ALFRED NOBEL UNIVERSITY, DNIPROPETROVS'K

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INTERNATIONAL AUDIT

COURSE BOOK

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INTERNATIONAL AUDIT:
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Навчальний посібник «Міжнародний аудит: практикум» спрямовано на вивчення методів і процедур, що використовуються в міжнародній аудиторській практиці.

Посібник був укладений відповідно до навчального плану курсу «Міжнародний аудит» для економічних напрямів. Він складається з 7 блоків. Кожен блок включає в себе питання для обговорення, тести і завдання для самостійної роботи.

Використання навчального посібника в навчальному процесі дозволить ефективно застосовувати знання та навички, а також професійні компетенції у сфері міжнародного аудиту.

«International Audit: course book» is aimed at the study of methods and procedures used in international audit.

The textbook has been compiled in accordance with the syllabus of the «International Audit» course for the economic directions of study. The textbook consists of 7 units. Each unit includes questions for discussion, tests and assignments for independent work.

Its use in the educational process will enhance both learning and effective application of the acquired knowledge and skills as well as professional competences in international audit.

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CONTENTS

INTRODUCTION

Audit is an independent examination of financial statements of an entity that enables an auditor to express an opinion whether the financial statements are prepared (in all material respects) in accordance with an identified and acceptable financial reporting framework (e.g. international or local accounting standards and national legislations).

The textbook «International Audit: Course Book» will help students to understand the role of audit in management of the international activity of an enterprise and make management decisions in business processes. This textbook examines the principal issues concerning concepts, methods and procedures used in international audit. These include the nature and development of auditing principles, auditing terminology and underlying concepts. Topics to be covered include an overview of the auditing process and procedures of auditing for the verification of the financial statements of enterprises.

The main aims of the «International Audit» course are to give students the theoretical base and practical knowledge of auditing, teach students how to use audit methods in a methodically right way and draw up an audit report skillfully. This course will help students to understand what audit is and apply the organizational and methodical ways to research the problems that audit deals with in foreign countries.

On completion of the course the students will be able to:

– apply the organizational and methodical ways to research the problems that audit deals with in foreign countries;

– use audit results to make management decisions in the activity of an enterprise in foreign countries;

– analyze the ratio of different audit reports;

– synthesize some of the recently acquired knowledge in audit reports of an enterprise;

– explain how International Standards on Auditing have been shaped by real world events;

– understand what the essence of GAAP (Generally Accepted Accounting Principles) is;

– explain the auditing methods, analytical procedures and tests according to Generally Accepted Accounting Principles;

– help to master the formation modes as well as the audit report analysis;

– conduct independent research on relevant topics within a preset time limit;

– develop a range of personal skills including argumentation, evaluation, problem identification and solving, interactive and group skills, self-appraisal and cross-cultural teamwork;

– express an independent opinion, formulate judgments and knowledge-based conclusions on relevant issues in auditing including international professional and academic literature.

Unit 1
ORGANIZATION AND STRUCTURE OF AUDITING ACTIVITY

1. Classification of basic types of audits.
2. Typical organizational structure of audit firms.
3. Typical organizational structure division of audit and performance (internal audit).

TASKS

1.1. Read the definitions of asset accounts and complete them with these words and word combinations.

Independent audits Operational audit
Administrative audit Internal audits and assessments
Process audits Compliance audit System audits
External audits Financial audit Integrated audit

1. ____________________ involves auditing your own organization to discover evidence of what is occurring inside the organization (self-assessment). These have restrictions on their scope, and the findings should not be shared outside the organization. The findings cannot be used for licensing.
2. ____________________ involves your customer auditing you, or you auditing your supplier. The business audits its customer or supplier, or vice versa. The goal is to ensure the expected level of performance as mutually agreed upon in their contracts.
3. ____________________ are outside of the customer-supplier influence. Third-party independent audits are frequently relied on for licensing, certification, or product approval. A simple example is independent consumer reports.
4. ____________________ evaluate the process method to determine whether the activities or sequence of activities meet the published requirements. We want to see how the process is working. This

involves checking inputs, actions, and outputs to verify the process performance.

5. ____________________ seeks to evaluate the management of the system, including its configuration. The auditor is interested in the team members' activities, control environment, event monitoring, how customer needs are determined, who provides authorization, how changes are implemented, preventative maintenance, and so forth, including incident response capability.

6. ____________________ verifies financial records, transactions, and account balances. This type of audit is used to check the integrity of financial records and accounting practices compared to well-known accounting standards.

7. ____________________ verifies effectiveness and efficiency of operational practices. Operational audits are used frequently in service and process environments, including IT service providers. An operational audit is detailed in Statement on Auditing Standard 70 (SAS-70).

8. ____________________ includes both financial and operational control audits. An integrated audit is detailed in SAS-94.

9. ____________________ verifies implementation of and adherence to a standard or regulation. This could include ISO standards and all government regulations. A compliance audit usually includes tests for the presence of a working control.

10. ____________________ verifies that appropriate policies and procedures exist and have been implemented as intended. This type of audit usually tests for the presence of required documentation.

1.2. Read the definitions of elements of financial statements and complete them with these words and word combinations.

Institute of Internal Auditors (IIA)
Certified Internal Auditor (CIA)
International Standards of Auditing (ISO)
Generally Accepted Auditing Standards (GAAS)
Auditing Standards Board (ASB)
Certified Government Auditing Professional (CGAP)

1. ___________________ refers to a set of systematic guidelines used by auditors while performing audits on companies' financial statements, thus ensuring the consistency, accuracy, and verifiability of the actions and reports produced by an auditor.

2. _________________ refer to professional standards dealing with the responsibilities of the independent auditor while conducting the financial audit of financial info.

3. _________________ exists to serve the public interest by improving the existing audit and attestation services in addition to encouraging new ones.

4. The most important objective of the _________________ is providing «dynamic leadership» for the global profession of internal auditing.

5. _________________ designation holds international recognition as a certification for internal auditors. Also, it is a standard through which individuals can demonstrate their competency and professionalism in the field of internal audit.

6. _________________ for Government performance auditing and Government Auditors.

1.3. Match each object (1-3) with two of its components (a-c).

Term	Explanation
1. INTERNAL AUDITORS	a. these governmental accountants perform accounting and auditing tasks for the entire government
2. GOVERNMENTAL AUDITORS	b. are not employees of the organization being audited or employees of the government
3. EXTERNAL (INDEPENDENT) AUDITORS	c. are employees of the organization whose activities are being examined and evaluated during an independent audit

1.4. Read the definitions of asset accounts and complete them with these words and word combinations.

Small firms Private and publicly traded companies
The government Large firms

As an auditor with your new CPA license in hand, you have a few options for finding a job, including the following:

– _________________**:** CPA firms can be huge. The big four CPA firms – KPMG, Ernst & Young, Pricewaterhouse Coopers, and

Deloitte – conduct the majority of all global audits of public companies (those that sell their stock on exchanges such as the NASDAQ).

– ________________: Many audit firms consist of a sole practitioner with a professional staff of three or four members. These types of CPA firms audit financial statements of private companies – those whose stock is closely held by a small group of investors.

– ________________: You can also find jobs working for private and publicly traded companies, usually in the capacity of an internal auditor (CPA license not mandatory).

– **:** You can get an auditing job working for local, state, and federal government – CPA license not mandatory as well.

1.5. Match each object (1-4) with two of its components (a-d).

Principles for oversight of Independent Auditors	Explanation
1. QUALIFICATIONS	**a. Self-regulatory or professional organizations may exercise, directly or indirectly, oversight responsibility for the development and implementation of auditing standards, as well as ethical standards. A government authority should have the ability to exercise authority over audits of public enterprises**
2. INDEPENDENCE	**b. Auditors of public enterprises should be required to have proper qualifications and competency before being licensed to perform audits, and take steps to maintain professional competence**
3. OVERSIGHT	**c. A strong enforcement program that includes a range of sanctions for non-compliance is necessary to effectively oversee independent auditors**
4. ENFORCEMENT AND SANCTIONS	**d. Auditors of public enterprises should be required to be independent of the enterprises that they audit. The condition of auditor independence must be met both in fact and appearance and be assessed regularly**

1.6. Based on the typical organizational structure of the audit firm (Fig. 1.1) make a review of its structure.

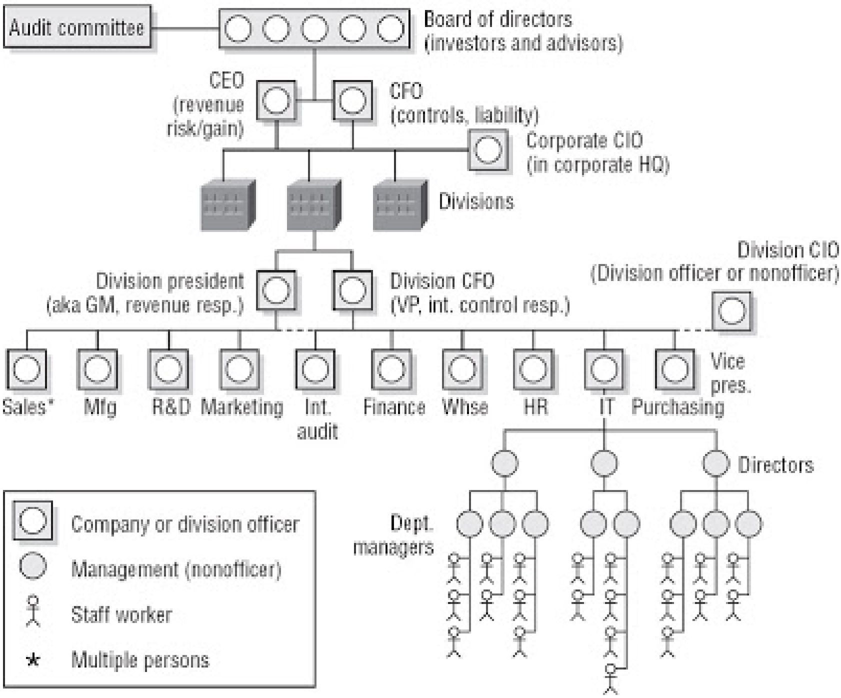


Fig. 1.1. A Typical Auditing Firm Organizational Chart

!!! ***An auditing (consulting) firm*** *is a hybrid organization. Internal clerical and support functions are similar to those in a typical business. The consulting side of the firm uses functional management positions. The staff are allocated according to temporary project assignments. At the end of each engagement, the staff will be reallocated by either returning to the available resource pool or by becoming unemployed until the next engagement.*

Solution:

Managing Partner. A managing partner refers to a C-level executive in the consulting practice. This could be a position equal to a corporate president. Managing partners have the responsibility and authority to oversee the business divisions. Various partners in the firm will report to the managing partner.

Partner. A partner is equivalent to a divisional president or vice president and is responsible for generating revenue. Their role is to represent the organization and provide leadership to maximize income in their market segment. Partners are required to maintain leadership roles in professional organizations and network for executive clients. Most partners have made financial commitments to produce at least $15 million in annual revenue along with supporting other business management functions. The partner and all lower managers are responsible for professional development of the staff.

Engagement Manager. This is a director-equivalent position with the responsibility of managing the client relationship. The engagement manager is in charge of the audit overall execution and the audit staff. The engagement manager is responsible for facilitating the generation of new income opportunities from the client.

Senior Consultant. This is a field manager whose responsibilities include leading the daily onsite audit activities, interacting with the client staff, making expert observations, and managing staff assigned to the audit.

Consultant. This is a lead position carrying the responsibility of interacting with the client and fulfilling the audit objectives without requiring constant supervision. A consultant is often promoted by demonstrating an ability to fulfill the job of a senior consultant or a supporting manager.

Systems Analyst. This is usually an entry-level position. Often the individual is selected for their ambition and educational background and may be fresh out of college. Systems analysts perform some lower-level administrative tasks as they build experience.

1.6. Based on the Typical Corporate Organizational Chart (Fig. 1.2) make a review of its structure and functions of staff.

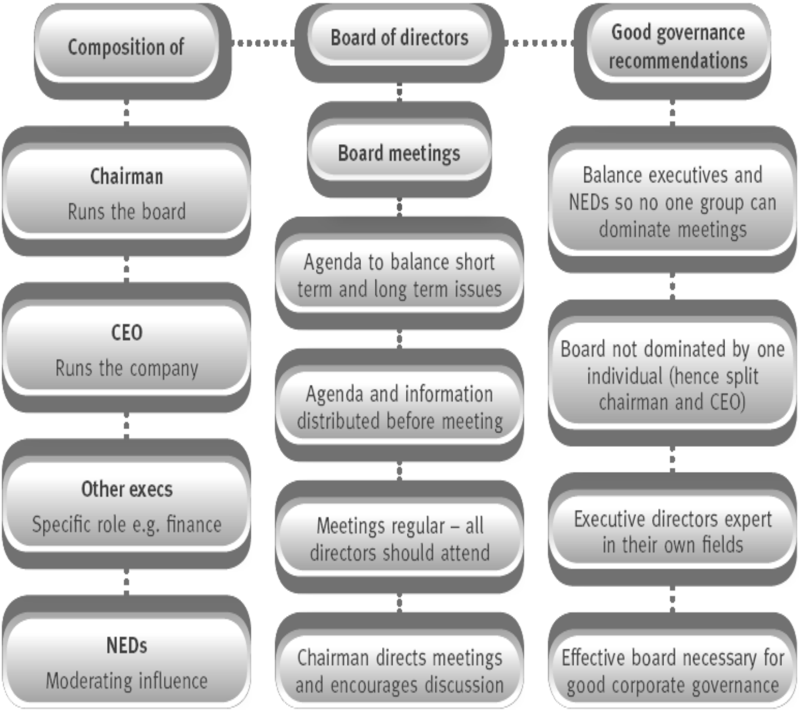


Fig. 1.2. A Typical Corporate Organizational Chart

!!! *Businesses are focused on generating money for investors. There will always be some type of management hierarchy in order to maintain control. Government and nonprofit organizations will use a similar control hierarchy; however, the titles will be different. For government and nonprofit organizations, the term mission objectives would be substituted for the term revenue.*

Solution:

Board of Directors. The board of directors usually comprises key investors and appointed advisers. These individuals have placed their own money at stake in the hopes of generating a better return than the bank would pay on deposits. Board members are rarely – usually never – involved in day-to-day operations. Some members may be retired executives or run their own successful businesses. Their job is to advise the CEO and the CFO. Most organizations indemnify board members from liability; however, government prosecutors will pursue board members if needed.

Audit and Oversight Committee. The members of the board will have a committee comprising directors outside of the normal business operations. Executives from inside the organization can come to the committee for guidance and assistance in solving problems. This committee has full authority over all the officers and executives. They can hire or fire any executive. Each audit committee has full authority with a charter to hire both internal and external auditors. Auditors are expected to discuss their work with the audit committee. An auditor has the right to meet in private to discuss issues with the audit committee once a year without the business executives present. If auditors discover certain matters that stockholders should be informed about, the auditor shall first bring it to the attention of the audit committee. Regulations such as SOX require that all significant weaknesses be disclosed to the audit committee every 90 days.

Chief Executive Officer (CEO). The CEO is primarily focused on generating revenue for the organization. The CEO's role is to set the direction and strategy for the organization to follow. The CEO's job is to find out how to attract buyers while increasing the company's profits. As a company officer, the CEO is liable to government prosecutors. Corporate officers have signing authority to bind the organization.

Chief Operating Officer (COO). The COO is dedicated to increasing the revenue generated by the business. This is a delegate in charge of making decisions on behalf of the CEO with assistance from the CFO. COOs are often found in larger organizations. As a company officer, the COO is liable to government prosecutors.

Chief Financial Officer (CFO). The CFO is in charge of controls over capital and other areas, including financial accounting, human resources, and IS. Subordinates such as the CIO usually report to the CFO. As a company officer, the CFO is liable to government prosecutors.

Chief Information Officer (CIO). The CIO is subordinate to the CFO. The CFO is still considered to be the primary person responsible for internal control. A CIO might not be a true company officer, and this title may bear more honor than actual authority, depending on the organization. An exception may be a CIO in corporate headquarters.

The CIO has mixed liability, depending on the issue and the CIO's actual position in the organization.

President/General Manager. The president, sometimes referred to as the general manager, is the head of a business unit or division. As a company officer, the president/general manager is usually liable to government prosecutors. Regulations such as SOX encourage management to require all divisional presidents and controllers to sign integrity statements in an effort to increase divisional officer liability.

Vice President (VP). The vice president is the second level of officers in a business unit or division. As a company officer, the vice president is usually liable to government prosecutors.

Department Directors (Line Management Position). Typically directors are upper-level managers supervising department managers and do not have company officer authority. In large organizations, you may encounter a major-level director and minor-level director.

Managers and Staff Workers. Managers are responsible for providing daily supervision and guidance to staff members. Staff members may be employees or contractors working in the staff role. Managers and staff members are seldom held responsible for the actions of a company unless they knowingly participate in criminal activity.

STAFF WORKERS

Audit Senior/Supervisor

Job Description: An Audit Senior/Supervisor's role covers the same area of responsibilities and functions as a senior accountant, but covers a broader area, including more complex assignments, a more extensive review function, and supervision of more than one engagement simultaneously. Accordingly, a supervisor often functions in the same capacity as a senior accountant but may also assume several manager responsibilities.

Basic Responsibilities/Functions:

· Coordinate the various planning phases of an engagement, including staff requirements, scheduling and the assignment of work to be performed by others;

· Review engagements and representation letters;

· Review the audit or other work programs and time budgets;

· Monitor each engagement to ensure that work is proceeding on schedule;
· Perform the most difficult phases of the work on larger and more complex assignments;
· Review and evaluate all work papers and determine compliance with professional standards and Firm policies;
· Make sure all documentation as required for Quality Control and Peer Review are included on all the assignments;
· Review reports, financial statements and tax returns;
· Review management letter;
· Review with the engagement partners any critical area or significant findings that raise questions involving accounting principles, auditing standards, tax regulations and Firm policies;
· Prepare and discuss staff performance evaluations on all staff under his/her supervision;
· Be involved in some Practice Development type activities;
· Be responsible for completing client work on timely basis;
· Be responsible for billing to and collection from client;
· Delegate duties to subordinates and provide training;
· Develop and maintain good working relationships with client management.

Requirements:
· BS in Accounting;
· Master's and CPA preferred;
· 5+ years of public auditing experience.

Audit Assistant (Auditor)

The role is to be a key member of onsite audit teams providing audit services to International Standards to a range of clients in the banking and financial services sector.

Responsibilities:
· On larger assignments you will be responsible for the completion of audit sections allocated to you including the supervision of staff working on those sections;
· On smaller assignments you will be the most senior member of staff on site and will have full responsibility for the conduct of the audit ensuring that it is completed on time and that the work carried out is of an appropriate quality.

Opportunity:
· Work directly with Managers and other Senior staff;

· Take early responsibility and progress quickly through our grading structure;

· Possibility of secondments;

· Work in a fast-paced but friendly organization.

Person:

· 1-3 years of relevant experience;

· ACCA / ACA student (partly qualified);

· Fluency in Russian and English (spoken and written);

· Banking audit experience is preferred;

· Candidates with experience of working with IFRS within banking will also be considered;

· Good communication skills;

· Professional attitude;

· Self motivated.

Example: description of the role of employees of the audit company

PROPOSED ENGAGEMENT STAFFING

– ***Staff Auditors:***

· Able to perform substantive testing on account balances;

· Able to observe year-end inventory account (this is for the auditors in the Hershey, PA office – more cost efficient to have local auditors, because of their proximity to Hershey's warehouse).

– ***Senior Auditors:***

· Also able to perform substantive testing on account balances (those that are somewhat more complex and require deeper analysis);

· Communicate with audit managers on progress of engagement;

· Can serve as first-line supervisors to staff auditors:

  · *Answer general questions;*

  · *Make assignments of duties and tasks;*

  · *Sign off on tasks and paperwork completed;*

  · *Audit Managers.*

· Ensure that all auditors involved in engagement are qualified and independent from client;

· Serve as supervisors to audit seniors.

– ***Engagement Partner:***

· Serve as primary contact with client (board of directors, management, and audit committee);

· Sign off on all paperwork submitted to the SEC, including the audit opinion.

– ***IT Specialist:***

· Able to quickly gain familiarity with Hershey's information system to aid in substantive testing of account balances;

· Can gauge appropriateness of system controls to help auditors understand the level of audit risk that is present.

– ***Member of Legal Counsel:***

· Has familiarity with federal regulations to help in contingency testing described above.

– ***International Auditor:***

· Can use expertise in international accounting to assess risk and material misstatements associated with international financial instruments.

– ***Tax Specialist:***

· Can verify that tax accruals were accounted for properly;

· Can possible help senior management at Hershey with tax planning issues for the coming year, if this causes no issues with independence.

1.7. Based on the typical organizational structure of division of audit and performance (Fig. 1.3) make a review of its structure and functions of staff.

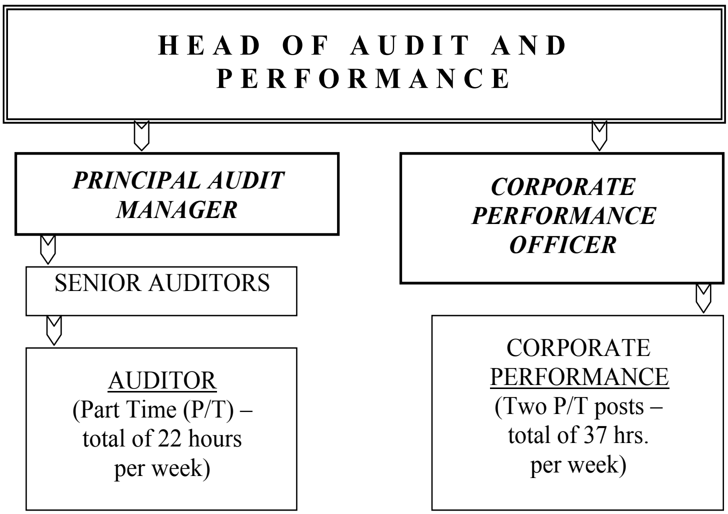


Fig. 1.3. A Typical Structure of Division of Audit and Performance (Internal Audit)

!!! *The Internal Audit function is provided internally, and the staffing of Internal Audit is as approved by the management company. As a rule, the Strategic Audit Plan assumes full staffing of the Internal Audit team and may be maintained for the three year period of the plan. Allowing for these factors, the staffing is assessed at the level necessary to ensure audit coverage of the key areas within the three year cycle.*

Solution:

Review of Staff Resources

Internal Audit forms part of the Audit and Performance Division that is responsible for a wide range of activities related to corporate governance and performance management. These activities include: Internal Audit; Risk Management; Performance Management; Corporate Governance; Procurement; Asset Management.

The structure of the Division is as follows (Fig 1.3.):

The significant workload in corporate performance activities requires the Head of Audit and Performance to allocate less of his time to audit matters. The Strategic Audit Plan includes an 80/20 apportionment of the time of the Head of Audit and Performance between corporate performance and internal audit work.

The Principal Audit Manager, Senior Auditors and Auditor are dedicated to audit work. This separation of responsibilities preserves the integrity and independence of Internal Audit, and also enables them to audit and advise on corporate governance and performance management activities.

STAFF AUDITOR

Working under the supervision of a senior auditor, staff auditors are accounting professionals employed in a wide variety of industries and companies. The main responsibilities of an auditor include examining, analyzing and verifying a company's operational and financial activities, as well as ensuring adherence to compliance regulations and guidelines. These professionals might conduct audits for clients or within their own organizations, and they are often called «internal editors.» They might be focused solely on financial aspects, or they might investigate hiring practices and procedures as well.

The primary goal for the staff auditor is to identify potential risk areas for a company, such as mismanagement, fraud and other types of discrepancies. Companies hire these types of professionals to avoid legal and financial problems. Other duties include reviewing ledgers, financial statements, receipts, financial and employment applications and employee files. The audit might also include reviewing all types of communications, such as emails, memos and letters, as well as interviewing other staff members. After the audit has been conducted, the auditor typically creates a report for the upper management team, including suggestions and remedies for identified issues.

Staff auditors work in many different areas and industries. Industries that have many regulations, such as financial institutions, non-profit organizations, human resource companies and medical research corporations, typically employ professionals of this type. A staff auditor might work independently or on a team with others. If the auditor works on a team, each team member usually is responsible for a specific area of the audit. He or she must have strong ethics and must be able to expose fraudulent occurrences without fail.

The staff auditor usually works traditional business hours from Monday to Friday. When a company has seasonal busy periods or is about to go through a regulatory filing process, the auditor might be required to work longer hours and through the weekend. Some work overtime to meet month-end closing goals, and some travel to work at off-site client locations.

Most people in this position typically hold four-year college degrees in the areas of finance, accounting or auditing. This position typically is held in the first one to three years of an accounting career. If the auditor earns a professional license, such as a Certified Public Accountant (CPA), Chartered Accountant (CA) or Certified Internal Auditor (CIA) license, he or she might qualify for promotions and raises. After mastering the staff auditor role, the accounting professional might pursue a senior auditor position.

QUESTIONS FOR SELF-ASSESSMENT

1. What is Big Four?
2. What is PricewaterhouseCoopers?
3. What is KPMG?
4. What is Deloitte Touche Tohmatsu?
5. What is Ernst & Young?
6. What are the peculiarities of the organization and functioning of the Association of Chartered Certified Accountants (ACCA)?

7. What are the peculiarities of the organization and functioning of the Institute of Chartered Accountants in England and Wales (ICAEW)?

8. What are the peculiarities of the organization and functioning of American Institute of Certified Accountants (AICPA)?

9. What are the peculiarities of the organization and functioning of American Accounting Association (AAA)?

10. What are the peculiarities of the organization and functioning of the Chartered Institute of Management Accountants (CIMA)?

11. What are the peculiarities of the organization and functioning of the Eurasian Council of Certified Accountants and Auditors (ECCAA)?

12. What are the peculiarities of the organization and functioning of the International Federation of Francophone Accountants (Federation Internationale des Experts-Comptables Francophone, or FIDEF)?

TASKS FOR SELF-ASSESSMENT

1.8. Read and decide if the following statements (1-5) are true or false.

1. IASB → International Accounting Standards Board: An independent, privately funded accounting standard-setter that is committed to developing a single set of high-quality, understandable, and enforceable global accounting standards.

a) True; b) False.

2. Independence → (conducted by the PCAOB) A process that leads to an assessment of the degree of compliance of each registered public accounting firm and associated persons of the firm with the SOX of 2002 and the board's requirements in connection with its performance of audits, issuance of audit reports, and related matters.

a) True; b) False.

3. Quality control standards → The appropriate form of an audit report when there is a limitation in the scope of the audit or when the financial statements depart from GAAP significantly enough to require mention in the auditors' report, but not so significantly as to necessitate disclaiming an opinion or expressing an adverse opinion.

a) True; b) False.

4. Special purpose financial reporting framework → A financial reporting framework other than GAAP which is one of the following bases of accounting: cash basis, tax basis, regulatory basis, or contractual basis.

a) True; b) False.

5. Adequate disclosure → All essential information as required by GAAP is included in the financial statements.

a) True; b) False.

1.9. Choose the correct option (a, b, c or d).

1. International Federation of Accountants: a worldwide organisation of national accounting bodies established to help foster a coordinated worldwide accounting profession with harmonized standards:

a) GAAS;
b) IASB;
c) IFAC;
d) IAASB.

2. The most important auditing standard which prohibits CPAs from expressing an opinion on financial statements of an enterprises unless they are independent with respect to such enterprise; independence is impaired by a direct financial interest, services as an officer or trustee, certain loans to or from the enterprise and various other relationships:

a) Consistency;
b) IFAC;
c) Independence;
d) Inspection.

3. All essential information as required by GAAP is included in the financial statements:

a) Independence;
b) Adverse opinion;
c) Adequate disclosure;
d) Audit risk.

4. The appropriate form of audit report when there is a limitation in the scope of the audit or when the financial statements depart from GAAP significantly enough to require mention in the auditors' report,

but not so significantly as to necessitate disclaiming an opinion or expressing an adverse opinion:

a) Qualified Opinion;
b) Audit risk;
c) Adverse opinion;
d) Disclaimer of opinion.

