Course Name	: Audit Practice and Procedures
Course Code	: APBBS 302
Course Level	: Level 3
Credit Unit	: 4 CU
Contact Hours	: 60 Hrs

Course Description
The Course details different definitions, scope and purpose of auditing, audit appointment process, internal control systems with in an organization, process of planning and audit, having an audit evidence, as well as understanding working papers.

Course Objectives
- To help students develop skills in evaluating different internal control systems of the organization.
- To enable them access knowledge and skills of developing an audit plan.
- To help students develop the idea of analyzing and interpreting several audits.
- To assist students learn the different theories of constructing an audit plan or procedure.

Course content
Introduction
- Definition of an Audit
- Reasons for performing an audit
- Scope of an external audit
- Types of audits
- Auditing regulatory frameworks
- Eligibility to conduct company audits
- Categories of Auditing Practice Board (APB)
- Accounting Vs Auditing

The Audit Appointment Process
- Client screening
- Before accepting information
- Communicate with present auditors
- Present auditors

Internal Controls
- Definition of internal control systems
- Reasons for need of internal controls
- Understanding the system
- Documenting the system
- Methods of ascertaining the system

Planning the Audit
- Typical planning procedure
- The overall audit plan
- Developing the audit plan to meet the audit objectives
- Definition of audit risk in relation to planning
- Form of audit risks

Audit Evidence
- Definition of audit evidence
- Factors that constitutes sufficient appropriate evidence
- Relevance of audit evidence
- Different techniques of gathering audit evidence
- Analytical procedures as substantive procedures

Working Papers
- Definition of working papers in auditing
- Contents of working papers
- Standardization of working papers
- Advantages of standardized papers

- Form and control of working paper
- General guidelines that are followed in preparation of working papers
- Confidentiality, safe custody and ownership of working papers
- Permanent file
- Contents of a typical permanent audit file

Mode of delivery Face to face lectures
Assessment
Coursework 40%
Exams 60%
Total Mark 100%

What is an audit?
An independent examination of the financial statements of an enterprise where such an examination is conducted with a view to expressing an opinion as to whether those statements give a true and fair view.

Why auditing
It was recognised that whenever a fiduciary relationship with the financial implications existed there was need for an outsider with sufficient independence and objectivity to review the accounts of stewardship and to express an opinion as to their honesty or otherwise. For example, audit of financial statements of a company to show how the directors have dealt with the assets of the company on behalf of the shareholders. The companies Act 1948 together with subsequent Acts emphasise the compulsory audit requirement including the recognised professional qualification, duties, powers, responsibilities and minimum disclosure levels by auditors.

Auditing is a very old profession, and the role of the auditor has changed since it originated, from a reviewer of simple accounts, to a role with a strong emphasis on the detection of fraud, to its current state of expressing an opinion on the truth and fairness of a company's financial statements.

Assignment
Read and make notes on the development of auditing.

The purpose of external audit
All users of financial statements have an interest in the state of the company's financial affairs. An independent audit fulfils the need to ensure that those financial statements are objective, free from bias and manipulation and relevant to the needs of the users.

Main reasons for performing an audit;
1. To fulfil a company requirement (legal requirements as per companies Act.)
2. To identify any material weaknesses in the accounting and internal control system and make recommendations for their improvement
3. Audited financial statements are a basis when soliciting credit financing
4. In case of business purchase, combinations or amalgamations the audited values of assets and liabilities are more reliable
5. A satisfactory audit report can be used to provide evidence of a well run business for the interest of stakeholders
6. Disputes between management are more easily settled; for instance profit sharing arrangements.

Disadvantages of an audit

1. High audit fees

The accountant may be involved in the preparing of financial statements or as a tax adviser or general
financial adviser. Since fees are based on time necessarily spent and personnel engaged, the fees are
high for sole traders and partnership

2. Disruption the audit work causes to staff and management of the client in giving time to provide information.

Scope of external audit

No audit is identical to any other however; a number of stages can be identified.

1. Planning of the audit

Assessing the accounting and internal control systems and audit risk assessment
At this stage the auditor makes a preliminary evaluation of the enterprise's internal controls

a) If the controls are likely to lead to a true and fair set of financial statements (strong) the auditor will test those controls (compliance testing/reliance approach)
b) If the controls appear weak, he will carry out extensive testing of the transactions and balances which appear in the financial statements.
c) If the controls are not operating currently the auditor takes on a substantive approach.

2. Consideration of the ways in which audit evidence can be sought
    - Testing of internal controls tests of control
    - Extensive testing of transactions and balances 'substantive procedures'

1. Finally the auditor will review the financial statements as a whole and formulate an audit opinion.

TYPE OF AUDITS

1. Year end audits
2. Interim and final audits

Interim stage - planning and tests of controls
Final state - substantive balance sheet audit

3. Continuous audits - for large clients.

The audit report lends credibility to the accounts since it is the opinion of an independent expert (the auditor). So third parties can rely on the accounts

AUDITING REGULATORY FRAMEWORK

Of the accounting professional bodies the following qualify in a practising firm and once a practising certificate is gained they can audit limited companies;

1. ACCA (Association of Chartered Certified Accountants)
2. ICAEW (Institute of Chartered Accountants in England and Wales)
3. ICAS (Institute of Chartered Accountants of Scotland)
4. ICAI (Institute of Chartered Accountants in Ireland)

Eligibility to conduct company audits;

1. Membership of a recognised supervisory body (RSB)
2. Eligibility under the rules of the RSB

RSB is a body, which exists to ensure that its members comply with their rules and thereby ensuring that all audits are performed to a satisfactory standard by qualified persons. The above professional boddies comprise the RSB.

Rules and practices of RSBs must be such that the following criteria are satisfied;

1. Only fit and proper persons can be appointed as company auditors

An auditor may be an individual, a firm or a body corporate (where 15% of the ownership and control is in the hands of qualified persons.)

2. The company audit work is conducted properly and with integrity;
    - High standards of performance
    - Compliance with statements of auditing standards
    - General ethical standards
    - Procedures to maintain competence, ensure compliance, monitoring and enforcement

Auditing Practice Board (APB)

It replaced the auditing practices committee (APC) who produce Auditing Standards and Guidelines.

It is different from APC in that its non-practitioner members (lawyers, industrialists, academics) have voices on the board and the board can issue standards in its own right without CCAB having to veto the issue of standards.

Categories of APB guidance

a) Statements of auditing standards (SAS's)

These contain the basic principles and essential procedures with which auditors are expected to comply.

To a greater extent, they agree with international standards on auditing but where there is conflict

UK standards prevail.

b) Practice Notes (PNs)

Give guidance to assist auditors in applying auditing standards in particular circumstances and industries.

c) Bulletins: Provide auditors with timely guidance on new or emerging issues.

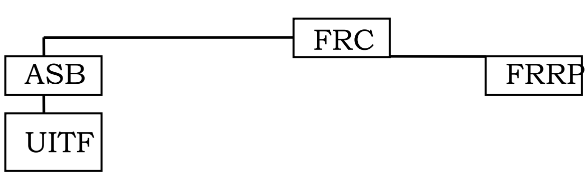
Statement of standards for reporting accountants (SSRA)

This is currently only one dealing with the reporting requirements of smaller companies that are exempt from the audit requirements.

The auditing profession is regulated by the APB guiding its members' activities through the publication of

- SASs
- PNs and
- Bulletins

The accounting standards setting process



a) The Financial Reporting Council FRC)

Comprises around 25 members who are users, prepairs and auditors of accounts

It is responsible for guiding the ASB on its planned work programme

b) The Accounting Standards Board (ASB)

Has about 9 members and issues Financial Reporting Standards (FRSs)

c) The Financial Reporting Review Panel (FRRP)
Has about 15 members
Is concerned with the examination and questioning of departures from accounting standards
Has authority to take companies to court to force them revise defective accounts.

d) The urgent issue task force (UITF)
Covers urgent matters not covered by the existing accounting standards and the normal standard-setting process is not practicable.

Accounting Vs auditing
Although the auditing progression is regulated by the APB the auditor must ensure that he maintains an independent knowledge of accounting standards and their application because he is primarily concerned with the end result of accounting - whether proper books of accounts have been kept, consistent and appropriate accounting policies were adopted and whether the financial statements comply with legislative requirements and accounting standards.

