's assets during these good times.

Meg, with the help of the experts, has prepared a summary of the relevant items, detailing the revised values for the assets and liabilities and the associated effects on income and retained earnings. The CEO has dismissed this summary and the audit recommendations with the comment, 'The market has hit the bottom and is recovering. There is no need to show these write-downs because by the time the financial report is published the values will be back to where they were before the market fell. It is all a waste of time. In fact, I think you are just being difficult to deal with. I think we need an auditor who is a bit more realistic'.

Required

(a) Discuss the ethical issues Meg faces and explain what she needs to do to comply with APES 110.
(b) Explain Meg's audit report options.
(c) Recommend a course of action for Meg.

Questions 12.34 and 12.35 are based on the following case.

Fabrication Holdings Ltd (FH) has been a client of Keith & Fiona Partners for many years. You are an audit senior and have been assigned to the FH audit for the first time for the financial year end 30 June 2017.

FH's' financial report for the year ended 30 June 2017 shows land and buildings at fair value of $20.8 million. As part of your subsequent events procedures, you become aware that FH sold the property in July 2017 when an independent third party made an unexpected offer of $24.5 million. The difference between the sale price and the amount stated in the financial report (which has not been adjusted) is material. You have not yet signed the audit report.

Source: Adapted from the CA Program's *Audit & assurance exam,* May 2008.

12.34 SUBSEQUENT EVENTS ★★★ — LO3

Analyse the events surrounding the sale of land and buildings. Is it a subsequent event? If so, which type?

12.35 AUDIT REPORTS AND SUBSEQUENT EVENTS ★★★ — LO7

Based on your answer to the question 12.34, explain what type of audit opinion you would issue. Why?

Questions 12.36 and 12.37 are based on the following case.

Chan and Partners Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year, Chan and Partners gained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home
- Total Cancer Specialists Limited (TCSL), a private oncology clinic that specialises in the treatment of cancer.

Year-end for all MSHG entities is 30 June.

You are the audit partner reviewing the audit work papers for MSHG for the year ended 30 June 2017. Today is 13 July 2017 and the audit report is due to be signed in three weeks' time.

During your review you note that the fixed-term borrowings of MSHG totalling $75 million are approaching maturity and MSHG does not seem to have renegotiated any terms of refinancing. You are aware, from your experience with other clients, that banks are reluctant to extend financing on the same terms in the current market. The financing of MSHG was historically managed by the group's treasurer who left the group six months ago and has not been replaced.

MSHG's financial controller, who has been with the group for nine months, has advised you that he has been busy renegotiating with some of MSHG's key suppliers who recently requested cash on delivery for all orders rather than extending the normal credit terms.

You are also aware that a fire that occurred in the hospital cafeteria last week was not adequately covered by insurance. Fortunately, no one was seriously injured in the fire, but the cafeteria was so badly damaged it had to be closed. While discussing this matter with MSHG's law firm, they reveal that the hospital is unlikely to have adequate professional indemnity insurance to meet the current demands of several malpractice cases that have been brought against the hospital in the last 12 months.

Source: Adapted from the CA Program's *Audit & assurance exam,* December 2008 and March 2009.

12.36 FINAL REVIEW ISSUES — SUBSEQUENT EVENTS ★★★ LO3

(a) Explain your responsibilities with respect to the cafeteria fire.
(b) How will this event be handled in the financial report and the audit report?

12.37 FINAL REVIEW ISSUES — GOING CONCERN AND REPORTING ★★★ LO2, 7

(a) Are there any going concern issues for MSHG? Explain. If so, what are the mitigating circumstances?
(b) How will you recommend the issue be handled in the financial report and the audit report?

CASE STUDY — CLOUD 9

ASA 560 *Subsequent Events* requires the auditor to consider material events they may discover after the end of the financial period and up to (and including) the date the auditor's report is signed. In this assignment you will apply the requirements of ASA 560 to a number of different scenarios that could arise during the audit of Cloud 9.