5. A very precise document designed to communicate exactly the character and limitations of the responsibility being assumed by the auditors:

a) Peer Review;
b) Standard report;
c) Auditors report;
d) Audit risk.

6. AICPA standards for establishing quality control policies and procedures that provide reasonable assurance that all of CPA firms' engagements are conducted in accordance with applicable professional standards:

a) Qualified Opinion;
b) Internal control;
c) Auditors report;
d) Quality control standards.

7. All essential information as required by GAAP is included in the financial statements:

a) Independence;
b) Adequate disclosure;
c) Audit risk;
d) Adverse opinion.

Unit 2
AGREEMENT CONCLUDING. PLANNING

1. The relationship between documents of organization.
2. Audit planning.
3. Agreement concluding.

TASKS

2.1. Choose the correct option (a, b, c or d).

1. After accepting an audit engagement, the successor auditor would like to review the audit documentation of the predecessor auditor concerning the client's previous audit(s). The successor is looking to substantiate the following:

a) The various accounting methods that the client has used in the past;

b) The current reporting period opening balances of the balance sheet accounts;

c) Information on previous audit timing, audit difficulties and/or complexities, and any unresolved issues.

2. An auditor should design the written audit plan so that:

a) All material transactions will be selected for substantive testing;

b) Substantive tests prior to the balance sheet date will be minimized;

c) Each account balance will be tested under either tests of controls or tests of transactions;

d) The audit procedures selected will achieve specific audit objectives.

3. A successor auditor most likely would make specific inquiries of the predecessor auditor regarding:

a) The competency of the client's internal audit staff;

b) Specialized accounting principles of the client's industry;

c) Disagreements with management as to auditing procedures;

d) The audit procedures selected will achieve specific audit objectives.

4. In evaluating the reasonableness of an accounting estimate, an auditor most likely would concentrate on key factors and assumptions that are:

a) Consistent with prior periods;
b) Similar to industry guidelines;
c) Objective and not susceptible to bias;
d) Deviations from historical patterns.

2.2. You are the Engagement Partner of the X Company. The X Company will audit the consolidated balance sheet of the Y Corporation as of December 31, 2014, and the related consolidated statements of earnings, retained earnings and cash flows for the year then ended.

You need to draw up audit procedures and an audit plan for the Y Corporation.

!!! ***An external auditor*** *should be familiar with different policies, standards and procedures for any company or organization that he or she audits. In addition, he or she must understand the purpose of the audit.*

A plethora of documentation exists in the operation of any organization. Management uses this documentation to specify operating and control details. Consistency would be impossible without putting this information into writing.

Organizations typically have four types of documents in place (Fig. 2.1.):

Policies. These are high-level documents signed by a person of significant authority (such as a corporate officer, president, or vice president). The policy is a simple document stating that a particular high-level control objective is important to the organization's success. Policies may be only one page in length. Policies require *mandatory* compliance.

– The highest level of people in charge is the officers of upper management. Chief executives, financial officers, and operating officers are the principal issuers of policies.

Standards. These are mid-level documents to ensure uniform application of a policy. After a standard is approved by management, compliance is *mandatory*. All standards are used as reference points to ensure organizational compliance. Testing and audits compare a subject to the standard, with the intention of certifying a minimum level of uniform compliance.

– Public standards include the International Organization for Standardization (ISO), Sarbanes-Oxley, and most government laws.

Guidelines. These are intended to provide advice pertaining to how organizational objectives might be obtained in the absence of a standard. The purpose is to provide information that would aid in making decisions about intended goals (should do), beneficial alternatives (could do), and actions that would not create problems (won't hurt). Guidelines are often *discretionary*.

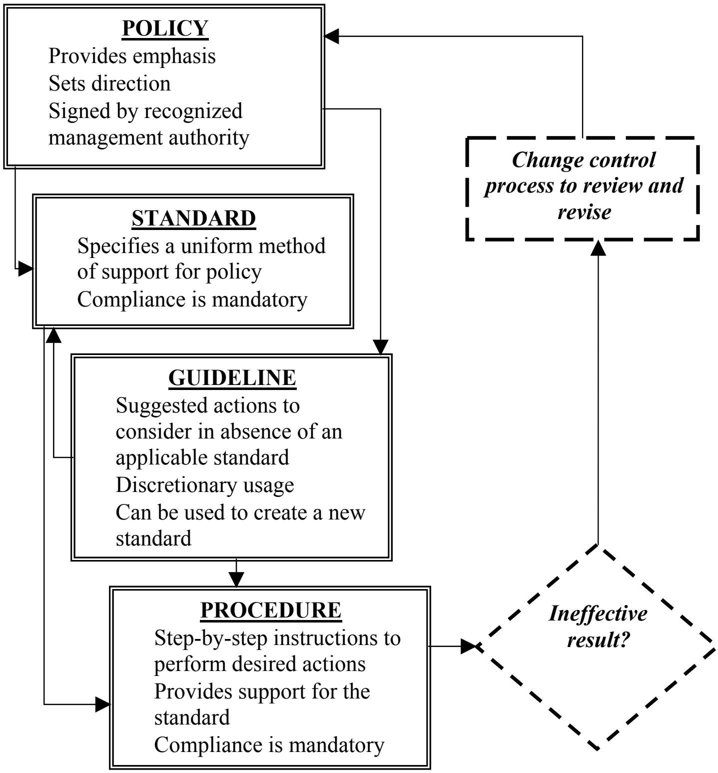


Fig. 2.1. The Relationship between a Policy, Standard, Guideline and Procedure

Procedures. These are «cookbook» recipes for accomplishing specific tasks necessary to meet a standard. Details are written in step-by-step format from the very beginning to the end. Good procedures include common troubleshooting steps in case the user encounters a known problem. Compliance with established procedures is *mandatory* to ensure consistency and accuracy. On occasion a procedure may be deemed ineffective. The correct process is to update the ineffective procedure by using the change control process described later. The purpose of a procedure is to maintain control over the outcome.

!!! *Although every audit is unique, the audit process is similar for most engagement, and normally consists of three stages: planning (sometimes called survey or preliminary review), executing and reporting.*

The most successful audits are those involving sound planning and those in which the auditee and the auditors have a constructive working environment (Fig. 2.2).

STAGE 1: Planning

– Engagement Letter
– Entrance Interview/Opening Conference
– Survey
– Internal Control Review
– Audit Program

STAGE 2: Executing

– Transaction Testing
– Advice and Informal Communications
– Audit Summary
– Working Papers

STAGE 3: Reporting

– Exit Conference
– Draft Report
– Management Response
– Auditee Comments
– Audit Follow-up

Fig. 2.2. The Main Stages of the Audit

STAGE 1: Planning

During the planning portion of the audit, the auditor notifies the auditee of the audit, discusses the scope and objectives of the examination with management, gathers information on important processes, evaluates existing controls, and plans the remaining audit steps.

1. Engagement Letter

The auditee is informed of the audit through an engagement letter from the Auditor General. This letter communicates the scope and objectives of the audit, the auditors assigned to undertake the audit, what materials/documents should be made available and other relevant information.

2. Entrance Interview/Opening Conference

During this meeting, the auditee describes or is asked about the department or system to be reviewed, available resources and other relevant information. If required, the auditor meets with other senior officers directly responsible for the department under review and any staff members he/she wishes to include. It is important that the auditee identify issues or areas of special concern that should be addressed.

3. Survey

In this phase the auditor gather relevant information about the auditee in order to obtain a general overview of operations. He/She talks with key personnel and reviews reports, files, and other sources of information.

4. Internal Control Review

The auditor will review the department's internal control structure, a process which is usually time-consuming. In doing this, the auditor uses a variety of tools and techniques to gather and analyze information about the operation. The review of internal controls helps the auditor determine the areas of highest risk and design tests to be performed in the fieldwork section.

5. Audit Program

Preparation of the audit program concludes the preliminary phase. This program outlines the fieldwork necessary to achieve the audit objectives.

STAGE 2: Executing

Conducting the fieldwork is the main activity under the executing stage and it concentrates on transaction testing and informal communications. It is during this phase that we, the auditors determine whether the controls identified during the preliminary review are operating properly and in the manner described by you the auditee. This stage concludes with a list of significant findings from which we will prepare a draft of the audit report.

1. Transaction Testing

After completing the survey the auditor performs the procedures set out in the audit program. These procedures usually test the major internal controls and the accuracy of transactions.

2. Advice and Informal Communications

As the fieldwork progresses, the auditor discusses any significant findings with the auditee. Hopefully, the auditee can offer insights and work with the auditor to determine the best method of resolving any queries or findings. Usually these communications are oral. However, when dealing with more complex situations written communications (memos, interim reports and emails) are used.

There are times when we may have an informal meeting with management or present an interim report if we think our findings must be address immediately.

3. Audit Summary

Upon completion of the field work the auditors summarize the audit findings, conclusions, and recommendations necessary for the draft audit report.

4. Working Papers

Working Papers are a vital tool of the audit profession. They are the support of the audit opinion and they connect all the dots, that is, the auditee records to what auditors found. They are comprehensive and serve many functions such as reference materials and providing a history of the audit relationship between the auditee and the OAG.

STAGE 3: Reporting

Our principal product is the final report in which we express our opinions based on proof collected during the executing process. Additionally, the audit findings are presented and recommendations discussed for improvements. In order to facilitate communication and ensure that the recommendations presented in the final report are practical we discuss this with the auditee prior to issuing our draft.

1. Exit Conference

When audit management has approved the draft report, we meet with the department's management team to discuss findings and recommendations.

2. Draft Report

The auditor then prepares a formal draft, taking into account any revisions resulting from the exit conference and other discussions. After the changes have been reviewed by audit management, the draft is issued to the auditee for management response.

3. Management Response

The auditee has the opportunity to respond to the audit findings prior to issuance of the final report which can be included or attached to our final report.

4. Auditee Comments

Finally, as part of the OAG's evaluation program, we ask auditees to comment on our performance. This feedback has proven to be very beneficial to us, and we have made changes in our procedures as a result of auditees' suggestions.

5. Audit Follow-up

At our next audit of a particular department we will perform a follow-up review to verify the resolution of the previous report findings.

AUDIT PLANNING

!!! ***Audit planning*** *is defined as the process in which the strategy is designed to conduct the expected result which also defines the scope of audit inside the company. The size, nature and the time for the audit plan may vary. It depends on the size of the business. If the business is spread to the large scale, the strategy making and its implementation will take more time and also the overall scope of Audit plan may also increase. It's basically the step by step methodology where the audit in control reviews the financial process and the internal environment along with the engagement preparation.*

An **audit plan** is a document used for capturing key information regarding the parts of the business to be reviewed, the manner in which the reviews will be conducted, and the frequency of reviews.

Benefits:

- Easy to use;
- Provides repeatable and documented process for review;
- Well known by process participants.

How to Use:

Step 1. Identify the process to be reviewed or audited.

Step 2. Identify the key audit points in the process.

Step 3. Determine the frequency of audits at each process point. Determine this based on total process cycle time, cycle time of each process step, and business requirements.

Step 4. Determine the method of capturing the data (e.g., observation, interviews, etc.).

Step 5. Determine the method of storing the data (e.g., electronic, paper, etc.) and the length of storage (e.g., six months, two years, etc.). This determination depends on the useful life of the data and business requirements.

Step 6. Determine the data assessment procedure.

Step 7. Conduct a dry run, or trial, to ensure the plan works as intended.

Step 8. Publish the plan.

Key audit points: A limited number of operations/processes/transactions that will be tested for compliance.

Frequency: Period of time during the year that the audit will be conducted (e.g., every six months). The frequency is generally defined based on risk to the business; the higher the risks, the more frequently you will want to audit.

Method of storing: How the audit results will be stored for future reference. Methods can include electronic files on a server, paper copies in a vault, or any acceptable form of storage, provided the results are easily retrieved and legible.

Audit Plan Template

Audit plan details	ABC details	Comments
Auditor contact details	Name: Address: Telephone (w): Telephone (m):	The auditee may need to query and negotiate issues prior to accepting the audit plan.
Auditee contact details	Contact person: Address: Telephone (w): Telephone (m):	You may need to clarify details with the auditee before you proceed

Table

Audit plan details	ABC details	Comments
The location to be audited		The location must be agreed upon by both parties
The scope of the audit	— Standards, codes & legislation — size of business — no. of sites — no. of employees — industry: — type of products — processing technologies — hours of operations — technical expert required? — team or solo audit? — which languages spoken?	This includes a summary of the areas to be audited and the references against which the auditee will be assessed for compliance
The scheduled time and proposed duration of the audit, including desk audit, site audit and delivery of final report		Both parties need to understand and agree on the time and likely duration of the desk audit, site audit and preparation of the report. While the exact times cannot be guaranteed there needs to be some guideline estimate understood between the parties involved
Date for receipt of desk audit documentation and time frame for review of documentation		The desk audit may be arranged in advance of the site audit and can be an important means of previewing and clarifying issues prior to the site audit
The preliminary agenda for the site audit		An agenda will give the auditee an ability to manage their daily work operations while the audit proceeds
Proposed date for completion of follow up actions		Set a date for the expected close out of all audit findings
Statements of confidentiality, OHS compliance and other business criteria		The auditee needs to know that the auditor will respect confidentiality, OHS obligations and may agree to other business related criteria such as public liability and professional liability

Table

Audit plan details	ABC details	Comments
Reasons for termination of audit		There can be events that warrant the audit to be terminated, such as unacceptable OHS risk or personal threat to the auditor. Both parties must be in agreement on these issues prior to the start of the audit
Actions or recourse in case of disagreement		The auditee should be advised of the mechanisms and actions that can be taken when there is a dispute regarding the findings of the auditor

2.3. Draw up an Audit Plan based on the scheme of audits of service operations in the local Bank (Fig. 2.3).

When conducting audits of service transactions in a local branch bank, an audit plan provides a pre-defined methodology for ease of use. In a normal banking transaction, each interaction has data collected, stored and analyzed.

The Fig. 2.3. below is part of the audit document:

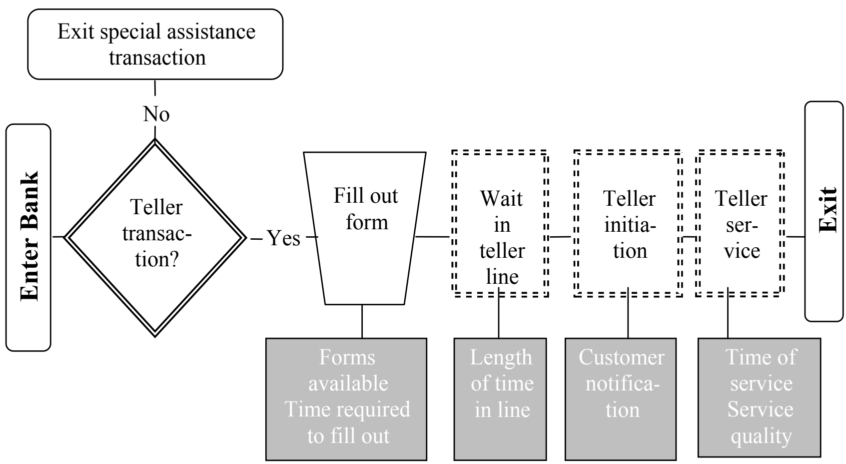


Fig. 2.3. The Scheme of Audits of Service Operations in the Local Bank

It indicates the different areas where key steps exist and elements to consider (e.g., whether forms are available, time required to complete them, etc.). Frequency of each element would be specified, along with how data are captured (e.g., customer survey), where data are captured (e.g., repository), and metrics for each question.

Solution:

Audit Plan

Audit Point	Frequency	Method of Capture	Method of Storage	Length of Storage	Analysis Method
Forms desk	3 times per day	Audit by manager recorded on daily branch report (supply full, supply low, supply empty)	Daily bank operations database	1 year	Use a graph to determine how often empty condition occurs
Teller line entry and exit	3 times per day, a greeter will track wait times for 30 minutes	Bank forms time-stamped upon line entry and by teller	Daily bank operations database	1 year	Analyze means and minimum and maximum monthly
Teller exit	3 times per day, a greeter will track wait times for 30 minutes	Greeter will verbally poll each customer on service level 1-5, 5 being best	Greeter will record these ratings in the daily bank operations database segmented by teller	1 year	Each teller receives a mean score which is used as part of his or her evaluation and the branch receives overall mean rating

2.4. You are the Engagement Partner of the X Company. The X Company will audit the consolidated balance sheet of the Y Corporation as of December 31, 2014, and the related consolidated statements of earnings, retained earnings and cash flows for the year then ended. You need to draw up audit procedures and proposed dates (or an audit plan) for the Y Corporation.

Solution:

a) draft audit procedures and proposed dates (or an **audit plan**) for the Y Corporation:

1. February 2014 – April 2014 (20% of audit work)

– Have preliminary discussions with management and audit committee of the Y Corporation.

– Obtain general information about the industry of the Y Corporation (financial ratios, technological developments, any areas that could lead to audit risk, etc);

– Review prior work papers for general information related to the company;

– **Write an engagement letter to the Y Corporation**.

2. May 2014 – July 2014 (30% of audit work)

– Determine staffing needs for engagement;

– Perform substantive testing on account balances to find material misstatements;

– Test information system controls to see if there is a lack of controls that could lead to material misstatements;

– Communicate with the client on progress of engagement;

3. August 2014 – October 2014 (30% of audit work);

– Continue substantive testing begun in the previous period;

– Obtain confirmations of account balances from vendors and customers;

– Communicate with the client on progress of engagement.

4. November 2014 – January 2015 (20% of audit work)

– At the end of November, do additional substantive testing on account balances that are deemed to have a high risk and assess other accounts for accuracy, including cash;

– Observe physical year-end count of inventory;

– Sign the audit opinion on January 26, 2015.

AGREEMENT CONCLUDING

!!! *When taking a new client, an auditor creates an engagement letter to solidify audit arrangements between the audit firm and the client. The letter serves as the contract, detailing the duties and obligations on either side of the table. Your CPA firm prepares* ***the Engagement letter.*** *Although you aren't required to have a written agreement with an audit client, it is unwise to undertake an audit with only a verbal agreement. Who you address the engagement letter to depends on the type of business entity. If you're working with a corporation, address the letter to the board of directors. If your client is a small corporation that doesn't have a board of directors, address the letter to the chief executive officer. If you're auditing a sole proprietorship, address it to the owner. For a partnership entity, address it to the partners.*

Audit engagement refers to audit performed by an auditor. It is the very first stage of an audit procedure where the client is notified by the auditor that the work pertaining to audit has been accepted by him/her and also provides clarifications with regard to the scope and purpose of audit. To be more specific, audit engagement can be referred to the written letter that the auditor uses to notify the client that he/she would be engaging in auditing services.

2.5. You are the Engagement Partner of the X Company. The X Company will audit the consolidated balance sheet of the Y Corporation as of December 31, 2014, and the related consolidated statements of earnings, retained earnings and cash flows for the year then ended. You need to draw up an Engagement Letter for approval.

Here are the topics you should cover in an engagement letter:

– **The objectives of the engagement:** For example, for a financial statement audit, the objective is to express an opinion on the financial statements.

– **Responsibilities of management:** These can vary based on the terms and conditions of the engagement. For example, the financial statements and the proper application of generally accepted accounting principles are the responsibility of management.

– **Responsibilities of the auditor:** These also vary. For a financial statement audit, one responsibility is that you conduct the audit in accordance with GAAS.

– **Limitations of the engagement:** You should address the fact that the audit is meant to provide reasonable assurance regarding whether the financial statements are free of material misstatements. However, because you don't examine all transactions, there's a risk that material errors, fraud, or illegal acts exist and aren't detected.

– **Hiring restriction:** A general engagement letter condition is that the client won't try to hire anyone on the current audit team. Usually there's a required, one-year cooling-off period between working on a client audit and accepting a position with that company.

Other items you should clear up through the engagement letter are your fees and when you expect the company to pay them. If you plan on using specialists in the company's field to assist you, include that fact as well. It's wise to spell out the conditions under which you'll terminate the engagement – for example, if the client's books render you unable to express an opinion.

What not to include in the engagement letter:

Don't use jargon that only CPAs understand. Doing so will make your client uncomfortable and may cause the client to refuse to sign the letter. Also, don't overstate what you can do. And certainly don't include any promotional or marketing information.

The engagement letter is signed by your CPA firm – for example, «Smith and Jones.» It can also be signed by the firm's contact person, such as «Joe Smith, Partner.» The engagement letter also has a place for the client to sign, acknowledging that it accepts the letter's terms.

!!! *ISA 210 requires the auditor to consider whether there is a need to remind the entity of the existing terms of the audit engagement for recurring audits and many firms choose to send a new letter every year, to emphasize its importance to clients.*

SAMPLE AUDIT ENGAGEMENT LETTER

[Date]

[Client Contact]
[Client Name]
[Client Address]

Dear [Client Contact]:

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will audit the consolidated balance sheet of [Client Name] as of [Date], and the related consolidated statements of operations, retained earnings (deficit), and cash flows for the year then ended.

The objective of our audit is the expression of an opinion about whether your consolidated financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our audit will be conducted in accordance with auditing standards generally accepted in the United States and will include tests of your accounting records and other procedures we consider necessary to enable us to express such an opinion. If our opinion is other than unqualified, we will discuss the reasons with you in advance.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventories, and direct confirmation of receivables and payables and certain other assets and liabilities by correspondence with selected customers, creditors, and financial institutions. We will also request written representations from your attorneys as part of the engagement, and they may bill you for responding to this inquiry. At the conclusion of our audit, we will require certain written representations from you about the financial statements and related matters. Those written representations are a material part of the audit we will perform, and your failure or refusal to provide them in a timely manner will constitute a scope limitation that may preclude us from completing the engagement and issuing our report.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Consequently, our audit will involve judgment about the number of transactions to be examined and the areas to be tested. Also, we will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material errors, fraud, or illegal acts, may exist and not be detected by us. In addition, an audit is not designed to detect immaterial errors, fraud, or other illegal acts or illegal acts that do not have a direct effect on the financial statements. Our engagement cannot, therefore, be relied upon to disclose errors, fraud, or other illegal acts that may exist.

Our audit will include obtaining an understanding of your internal controls sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal controls or to identify reportable conditions, that is, significant deficiencies or material weaknesses in the design or operation of internal control. Accordingly, we have no responsibility to identify and communicate significant deficiencies or material weaknesses in your internal controls as part of this engagement, and our engagement cannot be relied upon to disclose the same. However, during the audit, if we become aware of such reportable conditions, we will communicate them to you.

...

Our audit is intended for the benefit and use of [Client Name]. The audit will not be planned or conducted in contemplation of reliance by any other party or with respect to any specific transaction and is not intended to benefit or influence any other party. Therefore, items of possible interest to a third party may not be specifically addressed or matters may exist that could be assessed differently by a third party.

...

Name of Engagement Partner] is the engagement partner and is responsible for supervising the engagement and signing the report or authorizing another individual to sign it.

...

If, after full consideration and consultation with counsel if so desired, you agree that the foregoing terms shall govern this engagement, please sign this letter in the space provided and return the original signed letter to me, keeping a fully-executed copy for your records.

Thank you for your attention to this matter, and please contact me with any questions that you may have.

Very truly yours,

[Firm Contact]
[Title]

ACCEPTED AND AGREED:

[CLIENT NAME]

______________________________ __________
By: [Name of Signatory] Date
Its: [Title]

SAMPLE INTERNAL AUDIT ENGAGEMENT LETTER

[DATE]

[NAME, TITLE]
[School Board]
[STREET ADDRESS]
[CITY, POSTAL CODE]

Dear [Auditee]

The Internal Audit Team is planning its audit for [Audit Process, i.e enrolment]. The objectives of this audit will be:

[LIST ACTUAL OBJECTIVES HERE]

For example:

– Reliability and Integrity of Financial and Operational Information,

– Compliance with Laws, Regulations, and Contracts,

– Safeguarding of Assets, and

– Effectiveness and Efficiency of Operations of the [AUDIT AREA], and

– To follow-up on recommendations included in prior audit reports.

The proposed timetable for this year's audit is as follows:

Start date in the field: [DATE]
Estimated weeks to complete: [NUMBER OF WEEKS]

The audit team will include the following members:

[NAME], RIAM
[NAME], Staff Auditor
[NAME], Staff Auditor

At the beginning of our audit, we would like to have the opportunity to meet you to discuss our audit objectives and solicit your input. Our goal is to perform an effective and efficient audit. We will need your staff to provide us with the following documents and schedules on:

1. [DATE]
2. [DATE]

Before the audit team leaves the client site at the end of the fieldwork phase, a meeting will be held with you to discuss preliminary findings raised, any outstanding information and the next steps to the audit. The draft audit report will be completed by the audit staff and reviewed by RIAM in the next three weeks. You are then expected to provide a response to the draft report within two weeks. The report will be finalized and presented to the audit committee at their next meeting.

Our mission is to help you achieve [DEPARTMENTs] objectives by providing you with information about the effectiveness of internal control and by recommending courses of actions which improve performance.

If you have any questions about this year's audit, please do not hesitate to call at xxx-xxxxxx or email us at ....

Sincerely,

[RIAM]

CC: Audit Committee
CC: Director of Education
CC: ....

QUESTIONS FOR SELF-ASSESSMENT

1. What is an audit process?
2. What is obtaining a client?
3. What are predecessor auditors?
4. What is an engagement risk?
5. What is an engagement letter?
6. What is planning the audit?
7. What is an overall audit strategy?
8. What is an audit plan?
9. What is an audit program?
10. What are analytical procedures?
11. What is an audit committee?

TASKS FOR SELF-ASSESSMENT

2.6. Choose the correct option (a, b, c or d).

1. At this stage, an auditing firm should develop an overall audit strategy, an audit plan, and an audit program:

a) Planning the Audit;

b) Audit Plan;
c) Obtaining a Client;
d) Predecessor Auditors.

2. It should determine such issues such as timing of the audit, deadlines for reporting, and key dates that information will be received by management. Auditors will also make judgments on which areas represent a high risk of material misstatement, material locations and accounts, the approach towards internal control; and consider significant client and industry factors:
a) Audit Process;
b) Audit Program;
c) Audit Plan;
d) Overall Audit Strategy.

3. It is more detailed than the audit strategy and will include the nature, extent, and timing of the procedures to be performed by the audit team members in order to obtain sufficient audit evidence:
a) Audit Process;
b) Audit Program;
c) Audit Plan;
d) Audit Plan, 2.

2.7. Read and decide if the following statements (1-4) are true or false.

1. Audit Committee → It is detailed list of all the audit procedures to be performed in the course of the audit. A tentative audit program is developed from the auditors' initial risk assessment.
a) True; b) False.

2. Engagement risk → Before submitting a proposal, the audit firm should assess the risk to the firm of doing business with a certain client. They should consider such things as the reputation of management, the company's financial strength, and the credit rating of a prospective client.
a) True; b) False.

3. Audit Program → It is a detailed list of all the audit procedures to be performed in the course of the audit. A tentative audit program is developed from the auditors' initial risk assessment.
a) True; b) False.

4. Analytical Procedures → These are procedures which help the auditor gain substantive evidence for the audit. Sources for the procedures can be such items as prior year's financial statements, industry statistics, and their professional experience. Any discrepancies will be noted and be the subject of further investigation.

a) True; b) False.

Unit 3

RISK AND INTERNAL CONTROL ESTIMATION. THE AUDIT PROGRAMME DESIGNING

1. Audit risks and business risks.
2. Internal control estimation.
3. Audit procedures.
4. Audit programme designing.

TASKS

3.1. Match each object (1-3) with two of its components (a-c).

Term	Explanation
1. INHERENT RISK	a. This is the risk that a misstatement will not be prevented, or detected and corrected on a timely basis by the entity's internal controls. This is either due to the internal control system being insufficient in the circumstances of the business or because the controls have not been applied effectively during the period
2. DETECTION RISK	b. This is the susceptibility of a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or in aggregate, before consideration of related controls. In other words this is the risk that a misstatement occurs in the first instance
3. CONTROL RISK	c. This is the risk that the procedures performed by the auditor to reduce audit risk to an acceptable level will not detect potentially material misstatements, either individually or in aggregate

MATERIALITY AND AUDIT RISK

Materiality and audit risk are related. As noted in ISA section 320, «There is an inverse relationship between *materiality* and the *level of audit risk*».