Other influences
e) The government
Overseas the auditing and accounting profession by financing statutes and regulations within which the auditor must work. Self regulation for auditors was sanctioned by government in the recognised supervisory body and recognised qualifying bodies.

f) Department of trade and industry (DTI)
Monitors the auditing profession

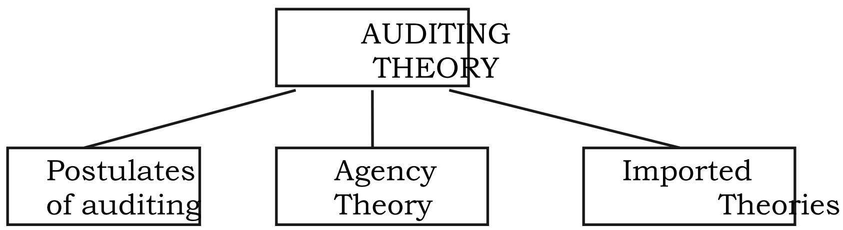
g) EC and European Directives
The Directives have an impact an audit practice for example the proposed voluntary community environmental auditing scheme.

b) International Auditing Bodies
The international federation of accountants (IFAC) publishes international standards on auditing (ISAs)
The FEE (Federation des Experts Compatibles Europeans) attempts to co-ordinate the activities of European accounting bodies.

Conclusion:
The main influences on the auditing profession are:

- The companies Acts legislation
- The auditing profession through the APB
- The accounting profession through FRC and its sub-bodies
- The government
- The DTI
- The EC and European directives
- The international auditing bodies

Question
Given that directors have to ensure that fixed assets are correctly recorded, adequately secured, properly maintained, appropriately depreciate and written down where necessary and acquisitions and disposals are properly authorised. What types of controls would you expect to find in such a setting.



Postulates of auditing
Auditing theory supports and justifies practice. Postulates of auditing originally laid down by <u>Martz</u> and <u>Sharat</u> and subsequently developed.

Definition
Postulate: Something which is assumed to be true as basis for an argument, something taken for granted. There are no means of directly verifying or proving postulates and they represent “facts of life” which cannot be further reduced and which must be accepted in order to operate in the field.

If the auditing postulates are not true, then auditing as a discipline has no defence because certain issues cannot be resolved (such as independence)

Mautz and Sharaf: the eight postulates

a) Financial statements and financial data are verifiable
b) There is no necessary conflict of interest between the auditors and the management of the enterprise under audit
c) The financial statements and other information submitted for verification are free from collusive and other unusual irregularities
d) Consistent application of generally accepted accounting principles (GAAP) results in the fair presentation of financial position and the results of operations.
e) In the absence of clear evidence to the contrary, what has held true in the past for the enterprise under examination will hold true in the future.
f) When examining financial data for the purpose of expressing an independence opinion thereon, the auditors act exclusively in the capacity of audit
g) The professional status of the independent auditors imposes commensurate professional obligations.

These postulates have been developed and refined, but their basic premise remains unchallenged.

1. **Financial statements and financial data are verifiable**

This postulate appears to be reasonable and also very practical. If this postulate was not true, then no audit could ever take place, because it represents the fundamental purpose of an audit. There are circumstances of course, where this postulate is discovered to be untrue, or at least it is not operating, when the accounts and systems concerned are too unreliable or inadequate. This situation usually leads to a qualified audit report, the qualification stating that the auditors are unable to form an opinion on the truth and fairness of the financial statements (Called a disclaimer of opinion).

Even in the situation described above, the initial assumption is that the postulate holds true. The main reason that it does hold true most of the time is that there are external pressures on the business to keep a good system of control, producing auditable accounts. Such pressures come from banks, investors, creditors and other invited parties and it is formalised in company acts.

2. **No necessary conflict of interest between auditors and management.**

The postulate assumes that auditors and managers are working together towards the same goal of producing a true and fair set of accounts. Conflicts which arise are part of the normal relationship, such as:-

a) Honest disagreements over, say, the application of an accounting policy
b) Profit related pay, or similar situations, leading managers to manipulate figures to increase their remuneration.
c) Management fraud.

3. If the auditors cannot rely on the representation, explanations and so on given by the managers, then they may be unable to form an opinion, unless other evidence is available.

4. Financial statements free from irregularities

This assumption is the basis for the sampling techniques used by auditors, where a relatively small sample is collected, after using statistical methods, from a much larger' population. The audit approach which reviews the system of internal controls and tests for weaknesses in the system allows statistical sampling to be used. If it was assumed that irregularities both collusive and non-collusive, exist then the sample sizes would be increased to unmanageable levels, increasing the cost of the audit. Managers and auditors would also come into conflict, and this would cause the problem.

There is a move in modern auditing away from this postulate and towards recognition of the possibility of material fraud. This recognised that auditors should carry out their work with the expectation of discovering and material misstatement.

Although in an ideal environment this postulate should hold true, no system can be 100% effective and so reduces might be a better word that eliminates". A good system of internal control should reduce the probability of loss of assets, error, collusive, irregularities, manipulation of results and management override of controls.

5. Application of GAAP results in fair presentation

It is not enough to say accounts show a true and fair view. A bench mark must be provided to aid the auditors, and this is provided by GAAP (Generally Accepted Accounting Practice).
UK GAAP consists of SSAPs, FRS and company law since compliance with a standard may occasionally to a result which is not true and fair, the consistency concept steps in. The appropriate policy should be applied consistently to show a true and fair view. Without this guidance, auditors opinions would become so subjective and personalised that they would become useless.

6. What has held true in the past will hold true in the future

This extends the going concern principle as it relies on the accuracy of forecasting and the consistency of decisions by management over a number of years. If it did not hold true, then it would be impossible to rely on trends in the accounts and inter-temporal analytical review procedures (comparing results year to year would become meaningless. The audit procedures to compensate for this loss would be onerous. Including full and long examinations of post balance sheet events. It might even leave the audit open ended until the next audit took place. This is important in the context of representations from management. Particularly from small businesses as any other evidence will be rare, apart from analytical procedures.

7. The auditors act exclusively in the capacity of auditor

This postulate focuses on the independence of the auditors, but it appears to be expressing an ideal which is not met in practice. Large accountancy firms, provide taxation, consultancy and corporate finance services to audit clients (remember that they cannot provide accountancy services to public companies). Small audit firms provide accountancy and taxation services to audit clients. Such audit firms may not see this as a problem affecting independence, but criticism from outside the profession has focused on this issue.

8. The professional status of the independent auditors imposes commensurate professional obligations.

This postulate underlies the concept of due care. It implies that auditors will maintain a standard of professional efficiency and put service before personal interest. As under any sale of services, the buyer is entitled to a good product for his money. The auditors can ensure this by, for example, keeping up to date with technical issues, but there is no absolute definition of what constitutes reasonable care and skill. The cost of negligence is high.

SAS 2002. The matters which should be considered include the following

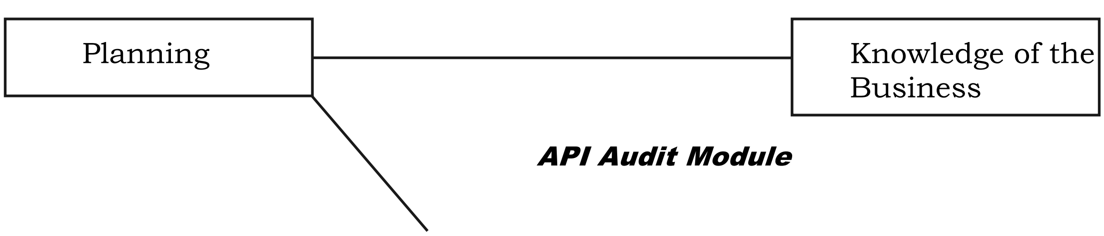
⇨ Knowledge of the entity's business
- Economic factors/industry conditions
- Important characteristics of the entity
- Operating style/control consciousness of directors
- Auditors cumulative knowledge, expected changes

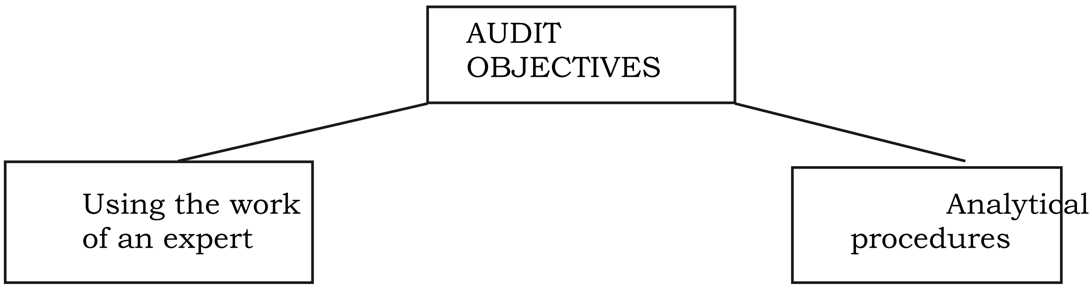
=> Risk and materiality
- Setting materiality for audit planning
- Assessment of risks errors, significant audit areas
- Indication of misstatements (Fraud)
- Complex accounting areas (Accounting estimates)

⇨ Nature, timing and extent of procedures
- Tests of controls Vs substantive procedures
- Use of IT by entity auditors
- Work of internal auditors
- Procedures at/before year end

⇨ Co-ordination, direction, supervision and review
- Involvement of other auditors
- Involvement of experts
- Number of locations
- Staffing requirements

⇨ Other materials
- Regulatory requirements
- Going concern matters
- Terms of engagement, statutory responsibilities
- Nature, timing of reports, communication etc





Planning

SAS 200 planning states that auditors should plan the audit work so as to perform the audit in an effective manner (SAS 2001).