The end of the financial year is 31 December 2016. The audit report was signed on 15 February 2017. The financial statements and directors' report was signed on 15 February 2017 and released to the public that same day along with the auditor's report.

Required

You have been given a number of independent situations:

i. You discover on 15 January 2017 that Shoez, a major customer, has become insolvent and Cloud 9 will not be able to collect amounts owing to them.
ii. You discover on 10 February 2017 that a customer is suing Cloud 9 after they slipped and fell inside a Cloud 9 retail outlet. The accident occurred in November 2016.
iii. On 31 January 2017 the federal government released a draft working paper proposing an increase in import duties on all goods from China of 150 per cent starting in July 2017. This increase in duties would increase the price of Cloud 9 shoes significantly.
iv. At the official launch of the financial statements you overhear the financial controller discussing a situation where an employee has been stealing cash from Cloud 9.
v. In March 2017 you read a newspaper article with regard to Cloud 9 possibly purchasing the shoe company Groovy Shooz (a competitor).
   (a) Describe what action should be requested of the client by the auditor in each of the following situations. Potential options include:
      - requesting that the client make a disclosure in the notes to the accounts
      - requesting that the client make an adjustment (name the account)
      - advising the client of a change in audit opinion (what sort of opinion should be given)
      - doing nothing.
   (b) Explain your answer. Include an accounting and/or auditing standard and paragraph reference to support your answer.

RESEARCH QUESTION

During the Global Financial Crisis (GFC) of the late 2000s several banks failed and other companies were adversely affected. It is possible that shareholders and lenders of failed companies could take legal action against auditors as they search for scapegoats and potential places to recover their losses. The tough economic times following the GFC could also cause companies to fail that would otherwise have survived, exposing bad management and poor quality auditing.

Required

Conduct a literature search for reports of threatened and actual legal action against auditors since the beginning of the GFC. Include in your search articles raising questions about auditors and the quality of their work even though legal action has not commenced.

Write a summary of your findings and comment on the merits of the cases against auditors. Is there any evidence of poor quality auditing?

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. d, 2. c, 3. d, 4. a, 5. c, 6. d, 7. a, 8. c, 9. b, 10. d.

NOTES

1. Long, C 2007, 'Forensic frenzy', *Charter*, vol. 78, no. 5, June, pp. 20–2.
2. ibid.
3. See for example, information about forensic accounting at www.forensic-accounting-information.com.
4. Long, op. cit.
5. ibid.
6. ibid.
7. EY 2013, *Forensic data analytics*, Ernst & Young LLP, www.ey.com/Publication/vwLUAssets/EY_-_Forensic_Data_Analysis/$FILE/Forensics-Data-Analytics.pdf.
8. Geiger, MA, Raghunandan, M & Riccardi, W 2014, 'The Global Financial Crisis: U.S. bankruptcies and going-concern audit opinions', *Accounting Horizons*, vol. 28, no. 1, March, pp. 59–75.
9. Auditing and Assurance Standards Board (AUASB) 2009, *AUASB bulletin*: *Auditing considerations in an uncertain economic environment*, April, www.auasb.gov.au.
10. Auditing and Assurance Standards Board (AUASB) 2012, *AUASB bulletin*: *Auditing considerations in a prolonged uncertain economic environment*, August, www.auasb.gov.au.
11. ibid., p. 1.

APPENDIX

W&S Partners is an Australian accounting firm with offices located in each of the major cities. W&S Partners has just won the 31 December 2016 statutory audit work for Cloud 9 Pty Ltd. The audit team assigned to the client is: Partner, Jo Wadley; Audit Manager, Sharon Gallagher; Audit Senior, Josh Thomas; IT Audit Manager, Mark Batten and you.

Prior-year audits were conducted by Ellis & Associates. As part of the transfer of records process, Jo Wadley met with RJ Ellis (Managing Partner, Ellis & Associates) to discuss acceptance of Cloud 9 Pty Ltd as a client and to inquire about access to Ellis & Associates' workpapers. In the discussion, RJ Ellis stated that there were no issues that W&S Partners should be aware of before accepting the client or commencing the work.