Since most firms strive for a relatively constant level of overall audit risk, choosing the wrong **materiality** level affects decisions about the nature, extent, and timing of the fieldwork. These decisions, in turn, affect the effectiveness or efficiency of the audit. Thus, making proper judgments about materiality is an important part of audit planning.

!!! ***Materiality*** *is a concept or convention within auditing and accounting relating to the importance/significance of an amount, transaction, or discrepancy.*
The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in conformity with an identified financial reporting framework such as Generally Accepted Accounting Principles (GAAP). The assessment of what is material is a matter of professional judgment.

Information is material if its omission or misstatement could influence the economic decision of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement.

Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

!!! ***Audit risk*** *is the risk that an auditor issues an incorrect opinion on the financial statements.*
Examples of inappropriate audit opinions include the following:
– Issuing an unqualified audit report where a qualification is reasonably justified;
– Issuing a qualified audit opinion where no qualification is necessary;
– Failing to emphasize a significant matter in the audit report;
– Providing an opinion on financial statements where no such opinion may be reasonably given due to a significant limitation of scope in the performance of the audit.

As shown in the following Fig. 3.1, auditors typically make the following two types of materiality judgments:

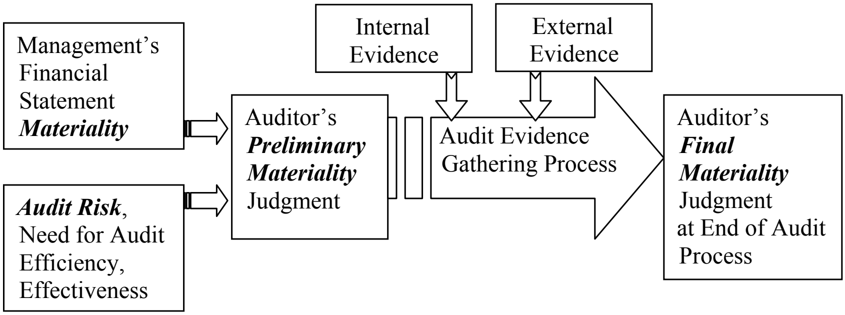


Fig. 3.1. Two Types of Materiality Judgments of Auditors

Preliminary materiality – the purpose of this materiality is to guide the auditor in determining the nature, timing, and audit procedures. This judgment would consider management's financial statement materiality amount but may be either higher or lower due to risk and needs of the audit process.

Final reporting materiality judgment – the purpose of this materiality is to assist the auditor in evaluating the effect of misstatements on his/her reporting.

The auditor's materiality decision is both **quantitative** and **qualitative** in nature. Moreover, as evidence is accumulated and facts change, materiality may evolve from a preliminary, planning judgment to a final, reporting judgment.

Quantitative Approaches

The auditing standards do not explicitly require the auditor to quantify materiality. However, although auditors may consider nonquantitative factors in making the materiality judgment, they typically prefer to quantify the preliminary materiality judgment.

Quantitative approaches by auditors to making the preliminary materiality judgment can be *classified* into the following categories:

1. ***Single rules***.
2. ***Variable or size rules***.
3. ***Average or blending methods***.
4. ***Formula methods***.

1. ***Single rules*** are ***«rules of thumb»*** that use a single financial variable for computing materiality. As a matter of policy, an audit firm typically provides three or four such rules and allows the individual auditor to choose the most appropriate rule based on an assessment

of qualitative factors. Examples of common single rules include the following:

– 5% of pre-tax income;
– 0.5% of total assets;
– 1% of equity;
– 0.5% of total revenues.

2. ***Variable or size rules*** are similar to single rules but differ in that they provide a range of possible different materiality levels for companies of different sizes. An auditor uses an assessment of qualitative factors to help decide what materiality level to select within the appropriate range. Examples of variable rules include the following:

– 2% to 5% of gross profit, if less than $20,000;
– 1% to 2% of gross profit, if between $20,000 and $1 million;
– 0.5% to 1% of gross profit, if between $1 and $100 million;
– 0.5% of gross profit, if more than $100 million.

3. ***Average or blending methods*** typically average four or five individual rules of thumb or weight each according to a particular formula. Presumably, the blending or averaging process provides an indirect way of considering qualitative factors. A simple example would be to average the previously listed four single rules, giving each a 25% weight.

4. ***Formula methods*** are often estimated by a statistical analysis of a sample of companies. The most widely known formula is used by KPMG, although there are many others in the audit literature. The 1998 version of KPMG's materiality formula is as follows:

$$\textbf{Materiality} = \mathbf{1.84} \times \textbf{(Greater of Assets or Revenues)}^{\mathbf{2/3}}$$

!!! *Since the materiality judgment is related to how much audit work is necessary, this means that variability in materiality judgments could result in auditors in the same audit firm doing widely differing amounts of work for essentially similar clients. Accordingly, many firms have adopted the Average or Blending method as way of eliminating the variability caused by the materiality judgment process in the other two methods.*

Quantitative approaches are best seen as decision aids that help auditors make their materiality judgment.

3.2. Calculate the preliminary materiality for the audit plan based on the financial statements of the ABC Company using the following methods:

1. Single rules.
2. Variable or size rules.
3. Average or blending methods.
4. Formula methods.

Analyze the results.

Summary Financial Statements for ABC Company (000s omitted):

ABC Company December 31, 2013				
Balance Sheet			*Income Statement*	
Assets	$3,000,000		Total Revenues	$9,000,000
			Cost of Merchandise	5,000,000
			Gross Profit	4,000,000
			Selling &Other Expenses	3,200,000
Liabilities	$2,000,000		Net Income before Tax	800,000
Owner's Equity	1,000,000		Income Tax	300,000
	$3,000,000		Net Income after Tax	$ 500,000

Solution:

1. Single rules method:

The single rule method would involve the auditor selecting one of the four following materiality amounts:

Single Rule	Computation	Materiality Amount
5% of pre-tax income (net income before tax)	5% × $800,000	***$40,000***
0.5% of total assets	0.5% × $3,000,000	***$15,000***
1% of equity (owner's equity)	1% × $1,000,000	***$10,000***
0.5% of total revenues	0.5% × $9,000,000	***$45,000***

2. Variable or size rules:

The variable or size rule method would involve the following computations with the auditor judgmentally selecting a materiality amount somewhere in the computed materiality range:

Variable or Size Rules	Computation	Materiality Amount
0.5% to	0.5% × \$4,000,000	***\$20,000 to***
1% of Gross Profit*	1% × \$4,000,000	***\$40,000***
** if gross profit between \$1 and \$100 million*		

3. Average or blending methods:

The average or blending method using the single rules previously given would involve the following computation:

Average Method	Computation	Materiality Amount
(5% of pre-tax income (net income before tax)	(\$40,000	
+ 0.5% of total assets	+ \$15,000	
+ 1% of equity (owner's equity)	+ \$10,000	
+ 0.5% of total revenues) / 4	+ \$45,000) / 4	\$27,500

4. Formula methods:

The formula method would involve the following computation if the KPMG formula was used:

KPMG Formula	Computation	Materiality Amount
1.84 × (Greater of Assets or Revenues)$^{2/3}$	1.84 × (\$9,000,000)$^{2/3}$	***\$79,612***

Conclusion:

As can be seen from the previous computations, the materiality amounts computed using either the Single Rule method or the Variable Rule method varied from a possible low of *\$10,000* to a possible high of *\$45,000* depending on the auditor's judgment. Empirical research on materiality has shown that different auditors may make widely different materiality judgments given the same set of facts and circumstances when using either the Single Rule method or the Variable Rule method.

As can be seen in the previous example, the Average Method materiality amount of *$27,500* is in the middle of the *$10,000* to *$45,000* range from the Single Rule methods and close to the middle of the *$20,000* to *$40,000* range given by the Variable or Size Method.

Finally, in this illustration the KPMG Formula resulted in a materiality amount approximately *twice amount* provided by the alternative methods, presumably due to differences in their audit process.

Audit Risk Model

Audit risk may be considered as the product of the various risks which may be encountered in the performance of the audit. In order to keep the overall audit risk of engagements below acceptable limit, the auditor must assess the level of risk pertaining to each component of audit risk.

Audit Risk = Inherent Risk × Control Risk × Detection Risk.

1. Inherent Risk is generally considered to be higher where a high degree of judgment and estimation is involved or where transactions of the entity are highly complex. For example, the inherent risk in the audit of a newly formed financial institution which has a significant trade and exposure in complex derivative instruments may be considered to be significantly higher as compared to the audit of a well established manufacturing concern operating in a relatively stable competitive environment.

2. Control Risk is considered to be high where the audit entity does not have adequate internal controls to prevent and detect instances of fraud and error in the financial statements. Assessment of control risk may be higher for example in case of a small sized entity in which segregation of duties is not well defined and the financial statements are prepared by individuals who do not have the necessary technical knowledge of accounting and finance.

3. Detection Risk is always present due to the inherent limitations of the audit such as the use of sampling for the selection of transactions. Detection risk can be reduced by auditors by increasing the number of sampled transactions for detailed testing.

3.3. Determine planned detection risk compatible with an audit risk model, if known:

ABC is an audit and assurance firm which has recently accepted the audit of XYZ. During the planning of the audit, engagement manager has noted the following information regarding XYZ for consideration in the risk assessment of the assignment:

– XYZ is a listed company operating in the financial services sector.

– XYZ has a large network of subsidiaries, associates and foreign branches.

– The company does not have an internal audit department and its audit committee does not include any members with a background in finance as suggested in the corporate governance guidelines.

– It is the firm's policy to keep the overall audit risk below 10%.

!!! ***Audit risk model*** *is used by the auditors to manage the overall risk of an audit engagement.*
Auditors proceed by examining the inherent and control risks pertaining to an audit engagement while gaining an understanding of the entity and its environment.
Detection risk forms the residual risk after taking into consideration the inherent and control risks pertaining to the audit engagement and the overall audit risk that the auditor is willing to accept.
Where the auditor's assessment of inherent and control risk is high, the detection risk is set at a lower level to keep the audit risk at an acceptable level. Lower detection risk may be achieved by increasing the sample size for audit testing. Conversely, where the auditor believes the inherent and control risks of an engagement to be low, detection risk is allowed to be set at a relatively higher level.

Solution:

1. *Inherent risk* in the audit of XYZ's financial statements is particularly high because the entity is operating in a highly regularized sector and has a complex network of related entities which could be misrepresented in the financial statements in the absence of relevant financial controls. The first audit assignment is also inherently risky as the firm has relatively less understanding of the entity and its environment at this stage. The inherent risk for the audit may therefore be considered as high (***60%***).

2. *Control risk* involved in the audit also appears to be high since the company does not have proper oversight by a competent audit committee of financial aspects of the organization. The company also lacks an internal audit department which is a key control especially in a highly regulated environment. The control risk for the audit may therefore be considered as high (***60%***).

3. The overall *audit risk* is below ***10%.***

Audit Risk = Inherent Risk × **Control Risk** × Planned Detection Risk

0.10 = 0.60 × 0.60 × ***Planned Detection Risk;***

0.10 = 0.36 × ***Planned Detection Risk;***

Planned Detection Risk = 0.10 / 0.36 = 0.278 (***27.8%***).

If inherent risk and control risk are assumed to be ***60%*** each, ***Planned Detection Risk*** has to be set at ***27.8%*** in order to prevent the overall audit risk from exceeding ***10%.***

AUDIT RISK AND BUSINESS RISKS

The complexities of modern day businesses and accounting practices have necessitated the consideration of business risks during the course of the audit. Business risks are the factors that could prevent or hinder the achievement of organizational goals and objectives.

!!! ***Business risks*** *facing an organization can be wide-ranging and diverse. The ultimate business risk any organization faces is the risk that it seizes to be a going concern. Business risks therefore comprise any factors that may contribute towards business failure.*

Examples of business risks include:
- Loss of customers;
- Increase in production costs;
- Cash flow problems;
- Decline in product demand;
- Litigations and claims;

– Technological obsolescence;
– Increase in market competition;
– Decrease in profitability;
– Political and economic instability;
– Over trading;
– Inadequate financing;
– High financial risk;
– Risk of fraud and theft.

Whereas business risks relate to the organization and its stakeholders, audit risk relates specifically to an auditor. Although audit risks and business risks are dissimilar in nature, it is often the case that identification of significant business risks leads to the detection of audit risks.

3.3. Correlate the business risk and audit risk on the basis of the initial data: AM is the audit manager of Energy PLC, a company operating in the energy exploration and production sector. As part of the risk assessment procedures during the planning for audit of Energy PLC, AM identified the following significant matters while examining the minutes of a meeting of the Company's Board of Directors held at the start of the year (**Table 3.1**).

Table 3.1

Correlation of Business Risks and Audit Risks

Matter	Business Risks	Audit Risks
The CFO apprised the Board of the initiation of legal proceedings against Energy PLC regarding damage caused to a customer's pipelines as a result of the supply of low quality gas by the Company	The litigation may result in a significant outflow of economic resources in the future. Significant management time will also need to be expended over the course of the litigation	Liabilities of Energy PLC might be understated as a result of non recognition of the provision in respect of the litigation. Alternatively, the disclosure regarding contingencies may not adequately disclose the effects of the pending litigation
The Board accepted the proposal of the Finance Director to sell off a low performing subsidiary of the Company after two year. The Finance Director remarked that the current market price of the subsidiary's shares is too low	The full worth of the subsidiary may not be realized by Energy PLC through the sale transaction	Financial results of the subsidiary might be manipulated to influence the market value of its shares prior to the sale transaction. Related party transactions with the subsidiary may be misrepresented in order to improve the market perception of financial performance of the subsidiary

Table 3.1

Matter	Business Risks	Audit Risks
CFO informed the Board about the progress towards the finalization of the gas sales agreement in respect of a gas field which commenced production in the preceding year	The finalization of the gas sales agreement may result in a significant cash outflow in the form of a price differential adjustment if the final price determined is lower than the price currently charged to the customer	Sales revenue is currently being recognized on an estimate basis in respect of the mentioned gas field. The estimate may be biased and not based on realistic assumptions regarding the sales price. Continuation of Table
CFO explained the basis of the provisional price being charged to the customer at the moment and that any price differential arising on the determination of the final price will be subsequently settled with the customer upon the finalization of the gas sales agreement		The effect of provisional pricing and any future revisions in price may not be adequately disclosed in the financial statement
The managing director apprised the Board regarding plans to drill a second exploratory well in an area. The drilling of the first exploratory well in the same area in the previous period could not be successful due to unsuitable rock formation	The cost to be incurred on drilling of the second exploratory well may not be recoverable if a similar rock formation to the first well is discovered.	Exploration and evaluation assets of the company may be overstated as a result of the unsuccessful exploratory well whose cost must be immediately expensed in the income statement. The cost incurred in the current period, if any, on the second well may also not be recoverable in which case the assets of Energy PLC may be overstated

!!! ISA 315** requires auditors to obtain an understanding of the entity and its environment in order to assess the risks of material misstatement of financial statements. This reinforces the importance of obtaining a bird's eye view of the entity's business and significant business risks by the auditor **at the audit planning stage.

In view of the high profile accounting scandals in recent times, the role and responsibilities of auditors have been questioned. In the particular instance of Enron, the company auditors, Arthur

Anderson, were alleged to have lacked sufficient understanding of the business, risks and exposures of the Company which ultimately caused them to overlook the effects of Enron's aggressive accounting practices.

INTERNAL SYSTEMS OF CONTROL

Corporate governance is the system by which a company is directed and controlled. The directors, or management, of a company are those individuals responsible for this.

As stewards of a company (i.e. they run the company on behalf of the owners), directors are responsible for making operational decisions in the best interests of the owners; safeguarding the assets of the owners; and providing the owners with relevant and timely information that they can use to assist with their decision making.

One of the key components of this is the need to implement internal control systems. They are vital to the effective operation of the company.

They are of particular significance to an auditor because the strength of a client's internal controls directly impacts the risk of:

– non-compliance with laws and regulations;
– fraud;
– misstatement in the financial reporting system.

!!! *Auditors therefore have to gain an understanding of the strengths and deficiencies of the* ***internal systems of control*** *to assist their risk assessment during the planning process.*
This includes:
– understanding the components of the internal system of control,
– documenting and testing the system, and
– identifying and reporting deficiencies in the system.

Internal controls ensure that all financial information represented on a company's financial statements is accurate and valid. Testing internal controls is audit processes that detect flaws in the internal controls and help the company management correct these problems in a timely manner. Controls are tested by selecting a sample of transactions and determining the accuracy and validity of the information.

How to Test Internal Control for Risk

1. Cash Reconciliation

Cash reconciliation controls ensure that outstanding deposits from one month's bank reconciliation are shown as deposits on the following month's bank statement. This ensures proper cash recording and depositing processes.

2. Accounts Payable

Accounts Payable (A/P) transactions are reviewed to ensure payments are made to actual company vendors and all invoices are properly coded and paid. A/P aging schedules are also reviewed for large unpaid balances.

3. Fixed Assets

Fixed assets are reviewed to determine that the proper asset class has been assigned and depreciation is being calculated correctly. Salvage values are also tested to determine validity.

4. Prepaid Expenses

Prepaid expense accounts are tested to ensure that all amounts have proper documentation for prepayment guidelines. To qualify as a prepaid expense, an invoice or contract for future periods of service must be on file in the accounting department.

5. Financial Statements

Financial statement controls are reviewed by comparing the statements to prior periods or using a trend analysis for comparison. Any large variances are reviewed to determine the reason for the large difference.

!!! ***Internal systems of control*** *include five categories of controls that management designs and implements to provide reasonable assurance that its control objectives will be met. These are called the components of internal control, and are:*

– Control environment;
– Risk assessment;
– Control activities;
– Information and communication;
– Monitoring.

Control environment is the broadest of the five and deals primarily with the way management implements its attitude about internal controls. The other four components are closely related to the control environment.

Risk assessment is management's identification and analysis of risks relevant to the preparation of financial statements in accordance with GAAP. To respond to this risk assessment, management implements control activities and creates the accounting information and communication system to meet its objectives for financial reporting.

Finally, management periodically assesses the quality of internal control performance to determine that controls are operating as intended and that they are modified as appropriate for changes in conditions (*monitoring*).

The five categories of control activities are:

– Adequate separation of duties.

Example: The following two functions are performed by different people: processing customer orders and billing customers.

– Proper authorization of transactions and activities.

Example: The granting of credit is authorized before shipment takes place.

– Adequate documents and records.

Example: Recording sales is supported by authorized shipping documents and approved customer orders.

– Physical control over assets and records.

Example: A password is required before entry into the computerized accounts receivable master file can be made.

– Independent checks on performance.

Example: Accounts receivable master file contents are independently verified.

!!! *Separation of operational responsibility from record keeping is intended to reduce the likelihood of operational personnel biasing the results of their performance by the incorrect recording of information.*
Separation of the custody of assets from accounting for these assets is intended to prevent misappropriation of assets. When one person performs both functions, the possibility of that person's disposal of the asset for personal gain and adjustment of the records to relieve himself or herself of responsibility for the asset without detection increases.

An ***example*** of a physical control the client can use to protect each of the following assets or records is:

1. Petty cash should be kept locked in a fireproof safe.
2. Cash received by retail clerks should be entered into a cash register to record all cash received.
3. Accounts receivable records should be stored in a locked, fireproof safe. Adequate backup copies of computerized records should be maintained and access to the master files should be restricted via passwords.
4. Raw material inventory should be retained in a locked storeroom with a reliable and competent employee controlling access.
5. Perishable tools should be stored in a locked storeroom under control of a reliable employee.
6. Manufacturing equipment should be kept in an area protected by burglar alarms and fire alarms and kept locked when not in use.
7. Marketable securities should be stored in a safety deposit vault.

!!! *Independent checks on performance are internal control activities designed for the continuous internal verification of other controls.*

Examples of independent checks include:

– Preparation of the monthly bank reconciliation by an individual with no responsibility for recording transactions or handling cash.

– Recomputing inventory extensions for a listing of inventory by someone who did not originally do the extensions.

– The preparation of the sales journal by one person and the accounts receivable master file by a different person, and a reconciliation of the control account to the master file.

– The counting of inventory by two different count teams.

– The existence of effective internal audit staff.

AUDIT PROCEDURES

Audit procedures include ***analytical procedures*** and ***control tests*** as well as tests of ***account balances*** and ***details***.

1. Analytical Procedures:

Analytical procedures enable auditors to identify numerical relationships and trends among financial data. These procedures also allow corporate reviewers to verify that these trends are consistent from one period to another. For example, an auditor may note that a company's expenses have averaged 50 percent of total sales over the last five years. Using analytical procedures, the auditor may question the accuracy of the current year's data if expenses increase to 80 percent of total revenues. Analytical techniques ensure financial accuracy. Incorrect accounting reports undermine investors' confidence and trust in corporate operating results, which are essential elements that corporate management takes into account when drawing up funding strategies.

2. Control Tests

By testing internal controls, auditors familiarize themselves with a company's decision-making mechanisms, with a special emphasis on how personnel resolve conflicts and address operating risks. A control is a set of directives that department heads rely on to prevent losses resulting from fraud, theft, errors and technological breakdowns. To test corporate controls effectively, auditors use skills and expertise that they hone through on-the-job training, academic instruction and professional certification. Reviewing internal policies enables auditors to ensure that companies run law-abiding businesses.

3. Tests of Account Details

Tests of account details provide insight into a firm's bookkeeping practices, enabling auditors to lift the veil on corporate financial reporting policies. During testing, auditors ensure that journal entries conform to accounting norms, such as generally accepted accounting principles and international financial-reporting standards. For example, an auditor testing customer-receivables account details ensures that bookkeepers debit and credit the appropriate accounts. Customer-receivables are an asset account that corporate accountants report in a statement of financial position, also called a balance sheet.

4. Tests of Account Balances

A test of account balance indicates to auditors whether individual ledger accounts add up to financial statement accounts. For example, an auditor wants to review a company's «property, plant and equipment» (PPE) account balance. PPE is a long-term asset account indicated on a corporate balance sheet. As the end of the year, the company's PPE account balance might be $1 million. The auditor performs an in-depth test to ensure that all individual sub-accounts in the PPE account are accurate. After adding up four sub-account balances – machinery ($100,000), commercial property ($600,000), equipment ($150,000) and corporate cars ($150,000) – the reviewer determines that the PPE account balance is accurate.

Every procedure must state:
– the assertion tested;
– the audit procedure;
– the reason for the procedure.

Identify the assertion tested

Audit procedures are performed in order to test financial statement assertions. Therefore, the first step in explaining an audit procedure is to **identify the assertion that needs to be tested**.

The assertions embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur, may take the following forms:

Transactions and events	Account balances at the period-end	Presentation and disclosure
Occurrence	Existence	Occurrence and rights and obligations
Completeness	Rights and obligations	Completeness
Accuracy	Completeness	Classification and understandability
Cutoff	Valuation and allocation	Accuracy and valuation
Classification		

Completeness

This means that *all* transactions have been recorded in the financial statements – i.e. all assets, liabilities, equity interests (capital and reserves) and other disclosures have been included in the financial statements.

Occurrence

This assertion means that transactions and events and other matters that have been recorded actually took place – and relate to this organization.

Valuation and allocation

This means that all items have been included in the financial statements at appropriate amounts according to company policy and the relevant financial reporting framework. Furthermore, any allocations or valuation adjustments required (like impairment) have been made and financial and other information is disclosed fairly and at appropriate amounts.

Classification and understandability

Financial information is appropriately presented and disclosed, and disclosures are clearly expressed so as to make them understandable to the users. For this, the disclosures should use simple language and state matters clearly and concisely.

Accuracy

Accuracy means that amounts and other data relating to transactions and events have been recorded at the correct amounts – i.e. at the amounts appearing in the source documents.

Rights and obligations

This means that the entity has a right to its assets – i.e. it is free to use or dispose of the assets as it sees fit. Furthermore, the entity is obliged to pay off the liabilities that are shown in the statement of financial position.

Existence

This means that assets, liabilities and equity interests (capital and reserves) are physically present/belong to the entity on the reporting date.

Cutoff

This means that transactions and events have been recorded in the correct accounting period – for example, if goods are delivered prior to year end, they are included in the cost of goods sold, not inventory.

Identify the audit procedure

	Explanation	Example of substantive procedure relating to valuation of *property, plant and equipment* (PPE)
1	Choose the assertion that will be tested	Choose an assertion from Completeness, Valuation and allocation, Rights and obligations and Existence if you are testing the period-end balance of PPE; valuation of non-current assets is the assertion tested
2	Identify the risk that will cause a material misstatement in the financial statements – the audit risk is the total value of PPE that may be misstated due to over-valuation/ undervaluation of PPE	One risk relates to the revalued assets not representing fair values, thus under/overstating PPE
3	Think of the audit procedures that should be performed in order to avoid the risk mentioned in step 1 (refer to «AEIOU» below)	The auditor will agree the availability of a revaluation report (a source document for the revaluation) and confirm that the value mentioned in the valuation report matches the amount at which the PPE is revalued and shown in the financial statements.

Table

	Explanation	Example of substantive procedure relating to valuation of *property, plant and equipment* (PPE)
		Furthermore, the auditor will recalculate the revaluation surplus in accordance with the provisions of IAS 16, *Property, Plant and Equipment* to confirm the correctness of the accounting entries relating to revaluation surplus. The amount added to revaluation surplus should be the difference between the net book value of PPE and the revalued amounts. The auditor should agree the assumptions used in the report for reasonableness. For example, the value per square feet in the valuation report should be similar to the value per square feet of other similar properties in that locality. There are many more procedures that will apply to this risk.

Follow the above method for testing other assertions too.

!!! ***Choose audit procedures from AEIOU:***
*A: **A**nalytical procedures.*
*E: **E**nquiry and confirmation directly from a third party — i.e. inquiry.*
*I: **I**nspection of records and assets.*
*O: **O**bservation.*
*U: recalc**U**lation and reperformance.*

Note the following while writing down the audit procedure

1. Write it clearly

Audit procedures should be written in such a way that even a junior auditor will be able to understand what is to be done. For example, avoid vague procedures like «check goods received notes». This is vague as it does not explain what is to be examined in the goods received notes. Is it the description of items received, the quantity received or the name of the vendor?

2. Write down the reason for performing the audit procedure

The audit procedure «check goods received notes» does not mention why the goods received notes are to be checked. Instead, write the audit procedure as: «agree the description of items and the quantities ordered mentioned on the goods received note with the descriptions on the purchase orders raised on the vendor». This confirms that the entity has procured goods based on an authorized purchase order.

3. Use audit terminology

Use terminology relating to audit like «cast», «agree», «trace», etc.

• Use the word 'cast' to mean totaling up a list – for example, «cast the trial balance».

Use the words «agree» or «trace» to mean matching information from two documents/ records – for example, «agree the total sales of the sales day book to the general ledger account»; or «trace a sample of trade payables to the purchase invoices, to confirm the existence of the rights to the goods purchased».

A complete audit procedure would read as follows:

The auditor will agree a sample of items from the inventory sheets to the raw material inventory (**1**) to ensure that the inventory recorded on the sheets actually exists (**2**). This will confirm the assertion of existence of inventory as an asset in the financial statements (**3**).

***1** = the audit procedure;*

***2** = the reason for the audit procedure;*

***3** = the assertion.*

If the above mentioned procedure is written as «The auditor will check a sample of items from the inventory sheets to the raw material inventory», it is incomplete as it does not mention why the audit procedure is being performed.

Common errors that must be avoided

The examiner's reports mention various errors that candidates make while writing audit procedures. Here is a summary of the common errors.

While writing audit procedures, avoid the following:

– **Writing an audit procedure without explaining the reason for the procedure** – for example, «The auditor will check a sample of items from the inventory sheets to the inventory.»