Objectives of audit planning are:-

- Appropriate attention is given on different audit areas
- Potential problems identified
- Facilitate review

SAS 200 looks at recurring audits. For new audits, the procedures below should be extended.

Distinguish between:-

- Overall strategy: audit plan
- Detailed procedures: The audit programme.

Considerations which are relevant in deciding whether a client is high risk include:-

i) Evidence of client engagement in fraudulent or illegal activities.
ii) The state of economic sector in which client operates (A depressed sector may indicate risk)
iii) The nature of the industry and client product lines, for example the building industry or fashion industry which are volatile
iv) The clients previous audit history (frequent changes of auditors and qualified reports are obviously bad news.
v) The general abilities of the client management

THE AUDIT APPOINTMENT PROCESS

CLIENT SCREENING

When a potential client approaches an auditor asking him to conduct an audit, the auditor will need to consider legal requirements and ethical considerations (where the potential client has previously had an auditor) when deciding whether or not to accept the potential client as a client.

Auditing standards require auditors to obtain a knowledge of the clients business, sufficient enable them to identify and understand those issues that may have a significant impact on the financial statements.

The knowledge is obtained both before accepting the client and after and should cover the following areas.

a) Industry conditions affecting the client business

b) The entity itself
c) The entity's products, market, suppliers, expenses, and operations
d) The entity financial performance and condition
e) The reporting environment

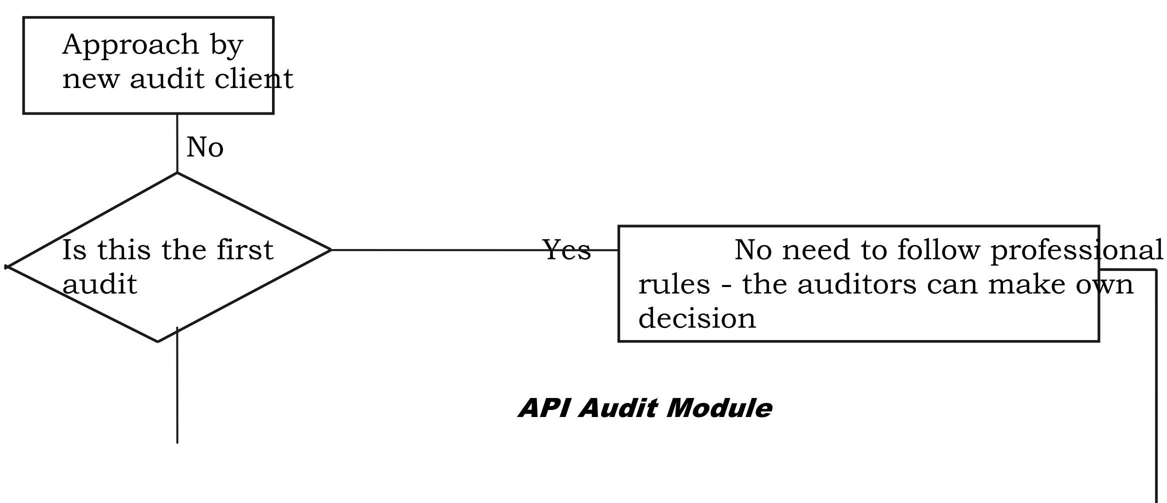
Risk
Client screening procedures are designed to screen out potentially risky audit clients. A risky client is one which may result in costs exceeding the audit fees due to the extra work that the auditors would need to perform to satisfy his objectives and give this audit opinion. Costs need to be viewed in their widest context e.g if the client ends up suing the auditor for negligence, the auditor will incur costs in defending the action and his reputation will be damaged, particularly if a number of clients are pursuing negligence claims.

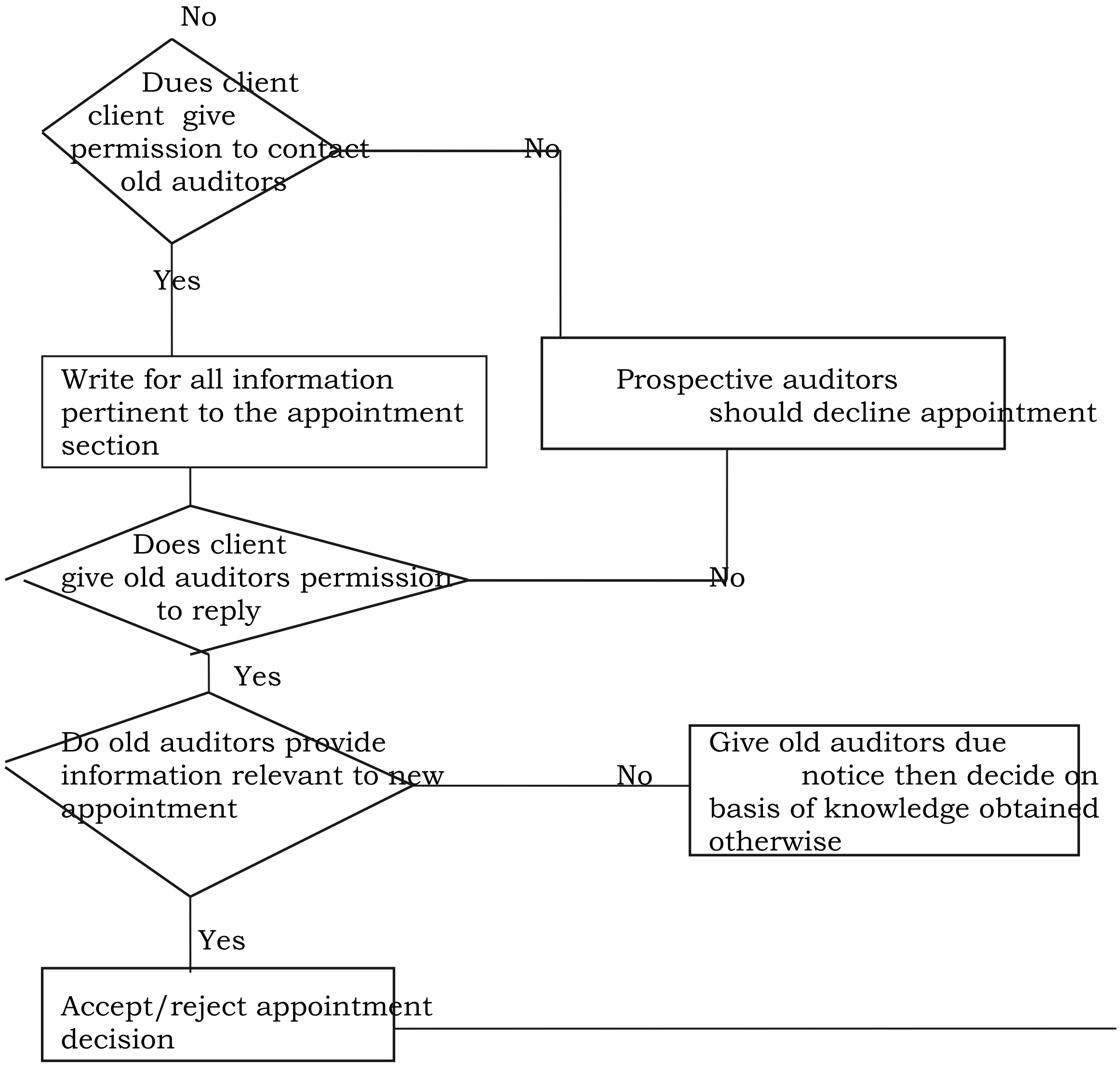
The Audit appointment process

New audit engagement
There are additional audit considerations when a new audit client is obtained
⇨ Before accepting nomination
- Ensure properly qualified to act i.e independent, competent
- Ensure firms resources are adequate to service clients needs i.e staff, expertise, time
- Obtain references in respect of new client, e,g Dun P Bradstreet and assess risk
- Communicate with present auditors

Communicate with present auditors
Rules of professional conduct statements 5 changes in professional appointment.
- Obtain clients permission to communicate with present auditors if refused decline nomination
- Write to auditors requesting information which may help decision whether to accept nomination

Present auditors
On receiving the above request the present auditors should:-
- Request clients permission to discuss affairs freely
- If refused inform proposed new auditors (who should decline nomination)
- Discuss freely all relevant matters





A working paper for the audit file to be used by he audit partners in deciding whether or not to accept an audit client. Consideration should be given to the following factors

i) legal
ii) ethical
iii) practical

Legal

The CA 1985 prohibits officers or servants of the company or partners or employees of an officer or servant of the company from accepting the position of auditors to the company.