Cloud 9 Pty Ltd company background

Originally founded in 1980 by R.A. McLellan, the Sydney-based company was a manufacturer and retailer of customised basketball shoes. In 1996, Cloud 9, Inc. (a publicly listed United States [US] company) purchased the original company from R.A. (Ron) McLellan and renamed it Cloud 9 Pty Ltd. As part of the sale agreement, R.A. McLellan was appointed to the Cloud 9 Pty Ltd board of directors.

The parent company, Cloud 9, Inc., has wholly owned subsidiaries in the United Kingdom (UK), Germany, Canada, China and Brazil, and has built a reputation around the fact that its shoes have comfort and durability. The company promotes itself using its now well-known tagline 'Our shoes are so comfortable; it's like walking on Cloud 9'. Currently, Cloud 9 Pty Ltd is primarily a wholesaler of athletic shoes to its main customers: David Jones, Myer, Foot Locker and Rebel Sports. In 2013, it also started a small on-line channel to supply direct to customers.

Cloud 9 Pty Ltd receives the majority of its stock from the China production plant, with the remainder coming from the US. All stock is purchased on free on board (FOB) shipping terms, which means Cloud 9 Pty Ltd takes ownership of the products once the international courier accepts the goods for delivery. The stock is sent to the main warehouse in Botany, Sydney, that is linked to retailers via an electronic inventory system. When retail stock levels get low, the company ensures deliveries are made using their own transport trucks, thus ensuring control throughout the entire process.

In February 2008, Cloud 9, Inc. launched a new product line that included the 'Heavenly 456' walking shoe. Advertising campaigns and media coverage have been very successful and sales for this style of shoe have steadily increased. For Cloud 9 Pty Ltd, the 'Heavenly 456' now makes up 20 per cent of total sales.

In July 2014, Cloud 9, Inc. launched its new product line called 'Work on Clouds', a safety boot with steel capped toes, primarily targeted for fly-in fly-out workers in the mining industry. Cloud 9, Inc. has been successful in launching this product with two key customers being Rin Tin Limited and Peacock Prospecting Limited making up 75 per cent of all sales of this product. They are also in final negotiations with Newnotold Mining Limited to supply their workers in their Indonesian gold mine as a 1-year trial.

A new and creative marketing campaign was initiated in 2010 to promote and build the 'Cloud 9' brand in Australia and New Zealand. The Australian company was granted permission from its parent entity to sponsor the A-league soccer team, Queensland Thunder, for the 2010 season. Given the success of this sponsorship agreement, they also now sponsor the Melbourne Rugby Union team as well as the New Zealand Rugby League team. Under these sponsorship agreements, Cloud 9 Pty Ltd provides all the athletic footwear for the team as well as having sole merchandising rights. The agreement also includes general advertising rights at the stadiums where each team play and naming rights for the player uniforms.

The first 'Cloud 9' retail store was opened in the Sydney CBD on 1 June 2010. The store operates on a just-in-time inventory system linked with the main warehouse in Botany. In the first 12 months, the management team reported a few hiccups in determining ideal stock quantities for the store to allow optimum availability of merchandise to the customers. There were also some thefts of merchandise from the store and, in order to reduce stock loss by theft, the company installed closed-circuit television cameras. These initial teething problems were resolved quickly, and Cloud 9, Inc. has expanded its retail network to include a store in Chadstone Shopping Centre, Melbourne, Westfield Carousel Shopping Centre in Perth and Sylvia Park in central Auckland.

Personnel

Cloud 9 Pty Ltd has 82 full-time employees. In the retail stores, the company employs part-time staff, with casual employees enhancing staff levels in the busier retail periods.

To administer the company's finances Cloud 9 Pty Ltd employs Finance Director, David Collier; Financial Controller, Carla Johnson; and Business Systems Manager, Justin Reeves. These three employees are entitled to participate in the employee share-purchase plan and receive stock options in Cloud 9, Inc. if a number of key performance targets are met. These include revenue and profit before tax targets.