– **Stating an assertion word as a reason for performing a procedure** – for example, «confirming the occurrence of sales».

– **Writing what the internal control system should do rather than stating the audit procedure** – for example, «for all goods received, there should be a goods received note raised».

– **Writing vague procedures** – for example, «check the invoice», «check the goods received note», etc. These procedures are inappropriate as they do not mention what is to be checked and the reason for checking them.

– **Quoting incorrect assertions** – for example, «tracing details from the purchase orders to the goods received notes in order to confirm existence of the goods» – the completeness assertion would apply here.

– **Including procedures that cannot be carried out** – for example, «agree individual items of physical inventory to the sales invoice». It will not be possible to agree the physical goods to the sales invoice as the goods will already be sold.

– **Including procedures that are incorrect** – for example, «agree details from the purchase orders (like description of items ordered, quantities ordered) to the goods held in the inventory store». This is an incorrect audit procedure as goods received notes (not purchase orders) are used to update inventory.

– **Writing impractical procedures** – for example, suggesting a segregation of duties between the person authorizing petty cash vouchers, recording petty cash vouchers and dispensing the petty cash.

– **Writing irrelevant audit procedures** – for example, when you are asked to write audit procedures relating to depreciation of a non-current asset, it will be inappropriate to provide general audit procedures relating to audit of non-current assets.

AUDIT PROGRAMME DESIGNING

!!! ***An audit program*** *is a set of policies and procedures that dictate how an evaluation of a business is done. This generally involves specific instructions as to what, and how much, evidence must be collected and evaluated, as well as who will collect and analyze the data and when this should be done. These types of programs are used to check up on things like a business' performance, finances, economy, and efficiency, and are generally tailored to a specific business or purpose.*

3.4. Form a General Audit Program having studied previous reports, applicable laws, policies and standards.

GENERAL AUDIT PROGRAM

I. PRELIMINARY SURVEY

Objective: To adequately plan the audit & obtain background information for the activities to be audited including researching past reports, applicable laws, policies and standards as well as best practices.

	Audit Step	W/P No	Est. Hrs	Act. Hrs
A.	1. Document the planned meeting of the Internal Audit Director or agency representative. Obtain name of system, identification of previous reviews, and applicable laws, policies and standards, and related documentation such as the system boundary definition, any interconnectivity with other systems, system risk assessment and system roles and responsibilities.			
B.	2. List draft major Scope (including System(s) Names), Objective or Resources decisions including any technical assistance needed and any coordination with the Auditor of Public Accounts (APA). ______________________________			
C.	3. Is APA Coordination Needed? **YES NO** IF «YES» State what, when & who: ____________________ for Year Ending _______, 20xx Meeting date – ______, 20xx, Representing			
D.	4. Is technical Assistance Needed? (circle) **YES NO** IF «YES» State what, when, who & estimated cost:			
E.	__			
F.	Prepare Date & Time Budget: **Phase Deadline Budget** Familiarization x/xx/20xx xx.x Preliminary Survey x/xx/20xx xx.x Fieldwork x/xx/20xx xx.x Draft Report x/xx/20xx xx.x Final Report x/xx/20xx xx.x Administration x/xx/20xx xx.x TOTALS: **xxx.x** Time reports should be included in the work papers behind the Date and Time Budget.			
G.	Prepare Engagement Memorandum signature & include: proposed review scope & objectives, 1. Estimated starting & completion dates, 2. Auditor-in-Charge (AIC) & staffing, 3. Physical facilities required, if any, &			

Audit Step		W/P No	Est. Hrs	Act. Hrs
	4. General questionnaire of background information needed & timeframe for receipt.			
H.	Review and document any applicable IA reports, APA reports & any reports issued from other sources such as Agency, DPS Review Team, JLARC, Consultants, etc. List any issues and dispositions related to the system or the general control environment that might be pertinent.			
I.	Review and document any Federal or State laws pertinent to the system as well as the Commonwealth IT Security Policies and Standards Review and document pertinent industry information technology guidance from the Institute of Internal Auditors, ISACA and the AICPA as well as from organizations such as: 1. CobiT from the IT Governance Institute: 2. National Institute of Standards & Technology Computer Security Division: 3. International Standards Organization Guidance on Information Security 4. AuditNet – Kaplan's comprehensive KARL (audit resource list) and ASAP (auditors sharing audit programs) **Total For Familiarization**			

II. PRELIMINARY SURVEY

Objective: To obtain an understanding of the IT System area being audited including goals & objectives, regulations, & areas of management concern.

Audit Step		W/P No	Est. Hrs	Act. Hrs
A.	Analyze the strengths and weaknesses of the major processes in the narratives and flowcharts. Prepare			
B.	a Risk Matrix that identifies the following for each preliminary audit objective: - the risks and expected controls for each objective; - actual practices that fulfill each element (strength) or the absence of such (weakness) with work paper reference to the flowchart or narrative and - the disposition for each actual practice listed as appropriate from one of the following: report without testing, Detailed Fieldwork Program reference or no further action (NFA) as outside scope or immaterial.			
C.	Prepare a summary of proposed modifications to the audit scope & objectives & prioritize the objectives in order of significance.			

Table

	Audit Step	W/P No	Est. Hrs	Act. Hrs
D.	Develop the Detailed Fieldwork Program to include test steps for each objective as well as the sampling plans. Estimate time for audit steps & calculate completion date – document detailed time on by step and total time and the deadline on **I. B.** Reference the applicable audit steps on the risk matrix. If necessary, draft proposed revisions to budget & report due date & submit or approval – include on this General Audit Program.			
E.	If there are revisions to the audit scope, objectives, report due date or other areas of significance based on preliminary survey, prepare a memorandum to the attendees of the Entrance Conference to communicate the changes.			
F.	Prepare a Conclusion Summary for inclusion in the report for items which will not be addressed in fieldwork & discuss with operating manager(s) & obtain signature(s).			
G.	Submit work papers, detailed fieldwork program & Permanent File for review and clear any resulting review notes.			
	Total Hours For Preliminary Survey			
	FAMILIARIZATION & PRELIM. SURVEY: Date Completed __________________Total Hrs:			

III. FIELDWORK

Objective: To collect, analyze, interpret, & document sufficient, competent, & relevant information as outlined in the detailed fieldwork program to support audit results & ensure that the audit objectives are achieved.

	Audit Step	W/P No.	Est. Hrs.	Act. Hrs.
A.	Perform testing as specified on the Detailed Fieldwork Program (total estimated time should be listed here). When completed, record actual total testing time here. Ensure that testing results are discussed with affected personnel as encountered. Do not document results in Conclusion Summaries without first discussing the issues with applicable operating managers to ensure their awareness & the auditor's complete understanding.			
B.	For each testing section prepare a Conclusion Summary stating objective, conclusion, procedures & summary of the prioritized results of testing which substantiate conclusions. Cross reference results to detailed W/P's. Include proposed disposition; place «Verbal» points last.			

C. D. E.	Review work to ensure that work papers are complete: 1. a heading, states name of the function examined, description of the contents of the work paper, period of the audit, & detailed fieldwork program step performed, 2. page number, initial & date (1st page of series), 3. purpose, source, scope & conclusion, 4. adequate to support conclusions, and 5. Conclusion Summary Sheets are cross-referenced to support. Submit working papers & the permanent file for review & clear subsequent review notes. Discuss Conclusion Summary Sheets with operational managers and directors, document the results, revise Sheets & index as necessary. **FIELDWORK:** **Date Completed__________Total Hours:**			

IV. REPORTING

Objective: To communicate the results of the audit to management.

	Audit Step	W/P No.	Est. Hrs.	Act. Hrs.
A. B. C.	Prepare a Draft Report: 1. Write report introduction, background & scope. 2. Consolidate conclusion summaries into a report, x-ref. 3. Write a memo for less significant items. 4. Submit a report for review & clear review notes. 5. Set up the Exit Conference and distribute Draft Report. 6. Conduct Exit Conference to brief on the audit results and request a date for completion of the corrective action plan. (Note: If any material changes to the audit report are identified, establish the date for the revised report to be issued.) Obtain Corrective Action Plan: 1. Analyze the Corrective Action Plan for adequacy and document. 2. Advise agency management of any apparent inadequacies in the Corrective Action Plan & resolve. Prepare a Final Report: 1. Add the revised Corrective Action Plan to the revised Draft Report to prepare the Final Report. 2. Submit the report for review & clear review notes. 3. Distribute the final report. **REPORTING:** **Date Completed _______________Total Hours:**			

QUESTIONS FOR SELF-ASSESSMENT

1. What is the audit risk?
2. What is risk based internal audit?
3. What are the three components of audit risk?
4. What is inherent risk in audit risk?
5. What are the procedures of auditing?
6. What are the procedures of auditing of salaries and wages?
7. What is the difference between Generally Accepted Auditing Standards and auditing procedures?
8. What is an audit program?

TASKS FOR SELF-ASSESSMENT

3.5. Read and decide if the following statements (1-3) are true or false.

1. Engagement risk → Before submitting a proposal, the audit firm should assess the risk to the firm of doing business with a certain client. They should consider such things as the reputation of management, the company's financial strength, and the credit rating of a prospective client.

a) True; b) False.

2. Audit Program → A detailed list of all the audit procedures to be performed in the course of the audit. A tentative audit program is developed from the auditors' initial risk assessment.

a) True; b) False.

3. Analytical Procedures → Procedures which help the auditor gain substantive evidence for the audit. Sources for the procedures can be such items as prior year's financial statements, industry statistics, and their professional experience. Any discrepancies will be noted and be the subject of further investigation.

a) True; b) False.

Unit 4
TESTING VOLUME. AUDITOR'S WORK DOCUMENTS

1. Testing volume:
   a. Statistical sampling.
   b. Non-statistical sampling.
2. Auditor's work documents.

TASKS

4.1. Match each object (1-3) with two of its components (a-c).

Term	Explanation
1. SIMPLE RANDOM SAMPLING	a. This method provides for the selection of sample items by breaking the population down into stratas, or clusters. Each strata is then treated separately. For this plan to be effective, dispersion within clusters should be greater than dispersion among clusters. An example of cluster sampling is the inclusion in the sample of all remittances or cash disbursements for a particular month. If blocks of homogeneous samples are selected, the sample will be biased
2. SYSTEMATIC (INTERVAL) SAMPLING	b. In auditing, this method uses sampling without replacement; that is, once an item has been selected for testing it is removed from the population and is not subject to re-selection. An auditor can implement simple random sampling in one of two ways: computer programs or random number tables
3. STRATIFIED (CLUSTER) SAMPLING	c. This method provides for the selection of sample items in such a way that there is a uniform interval between each sample item. Under this method of sampling, every «Nth» item is selected with a random start

4.2. Choose the correct option (a, b, c or d).

1. A simple random sample requires that:
a) The population is unbiased;

b) Every item in the population has an equal chance of being selected;

c) The distribution of original data is approximately normal;

d) The expected deviation rate is low (less than 5%).

2. An auditor wishes to sample 200 sales receipts from a population of 5,000 receipts issued during the last year. The receipts have preprinted serial numbers and are arranged in chronological (and the serial number) order. The auditor randomly chooses a receipt from the first 25 receipts and then selects every 25th receipt thereafter. The sampling procedure described here is called:

a) Systematic random sampling;

b) Dollar unit sampling;

c) Judgment interval sampling;

d) Variables sampling.

3. Internal auditing is conducting an operational audit of the organization's mailroom activities to determine whether the use of express mail service is limited to cases of necessity. To test cost-effectiveness, the auditor selects the 100 most recent express mail transactions for review. A major limitation of such a sampling technique is that it:

a) Does not allow a statistical generalization about all express mail transactions;

b) Results in a sample size that is too small to project to the population;

c) Does not evaluate existing controls in this area;

d) Does not describe the population from which it was drawn.

4. In a regional survey of suburban households to obtain data on television viewing habits, a statistical sample of suburban areas is first selected. Within the chosen areas, statistical samples of whole blocks are selected, and within the selected blocks, random samples of households are selected. This type of sample selection can best be described as:

a) Attribute sampling;

b) Stratified sampling;

c) Cluster sampling;

d) Interval sampling.

5. You seek to determine the misstatements made in recording sales invoices. Which of the following factors will usually be most

significant in determining the number of sales invoices to select for testing?

a) The total number of invoices for the period;
b) The estimated loss being incurred by the division;
c) The dollars of sales considered to be material;
d) The precision desired.

TESTING VOLUME

!!! *«The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population» (ISA 530, Audit Sampling).*

The auditors will not usually check all the information available to them, because it would be impractical and uneconomical. Instead, the auditor will use the ***sample*** as a method of audit to form their own conclusions. The use of sampling is widely adopted in auditing because it offers the opportunity for the auditor to obtain the minimum amount of audit evidence, which is both sufficient and appropriate, in order to form valid conclusions on the population. Audit sampling is also widely known to reduce the risk of 'over-auditing' in certain areas, and enables a much more efficient review of the working papers at the review stage of the audit.

Sampling and Non-sampling Risk

!!! ***Sampling risk*** *should be considered when an auditor performs an audit procedure on less than one hundred percent of a clearly definable population for the purpose of evaluating the population. There are two aspects to sampling risk when performing tests of controls:*

– *The* **risk of assessing control risk too low** *represents the risk that an audit sample supports the conclusion that the design and operation of an internal control is effective when in fact it is not.*

– *The* **risk of assessing control risk too high** *represents the risk that an audit sample supports the conclusion that the design and operation of an internal control is not effective when in fact it is effective.*

__Non-sampling risk__ is audit risk not due to sampling. An auditor may apply a procedure to all transactions or balances and fail to detect a material misstatement. Non-sampling risk includes the possibility of selecting audit procedures that are not appropriate to achieve a specific objective.
For example, confirming recorded receivables cannot reveal unrecorded receivables. Non-sampling risk can be reduced to a negligible level through adequate planning and supervision.

Similarly there are *two aspects* to sampling risk when performing substantive tests:

– The *risk of incorrect acceptance* represents the risk that an audit sample supports the conclusion that a material misstatement does not exist when in fact a material misstatement does exist. This risk is similar to the risk of assessing control risk too low.

– The *risk of incorrect rejection* represents the risk that an audit sample supports the conclusion that a material misstatement exists when in fact a material misstatement does not exist. This risk is similar to the risk of assessing control risk too high.

Sampling risk can be considered using a ***statistical*** or ***non-statistical*** approach. Both approaches require professional judgment. The main difference between the two approaches is that statistical approaches allow auditors to quantify sampling risk.

ISA 530 recognizes that there are many methods of selecting a sample, but it considers such principal methods of audit sampling as follows:

Statistical sampling	*Non-statistical sampling*
Random sampling	Haphazard sampling
Systematic sampling	Block selection
Monetary unit sampling	Judgment sample

STATISTICAL SAMPLING

!!! *__Statistical sampling__ is appropriate whenever an auditor wishes to draw a conclusion about a population without performing an examination of all the items composing that population. Moreover, statistical sampling is appropriate when the auditor has no prior knowledge as to which specific items in a population are misstated.*

For statistical sampling techniques, there is a measurable relationship between the size of the sample and the degree of risk. Statistical sampling procedure uses the laws of probability and provides a measurable degree of sampling risk. Accepting this level of risk, (or conversely at a definite assurance level) the auditor can state his conclusions for the entire population. In sum, statistical sampling provides greater objectivity in the sample selection and in the audit conclusion.

The auditor must consider ***four statistical parameters*** to determine an appropriate sample size to select for the planned control test: *Confidence level, Expected deviation rate, Tolerable rate, and Population.*

Although guided by assessed risk, inquiries of the audit client, and prior audit experience, each parameter is ultimately based on professional auditor judgment.

Confidence Level

The sample's confidence level refers to the reliability the auditor places on the sample results. Confidence levels of 90 percent to 99 percent are common (Table 4.1). A 95 percent confidence level means the auditor assumes the risk that five out of 100 samples will not reflect the true values in the population.

Table 4.1

Correlation between the Level of Audit Risk and the Confidence Level

Assurance from ***audit risk*** evaluation	Assurance from internal control (SBA)	Assurance from substantive analytical review procedures	Required assurance from detailed substantive tests ***confidence level***
High	High (Excellent system)	Med Low Nil	60 70 75
	Med (Good system)	Med Low Nil	65 75 80
	Low (Fair system)	Med Low Nil	75 80 85
	Nil (Poor System/DST)	Med Low Nil	92 94 95
Medium	High (Excellent system)	Med Low Nil	75 80 85
	Med (Good system)	Med Low Nil	80 85 90

Table

Assurance from ***audit risk*** evaluation	Assurance from internal control (SBA)	Assurance from substantive analytical review procedures	Required assurance from detailed substantive tests ***confidence level***
	Low (Fair system)	Med Low Nil	85 90 92
	Nil (Poor System/DST)	Med Low Nil	95 96 97
Low	High (Excellent system)	Med Low Nil	90 92 94
	Med (Good system)	Med Low Nil	92 94 95
	Low (Fair system)	Med Low Nil	94 95 96
	Nil (Poor System/DST)	Med Low Nil	98 99 99

The auditor's assessment of the control environment contributes to the level of risk the auditor is willing to assume. At a 95 percent confidence level, 5 percent – the complement of the confidence level – reflects the auditor's risk of «assessing control risk too low».

Expected Deviation Rate

The expected deviation rate represents the auditor's best estimate of the actual failure rate of a control in a population. The rate usually is based on client inquiries, changes in personnel, process observations, prior year test results, or even the results of a preliminary sample.

Tolerable Rate

The tolerable rate defines the maximum rate of noncompliance the internal auditor will «tolerate» and still rely on the prescribed control. Many auditors will coordinate with their audit client before establishing a tolerable level. Client control objectives help determine the nature and frequency of deviations that can occur and still allow reliance on the control.

Population

The population contains all items to be considered for testing. Each must have an unbiased chance of selection to ensure the final sample is representative of the population. For large populations containing thousands of items, population size will cause little impact on total sample size and is often irrelevant for audit sample planning.

When testing for amounts, the tolerable error is limited by the level of materiality set by the auditor. The lower the tolerable error, the larger the sample size. The population size is immaterial for the sample size when the auditor is working normal populations. Sample size is determined as:

Sample size = Reliability Factor /Tolerable Error Rate.

Example 1.

This approach is based on the Risk Model and takes into account the factors like Expected Errors in Population, Tolerable Error Rate (which should be less than the expected error rate) and the Confidence Level. We give below an example of the *Reliability Factors* based on the POISSON DISTRIBUTION (Table 4.2):

Table 4.2

No. of Sample Errors	Confidence Levels			
	80%	90%	95%	99%
0	1.61	2.31	3.00	4.61
1	**3.00** *(Reliability Factors)*	3.89	4.75	6.64
2	4.28	5.33	6.30	8.41
3	5.52	6.69	7.76	10.05

Thus if the maximum ***risk*** the auditor is willing to accept is **20%** (100% – 80%),

Expected number of errors =1,

Tolerable error rate = 4% (or ***0.04).***

Sample size = 3.00 / 0.04 = ***75.***

In case the auditor finds *2* errors in the sample of *75*,

Upper Error rate = Reliability Factor/ Sample Size,

Upper Error rate = 4.28 / 75 = ***5.5*** (**!!!** *5.5 > Tolerable Error*).

Thus the auditor has to adjust his confidence level which will then become *75%* commensurate with *2* errors at the tolerable error level of *4%*. He will place less reliance on controls and may increase the scope of his substantive tests/ procedures etc. Alternatively, the sample size will go up if he is to retain *80%* level of confidence.

Example 2.

In a test of sales orders for appropriate credit approval, suppose the auditor estimates a *1.5%* ***expected deviation rate*** of missing credit approvals relative to total sales orders, establishes a ***tolerable rate*** of

6%, and accepts a *95%* ***confidence level*** that the sample results will reflect missing credit approvals fairly in the population.

For the statistical parameters provided, a **sample size of 103** sales orders would be needed based on the «Statistical Sample Sizes for Test of Controls» chart below:

Statistical Sample Sizes for Test of Controls

Five Percent Risk of Assessing Control Risk Too Low
(number of expected errors in parentheses)

Expected Population Deviation Rate (%)	Tolerable Deviation Rate										
	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)	29(0)	19(0)	14(0)
0.25	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
0.50	*	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
0.75	*	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00	*	*	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25	*	*	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50	*	*	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75	*	*	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00	*	*	*	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25	*	*	*	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50	*	*	*	*	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75	*	*	*	*	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00	*	*	*	*	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25	*	*	*	*	*	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50	*	*	*	*	*	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75	*	*	*	*	*	185(7)	129(5)	100(4)	76(3)	40(2)	22(1)
4.00	*	*	*	*	*	*	146(6)	100(4)	89(4)	40(2)	22(1)
5.00	*	*	*	*	*	*	*	158(8)	116(6)	40(2)	30(2)
6.00	*	*	*	*	*	*	*	*	179(11)	50(3)	30(2)
7.00	*	*	*	*	*	*	*	*	*	68(5)	37(3)

*Sample size is too large to be cost-effective for most audit applications.

Note: This table assumes a large population.

Random selection

This method of sampling ensures that all items within a population stand an equal chance of selection by the use of random number tables or random number generators. The sampling units could be physical items, such as sales invoices or monetary units.

!!! ***Random sampling*** *can be vulnerable to detection (sampling) error. In an audit scenario this means that the audit sample selected may not contain any erroneous items, but that doesn't guarantee there are not errors in the population. Auditors minimize this risk by using statistically determined audit sample sizes. By specifying the level of acceptable detection risk, and knowing the size of the population and the expected error rate (the estimated number of erroneous items in the sample) the sample size can be calculated.*

Example 3

This method:

- is least biased of all sampling techniques, there is no subjectivity – each member of the total population has an equal chance of being selected;
- can be obtained using random number tables;
- Microsoft Excel has a function to produce random number.

The function is simple:

- =RAND()

Type that into a cell and it will produce a random number in that cell. Copy the formula throughout a selection of cells and it will produce random numbers.

You can modify the formula to obtain whatever range you wish, *for example*, if you wanted random numbers from one to *250*, you could enter the following formula:

- =INT(250 × RAND())+1

Where INT eliminates the digits after the decimal, *250** creates the range to be covered, and *+1* sets the lowest number in the range.

Paired numbers could also be obtained using;

- =INT(9000 × RAND())+1000

Microsoft Excel does not generate the same random number twice. If more than one random number of the same value is generated, it is discarded and replaced by a new one.

!!! Remember that for monetary unit samples, the item selected is actually a cent, not a dollar, so it is unlikely that any numbers in a monetary unit sample will be discarded. The implication of this is that in record sampling the same record will not be selected twice, but in monetary unit sampling, the same record might be selected more than once.

Microsoft Excel might generate the numbers *244, 261, 339, 874,* and *985*. These items would then be selected.

!!! If you use random sampling, be aware that while each item has an equal chance of selection, there is no guarantee that the results will be evenly distributed.

In the previous example, there is a gap between *339* and *874*, meaning that no selections were made from more than *500* items.

Systematic selection

!!! *The method divides the number of sampling units within a population into the sample size to generate a sampling interval. The starting point for the sample can be generated randomly, but ISA 530 recognizes that it is more likely to be «itruly» random if the uses of random number generators or random number tables are used.*

The systematic sampling is also referred as *«interval» sampling*. This sampling technique involves the auditor to take the number of sampling units in the population and segregate this into the sample size so as to provide a sampling interval.

Example 4

You are the auditor of Jones Co and are undertaking substantive testing on the sales for the year ended 31 December 2013. You have established that the 'source' documentation that initiates a sales transaction is the goods dispatch note and you have obtained details of the first and last goods dispatched notes raised in the year to 31 December 2013, which are numbered *10,000* to *15,000* respectively.

The random number generator has suggested a start of *42* and the sample size is *50*. You will therefore start from goods dispatch note number *10,042 (10,000 + 42)* and then sample every *100th* goods dispatch note thereafter until your sample size reaches *50*.

!!! *This method provides for the selection of sample items in such a way that there is a uniform interval between each sample item. Under this method of sampling, every «Nth» item is selected with a random start.*

Monetary unit sampling

The method of sampling is a value-weighted selection whereby sample size, selection and evaluation will result in a conclusion in monetary amounts. The objective of monetary unit sampling (***MUS***) is to determine the accuracy of financial accounts. The steps involved in monetary unit sampling are to:

– determine a sample size;
– select the sample;
– perform the audit procedures;
– evaluate the results and arrive at a conclusion about the population.

Auditors use monetary unit sampling, also called probability-proportional-to-size or dollar-unit sampling, to determine the accuracy of financial accounts. With monetary unit sampling, each dollar in a transaction is a separate sampling unit. A transaction for $40, contains 40 sampling units. Auditors usually use monetary unit sampling to sample and test accounts receivable, loans receivable, and inventory.

Example 5

The audit client's accounts receivable book value is *$300,000*, and the sample size is set at 96 records.

1. Figure the sampling interval by dividing book value by sample size (***300,000/96 = 3,125***).

2. Arrange the client's accounts receivable in an ordered list using some sort of ordering sequence.

For example, you can arrange them alphabetically by customer name or numerically by customer number.

3. Pick a random number between ***1 and 3,125***.

For this method to work correctly, the random number has to be less than the sampling interval and greater than the smallest sampling unit. Auditors usually use a random-number-generator computer program to pick the random number. The sampling unit and sampling interval limits are programmed into the software before the task is run. In this case, say the software selects ***the random number 556***.

The following table shows an example.

Customer Name	Customer Balance	Cumulative Balance	Sampling Item
ABC Electric	$435	$435	
Best Friend Cat Care	$785	$1,220 *($435+$785)*	(1) $556
Brandy's Grill	$1,510	$2,730 *($1,220+$1,510)*	
Buddy's Gas Station	$5,000	$7,730 *($2,730+$5,000)*	(2) $3,681 *($556+$3,125)*
...			(3) $ 6,806 *($3,686+$3,125)*

First, pick the records to test: Take the alphabetically ordered list shown in the Customer Name column, which lists every customer balance by dollar amount, and count each dollar until you get to *$556* (remember that the random number generator gives you the number 556 in Step 3 in the previous numbered list). The cumulative dollar amount for ABC Electric is under ***$556***.

That tells you that the first sampling item is Best Friend Cat Care, which at a cumulative total of *$1,220* is the first customer in the list with a cumulative balance over $556. The client gives you the Best Friend Cat Care file. You go through these ordered invoices (usually the invoices are ordered by date) to find the invoice with the 556th dollar. That invoice is your item to sample.

To select your next invoice to sample, add the sampling interval of *$3,125* to your random number of *$556*. This equals ***$3,681***, which is your next sampled item dollar amount. Brandy's Grill at *$2,730* cumulatively is under *$3,681*, so skip past Brandy's to Buddy's. Follow the same procedure you use for Best Friends to find the Buddy invoice with the 3,681st dollar.

Although the table only goes as far as Buddy's, your client has many more customers. To pick the next sampling item, add the sampling interval of $3,125 to your prior sampling item of *$3,681*, which equals *$6,806*, and so on until you reach the last name in the customer list.

When you're sampling, you're looking for misstatements. If an invoice should have been entered for $986, for example, and it was entered as $896, the misstatement is 9 percent of the transaction (the inverse of 896/986). If the total misstatements exceed your assessed tolerance level, you have to decide whether to perform other procedures.

NON-STATISTICAL SAMPLING

!!! *Non-statistical sampling can be used with tests of controls or substantive tests. Non-statistical sampling does not require the use of a probabilistic selection method. The main advantage of non-statistical sampling is that it is less complex and less time consuming than statistical sampling. The main disadvantage is that sampling theory cannot be used to quantify sampling risk.*

Sample size for non-statistical sampling is left entirely to the auditor's professional judgment. The factors considered when determining sample size for tests of controls using a non-statistical approach are the same as those considered for attributes sampling. The factors considered when determining sample size for substantive tests using a non-statistical approach are:

– *Risk of incorrect acceptance* represents the risk that the auditor concludes that a material misstatement does not exist when in fact a material misstatement does exist. The level used for this risk is based on the auditor's planned detection risk and other planned substantive tests. A higher risk of incorrect acceptance is used with a higher planned detection risk and/or other planned substantive tests. This risk is inversely related to sample size.