The auditor must be a member of a recognised supervisory body (RSB) and eligible under the rules of that body. An RSB must only deem persons eligible for appointment who are

- appropriately qualified
- a member of a firm controlled by a qualified person

Ethical

If the fees from this appointment would exceed 15% of the gross fees of the practice (other than new practices) then the appointment should not be accepted.

Any personal relationship (kinship, friendship or mutual business interest) with an officer or employee of the company would be considered unethical. Any financial involvement with the company such as a shareholding or a loan to or from the company would also be regarded as unethical.

INTERNAL CONTROLS

Definition of internal control system

Defines the internal control system as comprising the control environment and control procedures. It includes all the policies and procedures adopted by the management of an entity to assist in their objective of achieving, as far as practicable, the orderly and efficient conduct of the business, including adherence to management policies, the safeguarding of assets, the prevention and direction of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

Control environment means that overall attitude, awareness and actions of directors and management regarding the internal control system and its importance to the entity. It encompasses management style, corporate culture, values, philosophy and operating style, the organisational structure, personnel policies and procedures.

Personnel policies and procedures, for example, would include those covering recruitment, retention and dismissal. The organisation structure should have clear lines of reporting responsibility and the maintenance of an internal audit function and audit committee demonstrates a commitment to high level controls. The use of management accounts for the purposes of variance analysis is also a high level control.

The control environment provides a background to detailed control procedures. It does not of itself, of course, ensure the effectiveness of the internal control system as a whole.

Control procedures are those established to achieve the entity's specific objectives. These objectives in an accounting context include the proper authorisation, timely and accurate recording of transactions in the correct period, the safeguarding of assets and ensuring the existence of assets recorded. They include particular procedures to prevent, detect and correct errors. They differ from entity to entity and are affected by the size of the entity.

In practice, the choice of controls may reflect a comparison of the cost of operating individual controls against the benefits expected to be derived from them.

Many of the internal controls which would be relevant to the large enterprise are not practical, appropriate or necessary in the small enterprise. Managements of small enterprises have less need to depend on formal internal controls for the reliability of the records and other information, because of their personal contact with, or involvement in, the operation of the enterprise itself.

2. **Why do companies need internal controls?**

Companies need internal controls to stop things going missing and to make some sense of how the business is doing. Documents get lost and assets go home with the staff even where there are controls in place to record everything. Managers have a gut feeling for how the business is doing, but when all they have to prove it is three large boxes stuffed full of invoices and two large boxes full of expenses (and neither of these are quite complete), they may find it difficult to prove their ideas to the taxation authorities, and of course they may well be very wrong.

Documents are batched and pre-numbered so that once can check that they are all there. If some sales invoices have gone missing we may not be collecting what is owed to us. This means that our cash flow suffers and we cannot pay our debts. It also means that our financial statements may be wrong. If our financial statements understate our income we will find it more difficult to obtain finance from the bank we will appear less attractive to investors. If our purchase invoice go missing, or we do not match goods received notes to invoices at the period end in order to arrive at a goods received not invoiced figure, matters are even worse. We think we are making good profits but we are not. We spend money that is owing to creditors and when they present their final demands we have no cash and they threaten to put us into liquidation. Business goodwill is damaged. We then have to adjust profits downwards and we are accused of misleading the bank about our profits in order to obtain finance.

But what is the amounts involved are small? Does one invoice really matter? Experience shows that if one invoice has gone missing it is highly likely that several more are also missing, and the larger the organisation gets, the bigger the numbers get, and the tighter the controls have to be prevent significant errors.

Why so many authorisation controls? In order to allocate responsibility and deal with everyday problems. If fifteen people are involved in the processing of one invoice and something is badly wrong with it, there has to be a mechanism to show that the error occurred at a particular stage. If we do not this, errors continue to happen, no-one takes responsibility and the organisation gets a reputation for inadequate administration and inefficiency, and frauds become possible. Say for example, a clerk routinely authorises a false purchase invoice raised by a friend outside the company. The company pays the invoice and the clerk and his friend share the proceeds. This is a very common type of fraud. Controls to prevent this require payments to be authorised only with reference to purchase invoices that are attached to goods received notes, or authorisations for the receipt of services by managers completely unconnected with the accounting function.

State that internal controls within an accounting system are needed to ensure that:

a) transactions are executed in accordance with general or specific authority
b) all transactions are recorded at the correct amount in the correct account in the proper period so as to permit the preparation of financial statements
c) access to assets and records is authorised.
d) recorded assets are compared with existing assets periodically and appropriate action is taken with regards to differences.

At an early stage in his work the auditor will have to decide the extent to which he wishes to place reliance on the internal controls of the enterprises. As the audit proceeds, that decision will be kept under review and, depending on the results his of his examination, he may decide to place more or less reliance on these controls.

The principal reason why internal control interests the auditor is that the reliance of the accounting records. If the auditor is satisfied that the internal control system is functioning, there is therefore a reduced risk of error in the accounting records.

The operation of internal controls should ensure the completeness and accuracy of the accounting records. If the auditor is satisfied that the internal control system is function, there is therefore a reduced risk of error in the accounting records.

It is very important to the auditor therefore to establish what internal control system exists and then to test that system to ensure that it is working properly.

Another reason that the auditor needs to consider the adequacy of the accounting system is that the auditor usually has an additional responsibility under legislation to form an opinion as to whether proper accounting records have been kept. This implies the operation of a sound system of internal control.

By recording the accounting system and checking its operation by tests of control, the auditor can reduce the amount of substantive procedures. The total amount of work is reduced as a result.

Specific control procedures

The include;

a) Reporting, reviewing and approving reconciliation
b) Checking the arithmetical accuracy of the records

Such controls include checking the casts on a purchase invoice, and recalculating the sales tax on sales invoices.

c) Controlling applications and the environment of computer information
d) Maintaining and reviewing control accounts and trial balances

Control accounts include receivables and payables ledger control accounts, bank reconciliations and non-current asset registers.

e) Approval and control of documents

In a purchase system for example, there should be present authority limits. An order up to the value of $1,000 could be approved by a department head, up to $5,000 by any one director, and beyond this by the Board as a whole.

f) Comparing internal data with external sources of information

This might include supplier statement reconciliation

g) Comparing the results of cash, security and inventory counts with the accounting records

An important general principle with respect to assets and records is that segregation. In particular there should be a division of responsibilities for:

i) authorising or initiating the transactions:
ii) the physical custody and control of assets involved
iii) recording the transaction

No one person should be in a position both to misappropriate an asset and to conceal his act by falsifying the records. For example, in a sales system the duties of receiving money from customers and writing up the sales ledger should be separated. If not, money could be misappropriated and the records falsified to cover this.

i) Comparing and analysing the financial results with budgeted amounts.

UNDERSTANDING THE SYSTEM

Accounting and internal control systems.

ISA 400 requires that auditors obtain and document an understanding of the accounting system and control environment sufficient to determine their audit approach, whether that be a systems based approach, or a substantive approach. It also helps with the assessment of inherent and control risk. If control risk is to be assessed as less than high, the justification for that assessment must be documented.

This understanding can be updated year on year and auditors often perform 'walk through' tests, to ensure that their understanding and documentation of the system are correct. This simply involves taking a transaction through the system from source to destination and can often 'double' as a test of control and as a substantive procedure, depending on which elements of the transactions are checked. Such tests are particularly useful where the auditor is relying on the client's documentation of the system.

Remember that most companies are under a legal obligation to keep proper accounting records and that auditors are required to form an opinion as to whether they have done so. Most national laws require that:

a) The accounting records must be sufficient to show and explain the company transactions and must be such as to:
   i) disclose with reasonable accuracy, at any time, the financial position of the company at that time; and
   ii) enable the directors to ensure that any balance sheet and income statement company with the requirements of the legislation as to their form.