Financial information

Cloud 9 Pty Ltd has set a goal to increase its revenue by 3 per cent (compound) for the 5 years beginning 1 July 2014. One of the critical success factors for the company to achieve this 3 per cent increase is to grow its share of the Australian footwear market, including in particular the safety boot market.

In addition, to build customer loyalty and promote sales online and in the retail stores, Cloud 9 Pty Ltd has a loyalty program whereby customers earn one point for every $10 that they spend. Customers can then redeem points online to receive coupons that can be exchanged for merchandise in the store.

On 1 October 2014, the company took out a new loan of $2 million with the ANZ Bank to help fund the expansion of the online supply chain (a larger warehouse and higher inventory on hand given the new safety boot line). This loan is repayable over 5 years. The company's other debt relates to loans from one of R.A. McLellan's other companies, which were issued between 1980 and 1993 when the original company was a sole proprietorship. R.A. McLellan extended the repayment date as part of the consideration for the sale.

All stock is purchased in US dollars, which the company acquires under forward exchange contracts. The company provides a 12-month warranty on all footwear. The warranty covers any manufacturing faults but excludes normal wear and tear. Historical claims have been 2 per cent of total sales.

Refer below and on the next page for the prior-year statement of comprehensive income and statement of financial position.

CLOUD 9 PTY LTD
Statement of comprehensive income
31 December 2015

	Notes	31 December 2015 $	31 December 2014 $
Revenue	2	60 572 216	59 910 912
Borrowing costs	3	(769 051)	(937 145)
Other expenses from ordinary activities	3	(56 803 326)	(55 407 794)
Profit before income tax		2 999 839	3 565 974
Income tax expense	4	(758 880)	(523 366)
Profit attributable to members of the company		2 240 959	3 042 608

CLOUD 9 PTY LTD Statement of financial position 31 December 2015	**Notes**	**31 December 2015 $**	**31 December 2014 $**
Current Assets			
Cash assets		801 641	1 842 244
Trade receivables		15 874 289	15 736 574
Inventory		5 830 382	6 269 228
Financial assets		1 983 795	2 918 992
Prepayments and other assets		620 022	666 691
Total Current Assets		25 110 129	27 433 729
Non-Current Assets			
Property, plant and equipment		5 507 106	3 457 844
Deferred tax assets		258 377	277 824
Total Non-Current Assets		5 765 483	3 735 668
Total Assets		30 875 612	31 169 397
Current Liabilities			
Payables		9 451 762	11 251 332
Interest-bearing liabilities		4 549 007	5 097 005
Current tax liabilities		267 421	252 284
Provisions		565 373	532 414
Total Current Liabilities		14 833 563	17 133 035
Non-Current Liabilities			
Deferred tax liabilities		332 293	313 484
Interest-bearing liabilities		900 000	950 000
Provisions		106 513	101 441
Total Non-Current Liabilities		1 338 806	1 364 925
Total Liabilities		16 172 369	18 497 960
Net Assets		14 703 243	12 671 437
EQUITY			
Issued capital		5 448 026	5 448 026
Reserves		(446 826)	(237 673)
Accumulated losses		9 702 043	7 461 084
TOTAL EQUITY		14 703 243	12 671 437

Following is the September 2016 trial balance for Cloud 9 Pty Ltd, a transcript of a meeting with Carla Johnson, Cloud 9 Pty Ltd Financial Controller, and sales and cash control testing support.