– *Risk of incorrect rejection* represents the risk that the auditor concludes that a material misstatement exists when in fact a material misstatement does not exist. The level used for this risk is based on the cost and difficulty of obtaining additional evidence. A lower risk of incorrect acceptance is used when more costly or difficult evidence will be required if expanded testing is needed. This risk is inversely related to sample size.

– *Expected Misstatement* represents the auditor's best estimate of the population misstatement. This estimate is normally based on prior experience with the client. This estimate is directly related to sample size.

– *Tolerable Misstatement* represents the highest misstatement that could occur before the population would be considered materially misstated. This amount has an inverse relationship with sample size.

Haphazard sampling

When the auditor uses this method of sampling, he does so without following a structured technique. ISA 530 also recognizes that this method of sampling is not appropriate when using statistical sampling. Care must be taken by the auditor when adopting haphazard sampling to avoid any conscious bias or predictability. The objective of audit sampling is to ensure that all items that make up a population stand an equal chance of selection. This objective cannot be achieved if the auditor deliberately avoids items that are difficult to locate or deliberately avoids certain items.

Block selection

This method of sampling involves selecting a block (or blocks) of contiguous items from within a population. Block selection is rarely used in modern auditing merely because valid references cannot be made beyond the period or block examined. In situations when the auditor uses block selection as a sampling technique, many blocks should be selected to help minimize sampling risk.

An example of block selection is where the auditor may examine all the remittances from customers in the month of January. Similarly, the auditor may only examine remittance advices that are numbered 300 to 340.

Judgment sample

Judgment sample selection is based on the auditor's sound and seasoned judgment. Three basic issues determine which items are selected:

1. Value of items. A sufficient number of extensively worked or older accounts should be included to provide adequate audit coverage.

2. Relative risk. Items prone to error due to their nature or age should be given special attention.

3. Representativeness. Besides value and risk considerations, the auditor should be satisfied that the sample provides breadth and coverage over all types of items in the population.

AUDITOR'S WORKING DOCUMENTS

When attacking the audit in accordance with SA 230, auditors must manually record their comments and audit tasks in their documentation associated with material of their clients, supporting the findings of the audit.

!!! ***Audit working papers*** *are the property of the auditor. In order to keep professional ethic, it cannot discover to third party without consent of the client unless limited specified situations mentioned in ISA 230 Documentation and required by law, the examples are court order, for public interest and so on.*

1. The auditor must prepare audit documentation in connection with each engagement conducted pursuant to the ISAs.

Documentation shall be prepared **on a timely basis** which helps to enhance the **quality** of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized.

Audit documentation should be prepared in sufficient detail to provide a clear understanding of its:

– purpose;
– source;
– conclusions reached.

2. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

– the identifying characteristics of the specific items or matters tested;
– who performed the audit work and the date such work was completed;
– who reviewed the audit work performed;
– the date and extent of such review.

3. Audit documentation may be in the form of:

– paper;
– electronic files; or
– other media.

To prepare work papers, you can use the following elements (Fig. 4.1).

4. Examples of audit documentation include (see Appendices):

– Memoranda;
– Notes of meeting with management, those charged with governance and others;
– Analyses;
– Confirmations;
– Correspondence;

– Summaries of significant matters;
– Schedules;
– Checklists;
– Audit programs;
– Letters of representation.

ELEMENTS	
A descriptive heading	It should include the client's name, the work paper's purpose, and the date under examination.
Indexing	Like a book, every work paper has a unique page number showing its place in the audit file.
Cross-referencing	To improve your efficiency, you want to cross-reference your work paper to related and supporting work papers. Doing so eliminates the duplication of work.
Tick marks	For the sake of brevity, you use tick marks as abbreviations for standard auditing tasks. For example, *V* means that the item you're reviewing *vouched* to the source document. Another common tick mark is *F,* which stands for *foot* and which means that you confirmed the arithmetic calculations on the work paper or schedule.
The source of the information	Be sure to include what documents you examined or who you interviewed to gain evidence about the auditing matter at hand.
A conclusion	Write a summary of the results of your analysis and your opinion of the validity of the client assertion.

Fig. 4.1. The Main Elements to Prepare Auditor's Working Documents

For routine audits and special projects, the structure of working papers should follow the standard format.

Example of the General requirements for working paper:

Format	Description
Paper Size	Audit work should be presented on 8 1/2» x 11» paper. Whenever possible, working papers and exhibits should be placed in a binder so the information on the page can be read without turning the binder. Items with information presented in landscape format should usually be mounted on 8 1/2 x 11 with the excess width folded at the right. Single-page exhibits with information presented in portrait format can be placed in a binder as an individual working paper. However, if more than minor analysis of the information on the exhibit is needed, the exhibit should be mounted on left hand side of 14-column ledger paper with the analysis summarized on the right of the 14-column. This 14-column presentation should also be used for multi-page exhibits in portrait format
Headings	Each working paper should have a descriptive, 4-line heading of: – UNC Internal Audit, – (area audited), – (as of date or review period) – (description of test/ item on the page)
Initials/Date	Each working paper should be dated and initialed by the preparer; the reviewer should mark the working paper to show that it has been reviewed and approved
Tickmarks	Tickmarks are used to simplify documenting work done and conditions found, usually during fieldwork. A legend that defines each tickmark should be provided and located near the tickmarks used. If the tickmark legend is not on the working paper where the tickmarks are used, the working paper should be referenced to the tickmark legend. Tickmarks should be concise and should adequately explain the results of the audit procedure performed. It should be evident as to whether or not an error or weakness was noted. Items tested should never be left blank, either the results of the test should be documented, the attribute should be marked as not applicable, or an explanation should be provided as to why the test could not be performed. Explanations should be provided to show why items marked «N/A» are not applicable
W/P Numbering	Each page in the working paper should be given a unique reference number that identifies its location. The number assigned should begin with a capital letter that matches the section of the working papers where the page will be filed (e.g. planning working papers will start with the letter D), followed by a dash and a number that allows the page to be filed in a logical sequence. If a w/p continues for multiple pages, or if there are exhibits supporting a working paper, subsequent pages and the exhibits should have the same letter and first number identifier followed by a lower case letter or by a period and another number.

Format	Description
	For example the first page of the Planning Memo is numbered D-1 with subsequent pages of the memo numbered D-1a, D-1b etc. or D-1.1, D-1.2, etc. Or, in the Internal Control section, the first control narrative would be numbered E-2 and subsequent pages of the narrative would be numbered E-2a, E-2b... Exhibits supporting information contained in the narrative would also be numbered E-2.1, E-2.2, etc. The second control narrative would be numbered with an E-3 sequence. This approach provides a way to logically link related w/p's and gives enough flexibility for pages to be added as needed. Avoid numbering pages X-1, X-2, X-3... (where X is any letter identifier) when the pages contain related information
Content	For every audit program step, working papers should contain a summary of the results of work performed and a conclusion about these results. For internal control and workflow evaluations, conclusions should address the adequacy of the system or process. That is, whether the design of the system contains the features needed to provide reasonable assurance that management's objectives will be met. The conclusion should appear at the end of the control narrative. Conclusions about testwork should address whether or not the expected controls or processes identified in the review of internal controls or work flows are in effect. If there is room, the summary and conclusion can be placed on the working paper that documents the testwork. Otherwise, a leadsheet that contains the summary and conclusion for the audit step should be prepared. In both cases, the conclusion should identify the overall significance of any weaknesses or exceptions found. Information that is protected by privacy laws should not be included in the working papers. Personnel records and student records are protected by privacy laws. When we review these types of records in an audit, names, social security numbers, and other identifying information should be expunged from the working papers. Avoid including multiple copies of an item in the working papers or any item that is not needed to support the work performed and the findings and conclusions in the audit report
Memos to Future Auditors	Memos to future auditors should be placed in the Administration section of the w/p's. A copy should also be placed in the departmental file for the area audited or the area that is affected by the memo

QUESTIONS FOR SELF-ASSESSMENT

1. What is a sampling risk?
2. What is a non-sampling risk?
3. What is statistical sampling?
4. What is non-statistical sampling?
5. What is random sampling?
6. What is systematic sampling?
7. What is monetary unit sampling?
8. What is haphazard sampling?
9. What is block selection sampling?
10. What is a judgment sample?
11. What types of documentation audit do you know?
12. What is an audit file?

TASKS FOR SELF-ASSESSMENT

4.3. Complete the following sentences. Choose the correct word or word combination.

Confidence level haphazard exceeds non-statistical
Statistical sampling systematic selection 95% little, bigger
Taking larger samples confidence sampling unit small
Sampling risk non-statistical

1. ________ is the risk the sample isn't representative of the population.
2. Sampling risk can be reduced by _________________.
3. _________ is the complement (opposite) of sampling risk.
4. If sampling risk is 5%, the confidence level would be _______.
5. Once desired confidence level is established, the sample size is largely determined by how much the tolerable error _______ the expected error.
6. If the tolerable error rate is 5% and the expected error rate is 4%, there is ___________ margin for error and thus the sampling size will be ______________.
7. In _____________ sampling, the auditor doesn't use statistical techniques to determine sample size, select sample items, or measuring risk.
8. ______________ uses the laws of probability to compute sample size and evaluate the results. The auditor is able to use the most efficient sample size and quantify sampling risk.

9. Each ________ makes up one item in the population. This should be defined in relation to the specific control being tested.

10. The _________ is the desired level of assurance that the sample results will support a conclusion that the control is functioning effectively.

11. Population size decreases sample size only when population is _______.

12. In ______________ the auditor determines the sampling interval by dividing the population by the sample size. A starting is randomly selected in the first interval & every nth item is chosen after.

13. Non-statistical sampling allows for use of random or systematic selection but also for __________ selection.

14. Sampling is __________ if:

– judgment is used to determine sample size;
– haphazard sample selection is used;
– sample results are evaluated judgmentally.

Unit 5
AUDIT OF THE SALES CYCLE. PURCHASE CYCLE AUDIT

1. Audit of the sales cycle:
    a. Analysis of reporting method.
    b. Internal control of the taxpayer's system.
2. Purchase cycle audit:
    a. The documents and records that are usually found in the purchase and payment cycle.
    b. The general audit procedures for the test of internal controls of this cycle.

TASKS

5.1. Read and decide if the following statements (1-5) are true or false.

1. Subtests of transactions for shipments made to non existent customers → trace invoice to customer file – look at disposal of accounts receivable – credit memos – write off receivables – check the shipping documents.
a) True; b) False.

2. Conditional sales → recording sales with contingencies sales must be earned and realized/able.
a) True; b) False.

3. Controls for cash receipts → policy for write-offs should be conservative, aging schedule should be prepared – follow-up on payments.
a) True; b) False.

4. Subtests of transactions for cash receipts, audit objective: Cash received is recorded → find proof of cash receipts, compare cash

receipts for a period of time with bank deposits – they should mostly match.

a) True; b) False.

5. Sham sales → recording sales with contingencies sales must be earned and realized/able.

a) True; b) False.

5.2. Read the definitions of asset accounts and complete them with these words and word combinations.

Existence (test of details) Rights and Obligations (test of details)
Invoice processing Requisitioning Receiving
Accounts payable Purchasing Disbursement
Occurrence (test of controls) Completeness (test of controls)
Classification (substantive tests of transactions)

1. ____________________
Initiation and approval of request for goods and services by authorized individuals consistent with management criteria.

2. ____________________
Approval of purchase orders and proper execution as to price, quantity, quality and vendor.

3. ____________________
Receiving the goods.

4. ____________________
Processing of vendor invoices for goods and services received.

5. ____________________
Paying vendors.

6. ____________________
Recording of all vendor invoices, cash disbursements and adjustments in individual vendor accounts.

7. ____________________
Test a sample of vouchers for the presence of an authorized purchase order and receiving report.

8. ____________________
Trace a sample of receiving reports to the respective vendor invoices and vouchers; trace a sample of vouchers to the purchases journal.

9. ____________________
Review voucher packets for all documents.

10. ___________________

Verify classification of charges for a sample of purchases.

11. ___________________

Vouch selected amounts from the accounts payable listing and schedules for accruals to voucher packets, obtain selected vendors' statements and reconcile to vendor confirmation of selected accounts payable.

AUDIT OF THE SALES CYCLE

!!! *The **sales cycle** in a business refers to the set of processes that begin when a customer purchases goods or services and ends when the company receives complete payment for the purchase. As part of the year-end audit of a company's financial statements, external accountants test sales transactions and the internal controls over those transactions to ensure that the company has not materially misstated its revenues or accounts receivable.*

The primary purpose of ***the sales tax audit*** is to confirm that the taxpayer has reported the correct amount of tax. Reported amounts from the sales tax history must be analyzed when examining the taxpayer's records.

Example

ABC Company is the establishment of representation in the State of Texas, making a taxpayer responsible for collecting sales or use tax. The due process clause of the United States Constitution requires some definite link, some minimum connection between the state and the person, property, or transaction it seeks to tax. This link, referred to as representation, is determined to be sufficient by an analysis of the benefit derived. The analysis indicates whether the taxpayer has received some economic gain or advantage from his association with the state.

These are types of documentation for analysis:

- Shipping documents;
- Vehicle logs;
- Sales invoices;
- Gasoline tickets;
- Territorial assignment sheets;

– Documentation of a place of operation by the taxpayer;
– A written statement from the taxpayer;
– Delivery directions;
– Travel notes;
– Expense vouchers;
– Itinerary sheets or logs.

Reporting Categories

Reporting categories are broken out as follows on the sales tax return:

– Total Sales;
– Taxable Sales;
– Taxable Purchases;
– Amount Subject to State Tax;
– Amount Subject to Local Tax;
– Amount Subject to City Tax;
– Amount Subject to Transit (MTA/CTD Tax);
– Amount Subject to County/SPD Tax.

Even though the category «Deductions» does not appear on the sales tax return, this amount is calculated by the computer and appears on the Audit History.

Total Sales – Taxable Sales = Deductions

!!! *Audit procedures used in each audit situation will be adapted to the individual taxpayer's system of accounting and recordkeeping. Since different reporting methods are used by taxpayers to complete sales tax returns, it is important that the auditor understands the method utilized by the taxpayer.*

The auditor should complete an analysis of the accounting system and devise specific audit procedures applicable to the audit. Certain procedures must be performed on each and every audit:

– Sales tax reconciliation,
– Gross Sales (Total Sales) reconciliation,
– Examination of purchases, etc.

Analysis of Reporting Method

During the entrance conference, the taxpayer or the taxpayer's representative should explain the reporting method utilized.

Consider the following areas:

– The step-by-step process by which the information is obtained and summarized to prepare the return – includes the records used to prepare the return.

– Any working papers used to prepare the return.

– General ledger accounts that have been used by the taxpayer in reporting. Check for related accounts when the Chart of Accounts is reviewed.

– Changes in personnel who prepared the return. Obtain the name and position of anyone who prepares a specific portion of the return.

– The possibility of using computer audit assistance should be considered if any areas of the return or record keeping are computerized. Examine the computer section of the Audit Questionnaire.

– Availability of resale/exemption/direct payment exemption certificates for tax-free sales.

– Checking to see what items are being claimed as Deductions.

– Are Deductions being reported or are they «netted»?

– Are Taxable Purchases being reported? If so, what items are being included?

– Unusual areas – changes in the reporting method, fluctuations in reported amounts, etc.

– Testing one or two reports to verify that the procedures as explained are used to prepare the return.

– Checking to see if the reporting method has been changed. If so, check the different methods used and document the changes on the Audit Plan.

Common Sales Tax Reporting Methods

Two common methods frequently used by taxpayers for reporting sales tax are:

– Netting non-taxed sales with Gross Sales;

– Backing into Taxable Sales.

Examples

The taxpayer's records indicate the following monthly amount:

Gross Sales (Nontaxable & Taxable)	\$5,000,000
Non-taxed sales	\$2,000,000
Sales Tax Accrued (@ 8%) *(\$5,000,000 – \$2,000,000 = \$3,000,000 \$3,000,000 × 8% = \$240,000)*	\$240,000

Example 1

The corresponding amounts would be reported on the monthly sales tax return using the «netting method»:

Gross Sales	$3,000,000
Taxable Sales	$3,000,000

When this method is utilized by the taxpayer, Gross Sales reported will usually be incorrect and should generally not be used for projections. If adjustments to reported Gross Sales and Deductions net to zero, the adjustments should not be made.

Example 2

The corresponding amounts would be reported on the monthly sales tax return by «backing into» Taxable Sales:

Gross Sales	$5,000,000
Taxable Sales *($240,000 / 0.08)*	$3,000,000

!!! *When reported taxable sales are backed into, any differences between Taxable Sales on the books and reported Taxable Sales should be analyzed.*

Internal Control of the Taxpayer's System

The taxpayer's system of internal control must be analyzed and evaluated to determine the reliability of the records being examined. The depth of the audit examination is determined in great part by the reliability of the taxpayer's internal control system.

Characteristics of Good Internal Controls

Some characteristics of good internal control are listed below. Each system must be analyzed for specific strengths and weaknesses.

– A clearly defined responsibility for each function.
– An adequate system of authorization.
– Adequate supervision of duties.
– Adequate documentation.
– Adequate protective measures (i.e., locked rooms for inventory, etc.).

– Segregation of duties.
– Internal verification.

Total Sales (Gross Sales)

Total sales consist of all taxable and nontaxable sales during the reporting period for each outlet. Taxable and nontaxable sales include:

– All sales, leases, and rentals of tangible personal property. Sales of intangibles such as stocks and bonds would not be included.

– All labor and service charges.

– Sales tax collected should not be included in reported total sales.

Generally, verification of Gross Sales includes:

– Reviewing the chart of accounts for revenue accounts.
– Reviewing the taxpayer's method of reporting sales.
– Reconciling recorded and reported amounts.
– Determining which accounts make up Gross Sales.
– Determining how cash sales are handled.
– Determining how bad debts are handled.

Reconciliation of Recorded and Reported Sales

A reconciliation of sales should be performed by comparing reported sales, per the sales tax return, with audited sales, per books and records. This reconciliation may be completed by report period or by year.

Reported Gross Sales should also be compared to:

– Federal Income Tax returns.

– Franchise Tax Gross Receipts – now part of the taxpayer's Audit History.

– Financial Statements.

Any differences found between reported and audited sales should be analyzed taking into consideration the taxpayer's reporting method. Determine if the differences result from taxable or nontaxable sales. Audit adjustments should be made for unreported taxable sales and included in an exam of «Adjustments to Gross Sales».

If the reconciliation does not result in any differences, then document this fact in the audit plan.

Preliminary Review (Short Testing)

Preliminary reviews (short tests) should be done before a thorough examination of records is performed. Short tests will provide the necessary information to determine whether to perform detail or sample audit procedures. Short tests highlight key areas that may need a more detailed examination. Before relying on taxpayer's records, perform short tests of the following:

– Trace postings in sales journals to general ledgers.

– Trace recording of daily sales totals or invoices to sales journals.

– Trace recording of sales invoice information to sales journals.

– Verify sales journals footings (totals).

– Scan for unusual entries in journals and ledgers such as debits to the sales tax accrual account.

– Verify recording accuracy and records flow.

– Verify tax charged and the rate of tax.

– Verify that tax is being collected and allocated to the correct local jurisdictions.

Document in the Audit Plan the steps and findings of the short tests. If short tests reveal that summary records accurately reflect the taxpayer's method of accounting, then use the taxpayer's summary records. If not, then an examination of the original source document may be necessary.

!!! *Short tests are not used to reconcile reported totals, only to reconcile the steps used to arrive at those totals.*

Examination of Records

General Ledgers

Examine general ledger accounts for debits and credits which may represent unreported taxable sales or services such as:

1) Sales of merchandise at cost credited to purchase or inventory accounts.

2) Sales of by-products credited directly to profit and loss, surplus or expense accounts.

3) Sales of furniture, equipment or other capital assets credited to equipment, depreciation, gain or loss or other accounts.

4) Sales of taxable services such as:

– Amusement services.

– Cable television services.

– Laundry, cleaning and garment services (Personal Services).

– Motor vehicle parking and storage services.

– Repair, remodeling, maintenance and restoration of tangible personal property except for:

a) Aircraft;

b) A ship, boat, or other vessel other than a taxable boat or boat motor;

c) The repair, maintenance, and restoration of a motor vehicle.

– Repair, maintenance, creation, and restoration of a computer program, including its development and modification not sold by the person performing the repair, maintenance, creation, or restoration service.

– Real property services.
– Debt collection services.
– Information services.
– Data processing services.
– Insurance services.
– Telecommunication services.
– Credit reporting services.
– Real property repair and remodeling.
– Security services.
– Telephone answering services.
– Internet access services.
– Utility distribution.

General Journal

Examine the general journal and note entries which may indicate unreported taxable sales or services.

Consider all data pertaining to general journal entries in determining if an entry represents an unreported taxable sale or service. This data may include:

– Correspondence.
– Contracts.
– Invoices and other documents.

Cash Receipts Journal

Examine the cash receipts records to determine whether receipts from cash sales have been credited to the proper sales or revenue accounts. Be careful not to duplicate taxable sales or services found in other records.

Accounts Receivable Ledger

Examine the accounts receivable from the owners, partners, officers or employees of a firm for evidence of taxable sales or services not otherwise recorded in the sales or revenue accounts. Examine partners' drawing accounts and employees' advance accounts.

Purchase Journal

Entries may be made in the purchase journal for sales at cost or returned merchandise. Inventory withdrawals which should have been reflected in the inventory accounts may also appear as credits in the purchase journal. Examine these postings for taxable sales or services.

Sales Invoices and Journals

Sales invoices are source documents and usually represent the original record of a transaction. It is a necessary part of audit procedure to examine a representative number of these invoices to determine:

– How the transactions are recorded on the invoices.

– If the tax was properly assessed.

– How the invoices are filed – By invoice number? By customer's name? By days? By months?

!!! *Many taxpayers have multiple sets of invoices. For example, one set of sales invoices may be filed in numerical while another set may be filed in customer folders.*

Invoices are used to verify:

– Postings.

– Tax accruals.

– Deductions.

– Types of transactions.

Postings

Tracing the postings of sales invoices is the first step in verifying the accuracy of the books of original entry. The sales invoice is traced directly to the sales or revenue journal for accuracy of posting relative to amount and classification. Trace source documents through to summary records and check for errors and omissions.

Determine if:

– They are consistent.

– There is a posting from each source for each month or accounting cycle.

– There are sources of postings that might reveal operations not disclosed in pre-audit research or discussions with the taxpayer.

Tax Accruals:

The tax assessed on the invoice is important because the tax accrual account is based on the tax rate times the taxable value. This is especially important on audits of taxpayers who derive total sales, taxable sales or deductions based on the amount of tax accrued.

Deductions:

Note what type of deductions the taxpayer is claiming because they may lead to a detail of certain accounts. Ensure that the taxpayer is in possession of all necessary resale, exemption, and direct payment exemption certificates.

Type of Transactions:

For the sale of tangible personal property or taxable services, examine invoices to determine if charges are consistently separated or billed as a lump sum. This information is also important to know when examining purchases.

If there is a lump sum charge which includes both taxable and nontaxable amounts, the entire charge is taxable. To be excluded from the taxable amount, the nontaxable items must be separately stated on the invoice or other billing document.

Federal Income Tax Returns

A comparison of sales reported for federal income tax purposes with state sales and use tax returns is a good audit practice. This may not be feasible if the taxpayer files a consolidated federal income tax return. However, the taxpayer should have working papers showing how these figures were obtained.

Reconcile the differences if a taxpayer has acceptable records but gross receipts recorded in the books and reported on sales and use tax returns do not agree with gross receipts on the federal income tax returns. Material differences should be analyzed. Determine if the difference is the result of taxable or nontaxable sales. Also review Schedule D of the federal income tax return for any fixed asset sales.

In making this reconciliation, differences may be due to:

– Timing;

– Accounting basis – reporting on cash basis for income tax purposes and using an accrual basis for sales and use tax purposes or vice versa;

– Netting – Gross Sales shown on the sales tax returns may actually be the net of sales minus deductions.

Sales Tax Verification

Sales tax collected versus sales tax reported should be reconciled in detail for every audit. Gross Sales should not include sales tax collected but:

If a taxpayer does not separate tax and selling price (Gross Sales figure includes tax), determine if:

— Total amounts, (including tax) of sales invoices are entered into the sales revenue account including exempt sales, and

— The sales price and tax rung up on the cash register are recorded in the sales revenue account.

— Then determine Gross Sales by:

— Reducing the Gross Sales figures (tax included) by the amount of tax-exempt sales to arrive at total Taxable Sales (tax included).

— Dividing total Taxable Sales (tax included) by one plus the appropriate tax rate to arrive at total Taxable Sales (tax excluded).

Add total Taxable Sales (tax excluded) and tax-exempt sales to obtain a Gross Sales figure.

Example

XYZ Restaurant is located inside the city limits of a taxing city and within a taxing of the Metropolitan Transportation Authority (MTA) (total tax rate is 8.25%). The total amount of sales tickets is entered in the cash receipts journal. The restaurant occasionally caters church functions, and these exempt sales are marked in the cash receipts journal. Figures from a cash receipts journal show:

Total Sales (tax included)	$113,250	
Less: Exempt Sales	< 5,000>	
Equals: Total Taxable Sales (tax included)	108,250 -------	
Total Taxable Sales (tax excluded) equals $108,250 divided by 1.0825		$100,000
Add:		
Total Taxable Sales (tax excluded)		$100,000
Plus: Exempt Sales		5,000
Equals: Gross Sales		$105,000

Analyze Sales Tax Accrual Accounts

Compare Tax Accrued to Tax Reported

Verify tax accrual account (also called sales tax payable account) by comparing tax accrued to tax reported for the audit period. If differences exist, determine the reason for the difference, and, if necessary, prepare a schedule and make an adjustment in the audit. Differences may occur due to:

– Other credits in the sales tax accrual account (i.e., discounts);

– Returned merchandise sales for which credit memos have not been recorded in the sales journal and/or tax accrual account;

– Tax on taxable purchases being posted to the tax accrual account.

> **!!!** *If the taxpayer does not maintain a tax accrual account, examine available summary records.*

Analyze Debit Entries

Analyze debit entries to determine if:

– Excess tax is being written off to a miscellaneous income account;

– Debit entries exist for bad debts, discounts, returned merchandise and refund claims – verify tax refund claims to determine if the customers have received them;

– Debit entries are due to customers not remitting tax – verify that the taxpayer has valid resale/exemption certificates to support them.

Credits and Refund Claims

During the course of an audit, tax reconciliation is normally performed for the audit period. However, when refunds or credits have been allowed in an audit or refund period, the tax reconciliation must be expanded to include the most current report filed. This procedure is necessary in order to verify that the refund or credit has not been taken in subsequent report periods.

Fixed Asset Sales

Examine summary records for the sale of fixed assets:

– Review general ledger fixed asset accounts for credit entries;

– Review Schedule D of the taxpayer's federal income tax return;

– Examine gain or loss accounts in the general ledger;

– Trace sales to journal entries, cash receipts, and source documents to determine if tax was collected and reported or if the sale was exempt.

Deductions

Verification of Deductions is an important area of an audit. Although not specifically reported by the taxpayer, Deductions are the difference between Gross Sales and Taxable Sales.

Items included in Deductions:

– Deductions supported by valid certificates (resale, exemption, direct payment exemption);

– Deductions based upon sales destination (items shipped out-of-state);

– Deductions for sales and services specifically exempt by sales tax law and rules;

– Deductions for adjustments to sales when sales tax has been paid (returned items).

Normally, the review and reconciliation of Deductions is made at the same time as that for Gross Sales. Whenever feasible, adapt the audit procedure to the method used by the taxpayer to report Deductions. The scope of the examination of Deductions will depend on the conditions encountered. Deductions consist of the total nontaxable sales claimed by the taxpayer. Most claimed Deductions are supported by resale and exemption certificates and exemptions by law.