National legislation often prescribes specific books and accounts that must be kept

DOCUMENTING THE SYSTEM

Introduction

The various methods of ascertaining and recording the system may be summarised as follows:

Ascertaining	Recording
a) Examining previous audit work	a) Narrative notes
b) Client's own documentation of the system	b) Organisation chart
c) Interviews with client's staff	c) Internal control questionnaires (ICQs) or checklists
d) Tracing transactions	d) Flowcharts
e) Examining client's documents	
f) Observation of client's procedures	

Methods of ascertaining the system

a) Examining previous audit work

In any situation except the first audit, the audit files should contain a record of the system as it operated at the last audit date. Unless there have been major changes, this will only require updating. Thus, the systems examination is work largely carried out at the first audit of a new client.

b) Client's own documentation of the system

Some clients, especially large clients, will have manuals of accounting procedures. These will provide a valuable source of information

c) Interviews with client's staff

At various stages during the examination of the system, the auditor will need to sit down with members of the client's staff and find out how they carry out their functions.

d) Tracing transactions (Walk-through checks)

In order to follow a particular sequence relating to a single transactions, it may be best to follow through a few typical transactions.

e) Examining client's documents

Example of part of an ICE adopted by a practising firm

INTERNAL CONTROLL EVALUATION CHECKLIST PURCHASES - PAYABLES- PAYMENTS	Prepared by: Date:

CLIENT:

Reviewed by:

PERIOD

Date

a) Control objectives.
b) Business considerations.
c) The checklist.

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a) Control objectives As ICQ
b) Business consideration As ICQ
c) The checklist

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1. Purchases

1.1 Can goods be purchased without authority?	Reference	Comments
a) purchase requisitions approvals?		
b) limit of buyers' authority to order?		
c) purchasing segregated from receiving, accounts payable and inventory records?		
unissued orders safeguarded against loss?		

1.2 **Can liabilities be incurred although goods not received?**
- a) receiving segregated from purchase, accounts payable and inventory records?
- b) are all goods passed directly to stores?
- c) GRNs or equivalent prepared independently?
- d) adequate comparison with order, claims for short shipments etc?
- e) invoices, GRNs, direct to accounts payable not purchasing?
- f) invoices checked to order and GRNs, prices checked?
- g) check of extensions, additions, discounts?
- h) documents cancelled to prevent re-use?
- i) unmatched documents investigated regularly?
- j) freight checked, bills matched to consignments?
- k) purchase returns and allowances controlled-follow-up?
- l) forward purchases controlled?

1.3 **Can cut-off errors occur?**
- a) time lapse from recent of goods to invoice processing?
- b) valuation of unmatched GRNs?
- c) adequate control and recording of receipts?

1.4 **Can invoices be wrongly allocated?**
- a) nominal ledger analysis?
- b) analysis independently checked?
- c) staff purchases controlled?
- d) independent and regular review?

1.5 **Can liabilities be recorded for goods or services not ordered?**

a) goods received without authority?

2. **Trade payables**

2.1 **Can liabilities be incurred but not recorded?**

a) payables agreed periodically?
b) supplier's statements independently reconciled?
c) invoice register?
d) forward contracts?
e) order backlog follow up?
f) debit balances controlled?

3. **Payments**

3.1 **Can payments be made if not properly supported?**

a) discounts taken?
b) control over invoices before validating complete?
c) cheque signatories independent of purchasing, receiving, accounts payable and cheque preparation
d) signatories examine support for payment, check completeness, cancel support?
e) control over signature plates or presigned cheques?
f) control where one signature?
g) frequency with which cheques mailed?
h) independent regular bank reconciliation, with cheques directly from bank and review reconciliation?
i) cheques crossed account payee only, continuity accounted for, control over unused cheques?
j) bank transfers controlled - standing orders?
k) issue of bearer or 'cash' cheques?
l) advances and loans controlled?
m) giro payments, traders credits, direct debits?

PLANNING THE AUDIT

Objective and general principles governing an audit of financial statements
ISA 200 objective and general principles an audit of Financial Statements states that the auditor should carry out an audit in accordance with ISAs and ethical principles to provide reasonable assurance that the financial statements are free from material misstatement.

Reasonable assurance is subject to the inherent limitations of the audit process which arise from the use of testing, the inherent limitations of any accounting or internal control system and the fact the most evidence is persuasive rather than conclusive. A significant element of any audit involves the use of judgement.

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

An example of this principle is that the auditor should look to find additional evidence to support representations from management, and should not simply assume that they are correct.

Extent of audit work

It is for the auditor to decide on the extent of audit work he considers necessary in order to support his opinion. He may decide to conduct an extensive review of the accounting systems by carrying out detailed tests on a large number of transactions, documents, records etc. On the other hand he may wish to rely on the internal controls which are in operation to justify a reduction in the level of audit testing on those items.

AUDIT PLANNING, KNOWLEDGE OF THE BUSINESS AND ANALYTICAL PROCEDURES

ISA 300 planning states that 'the auditor should plan the audit work so that the audit will be performed in an effective manner

Adequate planing of the audit work helps to ensure that appropriate attention is devoted to important areas of the audit, that potential problems are identified and that the work is completed expeditiously. Planning also assists in proper assignment of work to assistants and in co-ordination of work done by other auditors and experts.

The extent of planning will vary according to the size of the entity, the complexity of the audit and the auditor's experience with the entity and knowledge of the business.

Obtaining knowledge of the business is an important part of planning the work. The auditor's knowledge of the business assists in the identification of events, transactions and practices which may have a material effect on the financial statements.

The auditor may wish to discuss elements of the overall audit plan and certain audit procedures with the entity's audit committee, management and staff to improve the effectiveness and efficiency of the audit and to co-ordinate audit procedures with work of the entity's personnel. The overall audit plan and the audit programme, however, remain the auditor's responsibility.

The auditor should develop and document an overall audit plan describing the expected scope and conduct of the audit;

While the record of the overall audit plan will need to be sufficiently detailed to guide the development of the audit programme, its precise form and content will vary depending on the size of the entity, the complexity of the audit and the specific methodology and technology used by the auditor.

<u>Typical planning procedures</u>

Although the auditor's planning procedures will vary from one audit to the next the following are typical:

a) Consider the background to the client's business and attempt to ascertain any problem for that
   sector of industry or commerce which may affect the audit work.
b) Consider an outline plan of the audit including the extent to which he may wish to rely upon internal controls and the extent to which work can be allocated to interim or final audit stages.
c) Review matters raised in the audit of the previous year by examining the audit files and discussing points with staff previously in outed in the audit to ascertain those facts which may have relevance to the current year.
d) Assess the effect if any change in legislation or accounting practice on the financial statements of the client.

e) Review any management or interim accounts which the client may have prepared as these may indicate areas of concern in the audit.
f) Meet the senior management of the client to identify problem areas e.g material variances between budgeted and actual results and significant changes in the client's accounting procedures.
g) Consider the timing of significant phases of the preparation of the financial statements e,g dates of physical inventory counting, balancing of receivable and payable ledgers, posting of general ledgers, preparation of trial balance (list of account balances) and draft accounts
h) Consider the extent to which the client employees may be able to analyse and summarise the financial data and the relevance to the audit of work carried out by the client's internal auditors.
i) Consider the need for expert help and the involvement of other auditors in group audits
j) Determine the number and grade of audit staff to be allocated to each stage of the audit
k) Consultant members of the audit team to discuss any foreseeable problems. Often the partners will consult the manager who then becomes responsible for communication with other personnel used on that particular job. The preparation of a memorandum setting out the outline audit approach may be helpful.
l) A budget should be prepared allocating the time of each member (or grade) of the audit team. This budget should be used to control the time spent on that audit and any major variation (time both under and over spent) should be investigated by the manager. The use of the budget for the previous year would prove a valuable aid inn the preparation of this year's budget.
m) The client should be informed of the expected data of attendance by the auditors' staff and his agreement obtained.

The key failing in the planning process of auditors arise from:
a) the auditor commencing detailed. Testing before have complete the planning work, resulting in omissions, unnecessary work and misunderstandings with the client
b) inadequate documentation
c) lack of a proper understanding of the business

ISA 310 knowledge of the business, required auditors to obtain a knowledge of the business, sufficient to enable them to identify and understand those issues that may have a significant impact on the financial statements.
Knowledge is obtained both before accepting the client and after and should cover general economic factors, industry conditions affecting the client's business, the entity itself, the entity's products, market, suppliers, expenses and operations, the entity's financial performances and condition and the reporting environment.