CLOUD 9 PTY LTD Trial balance				
	30 Sept 2016		30 Dec 2015	
Cash — Operating Account	364 182		343 568	
Cash — Savings Account	136 319		454 396	
Petty Cash	3 188		3 008	
Cash — Store Locations	709		669	
Trade Receivables — Stores	314 914		297 089	
Trade Receivables — Wholesales	16 453 793		16 290 884	
Allowance for Doubtful Debts		(930 949)		(878 253)
Sundry Debtors	72 136		68 053	
GST Clearing	34 912		32 936	
Employee Receivables	67 395		63 580	
Inventory	5 330 930		5 732 182	
Goods in Transit	544 745		585 748	
Provision for Obsolescence		(453 420)		(487 548)
Derivative Financial Assets	966 938		1 534 822	
Amounts Receivable from Parent	417 545		448 973	
Prepaid Rent	183 273		197 068	
Prepaid Insurance	361 530		388 742	
Other Prepaid Expense	31 817		34 212	
Deferred Tax Asset	240 290		258 377	
Furniture and Equipment	5 684 896		4 211 034	
Accum Depr — Furniture and Equipment		(1 348 861)		(1 450 388)
Leasehold Improvements	4 257 757		3 153 894	
Accum Depr — Leasehold Improvements		(378 914)		(407 434)
Trade Creditors		(1 835 492)		(1 782 031)
Bonus Provision		(315 192)		(338 916)
Sales Commissions		(445 246)		(478 759)
Other Accrued Expenses		(3 823 536)		(3 225 449)
I/C Payables		(563 652)		(606 078)
Hedge Payable		(2 416 424)		(3 020 530)
Annual Leave Provision		(277 583)		(261 871)
Long Service Leave Provision		(161 708)		(152 554)
Loyalty Program Provision		(110 744)		(104 475)
Warranty Provision		(162 165)		(152 986)

	30 Sept 2016		30 Dec 2015	
Loan with Bank		(4 762 353)		(5 291 503)
Loans with Directors		(148 053)		(157 504)
Provision for Current Tax Liabilities		(283 466)		(267 421)
Provision for Deferred Tax Liabilities		(352 231)		(332 293)
Share Capital		(5 448 026)		(5 448 026)
Reserves	540 660		446 826	
Retained Earnings		(9 702 043)		(7 461 084)
Revenue — Stores		(2 764 163)		(3 649 061)
Revenue — Wholesales		(45 594 829)		(56 289 912)
Interest from Bank		(89 675)		(106 756)
FX Gain/Loss		(70 006)		(83 340)
Proceeds on Disposals		(1 576 859)		
Other Revenue		(9 971)		(443 147)
COS — Stores	805 991		985 922	
COS — Wholesales	20 695 493		25 315 587	
Salaries and Employee Benefits	6 395 361		7 823 072	
Storage — Rent Expense Store	209 638		256 437	
Storage — Rent Expense Warehouse	3 722 228		4 553 184	
Distribution Expenses	2 601 503		3 182 266	
Telephone	125 202		153 153	
Computer and IT Costs	317 562		388 455	
Advertising & Promotion — Print	2 263 587		3 209 280	
Trade Shows	412 173		504 187	
Advertising & Promotion — TV	1 200 374		1 468 348	
Advertising & Promotion — Sponsorships	2 006 788		2 454 786	
Rent Expense — Office	388 881		475 695	
Bad Debt Expense	95 232		116 492	
Depreciation — Furniture and Equipment	1 081 510		1 020 293	
Depreciation — Leasehold Improvements	337 616		309 739	
Entertainment	334 406		409 059	
Professional Fees	400 247		489 598	
Insurance Expense	2 571 450		3 145 504	
Recruitment	443 303		542 266	
Interest Expense — Loan From Bank	569 289		696 378	
Interest Expense — Directors	59 410		72 672	
Tax Expense	620 384		758 880	
	84 025 557	(84 025 557)	92 877 318	92 877 318

Transcript of meeting with Carla Johnson

Present: Carla Johnson, Financial Controller, Cloud 9 Pty Ltd
Josh Thomas, Audit Senior, W&S Partners

JT: Thanks for seeing me Carla.

CJ: You're welcome, Josh. What can I do for you?

JT: I need to ask you some questions around Cloud 9's process for recording wholesale revenue transactions, including the accounts receivable and cash receipts aspects. After I understand the process, I'll need to select a sample transaction to confirm my understanding of the process as you have explained.