Conduct a detail examination if:

– Claimed Deductions consist of relatively few items;

– All transactions can be examined in a reasonable amount of time.

Consider a sample examination if:

– Gross Sales are numerous;

– Gross Sales are of similar unit value;

– Claimed Deductions are numerous.

Consider a stratified sample if:

– There is a large variation of price for units sold;

– There is only an occasional large sale.

PURCHASE CYCLE AUDIT

!!! *The purchasing cycle consists of the acquisition of goods and services in exchange for cash or promises to pay cash. The audit of accounts in the purchasing cycle (e.g., purchases of merchandise or raw materials, various expenses, accounts payable, and cash) usually consists of a combination of substantive tests and tests of controls to support an assessment of control risk that is below the maximum or at low. This course covers the process by which the auditor determines the strategy for auditing the purchasing cycle.*

Documents and Records

1. **Purchase requisition** is a form detailing the request for goods or services by an **authorized** employee of the user department and it is then passed from the user department to the purchase department. For example, order of materials by a factory/ storeroom supervisor.

Please contact Purchasing, 703-993-2580, with questions regarding the proper use of this form.

PURCHASE REQUISITION

Sample Sample

835457

SUGGESTED VENDOR	DELIVERY INSTRUCTIONS	DEPARTMENTAL APPROVAL
	DELIVER TO:	DATE NEEDED:
	DEPARTMENT:	FUND CODE:
	TELEPHONE:	APPROVAL SIGNATURE:
	BUILDING:	
	ROOM NUMBER:	TITLE:
		DATE APPROVED:

ITEM NUMBER	DESCRIPTION OF ITEM/SERVICE DESIRED	QUANTITY	UNIT	UNIT PRICE	EXTENSION
		TOTAL AMOUNT OF REQUISITION:			

2. **Purchase order** is a document from a company to the supplier recording the description, quantity and amount of the goods or services ordered and it should be properly authorized by the company.

New World Company

Floor 100, 100 Main Street
G.P.O. Box 100, Globecity Globeland, 1000
Telephone: (01) 9999 9999
Fax : (01) 9999 8888

PURCHASE ORDER

P.O. Number	NW-01-16366
P.O. Date	Feb/28/2001
Resale No.	SR AC 16-943236
GSA Sale	No
Phone	(999) 999-9999
Contact	John Hancock

TO: *Acme Parts Corporation*
1223 Kelton Street
Globecity, Globeland 1000
(via FAX 999/999-9999)

SHIP TO: *The New World Company*
2467 Pioneer Road
Globecity, Globeland, 1000
Attn: Shipping/Mary

FOB: Vendor/Globecity Globeland SHIP VIA: UPS TERMS: Net 30 days

ITEM	QUANTITY	PART NUMBER	DESCRIPTION	REQUIRED DATE	U/M	UNIT PRICE	PRICE	QUOTE NO.
001	10	F54749	NW Globe Chassis, 1492 Model	28/02/01	EA	29.50	295.00	Q84645
002	15	F85352	NW Globe Light Kit	28/02/01	EA	19.00	285.00	Q84646
003	6	F84352	NW Globe 30" Oak Stand	28/02/01	EA	30.00	180.00	Q84647
004	20	L86355	NW Atlas Leather-Bound	28/02/01	EA	25.00	500.00	Q84648
005	12	L86362	NW Atlas Young Readers Series	28/02/01	EA	10.00	120.00	Q84649
006	40	A86357	NW Pen Rollerball	28/02/01	EA	7.50	300.00	Q84650
007	25	A86362	NW Pen Fountain	28/02/01	EA	16.00	400.00	Q84651
008	50	A86552	NW Globe Beach Balls, 24"	28/02/01	EA	5.00	250.00	Q84652
009	100	A84352	NW Promotional Calendars	28/02/01	EA	0.10	10.00	Q84653
010	100	A36352	NW Promotional Balloons	28/02/01	EA	0.15	15.00	Q84654

1. ***PURCHASE ORDER NUMBER, PART NUMBER AND QUANTITY MUST SHOW ON EACH CARTON.***
2. Two packing sheets must accompany each shipment.
3. Protection of Material in Transit. All articles delivered on this order to be packed adequately to prevent any damage in shipment and storage. Use of newsprint and glassine bags prohibited. All packages to be properly identified.
4. Seller must execute acknowledgment copy hereof and return to buyer. No other form of acceptance is binding on buyer. Buyer expressly limits acceptance to the terms stated herein and any additional or different terms proposed by seller shall not be binding on buyer, whether or not they would materially alter this order, and are rejected.
5. ***ANY BOX OVER 50 KILOS WILL BE REFUSED.***

NW-01-16366

SUB-TOTAL	2,355.00
TAX	141.50
TOTAL	**2,496.50**

P.O. ACKNOWLEDGED BY:

NAME: ____________________

DATE: ____________________

Page: 1 of 1

BUYER: John Hancock DATE: Feb/28/2001

PurchaseOrder.cfb6 – Sep2004

3. **Goods received note** is a document prepared by the supervisor of the storeroom/receiving department at the time the goods are received. It shows the description, quantity, condition and date of the goods received.

GOODS RECEIVED NOTE

Supplier: GRN no.:

GRN date:

Delivery note no.:

Supplier a/c no.: Delivery note date:

Carrier: Checker:

Order no.	Quantity ordered	Quantity delivered	Description	Tick box or enter details if goods damaged or discrepancy identified

4. **Purchase invoice** is a document received from a vendor which indicates the date, description, quantity and the total amount of goods and services the company has received.

5. **Purchase journal and ledgers:**

(a) A journal (day book) for recording the purchases of goods or services.

(b) Vendors' accounts in the purchase ledger will also be updated with the remittance advice/receipts when payments are made to vendors.

6. **Payment voucher** is an internally generated document that establishes a formal means of recording and controlling cash disbursements. It is usually accompanied with a purchase invoice, goods received note and/or purchase order when approval for payment is sought.

The Coffee Roasting Company

Payment Voucher

987 Campus Lane
Corvallis, OR 9733

No: 9571

Remit To: VieImp
Vienna Imports Coffee Co.
39 Porter Street
Tacoma, WA 98477

Date of Voucher	26-Apr-95

Corresponding Documents		
PO Number	Shipment Number for PO	Receiving Report Number
413	1	415

Coffee Bean Name	Bean Code	Bean Type	Quantity Purchased	Cost per Pound	Extended Cost
Vienna Mocha Decaf	VMD	Decaf	350	$5.60	$1,960.00
Vienna Mocha	VMR	Reg	550	$4.90	$2,695.00
		SubTotals:	**900**		$4,655.00
		Freight:			$232.75
		Total Payment			**$4,887.75**

7. **Cheque/Electronic transfer** is the means of paying the vendors when the payments are due.

8. **Remittance advice** is a document sent with the cheque to a vendor detailing the amount of payment for each corresponding invoice and the total amount paid.

9. **Cash book** records the authorized disbursements and individual entries are supported by payment vouchers and/or presented cheques.

10. **Vendor's statement** is a statement prepared by the vendor indicating the opening balance, purchases during the period, payments received by the vendor and closing balances.

Audit Testing and Internal Controls

The following description of the primary functions, internal controls to be identified and transaction-related audit objectives (control objectives) will clarify what an auditor is trying to accomplish in the audit of the cycle (Sample of the audit program for the test of controls, refer to Appendix I).

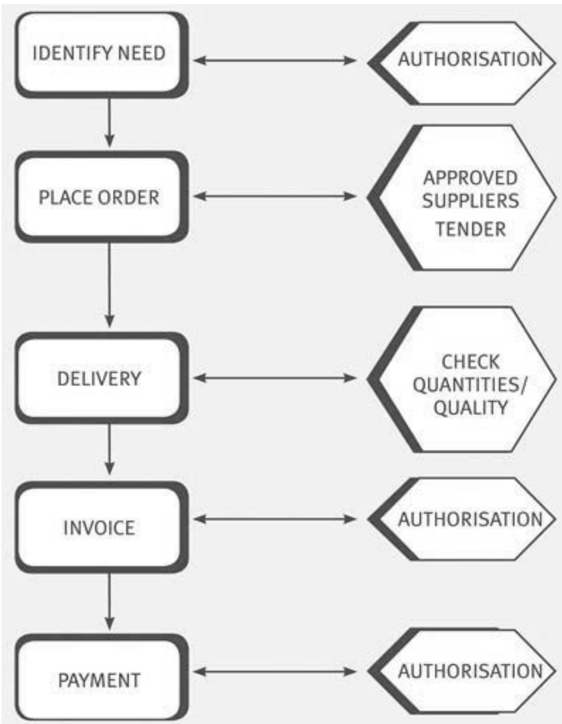
Transaction-related audit objectives for **purchases transactions.**

Objectives	Descriptions
Existence	All purchases and services recorded are received by the company
Completeness	All purchases and services that have actually incurred (received) are recorded in the accounting records
Accuracy	All purchases and services made are recorded accurately in the accounting records (e.g. purchases journal)
Classification	Purchases made are properly classified to the appropriate account
Timing	All purchases and services are recorded on a timely basis
Posting and summarization	Purchases and services made are included in the vendor's accounts of accounts payable ledger and properly summarized in the control accounts in general ledger

Transaction-related audit objectives for **cash payments transactions**.

Objectives	Descriptions
Existence	All cash payments recorded in the accounting records (e.g. cash payments journal) are made for goods or services actually received by the company
Completeness	Cash payments made for purchases and services have all been recorded in the accounting records
Accuracy	Cash payments are recorded accurately in the accounting records (e.g. cash payments journal)
Classification	Cash payments transactions are properly classified to the appropriate account (e.g. according to the company's chart of accounts)
Timing	All cash payments transactions are recorded on a timely basis
Posting and summarization	Cash payments made are included in the vendor's accounts of accounts payable ledger and properly summarized in the control accounts in general ledger

This is a summary of the purchases cycle, showing the possible problems and the related controls:



The table shows the various stages of the purchases cycle, together with:

a) the **risks** (what could go wrong);

b) **control procedures** (so that things **don't** go wrong!).

Process	Risks	Possible control procedures
Requisition made and order placed	– Order may be forgotten. – Wrong goods/services. – Goods not for business use. – Goods not needed. – May miss out on bulk discounts. – Best prices and quality not obtained	– All orders authorized by manager. – Inventory checked before orders placed. – Written, sequenced purchase order. – All outstanding orders kept on file for chasing. – Separate ordering department that plans orders to take account of discounts. – All new suppliers chosen by tender process. – Agreed suppliers list. – Agreed prices/terms lists. – Exception reporting of outstanding orders
Goods received (or service enjoyed)	– Wrong items arrive. – Poor quality items. – Goods are being stolen. – Goods never arrive.	– Goods logged in on arrival either: o Directly into system or o Goods received note (sequenced) prepared or o Supplier's delivery note incorporated into system grid stamped, etc. – Warehouse staff check goods against delivery information and sign if correct. – Delivery information then passed to accounts, as authority to pay associated invoice. – Goods arrival area kept secure. – Deliveries only signed for by warehouse manager. – Once goods checked in, inventory records updated. Person who made requisition informed of goods arriving

Table

Process	Risks	Possible control procedures
Invoice received	– Wrong items/prices. – Invoice does not add up. – Errors in posting to general ledger. – Errors in posting to payables ledger. – Settlement discount missed. – Overall, payment runs must take place when cash is available!	– Control account reconciled. – Payments allocated to specific invoices. – Where possible, all payments by bank transfer. – Bank transfers authorized by person with suitable level of authority. – All cheques signed by director, who sees supporting documents. – Larger cheques signed by two directors. – Supplier statements reconciled. – Planning of payments, to ensure cash available and discounts taken. – Cheque books kept secure
Credit received	– Credit not accounted for. – Returned goods are accounted for as dispatches, and hence sales. – Wrong amount of credit received.	– All credit notes sequenced. – Regular check that sequence complete in accounting records. – Credit note checked back to original invoice. – Any goods returned to suppliers are marked as return, to ensure GDN not prepared

Examples of tests of control

Functions	Test for:
Processing purchase orders	– Select sample of purchase orders and agree to authorized requisitions (existence). – Examine the purchase orders record to ensure that there is a system identifying the orders fulfilled from those unfulfilled (existence). – Examine purchases orders for indication of approval (existence and accuracy)
Receiving goods and services	– Discuss the procedures taken by the responsible official for receipt of goods (existence and completeness). – Select a sample of goods received notes to ensure that they are prenumbered and signed by the responsible official for goods received and examined. Enquire any missing goods received notes if necessary (existence, completeness and accuracy)

Table

Functions	Test for:
	— Observe the goods receiving procedures on a surprise basis to see whether any unrecorded receipt of goods or services and whether the client's policy is followed (existence, completeness and accuracy)
Recognizing the liability	— Select sample of invoices and agree to purchase ledger, purchase journal and stock records, and vice versa (existence and completeness). Note the date of recording also (timing). — Select a reconciliation of vendor's statements and purchase ledger accounts on a random basis, ensuring that it has been properly reviewed and discrepancies have been followed up with necessary action (accuracy and posting and summarization). — Examine samples of invoices for evidence of checking the calculation and details. Test check the footings and extensions of invoices (accuracy)
Processing and recording cash payments	— Examine invoices to ensure the evidence of approval for payment. Ensure that the cheque signatories are the officials with proper authorization to sign cheques within the authorized limit (existence). — Select a sample of paid invoices and ensure the evidence of preventing them from re-use (existence). — Account for sequence of cheques recorded in cash payments journal, investigating for reasons of any missing number (completeness). — Select bank reconciliation statements on a random basis and examine them for the evidence of review by a senior officer and ensure that all discrepancies have been investigated (accuracy)

QUESTIONS FOR SELF-ASSESSMENT

1. What are the major classes of transactions?
2. What are three types of substantive tests?
3. What are substantive tests of transactions for a recorded sale for which there was no shipment?
4. What are subtests of transactions for sales that were recorded more than once?
5. Identify the assertion about classes of transactions and events most benefited by the control for: sales recorded, goods not shipped.
6. How does the purchase process work?
7. What control objectives for the purchase and payable cycle relate to the «Accuracy» assertion?
8. What are the functions for the documents below?

a. Vendor invoice;

b. Voucher;
c. Voucher register/purchases journal;
d. Purchase requisition;
e. Purchase order;
f. Receiving report.

TASKS FOR SELF-ASSESSMENT

5.3. Read and decide if the following statements (1-5) are true or false.

1. When accounts receivable are confirmed at an interim date, auditors need not be concerned with → Sending negative confirmations to all customers as of the year-end date.
a) True; b) False.

2. An auditor noted that client sales increased by 10 percent for the year. At the same time, Cost of Goods Sold as a percentage of sales had decreased from 45 percent to 40 percent and year-end accounts receivable had increased by 8 percent. Based on this information, the auditor is most likely concerned about_ → Fictitious sales.
a) True; b) False.

3. Identify the assertion about classes of transactions and events most benefited by the control for: sales recorded, goods not shipped? → Entries in the accounts receivable subsidiary ledger were properly invoiced.
a) True; b) False.

4. An audit team is auditing sales transactions. One step is to vouch a sample of debit entries from the accounts receivable subsidiary ledger back to the supporting sales invoices. The purpose of this audit procedure is to establish that → Entries in the accounts receivable subsidiary ledger were properly invoiced.
a) True; b) False.

5. Which of the following responses to an accounts receivable confirmation on December 31 would cause an audit team the most concern? →
a. Assessed Level of Risk of Material Misstatement Relating to Receivables is high;
b. Number of Small Balances is few;
c. Proper Consideration by the Recipient is likely.
a) True; b) False.

Unit 6

LONG-TERM AND OTHER ASSETS AUDIT. AUDIT OF CAPITAL, LONG-TERM AND OTHER LIABILITIES

1. Audit of assets:
   a. Bank reconciliation.
   b. Audit Petty Cash.
   c. Confirming accounts receivable during an audit.
2. Audit of liabilities.
3. Audit of share capital.

TASKS

6.1. Read and decide if the following statements (1-6) are true or false.

1. All Presentation & Disclosure Assertions → Review loan agreements – to verify any loans collateralized by property or equipment for proper disclosure.
a) True; b) False.

2. Valuation & Allocation → Verify the client's ownership of the assets – by examining titles to the fixed assets.
a) True; b) False.

3. Rights & Obligations → Verify the client's ownership of the assets – by examining titles to the fixed assets.
a) True; b) False.

4. Who is responsible for the preparation of the bank rec? → Cutoff bank statement, which includes all paid checks and deposit slips, and is considered external evidence.
a) True; b) False.

5. Negative Confirmations → $$ amount on form, 3rd party will verify, correct & return.

a) True; b) False.

6. Primary document used to test the cash balance in the financial statements → Bank reconciliation. (It is also the first procedure in the audit of cash).

a) True; b) False.

BALANCE SHEET AUDIT

Auditing a balance sheet is one of the major tasks of an auditor. In balance sheet auditing, he/she has to check and verify different assets and liabilities. The main steps of Balance Sheet Audit are the following.

1st Step: Audit of Current Assets

First of all an auditor has to audit current assets and see whether they are correct or not.

a) Cash and Bank Balance Audit

An auditor has to check a cash balance with its physical existence. For checking a bank balance, he/she has to take the help of the bank statement. If there is a difference between a cash book and bank statement balance, he/she should check a bank reconciliation statement of the company to know the real reasons behind this. If there is any error in it, he/she should note which will be the part of the audit report.

b) Account Receivable Audit

An auditor also checks accounts receivable. He/She has to see bad debts account and provision for doubtful debt account and its accounting treatment in the balance sheet.

2nd Step: Fixed Assets Audit

In this audit, an auditor must check the depreciation on each asset, asset's sale value and its profit or loss and balance value which has been shown in balance sheet.

3rd Step: Investment Audit

In investment audit, he/she should audit the source of these investments. He/She also should check different investment schemes.

4th Step: Audit of Liabilities

An auditor should check the solvency ability of the company by liabilities audit. He should audit accounts payable, bank loans and outstanding liabilities. His eye should be total payment to creditors and what is recorded in the books. If he examines the difference between both, it may be a mistake or a fraud and it should be noted. He/She also examines any misconduct of accounting department relating to paying liabilities. He/She also tries to know the reasons of delay in the payment of interest, long term loans and other outstanding expenses.

5th Step: Audit of Capital / Equity

Stockholders' equity represents the claim that the corporation's shareholders have to the company's net assets. Stockholders' equity has three common components: paid-in capital, treasury stock, and retained earnings.

AUDIT OF ASSETS

a. Bank Reconciliation

A bank reconciliation statement is a report which compares the bank balance as per company's accounting records with the balance stated in the bank statement.

!!! *The* ***purpose*** *of preparing a Bank Reconciliation Statement is to detect any discrepancies between the accounting records of the entity and the bank besides those due to normal timing differences. Such discrepancies might exist due to an error on the part of the company or the bank.*

Importance of Bank Reconciliation:

– Preparation of bank reconciliation helps in the identification of errors in the accounting records of the company or the bank.

– Cash is the most vulnerable asset of an entity. Bank reconciliations provide the necessary control mechanism to help protect the valuable resource through uncovering irregularities such as unauthorized bank withdrawals. However, in order for the control process to work effectively, it is necessary to segregate the duties of persons responsible for accounting and authorizing of bank transactions and those responsible for preparing and monitoring bank reconciliation statements.

– If the bank balance appearing in the accounting records can be confirmed to be correct by comparing it with the bank statement balance, it provides added comfort that the bank transactions have been recorded correctly in the company records.

Preparing a Bank Reconciliation Statement

A sample Bank Reconciliation Statement is given below:

ABC LTD Bank Reconciliation Statement as at 31 December 2013					
Balance as per corrected Cash Book				1	xxx
Add:					
	Unpresented Cheques			2	xxx
Less:					
	Deposits in Transit			3	(xxx)
	Errors in Bank Statement			4	(xxx)
Balance as per Bank Statement					xxx

Balance as per corrected Cash Book:

This is the starting point of a bank reconciliation. Corrected bank balance is calculated by adjusting the cash book ledger balance for transactions that are recorded by the bank but not by the entity as shown below:

Balance as per Cash Book					xxx
Add:					
	Direct Credits			5	xxx
	Interest on Deposit			6	xxx
Less:					
	Bank Charges			7	(xxx)
	Direct Debits			8	(xxx)
	Standing Order			9	(xxx)
	Errors in Cash Book			10	(xxx)
Balance as per corrected Cash Book					xxx

Unpresented Cheques

These represent cheques that have been issued by an entity to a customer or another third party but which have not been presented to the bank by the reconciliation date. The entity records the payment in its cash book as soon as the cheque is issued to the person but the bank records the transaction when it receives the cheque. This causes a timing difference in the recording of the payment.

As the bank would not have recorded the unpresented cheques, the balance appearing in bank statement would be higher than the cash book balance which is why the amount of outstanding cheques is added to the cash book balance in the bank reconciliation.

Example 1

ABC & Co. purchases goods worth $2,000 and writes a cheque for the same amount in favor of the supplier on 28 December 2013. The following accounting entry was recorded by the entity on that date:

		$	$
Debit	Purchases	2,000	
Credit	Bank		2,000

The supplier however does not present the cheque until 3 January 2014. Therefore, $2,000 of unpresented cheques should appear in the bank reconciliation on 31 December 2013 because the bank had not accounted for the transaction by that date even though ABC & Co. had recorded the payment in its cash book on the date of payment.

Deposits in Transit

There may be a time lag between when a company deposits cash or cheque in its account and when the bank credits it. Since the company records the increase in bank balance in its accounting records as soon as the cash or cheque is deposited, the balance as per bank statement would be lower than the balance as per cash book until the deposit is processed by the bank. Therefore, any outstanding deposits must be subtracted from the balance as per cash book in the bank reconciliation statement.

Example 2

ABC & Co. deposits a cheque of $1,000 which it received from a credit customer on 29 December 2013. The following accounting entry was recorded by the company on that date:

		$	$
Debit	Bank	1,000	
Credit	Receivable		1,000

While preparing a bank reconciliation statement, ABC & Co. finds out that the bank had not credited the cheque in its account until 2nd January 2014. Therefore, $1,000 of deposits in transit should appear in the bank reconciliation on 31 December 2013 because the bank had not accounted for the transaction by that date even though ABC & Co. had recorded the receipt in its cash book on the date of deposit.

Errors in bank statement

Errors or omissions by the bank can lead to a difference between the balance as per bank statement and the balance as per cash book. For instance, the bank may incorrectly record the deposits or withdrawals of another account into the company's bank account. Likewise, a deposit or withdrawal can be erroneously recorded twice by the bank. Such discrepancies would cause the balance shown in the bank statement to be higher or lower than cash book balance depending on the nature of the error or the omission. The differences must be intimated to the bank for timely correction.

Example 3

ABC & Co.'s bank statement for the month of December 2013 shows that bank charges of $500 have been incorrectly recorded twice by the bank. As the balance as per bank statement would be lower than the balance as per ABC & Co.'s cash book due to the error, $500 must be subtracted from the balance as per cash book in the bank reconciliation statement.

Direct Credits

Direct Credits or Direct Deposits are amounts deposited directly by someone into an account of the company. The payer rather than the payee in this case initiate the deposit. Direct Credits are useful where regular receipts are expected from known parties (such as rent, interest on investment, royalties, etc) who can deposit the money without the involvement of the payee. The deposit may be made through cash, cheque or a fund transfer.

The bank records the amount received as soon as the transfer through direct credit is made but the business entity records the amount when it receives intimation by the bank through bank statement or otherwise. Therefore, the balance as per bank statement may be higher than the balance as per cash book due to direct credits not yet accounted for by the entity. The difference needs to be eliminated by adjusting the cash book of the company before the preparation of the bank reconciliation.

Example 4

ABC & Co. receives rent amounting to $1,000 on its leased property via direct credit into its bank account on 30 December 2013. The Company has not recorded the rent received in its books. The balance on the cash book shows a balance of $20,000. The bank statement shows the following:

Bank Statement of ABC & Co. for the month of December 2013					
Date	Particulars	Opening Balance	Debit	Credit	Balance
01-12-2010		20,000	–	–	20,000
30-12-2010	Fund Transfer	20,000	–	1,000	21,000

As the bank credited the account of ABC & Co. as soon as the direct credit was made, the balance as per bank statement is higher than the cash book balance by $1,000. ABC & Co. must record the rent received through direct credit in its cash book before preparing the bank reconciliation to remove the difference. The following accounting entry must be recorded to arrive at the corrected cash book balance:

		$	$
Debit	Rent	1,000	
Credit	Rent Income		1,000

Interest on Deposits

Interest earned on various savings accounts may be credited directly into the accounts by the bank at the end of a month. The account holding company records the interest receipt after it receives intimation from the bank through bank statement. Therefore, until the interest received is recorded in the cash book, the balance as per bank statement will be higher than the cash book balance. The difference needs to be eliminated by adjusting the cash book of the company before the preparation of the bank reconciliation.

Example 5

ABC & Co. earns interest on its savings account of $1.000 for the month of December 2013 which has been directly credited to the company's account on 31 December 2013 by the bank. The Company has not yet recorded the interest received in its books. The balance on the cash book shows the balance of $20,000. The bank statement shows the following:

Bank Statement of ABC & Co. for the month of December 2013					
Date	Particulars	Opening Balance	Debit	Credit	Balance
01-12-2010		20,000	–	–	20,000
30-12-2010	Interest-Dec	20,000	–	1,000	21,000

As the bank has already credited the account of ABC & Co. in respect of interest received, the balance as per bank statement is higher than the cash book balance by $1,000. In order to remove the difference, ABC & Co. must record the interest received in its cash book before preparing the bank reconciliation. The following accounting entry must be recorded to arrive at the corrected cash book balance:

		$	$
Debit	Bank	1,000	
Credit	Interest Income		1,000

Bank Charges

Bank charges are the various fees accountholders are charged in respect of maintenance of the account along with any other charges incurred in respect of specific transactions (e.g. cheque clearance charges, fund transfer charges, collection charges, etc). Bank charges are charged directly to the customer account thereby reducing the bank balance shown in the bank statement. These charges are usually not recorded by the business until the bank provides the bank statement at the end of a month which is why balance as per bank statement may be lower than the cash book balance. The difference needs to be eliminated by adjusting the cash book of the company before the preparation of the bank reconciliation.

Example 6

ABC & Co. has been charged $500 in respect of bank charges for the month of December 2013. The Company has not yet recorded the bank charges in its books. The balance on the cash book shows the balance of $20,000. The bank statement shows the following:

Bank Statement of ABC & Co. for the month of December 2013					
Date	Particulars	Opening Balance	Debit	Credit	Balance
01-12-2010		20,000	–	–	20,000
30-12-2010	Charges-Dec	20,000	500	–	19,500

As the bank has already debited the account of ABC & Co. in respect of bank charges, the balance as per bank statement is lower than the cash book balance by $500. In order to remove the difference, ABC & Co. must record the bank charges in its cash book before preparing the bank reconciliation. The following accounting entry must be recorded to arrive at the corrected cash book balance:

		$	$
Debit	Bank Charges	500	
Credit	Bank		500

Direct Debit

Direct Debit is an instruction to the bank to transfer funds to another account on a recurring basis. The payment is initiated by the payee himself although the account in which the funds will be transferred needs to be first authorized by the payer. Direct Debits are useful where regular payments are to be made to certain parties such as in payment of credit card bills, lease rentals, interest on bank loan, etc. This saves the company the hassle of issuing cheques every month. Whereas standing orders can only be made of specific amounts and dates, direct debits can be created for varying dates and amounts.

The bank records the amount paid as soon as the transfer through direct debit is made but the business entity records the amount when it receives intimation by the bank through the bank statement or otherwise. Therefore, the balance as per bank statement may be lower than the balance as per cash book due to payments made through direct debits not yet accounted for by the entity. The difference needs to be eliminated by adjusting the cash book of the company before the preparation of the bank reconciliation.