Analytical procedures include comparison of financial information with prior periods, budget and forecasts and similar industries

It also includes consideration of predictable relationships such as the relationship of gross profit to sales, and payroll costs to the number of employees

Analytical procedures are used at the planning stage to assist in understanding the business and changes in the business, to identify areas of potential risk and to plan other procedures. The auditor's work on planning the audit will usually take place before annual financial statements are available. Accordingly, any analytical procedures performed at this stage of the audit will necessarily be based upon interim financial statements, estimated or budgeted financial statements, financial statements prepared for internal management purposes, or even, in some cases, the prior period's financial statements. The auditor will have expectations as to the relationship between various items in the financial statements and he will examine the financial data available at the planning stage to see whether his expectations match with recorded values. In any case where the results vary from expectations, the auditor should plan to conduct further work.

The auditor in developing his expectations should consider non- financial data and the likely impact of changes in factors external to the enterprise. For example, the knowledge that the client has increased its production capacity may lead to an expectation that sales revenue will have increased; on the other hand, the knowledge that the industry in general has suffered a downturn in demand may lead the auditor to expect sales to have decreased. A variation in gross profit margin may be the result of a change of sales mix or a change in production efficiency, or it may be the result of a misstatement. In any event, where the auditor's procedures efficiency, or it may be the result of a misstatement. In any event, where the auditor's procedures reveal variations from expectations he should plan to conduct further work to discover their cause.

THE OVERALL AUDIT PLAN

Designing, documenting and recording of the audit plan

ISA 300 requires that auditors 'develop and document an overall audit plan describing the expected scope and conduct of the audit'. Matters to be considered include:-

a) the auditor's knowledge of the business
b) understanding the accounting and internal control systems
c) risk and materiality
d) the nature, timing and extent of procedures
e) co-ordination, direction, supervision and review

Although the planning containing the plan will be prepared before detailed audit work commences, it is important to bear in mine the fact that the planning stage does not end there. There will inevitably be adjustments to the original plan which can only be discovered later. A significant breakdown in internal control may entail more work: a change in the timing of physical inventory counting may mean rescheduling the audit. The work of planning is therefore a continuous process throughout the audit.

Developing the audit plan to meet the audit objectives

Most practising firms have formalised the planning exercise for all but the very small audit assignment by using a standard planning memorandum in which evidence of initial decisions as to the appropriate procedures relevant to each assignment is recorded together with adjustments and additions to those procedures resulting from audit tests and review processes.

a) Highlight three objectives of audit planning
b) Outline six typical planning procedures

a) The objectives of the audit planing are:
   i) to ensure that appropriate attention is paid to the different areas of the audit. This involves, for example, ensuring that adequate time is devoted to the audit of inventories, which are usually higher risk, and that petty cash, which is usually lower risk, is not overaudited.
   ii) to ensure that potential problems are identified, such as weakness in the control over payables, which might lead to a material understatement
   iii) to facilitate review

Planing also assists in the proper allocation of work to the audit team and the co-ordination of work done by other auditors and experts.

b) I) Review of points raised in previous year's audit
   ii) Assess the effects of changes in legislation or accounting practice

iii) Review of management accounts
iv) Review of significant changes in systems
v) Preparation of a timetable of audit work and a budget
vi) Consideration of the extent to which client's staff or internal audit can assist in accounting matters.

AUDIT RISK

At the planning stage of the audit the auditor considers the extent and nature of the audit work he is to perform. It is common sense to realise that the 'riskier' the client is, the more work the auditor will plan to perform.
This risk might take many forms. It could be a risk that the client is operating in a volatile market, and may not succeed. It could be a risk that the financial statements are misstated because management are biased, or because internal controls have failed to detect and correct errors.

Alternative approaches to an audit

In order to achieve the audit objectives, evidence is required. In practice there are two main way this evidence is acquired.

a) **Systems approach**
The evaluation of internal control forms the basis of the audit. Detailed testing of items the financial
statements is kept to a minimum.

b) **Direct verification approach**
More detailed testing of items in the financial statements is carried out. The opinion based upon the
ability of the auditor to obtain sufficient appropriate evidence from number of sources.

In most situations the systems based approach is used as it is the most efficient method of arriving at an audit opinion.

Risk-based audit

The risk-based audit is a development of the system based audit. It is used by auditors in order to concentrate on high risk clients and on high risk areas of a client's business rather than perform detailed audit tests on all areas of a client's business. It enables a cost effective audit to be achieve.

The auditor should obtain an understanding of the accounting and internal control system sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgement to assess audit risk and to design audit procedures to ensure it is reduced to an acceptably low level'.

The auditor aims to ensure that there is no more than, say, a 5% risk that his opinion on the financial statements is incorrect. Or, in other words, he is ensuring that he is 95% certain that his opinion on the financial statements is correct. (Audit confidence is measured here as 100% minus audit risk). The percentage used (i.e 95%) is one of convention only. It implies that we can never be 100% sure of any conclusion. This is known as audit risk and means the auditors accept that 5 in every 100 reports issued may be incorrect. Audit risk can be set at any level. If auditors set it at 100%, there is no need to do any work at all, but there is a high risk of being found negligent! Auditors in practice 'set' audit risk at 4 - 6% and tailor their audit procedures accordingly.
Total audit risks, the risk of giving an inappropriate opinion when financial statements are materially misstated, has three components:

a) inherent risk (or IR)

b) control risk (or CR); and
c) detection risk (or DR).

These three risks multiplied together give total audit risk.
Remember though that it is the auditor's judgement that is always used to determine the value to be placed on these items - there is no hard and fast rule that the auditor can follow. Broadly, the lower the risk level required, the greater the audit work required.

Inherent risk, control risk and detection risk

a) **Inherent risk**

Definition: The susceptibility of an account balance or class of transactions to material misstatements, irrespective of related internal controls.

The risk will be affected by such items as how much the company is subject to market forces, the cash situation of the company, the trading history of the company, the nature and incidence of unusual transactions. Inventory, for example is more inherently risky than cash as there is greater scope for manipulation and error. A business inn the construction industry is more risky than a food retailer as it is more volatile.

b) Control risk

Definition: The risk that material misstatement could occur in an account balance or class of transactions which would not be prevented or detected by the accounting or internal systems

The risk will be affected by such factors as the control environment at the company including for example, the integrity of the staff operating the system, the extent of supervisory controls, and the strength of controls in particular account areas.

The preliminary assessment of control risk should always be high unless the auditor can either identify controls that are likely to prevent or detect misstatements in each area, or, plans to perform tests of control to support the assessment.

There should be full documentation of the accounting and internal control system in the auditor's records, and of his assessment of control risk.

Evidence should be obtained through tests of control to support any assessment of control risk that is less than high and the lower the assessment of control risk, the more evidence is needed to show that systems are suitably designed and operating effectively.

When tests of control are complete, auditors should review their preliminary assessment of control risk.

c) **Detection risk**

Definition: The risk that auditor's substantive procedures do not detect a material misstatement in an account balance or class of transactions.

This is the 'variable' in the equation; the lower the auditor wishes detection risk to be, the more substantive procedures must be performed and the larger sample sizes must be. Detection risk can never be eliminated entirely because it encompasses human error.

The level of detection risk will determine the type and amount of audit testing to be carried out. If detection risk cannot be reduced to an acceptably low level, a qualified audit opinion should be issued. Detection risk is found by using the equation already given above, but re-arranging it to give:

$$DR = AR \div (IR \times CR)$$

This simply means that the less effective the control system, and the greater the inherent risk in the business, the greater the level of detection risk. The auditor will therefore need to increase his audit testing. This will compensate for the poorer controls of the client and/or the greater risk arising from the nature of the client's business.

Entity risk

The combination of inherent risk and control risk is referred to as client risk or entity risk i.e both these risks relate to a client as an entity. It is both elements of entity risk which the auditor needs to consider at the planning state although control risk will need to be re-considered when the client's accounting systems are examined in detail.

Many auditors use formal procedures at the planning stage of the audit in order to assess whether the client is high or low risk. This is in form of enemaluation questionnaire

PLANNING MATERIALITY

Concept of materiality

An item is material of its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

Materiality is considered in planning audit procedures and in evaluating the effect of misstatements.
The auditor in planning the audit therefore needs to establish materiality levels to ensure that any material misstatement or omissions in the accounting records are discovered.

Establishing materiality levels

There are two levels of materiality to be considered, materiality at the overall financial statement level and materiality for individual balances and classes of transactions. The latter is usually derived from the former.
There is an inverse relationship between materiality and the level of audit risk. The higher the materiality level, the lower the audit risk and vice versa. Where, for example, materiality is low, audit risk is increased and the auditor can compensate for this by either carrying out additional tests of control, or by increasing substantive procedures. Either will have the effect of reducing the assessed level of control risk.