CJ: Well, I can tell you what should be happening, but you may want to go and speak to the sales manager or warehouse managers to confirm they do what the company policy and procedures say.

JT: Good point, I'll make appointments to see them. Thanks. So let's start at the beginning — how does a sale transaction get started?

CJ: Well it depends. I can tell you what happens for retail orders but not direct orders that customers place online. That's only new and I'm not sure exactly how that works yet. You should talk to our Online Sales Director, Eddie Fitzpatrick to find out about that system. But for the normal customers we've got a pretty complex inventory management software system called Swift. It was designed by some of our tech guys in the US. It tracks and does everything!

JT: Sounds impressive!

CJ: Anyway, the customers — let's say the Myer store in Bondi Junction — complete a purchase order online through a site that is linked to Swift.

JT: How do the customers decide the quantity and know the price?

CJ: Swift is linked (don't ask me how) to their store inventory records and sends them an alert when their stock balance of our products gets below the predetermined limit they set with us. They can select the quantity based on their needs, but the prices are set in the system. They get sent price lists from the sales manager so they know the current prices.

JT: How often are prices changed?

CJ: Depends on the market, really. I don't think they change too frequently.

JT: What if you don't have the products?

CJ: The system doesn't allow them to place an order greater than our current stock levels. If they need more, they need to fill out a separate request form that gets emailed to our warehouse manager so he can place the order with China.

JT: OK, so they complete a purchase order, then what?

CJ: The submitted purchase order goes through a credit check and then becomes a sales order. That's all done behind the scenes in the system. We really don't see anything on our side until the sales order stage.

JT: Guess that saves a lot of time and trees!

CJ: Yeah, there's so much that we rely on the system to do for us, it's scary. If we were hit by an electrical storm, we'd be in trouble.

JT: What happens to the sales orders — how do they get filled?

CJ: Every day, the warehouse manager downloads the outstanding sales orders to these little handheld tablet/scanner thingies. It's very Star Trek. Warehouse personnel use these to select the items off the shelves onto pallets. The pallets are taken to a staging area where each product is then scanned. This establishes the dispatch note in Swift, which then gets printed for the delivery.

JT: Are the dispatch notes approved before the goods go out the door? How do you know that what got sent is what was ordered?

CJ: Swift matches the quantities and products on the draft dispatch note to the sales order. Once they match, the approval box is activated and the shipping supervisor can enter his pass code. This officially approves the dispatch note and it gets printed.

JT: **How many orders do you fill in a day? It sounds like a lot for one person to do.**

CJ: We probably complete about 150 orders a day. Shoes aren't perishable items, you know, so it's not like we are sending products to every store, every day. We're trying out the 'pit crew' concept where there's two shipping supervisors with about four to five warehouse employees in their crew team. So they are in the staging area with them and do it right there with the handheld devices. They like to have little contests on who can do it the fastest. You should go down there; it's quite a lively group. David encourages it and it's been great for productivity and morale.

JT: **Sounds like a great working environment. Better than being stuck in a broom closet sifting through invoices!**

CJ: Ah, the life of an auditor. I remember the good old days …

JT: **And the goods are sent out on your own trucks?**

CJ: That's right. We've bought our own trucks and vans rather than rely on couriers. The drivers pick up their loads in the morning and bring back anything undelivered. Because shoes are an easy product to off-load, we have to be careful about theft. So nothing can be left in the back of a truck at the end of the day. It comes back here and gets locked up in the shipping cage till it can be delivered again.

JT: **Why would goods be undelivered?**

CJ: Sometimes the drivers get behind or the store is closed unexpectedly. So there are occasions when all the goods won't get delivered in the day.

JT: **OK, so now the goods are delivered to the customer, how do you bill them?**

CJ: The drivers have the customers sign for the goods and then give us the signed copy. We go into the billing system and pull up the draft invoice that was generated when the dispatch note got approved. We match the quantities in the invoice against the dispatch note and confirm customer sign off. This way, we only bill for those goods that were actually received by the customer.