Example 7

ABC & Co. pays office rent amounting to $1,000 via direct debit on 30 December 2010. The Company has not recorded the rent paid in its books. The balance on the cash book shows the balance of $19,000. The bank statement shows the following:

Bank Statement of ABC & Co. for the month of December 2013					
Date	Particulars	Opening Balance	Debit	Credit	Balance
01-12-2010		21,000	–	–	21,000
30-12-2010	Fund Transfer	20,000	1,000	–	20,000

Since the bank debited the account of ABC & Co. as soon as the direct debit was made, the balance as per bank statement is lower than the cash book balance by $1,000. ABC & Co. must record the rent paid through direct debit in its cash book before preparing the bank reconciliation to remove the difference. The following accounting entry must be recorded to arrive at the corrected cash book balance:

		$	$
Debit	Rent	1,000	
Credit	Bank		1,000

Standing Order

A standing order is an instruction to the bank to transfer funds of a specific amount to another account on a specific date on a recurring basis. It is very similar to a direct debit except that the amount and date of payment cannot be varied. The payment is initiated by the payee himself although the account in which the funds will be transferred needs to be first authorized by the payer. Standing orders are useful where regular payments of fixed amounts are to be made to certain parties such as the payment of mortgage rent and loan installments.

Bank records the amount paid as soon as the transfer through standing order is made but the business entity records the amount when it receives intimation by the bank through the bank statement or otherwise. Therefore, the balance as per bank statement may be lower than the balance as per cash book due to payments made through standing orders not yet accounted for by the entity. The difference needs to be eliminated by adjusting the cash book of the company before the preparation of the bank reconciliation.

Example 8

ABC & Co has made a standing order to its bank to transfer an amount of $5,000 on the last day of the month as security charges to the security company. On 31 December 2013, the bank statement shows the balance of $20,000 whereas the cash book balance is $25,000. The difference represents the amount of payment through a standing order not yet recorded by ABC Co. LTD.

Bank Statement of ABC & Co. for the month of December 2013					
Date	Particulars	Opening Balance	Debit	Credit	Balance
01-12-2010		25,000	–	–	25,000
30-12-2010	Fund Transfer	25,000	5,000	–	20,000

In order to eliminate the difference between the two balances, ABC Co. LTD must record the following accounting entry:

		$	$
Debit	Security Charges Payable	5,000	
Credit	Bank		5,000

This will reduce the cash book balance to $20,000 which is equal to the balance as shown in the bank statement.

Errors in Cash Book

Errors or omissions in the cash book can lead to a difference between the balance as per bank statement and the balance as per cash book. For instance, an entity may incorrectly record the bank deposits or withdrawals in another accounting ledger or it may record the entry by a wrong amount. Likewise, a bank deposit or withdrawal may be completely omitted from the cash book. Such discrepancies would cause the balance shown in the bank statement to be higher or lower than cash book balance depending on the nature of the error or the omission. The difference needs to be eliminated by adjusting the cash book of the company before the preparation of the bank reconciliation.

Example 9

ABC & Co.'s bank statement shows a bank balance of $20,000 on 31 December 2013 whereas its balance in the cash book at that date is only $19,000. The difference is due to a bank payment of $1,000 incorrectly recorded twice by ABC & Co. in its cash book. The difference can be eliminated by adjusting the cash book by a debit entry of $1,000.

b. Audit of Petty Cash

!!! *A* ***Petty Cash fund*** *is a small amount of cash held by an organization or its separate departments for small day-to-day expenditures. Petty cash carries risks beyond monetary value, as the manner in which management handles petty cash may be indicative of broader management approaches to an organization's internal controls. It is widely used by organizations of all sizes, and auditors need to be aware of associated risks as well as internal controls in place to address them.*

Risks

Petty cash is an example of accepting inherent risks of holding cash against its potential benefits. Auditors need to be aware of these risks, which include:

– Waste.
– Misappropriation of funds.
– Human error.

Procedures

Auditors need to understand their organization's procedure for handling petty cash so they can help ensure controls are in place to mitigate the risk of theft or misuse. Although specific procedures for petty cash disbursement can vary among organizations, several principles are common.

Creation

Petty cash is created by withdrawing physical cash from a bank account and opening a corresponding account typically a petty cash imprest account in the organization's general ledger to record and control the funds. Opening a separate account is essential to segregate this item within the general ledger.

Disbursement

A designated employee prepares a prenumbered voucher, which is recorded with detailed information and authorized by a separate designated employee to ensure segregation of duties. Here, both preparer and authorizer rely on supporting documents (e.g., bills, invoices, and receipts) to justify the expense. The voucher is forwarded to the custodian of the petty cash fund who verifies the voucher and supporting documents to ensure authenticity and dual authorization and then disburses the cash under acknowledgment.

Replenishment

At least once a month, petty cash is replenished. All vouchers are sorted and summed up with respect to each type of expense and recorded in the system.

Controls

Most of the controls in the petty cash process that address the aforementioned risks are easy to identify prenumbered vouchers, segregation of duties in the disbursement process, supporting documents to ascertain the authenticity of each disbursement, and acknowledgement of the person receiving the cash and replenishment of petty cash on a monthly basis. However, additional internal controls can be implemented to strengthen the process.

The preparer of the petty cash voucher should maintain sequentially numbered vouchers and a journal that reflects the amount of cash currently held by the petty cash custodian.

Periodically (e.g., monthly), an independent designated employee should conduct a surprise review of petty cash on hand by comparing the physical cash and vouchers against the total imprest balance.

The petty cash, and its supporting documents and vouchers, should be kept in a secure environment under limited access by designated employees.

The employee overseeing the petty cash process should establish a maximum threshold for individual petty cash expenditures.

c. Confirming Accounts Receivable during an Audit

A major auditing issue with **accounts receivable** is whether the amount reflected in the customer's subsidiary ledger reconciles with the correct customer balance. When you audit accounts receivable, you often use confirmations to make sure the amounts reflected in accounts receivable are accurate.

Sending confirmations isn't mandatory for each audit. Whether you send confirmations is a function of your professional judgment and your prior experience with the client.

To confirm accounts receivable, you need to reconcile the accounts receivable subsidiary ledger to all the customers that owe the company money to the total amount shown on the balance sheet. Your job is to make sure of three things:

1. The transactions represented in accounts receivable are valid, authentic obligations of third parties.
2. The customer balance is correct.
3. All uncollectible accounts have been properly written off.

The accounts receivable subsidiary ledger report, also known as *an aged accounts receivable report*, shows all the amounts that customers owe to the company, grouped by the number of days outstanding as of a designated date. The normal grouping is as follows:

Current (under 30 days outstanding)

1. 30—60 days;
2. 61—90 days;
3. 91—120 days;
4. more than 120 days.

To achieve your first two objectives — verifying customer existence and the correctness of customer balances — you test using confirmation requests. These requests are form letters sent to customers listed in the accounts receivable subsidiary ledger to verify the facts and figures contained in the client's books. The confirmation form letter is short and lists the total amount that a customer owes at a certain date. Two types of confirmation requests are possible: positive and negative:

1. Positive confirmation: A positive confirmation request asks that a customer signs and mails the form back to you either attesting to the fact that the figure owed is correct or correcting it. A positive confirmation request can also show the dollar amount owed as blank, requiring the customer to fill it in according to its records.
2. Negative confirmation: A negative confirmation request asks the customer to reply only if the figure shown on your letter is incorrect.

!!! *Under generally accepted accounting principles (GAAP), your client must allow for uncollectible accounts. This allowance is an estimate.*

ILLUSTRATIVE LETTER OF CONFIRMATION TO BE SENT TO CREDITORS – POSITIVE FORM

[Letterhead of Entity]

[Date]

[Name and Address of Creditor]
Dear Sir,

For audit purposes, kindly confirm directly to our auditors (name and address of the auditors) that the balance of $ __________ due by us to you as on _________ as shown by our books, is correct.

The details of the balance are as under:

Invoice No.	Date	Order Reference	Amount
		Total	
		Less: Payments made/other debits	___________
		Net amount due by us ($)	___________

A stamped envelope addressed to our auditors is enclosed for your convenience.

If the amount shown is in agreement with your books, kindly strike-out the paragraph marked (B) below. If the amount shown is not in agreement with your books, kindly furnish the details in the proforma given in the paragraph marked (B) below and strike-out paragraph (A). In either case, kindly sign at the place provided below and return this entire letter directly to our auditors in the enclosed envelope. Your prompt compliance with this request will be appreciated.

Kindly return this form in its entirety.

Yours faithfully,
(Signature of responsible
official of the entity)

(Do not perforate the form at this point)

[Name and Address of Entity]

(A) We confirm that the above stated amount is correct as at __________.

OR

(B) We state that the above-stated amount is not correct as per our records. The details of the balance as at _________ as per our records are as below:

Invoice No.	Date	Order Reference	Amount
		Total	
		Less: Payments made/other debits	___________
		Net amount due by us ($)	___________

(Signature of creditor/
responsible official)

Date ....

AUDIT OF LIABILITIES

!!! *Liabilities generally constitute significant proportion of the total sources of funds of an entity. The* ***audit of liabilities*** *is primarily directed at ensuring that all known liabilities have been properly accounted for, since material omission or misstatement vitiates the true and fair view of the financial statements.*
An important feature of liabilities which has a significant effect on the related audit procedures is that these are represented only by documentary evidence which originates mostly from third parties in their dealings with the entity.

In any auditing situation, the auditor employs appropriate procedures to obtain reasonable assurance about various assertions. In carrying out an audit of liabilities, the auditor is particularly concerned with obtaining sufficient appropriate audit evidence to satisfy himself/herself that all known liabilities are recorded and stated at fair and reasonable amounts.

Verification of liabilities may be done by employing the following procedures:

- Examination of records;
- Direct confirmation procedure;
- Examination of disclosure;
- Analytical review procedures;
- Obtaining management representations.

The auditor should satisfy himself/herself that the liabilities have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

In addition to the audit procedures discussed above, the following *analytical review procedures* may often be helpful as a means of obtaining audit evidence regarding the various assertions:

– Comparison of closing balances of loans and borrowings, creditors, etc. with the corresponding figures for the previous year;

– Comparison of the relationship between current year creditor balances and the current year purchases with the corresponding figures for the previous year;

– Comparison of actual closing balances of loans and borrowings, creditors, etc. with the corresponding budgeted figures, if available;

– Comparison of current year's aging schedule of creditors with the corresponding figures for the previous year;

– Comparison of significant ratios relating to loans and borrowings, creditors, etc. with the similar ratios for other firms in the same industry, if available;

– Comparison of significant ratios relating to loans and borrowings, creditors, etc. with the industry norms, if available.

The auditor should obtain from the management of the entity a written statement that all known liabilities have been recorded in the books and that all contingent liabilities have been properly disclosed. While such a representation letter serves as a formal acknowledgement of the management's responsibilities for proper accounting and disclosure of the relevant items, it does not relieve the auditor of his/her responsibility for performing audit procedures to obtain sufficient appropriate audit evidence to form the basis for the expression of his/her opinion on the financial statements.

A sample management representation letter regarding liabilities and contingent liabilities is given below.

ILLUSTRATIVE REPRESENTATION LETTER FOR LIABILITIES AND CONTINGENT LIABILITIES

The following is a sample representation letter for liabilities and contingent liabilities. It might be used to supplement the general letter of representation or included therein. The letter should be modified where appropriate.

[Letterhead of Entity]
[Date]
[Name and Address of the Auditor]

Dear Sir,

In connection with your audit of the financial statements of X Ltd. as of ..20XX.., and for the year then ended, we confirm, to the best of our knowledge and belief, the following representations:

1. We have recorded all known liabilities in the financial statements.
2. We have disclosed in notes to the financial statements all guarantees that we have given to third parties and all other contingent liabilities.
3. Contingent liabilities disclosed in the notes to the financial statements do not include any contingencies which are likely to result in a loss and which, therefore, require adjustment of assets or liabilities.
4. Provisions have been made in the accounts for all known losses and claim of material amounts.

Yours faithfully,
(Signature of responsible
official of the entity)

!!! *The auditor should maintain adequate working papers regarding audit of liabilities and contingent liabilities. Among others, he should maintain on his audit file the confirmations received as well as any undelivered letters of request for confirmation. The management representation letter concerning liabilities and contingent liabilities should also be maintained on the audit file.*

AUDIT OF SHARE CAPITAL

A private limited company has two types of share capital:

1. Equity share capital
2. Preference share capital

!!! ***Equity share capital*** *is that part of capital that is not a preferential. In other words it is the basic kind of capital or ordinary share capital.*
Preference share capital *has the following characteristics:*
– It carries a preferential right as to the payment of dividend over other type of capital.
– It carries the preferential right as to payment of capital in case of winding up or repayment of capital over the other type of capital.

Special points in audit of share capital

In case of share capital issued by the company following points merit consideration of the auditor:

– Authorization of the issue.

– An auditor should check the minutes of the meeting of the board of directors to check the authorization of the terms of the issue of share capital.

– Vouching share applications.

– An auditor should test check the share application forms and vouch their respective entries in the cashbook.

–. Legal requirement.

– It should be checked that the legal requirements as laid down by the companies act and other regulatory bodies are met.

– Compilation requirements.

– An auditor should check that various compilation requirements of various statements with the registrar of companies are met.

– While doing the audit of share capital an auditor should vouch the following carefully:

- Memorandum of association;
- Articles of association;
- Minutes of the directors' meetings;
- Prospectus;
- Share application form;
- Letters of allotment;
- Letters of refund;
- Share registers;
- Cashbook;
- Ledger accounts.

Issue of shares at a premium

When a company issues its shares at a premium, an auditor should take care of the following points:

– He/She should check the prospectus.

– He/She should check the articles of association.

– He/She should check the minutes of the meetings of the board of directors.

– All the above should authorize the issue of shares at a premium.

– The receipt of premium should be vouched with the respective entries in the books of accounts.

– It should be vouched that the share premium account should be used for the authorized purposes only.

QUESTIONS FOR SELF-ASSESSMENT

1. How is it necessary to document audit evidence of financial audit?
2. What should you look for when you analyze account balances?
3. How is it possible to recognize contingent liabilities during an audit?
4. What does an auditor have to look for when auditing long-term and other assets?
5. What is it necessary to look for when auditing capital?
6. What does an auditor have to to look for when auditing long-term and other liabilities?

TASKS FOR SELF-ASSESSMENT

6.2. Choose the correct option (a, b, c or d).

1. Which of the following is an example of an accrued liability?

a) Accounts payable;
b) Notes payable;
c) Prepaid Insurance;
d) Product warranty liability.

2. When an auditor finds a debit to accounts payable, which of the following accounts is most likely to be credited?

a) Accounts Receivable;
b) Accrued liabilities;
c) Cash;
d) Cost of goods sold.

3. Auditors may choose not to confirm accounts payable because:

a) Confirmation obtains evidence identical to that obtained by cutoff tests;
b) Other reliable external evidence to support the balances is likely to be available;
c) A reading of the corporate minutes reveals that confirmation is unnecessary;

d) The balances due will have changed between the year-end and the date of confirmation.

4. Which of the following tests of control most likely would help assure an auditor that goods shipped are properly billed?

a) Scan the sales journal for sequential and unusual entries;

b) Examine shipping documents for matching sales invoices;

c) Compare the accounts receivable ledger to daily sales summaries;

d) Inspect unused sales invoices for consecutive pre-numbering.

5. An entity's internal control requires for every check request that there is an approved voucher, supported by a prenumbered purchase order, and a prenumbered receiving report. To determine whether checks are being issued for unauthorized expenditures, an auditor most likely would select for testing from the population of:

a) Purchase orders;

b) Canceled checks;

c) Receiving reports;

d) Approved vouchers.

6. The assertion most directly addressed when performing the search for unrecorded liabilities is:

a) Completeness;

b) Existence;

c) Presentation;

d) Rights.

Unit 7
AUDIT COMPLETION

1. Auditor's reports on financial statements in different countries.
2. Types of audit report:
   a. Unmodified audit reports.
   b. Modified audit reports.
   c. Going concern and auditor's report.

TASKS

7.1. Read and decide if the following statements (1-3) are true or false.

1. Adverse → not good, but minor mistakes.
a) True; b) False.

2. *After considering an entity's negative trends and financial difficulties, an auditor has substantial doubt about the entity's ability to continue as a going concern. The auditor's considerations relating to management's plans for dealing with the adverse effects of these conditions most likely would include management's plans to:*
→ Scope Paragraph: Yes
Notes to the F/S: NO

When a qualified opinion is issued due to a lack of sufficient audit evidence, the lack of evidence should be disclosed in an explanatory paragraph before the opinion paragraph. Since insufficient evidence is a scope limitation, the scope paragraph should also be modified to refer to the limitation and to the explanatory paragraph that discusses it.
a) True; b) False.

3. *Which of the following conditions or events most likely would cause an auditor to have substantial doubt about an entity's ability to continue as a going concern?* → Conditions that cause the auditor to

have substantial doubt about the entity's ability to continue as a going concern are inadequately disclosed.

Inadequate disclosure of the substantial doubt about an entity's ability to continue as a going concern is a departure from GAAP, resulting in either a qualified or adverse opinion.

a) True; b) False.

7.2. Read the definitions of asset accounts and complete them with these words and word combinations.

Types of Reports with Unmodified Opinions
Unmodified opinion – with an emphasis of matter paragraph
Unmodified opinion on group financial statements
Audit Report The Qualified opinion
Going Concern requirements
Unmodified opinion – with an other matter paragraph
Types of Reports with Modified Opinions
Unmodified opinion – standard report
Qualified Report – Departure from GAAP
Qualified Opinion – Departure from GAAP
The Disclaimer of opinion
The Adverse opinion
Adverse Opinion Report

1. ____________________

Providing an independent and expert opinion on the fairness of financial statements through an audit is the most frequent attestation service.

When performing an audit, the auditors obtain reasonable assurance that the statements are in conformity with GAAP.

2. ____________________

a) Unmodified opinion – standard report.
b) Unmodified opinion – with an emphasis of matter paragraph.
c) Unmodified opinion – with an other matter paragraph.
d) Unmodified opinion on group financial statements.

3. ___________________

This report may be issued only when the auditors have obtained sufficient appropriate audit evidence to conclude the financial statements are not misstated.

4. ___________________

To emphasize a matter appropriately presented in the financial statements (e.g., a change in accounting principles).

5. ___________________

To emphasize a matter other than those presented or disclosed in the financial statements (e.g., other information in documents containing audited financial statements).

6. ___________________

When two or more CPA firms are involved in an audit and the group auditor (firm that does most of the work) does not wish to take responsibility for the work of the component auditors.

7. ___________________

a) Qualified opinion.

b) Adverse opinion.

c) Disclaimer of opinion.

8. ___________________

– states that the financial statements are presented fairly in conformity with generally accepted accounting principles «except for» the effects of some matter.

9. ___________________

– means that due to a significant scope limitation, the auditors were unable to form an opinion or did not form an opinion on the financial statements.

10. ___________________

a) Immaterial – unmodified.

b) Material – qualified.

c) Material and pervasive – adverse.

11. ___________________

«In our opinion, except for the effects of not capitalizing lease obligations as discussed in the Basis for Qualified Opinion Paragraph...».

12. ___________________

a) Financial statements do not present fairly the financial position, results of operations, and cash flows of client in conformity with GAAP.

b) Material and pervasive departures from GAAP.

c) The auditor believes departure causes financial statements taken as a whole to be misleading.

13. ___________________

«In our opinion, because of the effects of the matters discussed in the Basis for Adverse Opinion Paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles ...».

14. ___________________

An auditor not required to perform procedures specifically designed to test going-concern assumption but must evaluate the assumption.

AUDITOR'S REPORTS ON FINANCIAL STATEMENTS IN DIFFERENT COUNTRIES

!!! *The auditor's report is a formal opinion, or disclaimer thereof, issued by either an internal auditor or an independent external auditor as a result of an internal or external audit or evaluation performed on a legal entity or subdivision thereof (called an «auditee»).*
The report is subsequently provided to a «user» (such as an individual, a group of persons, a company, a government, or even the general public, among others) as an assurance service in order for the user to make decisions based on the results of the audit.
The auditor's report usually does not vary from country to country, although some countries do require either additional or less wording.

An independent third party auditor's opinion is necessary when *financial reports* are submitted to regulatory bodies, other government organizations, lending institutions, or the investment community.

In the United States, auditors are required to include in the scope paragraphs a phrase stating that they conducted their audit

«... in accordance with generally accepted auditing standards in the United States of America»,

and, in the opinion paragraph, state whether the financial statements are presented

«... in conformity with generally accepted accounting principles in the United States of America».

Some countries, such as the Philippines, use similar reports to those issued in the United States, with the exception that second paragraph would state that the audit was conducted in accordance with *Philippine Standards on Auditing*, and that the financial statements are in accordance with *Philippine Financial Reporting Standards.*

Ireland has recently adopted the new clarified ISA's (International Standard on Auditing) in relation to audit reports. These were formerly dealt with under ISA 700 and are not replaced by 3 new standards; ISA 700, ISA 705 & ISA 706.

The key points on each new ISA are as follows:

– **ISA 700** auditor's report on financial statements covers all disclosures and requirements in relation to the audit report specifically clean audit reports;

– **ISA 705** modifications to opinions in the independent auditors report covers disclosures and requirements for qualified audit reports;

– **ISA 706** emphasis of matter paragraphs and other matter paragraphs in the independent auditors report covers disclosures and requirements for emphasis of matter paragraphs like going concern and introduces the new «other matter» paragraph.

In summary, the 3 new standards contain very few changes from the old ISA 700.

The key changes are as follows:

· References to the *«Accounting Standards Board»* have now been replaced by reference to the *«Financial Reporting Council»*. Auditing Practices Board references are still applicable.

· Terminology in relation to modified reports has changed, *for example:*

– A disagreement is currently detailed as a qualified opinion. Depending on the pervasiveness of the disagreement and the materiality it may now be detailed as an adverse opinion.

– Limitation on scope currently leads to a qualified opinion in certain circumstances and depending on the pervasiveness of the effect if material is now a disclaimer of opinion.

– ISA 706 introduces the use of an *«other matter»* paragraph. This allows for the auditor to disclose matters that he believes are relevant to the users of the financial statements. The difference between this 'matter' paragraph and an emphasis of matter paragraph (EOM) is that the issues raised in an emphasis of matter paragraph are fundamental to the users. An emphasis of matter paragraph also needs to be referenced to a note in the financial statements.

An example of an «other matter» paragraph could include the following:

– Disclosure of the fact that the comparative information has not been audited in the case of a first year audit.

– The main change from the old ISA 700 is the format of the audit report. The current format includes title, respective responsibilities of directors and auditors, basis of audit opinion, opinion and if required an EOM paragraph.

– Respective responsibilities of directors and auditors have now been condensed and just include references to responsibilities

– The 'Basis of audit opinion' has been replaced with *«Scope of the audit of financial statements»*. There are two choices for this paragraph. Option 1 refers to the FRC website, Option 2 explains in more detail what an audit is which is similar to the basis of opinion in the old format.

– Company law requirements have been pulled together and all appear in one paragraph under the heading *«Matters on which we are required to report by the Companies Act 1963 to 2012»*.

– Directors' remuneration and transactions are now required to be reported on in a separate paragraph headed up as *«Matters on which we are required to report by exception»*.

TYPES OF AUDIT REPORT

!!! ***ISA 700*** *Forming an Opinion and Reporting on Financial Statements provides guidance as to the nature and wording of the audit report. Most importantly the report must be in writing.*
In addition it recommends that the audit report be broken into distinct sections that explain the purpose, nature and scope of an audit.

Audits may be undertaken by internal auditors (reporting to senior management or boards of directors), or by external (third party) auditors. Categories of auditor's opinions: *Unqualified opinion; Qualified opinion; Adverse opinion; Disclaimer from opinion* (***Fig. 7.1.)***

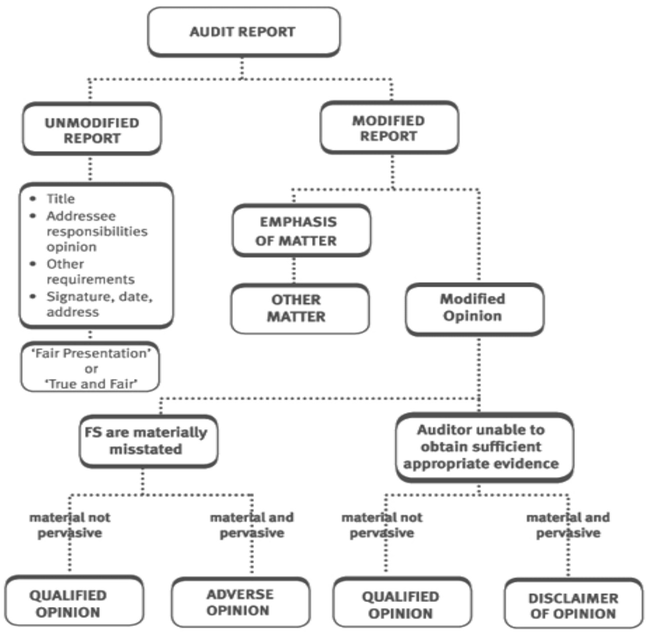


Fig. 7.1. Categories of Auditor's Reports and Opinions

The recommended elements of the report are as follows:

Title

– The title should be «appropriate». The use of 'Independent Auditor's Report' distinguishes this report from any other report produced internally or by other non-statutory auditors.

Addressee

– The report should be addressed to the intended user of the report which is usually the shareholders, or other parties as required by the circumstances of the engagement.

Introductory paragraph

– Identifies the entity whose financial statements have been audited;

– States that the financial statements have been audited;

– Identifies the components of the financial statements (by name and even page reference);

– Refers to the accounting policies applied to the financial statements;

– Specifies the date or period covered by the financial statements.

Statement of responsibilities of management

– Preparation of the financial statements in accordance with the applicable financial reporting framework;

– Designing and implementing an effective internal control system to enable the preparation of financial statements that are free of material misstatement.

Statement of responsibilities of the auditors

– Express an opinion;

– The audit was conducted in accordance with ISA's;

– Requirement to comply with ethical standards;

– The fact that the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free from material misstatement;

– Audit involves procedures designed to obtain evidence about amounts and disclosures in the financial statements;

– The procedures are based upon auditor judgment, including a risk assessment and consideration of internal controls;

– Obtain sufficient, appropriate audit evidence on which to base the opinion.

Auditor's opinion (headed «Opinion»)

· When expressing an unmodified opinion the auditor (unless otherwise required by relevant laws or regulations) uses one of the following phrases:

– «the financial statements present fairly, in all material respects........»; or

– «the financial statements show a true and fair view of ....».

Auditor's signature

– The report may be signed in the name of the firm, or the personal name of the auditor, as appropriate for the particular jurisdiction;

– There may also be a requirement to state the auditor's professional accountancy designation or that the firm is recognised by the appropriate licensing authority (i.e. that the firm/partner is a member of a recognised supervisory body and is registered to audit).

Date of report

– The audit report should be dated no earlier that the date on which the auditor has obtained sufficient appropriate evidence upon which to base their opinion;

– This requires that all the statements and notes/disclosure that comprise the financial statements are finalised and that those with responsibility for preparation of the financial statements have acknowledged their role;

– Practically this means that the auditor should sign their report after the directors have approved the financial statements.

Auditor's address

– The audit report should name a specific location, which is normally the city where the auditor maintains the office that has responsibility for the audit.

a. Unmodified audit reports

When the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the Generally Accepted Accounting Principles (GAAP) and there are no additional matters to report they issue an ***unmodified audit report***.

It is the best type of report an auditee may receive from an external auditor.

An Unqualified Opinion indicates the following:

– The Financial Statements have been prepared using the Generally Accepted Accounting Principles which have been consistently applied;

– The Financial Statements comply with relevant statutory requirements and regulations;

– There is adequate disclosure of all material matters relevant to the proper presentation of the financial information subject to statutory requirements, where applicable.

!!! *US auditing standards require that the title includes «INDEPENDENT» to convey to the user that the report was unbiased in all respects.*

An example of a standard unqualified auditor's report is given below.

INDEPENDENT AUDITOR'S REPORT
(Appropriate Addressee)
Report on the Financial Statements

We have audited the accompanying financial statements of the ABC Company, which comprise the statement of financial position as of 31 December, 20XX, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements 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. 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 presentation of the financial statements.