Materiality at the planning stage is often set at a lower level than is strictly necessary in order to reduce the risk of undiscovered misstatements, and to deal with the potential problem of having to adjust materiality levels at a later date in the light of evidence obtained.
The most common bases used are a percentage of sales, pre-tax profit or asset values

AUDIT PROGRAMMES

Designing the audit programme

ISA 300 requires auditors to 'develop and document an audit program setting out the nature, timing and extent of planned audit procedures required to implement the overall audit plan'.
The audit programme is essentially a record of the audit testing. It may also specify audit objectives for each area and time budgets. It shows the members of staff who have carried out the work and contains evidence of review of work.

The audit programme serves as:

a) a set of instructions to the audit team
b) a means to control and record the proper executive of the work
c) a record of the audit procedures to be adopted, the audit objectives, timing, sample size and basis of selection for each area

The audit programme is an important part of the auditor's working papers and records a significant part of the audit evidence required to justify the audit opinion.
Audit plans and the audit programme should be revised as necessary during the course of the audit

Standardised audit programmes and professional judgement

Definition: A standardised audit programme is a pre-prepared listing of objectives and tests which is used on any audit.

Standardised audit programmes are common in practice and are often drawn from a database of procedures in large firms.
Their advantages are that they streamline work and act as a checklist to ensure that all important areas are considered. They improve the efficiency of the audit and facilitate delegation and control.

However they have a disadvantage in that, if used slavishly, they may stifle professional judgement. Auditors need to use professional judgement in their work as all audits will be different and therefore tests need to be designed for the different circumstances found in each audit

A middle way is used by some firms who, in their audit manual, will suggest the items to be included in an audit programme rather than requiring a standard form to be filled in.

STAFFING AND TRAINING ISSUES

Staffing

Planning needs to cover such points as:

- number of staff required
- level of expertise required;
- length of time each member of staff will be needed;
- exact timing of their work.

To assist in the allocation of staff to each stage of the audit, larger firms will designate job titles to each member of the audit team.

Job tile	Job description as regards the audit
Partner	Agree fees with client Review audit Sign audit report (after approval of accounts by directors)
Manager	Set broad time limits to job Assign staff to job Agree detailed timetable with supervisor or senior Review staff requirements and timetable at various stages Review audit in detail at end of interim and final audits
Supervisor (or junior manager)	Take charge of large jobs e.g a large group of companies, where each company or division is audited by a senior.
Senior	Take charge of the audit Agree audit timetable with client, and manger or supervisor Decide on detailed audit work Compile audit working papers
Clerks, semi-seniors And juniors	Perform detailed audit work assigned by seniors.

Training

Membership via qualification with an appropriate professional body is a pre-requisite of entitlement to audit. Training requirements include the setting of examinations and practical training. The practical training should not stop when an auditor has qualified. The practical training continues through the requirement to undertake continuing professional education (CPE)

Large firms run internal training course to satisfy the CPE requirement; smaller firms are often members of a training consortium which provide equivalent course.

Recognising the needs and limitations of the use of experts

ISA 620 using the work of an expert recognises that the auditor's education and experience enable him to be knowledgeable about business matters in general, but he is not expected to have the expertise of a person trained in the practice of another profession, such as an actuary or engineer. He may need to obtain evidence in the form of reports, opinions, valuations or statements from an expert. And ' when using the work performed by an expert, the auditor should obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit.'

The following points are relevant to this area of auditing;

a) **Determining the need to use the work of an expert**

One element of the planning of an audit would be the consideration of whether specialist evidence

(From lawyers, stockholders, geologists, actuaries, etc) may be necessary for the auditor to form his opinion. Factors affecting this decision would include the materiality of the item concerned, the risk of misstatement based on the nature and complexity of the matter, and the quantity and quality of other audit evidence available.

If it decided that expert evidence is needed, the expert should be engaged or employed either by the client, or by the auditor with the consent of the client. If the client refuses, for whatever reasons, and there is no other source of evidence for the item concerned, the auditor should qualify his audit report.

b) **Competence and objectivity**

In order to be able to rely on the evidence provided by the expert, the auditor must be satisfied that the expert is competent and objective. Competence would be evidence by certification, licensing, or membership of an appropriate professional body, and suitable experience and reputation.

The expert will not be sufficiently objective if he is related to the entity by being financially dependent on it or by having an investment in it. Objectivity may also be impaired where the expert is employed by the entity.

c) **Scope of the expert's work**

Once a specialist is appointed, there should be a consultation between the auditor, client and specialist to determine the scope of the expert's work. This should clarify the objectives of the expert's work, sources of information available to him, the form and content of the report required, the intended use of the work, the expert's access to books and records, and the assumptions and methods to be used by him.

d) **Assessing the work of the expert**

The auditor will need to assess the appropriateness of the expert's work. He should, therefore, examine the specialist's report and determine if it is acceptable in the light of other work performed and the auditor's knowledge of the business. He should obtain an understanding of the assumptions and methods used and considered whether they are appropriate and reasonable. If the auditor is not satisfied with the expert's work, he should discuss the problem with the client's management and with the expert. It may occasionally be necessary to obtain the opinion of a second expert.

e) **The audit report**

Generally, no reference should be made to the use of an expert in the audit report as this may imply a division of responsibilities or be misunderstood as a qualification. If it becomes necessary to modify

the audit report, it may be appropriate to refer to the expert, but this is only appropriate with the
expert's permission. If this is refused, legal advice may be necessary.

AUDIT EVIDENCE

ISA 500 audit evidence requires that auditors 'obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.
'Sufficient' relates to quantity of evidence, 'appropriate' relates to the quality or reliability and relevance of evidence
Evidence will normally be sought from a variety of different sources as evidence is persuasive rather than conclusive and auditors seek reasonable, not absolute assurance.

Sufficient, appropriate evidence
The auditor's judgement as to what constitutes sufficient appropriate evidence is influence by such factors as:
a) the assessment of inherent risk at the financial statement level and the individual balance or class of transaction level
b) the nature of the accounting and internal control systems and control risk
c) the materiality of the item
d) experience gained during previous audits
e) results of audit procedures
f) the source and reliability of the information available

We have already noted that the assessment of risk affects the amount of evidence required.
Risk may be in a specific area, for example inventory or bad debt allowances are always subjective and hence high risk areas. Alternatively it may be a risk running through the financial statements as a whole. For example;
a) the auditor may have found material errors in the past; he may lack confidence in those preparing the records.
b) the company may be approaching insolvency and hoping to impress potential financial backers by showing the figures in a better light.
c) a bonus to be paid to management may be based on reported results.

Accounting and internal control systems:
ISA 400 Assessments and Internal Control requires that auditors obtain and document an understanding of the accounting system and control environment sufficient to determine their audit approach. The means of obtaining and documenting that understanding, by the use of narrative notes, flowcharts etc. Audit approach will broadly comprise either.
a) a system based approach whereby the auditor obtains comfort on the adequacy of the system by means of tests of controls, supplemented by a reduced level of substantive testing; or
b) a wholly substantive approach

The former is by the more efficient approach but the letter is often necessary in small business where the accounting and internal control systems are weak.

ISA 500 audit evidence requires auditors to obtain sufficient, appropriate evidence to support the assessed level of control risk.

Test of control are performed to obtain audit evidence about the effectiveness of the:
a) design of the accounting and internal control system for the prevention, detection and correction of misstatements
b) operation of internal control through the period.

So, for example, if the preliminary assessment of controls over payable is low risk (i.e the system of controls over payables appears to be goods at the planning stage) and tests of controls show that the controls are in fact good (i.e postings to payables are properly checked and authorised etc), it may be possible to reduce the sample of payables selected for circularisation or reconciliation at the year end.

Note that where control risk is assessed as less than high, auditors must document the basis for that conclusion and that it is often necessary to assess inherent risk and control risk together.

Deviations from prescribed controls may result from changes in personnel, human error or changes in the volume of transactions. The idea of an ‘exception’ is an important one. The auditor cannot excuse failure of a control on the grounds that the amounts involved were small. If a control can fail in respect of a small monetary amount, it is as likely to fail with a significant amount.

The auditor will not be able to take comfort from the operation of controls if he has found any exceptions - unless he can satisfy himself that the exception is an isolated departure. An example of this could be an error made on a day when a temporary clerk was employed where there are no errors in any other time periods. The auditor may have to take that day and test it more extensively (i.e not rely on internal controls), but he could rely on controls over the remaining period. He is effectively splitting the year into two populations, taking a systems approach for one, a substantive for the other. If substantially different controls are used at different times during the period, auditors need to consider each separately.