At 4pm, we do a batch run of the day's invoices, which are printed in duplicate, and mailed out. The copy is stapled to the signed dispatch note and put on file. The running of the batch run posts the invoices to the sales journal and accounts receivable subledger.

JT: **Does finance ever go back to the sales order?**

CJ: No, since the dispatch note can't get generated unless it agrees to the sales order, we don't go back that far into the process. Why, do you think we have to?

JT: **I wouldn't say so at this stage. But you'd have to be sure to have some tight controls around Swift given it seems to do everything.**

CJ: Like I said, it does everything.

JT: **What is the cash receipts process?**

CJ: We get most payments via EFT, so my AR clerk downloads the previous day receipts from online banking. She then goes into the subledger to post the receipts against the customer accounts. When she's finished posting each entry, she runs a batch report of all postings and reconciles it back to the bank report. I review that reconciliation and sign off.

JT: **How quickly are the bank reconciliations done?**

CJ: I do bank recs each month for the operating and savings accounts. David reviews and approves them. Keep in mind, what I just explained is for the wholesale transactions. We have separate procedures for the store regarding daily cash balance reconciliations from the POS system to the deposits in our operating bank account.

JT: **Yes, our graduate will be handling the store side of the sales to cash receipts process. They will probably come talk to you in a day or two. Well, I think that should do it for now. I may have some follow up questions for you as I start getting my head around all of this.**

CJ: Door's always open.

JT: **Thanks for your time.**

Sales control testing support

CLOUD 9 Pty Ltd
TAX INVOICE

TO: David Jones — Perth
14 South Street
Perth, WA
13 October 2016

332811
Swift Purchase order reference: P00332811
Dispatch reference: D00332811

Code	Description	Qty	Price per unit	Total Price
786541	Heavenly 456 — Women 9	5	$114.74	$573.70
786540	Heavenly 456 — Women 8	3	$114.74	$344.22
	Total			$917.92
	GST			$91.79
	TOTAL			**$1 009.71**

Payment due on 27 November 2016

CLOUD 9 Pty Ltd
DISPATCH NOTE

TO: David Jones — Perth
14 South Street
Perth, WA
12 October 2016

D00332811
Swift Purchase order reference: P00332811
Authorised: YES

Code	Description	Qty
786541	Heavenly 456 — Women 9	5
786540	Heavenly 456 — Women 8	3

Driver: R. Williams

I declare that all goods were received and no damage noted.

Customer Signature: Sally Rose 12/10/16

CLOUD 9 Pty Ltd
TAX INVOICE

TO: Rebel Sports — World Square
680 George Street, Shop 12
Sydney, NSW
27 October 2016

333410
Swift Purchase order reference: P00333410
Dispatch reference: D00333410

Code	Description	Qty	Price per unit	Total Price
587241	Maximum Speed — Men 12	4	$123.56	$494.24
786540	Heavenly 456 — Women 8	2	$114.74	$229.48
	Total			$723.72
	GST			$72.37
	TOTAL			**$796.09**

Payment due on 13 December 2016

CLOUD 9 Pty Ltd
DISPATCH NOTE

TO: Rebel Sports — World Square
680 George Street, Shop 12
Sydney, NSW
25 October 2016

D00333410
Swift Purchase order reference: P00333410
Authorised: YES

Code	Description	Qty
587241	Maximum Speed — Men 12	4
786540	Heavenly 456 — Women 8	2

Driver: R. Williams

I declare that all goods were received and no damage noted.