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

Opinion

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

Auditor's signature

[Date of auditor's report]
[Auditor's address]

INDEPENDENT AUDITOR'S REPORT

Board of Directors, Stockholders, Owners,
and/or Management of
ABC Company, Inc.
123 Main St.
Anytown, Any Country

We have audited the accompanying balance sheet of ABC Company, Inc. (the «Company») as of December 31, 20XX and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in (the country where the report is issued). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in accordance with generally accepted accounting principles in (the country where the report is issued).

AUDITOR'S SIGNATURE
Auditor's name and address
Date = Last day of any significant field work
[This date should not be dated earlier than when the auditor has sufficient audit evidence to support the opinion].

b. Modified audit reports

!!! *If the auditor concludes that either:*
– the financial statements as a whole are not free from material misstatement;
– they have been unable to obtain sufficient appropriate evidence; or
– there are additional matters to report;
then they have to issue a ***modified audit report****.*
There are two ways the audit report may be modified:
– by **modifying the audit opinion***, or*
– through inclusion of additional paragraphs in the audit report.

Types of reports with modified opinions:
– Qualified opinion.
– Adverse opinion.
– Disclaimer of opinion.

Qualified Opinion report

Qualified report is given by the auditor in either of these two cases:
– When the financial statements are materially misstated due to misstatement in one particular account balance, class of transaction or disclosure that does not have pervasive effect on the financial statements.
– When the auditor is unable to obtain audit evidence regarding particular account balance, class of transaction or disclosure that does not have pervasive effect on the financial statements.

The report is mostly like a clear opinion report and only includes a paragraph viz. Basis for Qualification after Scope paragraph and before Opinion paragraph. Opinion paragraph in addition to its standard wording includes

«... except for the matter described in Basis for Qualification paragraph the financial statements give true and fair view.»

The two types of situations which would cause an auditor to issue this opinion over the Unqualified opinion are:

1. Single deviation from GAAP

This type of qualification occurs when one or more areas of the financial statements do not conform with GAAP (e.g. are misstated), but do not affect the rest of the financial statements from being fairly presented when taken as a whole.

Examples of this include a company dedicated to a retail business that did not correctly calculate the depreciation expense of its building. Even if this expense is considered material, since the rest of the financial statements do conform with GAAP, then the auditor qualifies the opinion by describing the depreciation misstatement in the report and continues to issue a clean opinion on the rest of the financial statements.

2. Limitation of scope

This type of qualification occurs when the auditor could not audit one or more areas of the financial statements, and although they could not be verified, the rest of the financial statements were audited and they conform to GAAP.

Examples of this include an auditor not being able to observe and test a company's inventory of goods. If the auditor audited the rest of the financial statements and is reasonably sure that they conform with GAAP, then the auditor simply states that the financial statements are fairly presented, with the exception of the inventory which could not be audited.

The wording of the qualified report is very similar to the unqualified opinion, but an **explanatory paragraph** is added to explain the reasons for the qualification after the scope paragraph but before the opinion paragraph. The introductory paragraph is left exactly the same as in the unqualified opinion, while the scope and the opinion paragraphs receive a slight modification in line with the qualification in the explanatory paragraph.

The scope paragraph is edited to include the following phrase in the first sentence, so that the user may be immediately aware of the qualification. This placement also informs the user that, except for the qualification, the rest of the audit was performed without qualifications:

*«**Except as discussed in the following paragraph**, we conducted our audit...»*

The opinion paragraph is also edited to include an additional phrase in the first sentence, so that the user is reminded that the auditor's opinion explicitly excludes the qualification expressed. Depending on the type of qualification, the phrase is edited to either state the qualification and the adjustments needed to correct it, or state the **scope limitation** and that adjustments could have but not necessarily been required in order to correct it.

For a qualification arising from a deviation from GAAP, the following phrase is added to the opinion paragraph, using the depreciation example mentioned above:

*«In our opinion, **except for the effects of the Company's incorrect determination of depreciation expense**, the financial statement referred to in the first paragraph presents fairly, in all material respects, the financial position of...»*

For a qualification arising from a scope of limitation, the following phrase is added to the opinion paragraph, using the inventory example mentioned above:

*«In our opinion, **except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to perform proper tests and procedures on the Company's inventory**, the financial statement referred to in the first paragraph presents fairly, in all material respects, the financial position of...»*

Adverse Opinion report

An adverse opinion report is issued on the financial statements of a company when the financial statements are materially misstated and such misstatements have pervasive effect on the financial statements.

In audit report after Scope paragraph but before Opinion paragraph, Basis for Adverse Opinion paragraph is added. In Opinion paragraph the wording changes to,

«Because of situations mentioned in Basis for Adverse Opinion paragraph, in our opinion the financial statements of XYZ Co. Ltd. as mentioned in the first paragraph does not give true and fair view/are not free from material misstatements.»

The wording of the adverse report is similar to the qualified report. The scope paragraph is modified accordingly and an explanatory paragraph is added to explain the reason for the adverse opinion after the scope paragraph but before the opinion paragraph.

However, the most significant change in the adverse report from the qualified report is in the opinion paragraph, where the auditor clearly states that the financial statements are not in accordance with GAAP, which means that they, as a whole, are unreliable, inaccurate, and do not present a fair view of the auditee's position and operations.

«In our opinion, because of the situations mentioned above (in the explanatory paragraph), the financial statements referred to in the first paragraph do not present fairly, in all material respects, the financial position of...»

Disclaimer of opinion report

A disclaimer of opinion is issued in either of the following cases:

– When the auditor is not independent or when there is conflict of interest.

– When the limitation on scope is imposed by client, as a result the auditor is unable to obtain sufficient appropriate audit evidence.

– When the circumstances indicate a substantial problem of going concern in client.

– When there are significant uncertainties in the business of client.

The audit report changes significantly when there is Disclaimer of opinion. An additional paragraph *«Basis for Disclaimer»* is added in audit report which is placed after Scope paragraph and before Opinion paragraph. In Scope paragraph the wording changes to *«We were engaged to audit the financial statements of XYZ Co. Ltd.»* from *«We have audited the financial statements of XYZ Co. Ltd.»*. In Opinion paragraph wording changes to *«We do not express an opinion on the financial statements of XYZ Co. Ltd. due to situations explained in Basis for Disclaimer paragraph»*.

!!! *A* ***disclaimer of opinion****, commonly referred to simply as a* ***Disclaimer****, is issued when the auditor could not form and consequently refuses to present an opinion on the financial statements. This type of report is issued when the auditor tried to audit an entity but could not complete the work due to various reasons and does not issue an opinion.*

The following is a draft of the three main paragraphs of a disclaimer of opinion because of inadequate *accounting records* of an auditee, which is considered a significant scope of limitation:

«We ***were engaged to audit*** *the accompanying balance sheet of ABC Company, Inc. (the «Company») as of December 31, 20XX and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management».*

«The Company does not maintain adequate accounting records to provide sufficient information for the preparation of the basic financial statements. The Company's accounting records do not constitute a ***double-entry system*** *which can produce financial statements».*

«Because of the significance of the matters discussed in the preceding paragraphs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion of the financial statements referred to in the first paragraph».

c. Going concern and auditor's report.

!!! ***Going concern*** *is a term which means that an entity will continue to operate in the near future which is generally more than next 12 months, so long as it generates or obtains enough resources to operate.*

Auditors are required to consider the going concern of an auditee before issuing a report. If the auditee is a going concern, the auditor does not modify his/her report in any way. However, if the auditor considers that the auditee is not a going concern, or will not be a going concern in the near future, then the auditor is required to include an explanatory paragraph before the opinion paragraph or following the opinion paragraph in the audit report explaining the situation, which is commonly referred to as the **going concern disclosure**. Such an opinion is called an «unqualified modified opinion».

The following is the most widely used format of the paragraph which, in this case, deals with a company that has recurring losses:

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note (X) to the financial statements, the Company has suffered recurring losses and has a net capital deficiency. These conditions raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note (X). The financial statements do not include any adjustments relating to the recoverability and classification of asset carrying amounts or the amount and classification of liabilities that might result should the Company be unable to continue as a going concern.

QUESTIONS FOR SELF-ASSESSMENT

1. What is audit report?
2. What is unmodified opinion?
3. What is modified opinion?
4. How is it necessary to write an audit report?
5. How is it possible to determine when an unqualified audit report isn't sufficient?
6. What types of audit reports can an auditor issue besides unqualified?
7. What should be included in an unqualified audit report?
8. How is it possible to assess going-concerns?

TASKS FOR SELF-ASSESSMENT

7.3. Read and decide if the following statements (1-3) are true or false.

1. In which of the following situations would an auditor ordinarily choose between expressing a qualified opinion or an adverse opinion? → A change in accounting estimate (such as a change in the useful life of a depreciable asset) is accounted for prospectively and does not affect the comparability of financial statements between periods. Since the auditor's standard report implies that consistency exists, no modification to the report is necessary.

a) True; b) False.

2. The auditor's standard report should include reference to the United States as the country of origin of:

I. The accounting principles used to prepare the financial statements.

II. The auditing standards the auditor followed in performing the audit. → Both I and II.

a) True; b) False.

3. An auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. If the entity's financial statements adequately disclose its financial difficulties, the auditor's report is required to include an explanatory paragraph that specifically uses the phrase(s): → Management's conclusion regarding whether substantial doubt remains or is alleviated.

a) True; b) False.

7.4. Choose the correct option (a, b, c or d).

1. No opinion. There is no info to make an opinion on:

a) adverse;
b) disclaimer;
c) standard unqualified;
d) qualified.

2. Not good, but minor mistakes:

a) standard unqualified;
b) adverse;
c) qualified;
d) disclaimer.

EXAMPLE DISENGAGEMENT LETTER

[Date]

BY CERTIFIED MAIL/RETURN-RECEIPT REQUESTED

Board of Directors
[Corporate Name]
[Corporate Address]
RE: Termination of Professional Services

Dear Board Members:

I am writing to give you formal notice that as of the date of this letter, the Firm will cease to render any professional services to the Corporation or its individual shareholders, including but not limited to bookkeeping, accounting and tax-related services. I regret that disengagement has become necessary, but conflicts within the Corporation's management and our inability to obtain cooperation from the Corporation on critical engagement issues have led to our decision.

We are not aware of any impending tax or financial reporting deadlines that the Corporation must meet. The shareholders, however, are on extension relative to their federal and state income tax returns. Those returns must be filed by [Date]. We urge that the shareholders promptly retain successor tax professionals in order to meet those filing deadlines.

We are currently in possession of the Corporation's original general ledger, cash journals, and schedules of aged accounts receivable and fixed asset depreciation. We will forward those original documents to you promptly under separate cover. We do not possess any other original documents of the Corporation or the shareholders.

I wish to call your attention to the Corporation's outstanding account with this Firm for past services rendered in the amount of _____________, which is currently past due. Termination of future services does not discharge the Corporation's obligation to make full payment of that past due balance. I would appreciate your prompt attention to bringing closure to that account.

If you wish this Firm to provide a successor accounting or tax professional with information concerning the Corporation and/or its shareholders, please provide me with a letter informing me of the precise information you wish us to produce. Upon receipt of your written request, we will, at a minimum, follow the standards of our profession in cooperating with successor professionals. Please be advised that if the Corporation has paid this Firm's fees in full, we will also consider those aspects of your request that exceed the minimum requirements of our professional standards.

Thank you, and please contact me with any questions you may have.

Very truly yours
[Engagement Partner]

Example Internal Audit Plan

Organization: ABC Company
Audit Date: 4/2/2011
Scope: Significant Energy Use-Melting Operations
Objective: Evaluate and determine the implementation and effectiveness of management of the Significant Energy Use-Melting Operations
Audit Team: Carol Brown (Lead); Dianna Johnson

Process or Area to be Audited	Start Time/ End Time	Auditor(s)	Requirements (Criteria) to be Audited	References
Energy Management Representative	1:30 – 2:30 PM	Carol	Energy Planning – process for determining significance, Energy Planning – objectives, targets, and action plans	Energy Planning Procedure Record of SEUs Objectives and targets setting
Human Resources (Training Coordinator and EHS Coordinator)	1:30 – 3:00 PM	Dianna	Competence, awareness and training	Training procedure Training records Awareness records Contractor training records Sign–in sheets Visitor and contractor video
Maintenance (Technicians) Melting Operations (Supervisors and Operators)	2:30 – 4:00 PM	Carol	Operational control and maintenance	PM System Melting Operations Procedures
Construction & Facilities Management Purchasing	3:00 – 3:45 PM	Dianna	Design and Procurement	Design process – Gate 2 and 3 Purchasing specs Supplier evaluation criteria
Melting Operations Management	3:45 – 4:30 PM	Dianna	Monitoring, measurement and analysis	Measurement plan 2011 Melter VI monitoring records and analysis records
Operations VP Plant Manager	4:00 – 4:30 PM	Carol	Management review	Management review records Management review procedure

AUDIT PROGRAM

Actuarial Reserves

W/P REF		DONE BY	DATE
	Objective Determine that Generally Accepted Accounting Principles (GAAP) and local statutory accounting (STAT) reserves are properly calculated.		
	Audit Procedures Gain a thorough understanding of the reserves process.		
	1. Determine the adequacy of operating procedures and the control structure over the actuarial system.		
	2. Verify the accuracy of in-force policies — policies that are currently paying a premium. Consider how in-force policy information, such as control totals, input/output controls, and investigation of fall-out or variances, get from the administration systems to the valuation systems. — Is the in-force data loaded into the valuation system a fresh snapshot of all the information in the administrative system as of the last day of the period, or is it just the net change — net increase/decrease — in information that is loaded? — Is there any manual input to valuation system or are manual adjustments made to the in-force policy data in valuation system? — Are input cutoff dates enforced? Evaluate the timing of transaction processing: What happens with transaction requests, such as surrenders, not takens, and claims that are received on the last day of the period that have not yet been processed?		
	3. Test the GAAP reserve calculation for two products using the assistance of an actuary. — Obtain the policy product description and reserve factor information. — Load this information into a different valuation system/model and compare this independent calculation to the one generated by the reserves calculated by the business line. — Investigate and explain any differences.		

W/P REF		DONE BY	DATE
	4. Using actuarial assistance, review actuarial assumptions and methodologies for appropriateness and reasonableness.		
	5. Ensure that any changes to GAAP assumptions and methodologies were properly approved. – Gain a thorough understanding of the change process. – Verify that all changes to assumptions were properly supported and approved by the local and chief actuary. – Test all changes for one period, such as a specific quarter or year.		
	6. Review the business unit's analysis of reserve trends for reasonableness. – With actuarial assistance, review the trend analysis performed by the local actuary. – Determine whether reasonable analyses are performed to validate that the business unit's current reserve calculation is acceptable. – Review for both local STAT and GAAP analysis. – Determine what steps the local actuary takes to ensure that the reserve calculation is accurate and that testing validation procedures are in place.		
	7. Review deferred acquisition costs for adequacy.		

INTERNAL AUDIT
(Audit Project Title & No.)
AUDITOR ASSIGNMENT & INDEPENDENCE STATEMENT

Government Auditing Standard 3.02 states:

« In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be free from personal, external, and organizational impairments to independence, and must avoid the appearance of such impairments of independence.»

International Standards for the Professional Practice of Internal Auditing Standard 1120 Individual Objectivity states:

Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest.

By my signature below, I acknowledge my assignment to the above project and profess I know of nothing that might impair my independence and impartiality on the project.

In-Charge Auditor: ______________________ **Date:** __________

Staff Auditor: ______________________ **Date:** __________

Supervisor: ______________________ **Date:** __________

Assignment Source:
Audit Type:
Audit Objectives:
Audit Scope:
Special Instructions:
Start Date: **Estimated Audit Completion Date:**

Audit Director's Verification of Auditor's Assignment & Independence:

I have assigned the above staff and have determined they are adequately skilled to work on the stated project. I am not aware of anything that might impair their independence and impartiality on the project.

Audit Director Signature ________________________ Date: _________

INTERNAL AUDIT OFFICE
MEMORANDUM

TO: Name, Director Department **DATE:**

FROM: Director
Internal Audit Office

SUBJECT: Audit of (insert area)

Internal Audit will be performing an audit of (function/department), which is scheduled to begin on (date). We tentatively plan to complete our fieldwork by (date). Our audit scope will cover the period (date) to (date), and may be changed after the survey is completed. The general objectives of this audit will be to evaluate compliance with organization policies and procedures; laws, regulations or guidelines. We will also evaluate internal controls. This audit will focus on applicable financial and performance issues.

To assist us with this audit, we would like to obtain some documentation prior to the start of fieldwork. Please provide the following documentation:

- All applicable laws, regulations, and guidelines
- Any policy memorandums or directives
- A copy of your operating procedures manual (if available)
- Current organizational chart
- Applicable Budget Goals and Objectives

Please feel free to designate key member of your staff whom the auditors may contact when requesting data. In addition, please arrange a workspace for the auditor(s).

Rest assured that inclusion of your department for audit on the Long-Range Audit Plan does not mean that something is wrong. Our office is responsible for examining and evaluating the adequacy and effectiveness of the organization's systems of internal controls and the quality of performance by county departments.

I have assigned the following audit staff to this project:

	Name	Phone #
Supervisor:	______________________	____________
Auditor In Charge:	______________________	____________
Staff Auditors:	______________________	____________

I have enclosed a brochure describing our audit process for your information. (Name of AIC) will be contacting you to arrange a convenient time for the Entrance Conference meeting. Should you have any questions before we meet, do not hesitate to call me at (insert contact information).

Prepared by: ______
Date: ____________
Reviewed by: _____
Date: ____________

INTERNAL AUDIT
(Audit Project Title & No.)
INTERNAL CONTROL QUESTIONNAIRE

Department:	Auditable Function:
Discussed with:	Date:

Question	Yes	No	N/A	Comments

PROJECT TITLE
CLIENT
WORKPAPER INDEX

W/P Reference

A. Audit Program --	
B. Survey Planning Memo --	
C. Program Descriptions And Funding --------------------------------	
D. Organization And Resources ---------------------------------------	
E. Budget Analysis --	
F. Financial Analysis (CAATTS, FAMIS, CAFR, etc.) -----------------	
G. School Board Actions, Issues, Interests ----------------------------	
H. Applicable Laws And Regulations ----------------------------------	
I. Significant Policies And Procedures ---------------------------------	
J. Professional And Performance Standards ---------------------------	
K. Other Audits And Studies ---	
L. Professional Audit Resource Materials -----------------------------	
M. Entrance Conference --	
N. Audit Notification Memo --	
O. Strategy Meetings ---	
P. Audit Assignment Form --	

EXIT CONFERENCE MEMORANDUM

PURPOSE: To document the exit conference.
SOURCE: Exit Conference

AUDIT TITLE	DATE:

INTERNAL AUDIT	
STAFF PRESENT	

AUDITEES PRESENT	
(Include Titles)	

OVERALL OPINION ON AUDIT DISCUSSED?	**YES____ NO ____**
EXPLAINED AUDIT RESOLUTION AND FOLLOW UP POLICY?	**YES____ NO ____**
OTHER CONCERNS OR COMMENTS DISCUSSED AT THE EXIT CONFERENCE:	

AUDITEE RESPONSE TO POTENTIAL AUDIT COMMENTS:

PAC #	AUDITEE RESPONSE

Prepared By:
Date:
Reviewed By:
Date:

COMPANY NAME
DEPARTMENT NAME
SUMMARY OF INTERVIEW

Individual Interviewed:

Title:

Agency/Division:

Time/Date of Interview:

Auditor:

Others Present At Interview:

Name:

Title:

Name:

Title:

Summary of Discussion:

Prepared: ____________
Date: ____________

PROJECT
OBSERVEABLE CONDITIONS

Purpose: Document an observation made during the course of the audit.

Procedure: Complete the following for each observable condition.

1. Observed Condition: **W/P Ref.**		
When was the observation made?		
Where was the observation made?		
What was observed?		
What is implication of this observation?		

What is done?		
Who does it?		
Why is it done?		
How is it done?		
Where is it done?		
When is it done?		
How is it monitored?		
How much does it cost?		

Source:

REVIEW POINT SHEET

(Insert Project No. & Title)

Auditor:________________________Reviewer:____________________

Date: _________________________ Page ______of _____

Point # & Page #	Reviewer Points	Resolution

Prepared By: ________
Date: ________
Reviewed By: ________
Date: ________

(EXAMPLE)
PROJECT NAME AND NUMBER
SURVEY PLANNING MEMO

Background

This paragraph provides background information on the audit area including statistics. The background information will be appropriate for use in the audit report.

Recommended Survey Areas (Audit type, scope, objectives, & methodology)

I recommend that we conduct a review of internal controls over the (project area), to include controls over the (appropriate functions) because:

- It is a significant amount of revenue, i.e. over $100 million annually.
- This is a major change in the organization and process.
- It appears that little attention has been specifically directed toward internal controls in the new processes.
- This is a very significant part of the (insert department) involving complex and diverse practices as well as coordination between (departments).
- This is one of many efforts on the (position title) part to improve customer service and we can contribute by assuring that proper controls and procedures are not lost in the process.

Our audit objective should be the traditional approach of determining if internal controls over the new processes for the (audit area) are adequate to provide reasonable assurance that:

- objective 1
- objective 2
- objective 3
- objective 4

The suggested methodology is a combination of flowcharting of the processes and the use of the documentation worksheet. This worksheet includes documentation of control objectives, risks if objectives are not achieved, control techniques, and the auditors evaluation of the control.

At the conclusion of the survey an evaluation of whether or not there appears to be any material weaknesses or other issues that would warrant or necessitate continuing on with the fieldwork that would involve testing of the controls.

Approved: ______________________

Date: ______________________

THIS IS AN EXAMPLE OF A SURVEY PLANNING MEMO TO BE PREPARED AT THE CONCLUSION OF THE PLANNING PHASE

KNOW YOUR READER

1. Define who the reader(s) of your report is. (Position, Title)

____

2. How familiar is the reader with the subject?

3. What amount of explanation or background does the reader need?

X Detailed procedures or history
X Definition of terms
X Overview of the subject

4. What is your purpose in addressing this reader?

X Inform or Provide Requested Information
X Get Action
X Summarize Results
X Present Detailed Results

5. How will the reader use this information?

X Gain an understanding
X Make a decision
X Implement a procedure

6. What is the reader's likely reaction?

X Accepting
X Resistant
X Skeptical
X Sensitive or defensive

7. What opposition does the reader have to your ideas?

8. On what basis is the reader likely to react positively?

9. What is the reader's communication style?

Comptroller of Public Accounts Form 01-339 (Rev. 6-04/5)

TEXAS SALES AND USE TAX RESALE CERTIFICATE

Name of purchaser, firm or agency	Phone (Area code and number)
ABLE CONTRACTORS	713/864-1211

Address (Street & number, P.O. Box or Route number)
P. O. BOX 1234

City, State, ZIP code
HOUSTON, TEXAS 77008

Texas Sales or Use Tax Permit Number (or out-of-state retailer's registration number or date applied for Texas Permit - must contain 11 digits if from a Texas permit)

1 2 4 6 8 0 1 3 5 7 3 (Mexican retailer must show their Federal Taxpayers Registry (RFC) number on the certificate and give a copy of their Mexican registration form to the seller.)

I, the purchaser named above, claim the right to make a non-taxable purchase (for resale of the taxable items described below or on the attached order or invoice) from:

Seller: ABC SERVICES, INC.

Street address: 1212 GIBSON LANE

City, State, ZIP code: HOUSTON, TX. 77043

Description of items to be purchased on the attached order or invoice:

Repair of air conditioning unit of restaurant

Description of the type of business activity generally engaged in or type of items normally sold by the purchaser:

Repair of commercial real property

The taxable items described above, or on the attached order or invoice, will be resold, rented, or leased by me within the geographical limits of the United States of America, its territories and possessions, or within the geographical limits of the United Mexican States, in their present form or attached to other taxable items to be sold.

I understand that if I make any use of the items other than retention, demonstration or display while holding them for sale, lease or rental, I must pay sales tax on the items at the time of use based upon either the purchase price or the fair market rental value for the period of time used.

I understand that it is a criminal offense to give a resale certificate to the seller for taxable items that I know, at the time of purchase, are purchased for use rather than for the purpose of resale, lease, or rental and, depending on the amount of tax evaded, the offense may range from a Class C misdemeanor to a felony of the second degree.

sign here ▶ Purchaser	Title	Date
Robert Able	PRESIDENT	17-Sep-06

This certificate should be furnished to the supplier. Do **not** send the completed certificate to the Comptroller of Public Accounts.

CREDITOR'S CONFIRMATION

REQUEST FOR CONFIRMATION OF ACCOUNTS PAYABLE
(Prepared on client's letterhead)

(Date)
(Name and address of vendor)

Dear___________:

Our auditors (insert name and address of auditors) are conducting an audit of our financial statements as of (insert date) and for the (insert period [e.g., year, quarter]) then ended. Please confirm directly to them the amount of our liability to you as of (insert date). If there is a balance due, please attach a statement of the items comprising such balance. If no balance is due, please indicate this by checking the appropriate box below.

After checking the appropriate response below, please sign and date your reply and mail it directly to our auditors in the enclosed return envelope.

Thank you for your anticipated timely cooperation with this request.

Respectfully,
(Name of client)
(Client's authorized signature and title)

****

TO: (Insert auditor's name)

( ) Our records indicate that a balance of $_______ was due from (insert name of client) as of (insert date), as shown in the attached statement.

( ) Our records indicate that no balance is due from (insert name of client) as of (insert date).

Signature: ______________________________
Title: ______________________________
Date: ______________________________

COMPTROLLER OF PUBLIC ACCOUNTS

P.O. BOX 13528
AUSTIN, TX 78711-3528

January 31, 2007

David L. Smith
President
ABC Services, Inc.
1212 Gibson Lane
Houston, Texas 77043-2468

RE: Taxpayer Number 12345678903

Dear Mr. Smith:

Our audit, conducted in accordance with the provisions of the state and local sales tax statutes as administered by the Comptroller, is complete. The audit covered the period January 1, 2004 through December 31, 2006, and resulted in an adjustment in the amount shown on the attached Texas Notification of Audit Results. We have included a pre-addressed envelope for your payment convenience. For an explanation of the interest calculations, contact the Audit Processing Section of the Audit Headquarters Division at 1-800-531-5441, extension 3-4479.

After a careful examination of your account, we have denied waiver of penalty and interest. If you disagree with our decision, you may request a redetermination hearing by our Legal Services Division.

Adjustments are explained on the enclosed Audit Report.

At the exit conference, I gave you the brochure "What If I don't agree with the results of my audit?" (96-129) and advised you of the requirements necessary to initiate a redetermination hearing. You indicated your agreement with the audit results.

If you have any questions, please contact me in the Houston South Audit Office at 713/6651200. Thank you for your cooperation during the audit.

John A. Smith
Auditor

AUDIT REPORT

ABC CORPORATION
Taxpayer Number 12345678901
April 1, 1998 through December 31, 2001

This report summarizes the adjustments made in the audit.

1. A detail examination was completed for Exam 001. Adjustments were made for additional taxable sales.

2. A sample and projection was completed for Exam 002. Adjustments were made for items taken out of inventory and used in a taxable manner. For specifics, refer to the Notification of Sampling Procedures for State Tax Audit for this exam.

ABC Services
Houston, Texas
TP#: 12345678903

INDEX TO WORKING PAPERS

AMENDED AUDIT REPORT

ABC CORPORATION
Dallas, TX
TP# 12345678901

This audit was amended to delete non-taxable sales of items that were sold for resale. Resale certificates were presented to the auditor to support these changes. Also, purchases of items on which tax was paid were deleted from Exam 2. Additional documentation was presented by the taxpayer to support these changes.

John Smith
Auditor
Current Date

Should match the XISUMM address

To: Mary Jones – President
925 Jones St.
Fort Worth, TX 72222

CC: Bob Hart - CPA
123 Ross Ave
Fort Worth, TX 72222

REFERENCES

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