Customer Signature: Jenna Hennesey 26/10/16

CLOUD 9 Pty Ltd
TAX INVOICE

TO: Myer — Brisbane CBD
64 Kensington Ave
Brisbane, Qld
4 November 2016

334063
Swift Purchase order reference: P00334063
Dispatch reference: D00334063

Code	Description	Qty	Price per unit	Total Price
649852	Olympic — Women 6	4	$109.21	$436.84
475125	Thunder 75 — Men 14	2	$157.68	$315.36
	Total			$752.20
	GST			$75.22
	TOTAL			**$827.42**

Payment due on 19 December 2016

CLOUD 9 Pty Ltd
DISPATCH NOTE

TO: Myer — Brisbane CBD
64 Kensington Ave
Brisbane, Qld
3 November 2016

D00334063
Swift Purchase order reference: P00334063
Authorised: YES

Code	Description	Qty
649852	Olympic — Women 6	4
475125	Thunder 75 — Men 14	2

Driver: Ted McGinty

I declare that all goods were received and no damage noted.

Customer Signature: Julie Brown 4/11/16

CLOUD 9 Pty Ltd
TAX INVOICE

TO: Cross Country Sports
4 Main Street
Wagga Wagga, NSW
6 November 2016

334104
Swift Purchase order reference: P00334104
Dispatch reference: D00334104

Code	Description	Qty	Price per unit	Total Price
786541	Heavenly 456 — Women 9	2	$114.74	$229.48
	Total			$229.48
	GST			$22.94
	TOTAL			**$252.42**

Payment due on 21 December 2016

CLOUD 9 Pty Ltd
DISPATCH NOTE

TO: Cross Country Sports
4 Main Street
Wagga Wagga, NSW
5 November 2016

D00334104
Swift Purchase order reference: P00334104
Authorised: YES

Code	Description	Qty
786541	Heavenly 456 — Women 9	2

Driver: T. Carr

I declare that all goods were received and no damage noted.

Customer Signature: 5/11/16

CLOUD 9 Pty Ltd
TAX INVOICE

TO: Peacock Prospecting Limited
100 State Highway
Geralton, WA
12 December 2016

335215
Swift Purchase order reference: P00335215
Dispatch reference: D00335215

Code	Description	Qty	Price per unit	Total Price
587240	Work Rainstorm — Men 10	3	$123.56	$370.68
475123	Work Cloudburst — Men 12	3	$157.68	$473.04
347586	Work Heatwave — Men 15	2	$174.21	$348.42
	Total			$1 192.14
	GST			$119.21
	TOTAL			**$1 311.35**

Payment due on 15 January 2017

CLOUD 9 Pty Ltd
DISPATCH NOTE

TO: Peacock Prospecting Limited
100 State Highway
Geralton, WA
11 December 2016

D00335215
Swift Purchase order reference: P00335215
Authorised: YES

Code	Description	Qty
587240	Work Rainstorm — Men 10	3
475123	Work Cloudburst — Men 12	3
347586	Work Heatwave — Men 15	2

Driver: R. Williams

I declare that all goods were received and no damage noted.

Customer Signature: Sharon J Jones 11/12/16

CLOUD 9 Pty Ltd
TAX INVOICE

TO: Foot Locker — Pitt St Mall
435 Pitt St, Shop 4
Sydney, NSW
20 December 2016

335947
Swift Purchase order reference: P00335947
Dispatch reference: D00335947

Code	Description	Qty	Price per unit	Total Price
649852	Olympic — Women 6	2	$109.21	$218.42
786540	Heavenly 456 — Women 8	5	$114.74	$573.70
786539	Heavenly 456 — Women 7.5	2	$114.74	$229.48
	Total			$1 021.60
	GST			$102.16
	TOTAL			**$1 123.76**

Payment due on 31 January 2017

CLOUD 9 Pty Ltd
DISPATCH NOTE

TO: Foot Locker — Pitt St Mall
435 Pitt St, Shop 4
Sydney, NSW
18 December 2016

D00335947
Swift Purchase order reference: P00335947
Authorised: YES

Code	Description	Qty
649852	Olympic — Women 6	2
786540	Heavenly 456 — Women 8	5
786539	Heavenly 456 — Women 7.5	2

Driver: R. Williams

I declare that all goods were received and no damage noted.

Customer Signature: Tim Connolly 18/12/16