Where the exceptions found are unacceptably high, the effect is to require a reassessment of the control risk ie, the internal control system cannot be relied upon to the extent originally envisaged. Control risk is therefore increased and therefore the substantive testing will need to be increased. In addition the nature of the errors found may result in the auditor concluding that his initial assessment of the inherent risk is incorrect. You need to appreciate that the auditor in planning the audit is not possession of detailed facts about the company’s operations and the testing procedures provided him with further information that may be his original opinion.

Bear in mind that in practice it can be difficult to distinguish between a series of isolated deviations from the application of a control procedure and the non-functioning of that procedure as a whole. Consider the following: ‘Our regular member of staff was off sick in March, in April we employed a temporary clerk, in May we had a reorganisation and in June we had a full systems failure and spent all of our time reinputting information. For these reasons only half of your sample of credit notes have been authorised.’ On the assumption that credit notes were authorised for the rest of the period, do you consider the procedure to have been operating effectively, or has it broken down? It is of course a matter of professional judgement.

Substantive procedures - relevance

Substantive procedures are tests performed to obtain audit evidence to detect material misstatements in the financial statements and are of two types;

a) tests of details of transactions and balances analytical procedures
b) analytical procedures

The relevance of the audit evidence should be considered in relation to the overall audit objectives of forming a n opinion and reporting on the financial statements. To achieve this objective the auditor needs to obtain evidence to support the following financial statement assertions (i.e assertions by management embodied in the financial statements.

a) Existence: an asset or liability exists at a given date (i.e the assets and liabilities are not overstated.
Auditors spend a great deal of time on this assertion confirming the existence of assets such as
tangible non-current assets, inventories, receivable and cash. Clearly this is a fundamental assertion;
no other rights or obligations relating to the asset or liability).

b) Rights and obligations: an asset or liability pertains (i.e ' belongs') to the entity (i.e the entity has legal or other rights or obligations relating to the asset or liability).
The auditor must ensure that it is the business which owns the asset at the balance sheet date. There
are many situations where an asset could be on the business premises but belong to someone else.
Inventories, for example, may have been sold but not yet delivered. In a small business, some of the
assets may belong to the major shareholder.

c) Occurrence: a transaction or vent occurred during the relevant accounting period (i.e has correct cut-off been applied?)
d) Completeness: there are no unrecorded assets or liabilities, transactions or events (i.e the assets, liabilities, transactions and events are not understated.)
e) Valuation: the asset or liabilities is recorded at an appropriate carrying value; i.e for a non-current asset this would be initial cost plus increases (e.g revaluations), minus decreases (e.g depreciation and write downs to recoverable value).
f) Measurement: a transaction or event is recorded at the proper amount in the correct period. This refers to income statement items and prepayments and accruals
g) Presentation and disclosure: must be in accordance with relevant legislation and accounting standards (i.e the applicable financial reporting framework)

Two of the most important assertion tests are for completeness and existence. These are tests going in the 'opposite direction' to each other.

If for example the auditor wishes to test for the completeness of payables, he should take a sample of source documents such goods received notes, and trace them through the related invoices, daybooks and ledgers to the financial statements in the form of payables.

If on the other hand he wishes to test for the existence of receivables, he should start at the other end with a sample of receivables from the financial statements and trace these back through the ledgers, daybooks and invoices to the source documentation ie the orders or despatch notes.

Auditors in practice are concerned about the completeness or understatement of expenses and liabilities, and the existence or overstatement of assets and income. However, remember that if the overstated credit or an understated debit. If he discovers an understated credit there muse also be either an understated debit or an overstated credit.

The best test of the existence of an asset is to check its physical existence if it is tangible and the entity's document to title if it is not. Just because an asset exists does not mean to say that it belongs to the reporting entity; documentary evidence is needed to prove ownership.

Substantive tests may be incorporated with other procedures such as tests of control. An invoice for example is checked for both its accuracy (substantive) and its authorisation (test of control). The same invoices may also be used as part of a 'walk through' test which the auditor will perform as part of his preliminary assessment of internal controls at the planning stage.

Substantive procedures - reliability

Although the reliability of audit evidence is dependent upon the particular circumstances, the following general presumptions may be found helpful:

a) evidence obtained form external sources is more reliable than that obtained from the entity's record
b) evidence obtained from the entity's record is more reliable where the accounting and internal control system operate effectively;
c) evidence obtained directly by auditors by such means as analysis and physical inspection is more reliable than evidence obtained by or from the entity;
d) documentary evidence is more reliable than oral evidence

Documentary evidence is least reliable if created and held by the entity (e.g invoices). It is more reliable if it is created by third parties and held by the entity (e.g supplier statements). It is most reliable if it is created by third parties and held by the auditor (e.g confirmation of receivables).

The auditor should consider whether the conclusions drawn from differing types of evidence are consistent with one another. When audit evidence obtained from one source appears inconsistent with that obtained from another, the reliability of each remains in doubt until further work has been done to resolve the inconsistency. However, when the individual items of evidence relating to a particular matter are all consistent, then the auditor may obtain a cumulative degree of assurance higher than that which he obtains from the individual items. This is a form of 'synergy'.

Unfortunately, there are no hard and fast rules against which the reliability of evidence are by their nature difficult, and no satisfactory solution is as yet available. Most of the negligence claims against auditors arise where the quality of audit evidence is weak. Such cases rarely get into court but substantial cash settlements have been made out of court by many firms of auditors.

These settlements give a clear indication of the cost of lack of quality control and consequent weakness of audit evidence. Clearly when things go wrong in a business, a client will consider suing his auditors. The auditor must ensure that he has sufficient evidence to defend himself against such a claim.

Activity

Explain each of the following techniques of gathering audit evidence and give an example of each:

a) Inspection
b) Observation
c) Enquiry and confirmation
d) Computation
e) Analytical procedures

Activity solution

a) **Inspection** - this covers the physical review or examination of records, documents and tangible assets. An example of a test of controls is examining copy sales invoices for authorisation. An example of a substantive procedure would be checking the physical existence of a tangible asset. Additional work may be required to determine ownership, valuation and contractual obligations.

b) **Observation**- this technique involves looking at a process or procedure being performed. However, this observation may not be typical of the usual conduct of the procedure. An example is the distribution of wage packets to see that internal control procedures are adhered to or the observation by auditors of inventories being counted in accordance with instructions.
c) **Enquiry and confirmation** - seeking relevant information from knowledge persons inside or outside the enterprise, whether formally or informally, orally or in writing. The reliability of this techniques depends on the qualification and integrity of the source. An example is the seeking of formal representations from management on the value of a material subsidiary company in an overseas country. Confirmation consists of seeking to corroborate responses to enquiry information in the accounting records (e.g confirmation of receivable balances).
d) **Computation** - checking the arithmetical accuracy of source documents and accounting records or performing independent calculations (e.g checking the addition of the trial balance)
e) **Analytical procedures** - the analysis of significant ratios and trends including the resulting investigation of fluctuations that are inconsistent with other information, or deviate from predicted amounts.

Note that all of the above can be used as a rest of control or as substantive procedures and that many can be performed using computer assisted audit techniques which are dealt with in a later chapter.

Analytical procedures as substantive procedures

Analytical procedures deal with comparisons of financial and non-financial information and were considered above in the content of planning. Analytical procedures used as substantive tests can be used alone where the total amounts involved are immaterial and in conjunction with detailed tests of transactions and balances elsewhere. These procedures provide good 'overall' evidences as to the accuracy of a balance or class of transactions. Examples include the following:

a) A comparison of payroll costs on a monthly basis taking account of wage rises, starters and leavers and seasonal work.
b) A comparison of sales with expenses, on a monthly basis and as a comparison with prior years
c) A comparison of the ageing of inventories or receivable on a monthly or quarterly basis and calculation days sales outstanding or inventory turnover.

Analytical procedures are used widely but are limited by factors such as the accuracy and predictability of relationships and the availability, relevance and comparability of information. They are also limited by the auditor's knowledge of the business and the availability of other types of evidence. It is common for analytical procedures to be performed on management accounts.

Backtor

a) I) Flowcharts provide evidence of the system in operation and, as they were prepared by the audit staff, the value of the evidence is good. The tests of control demonstrated that the system does in fact operate as recorded and, if it is necessary, this could be further substantiated by walk through tests.
   ii) The statement provides evidence as to the accuracy of the depreciation chart the income statement, and the net book value of plant in the balance sheet. As oral

evidence from someone from within the enterprise, it is not particularly reliable. Further evidence could be obtained by considering the useful live similar items of plant in the past or consulting trade journals which may detail relevant information.

iii) The newspaper report provides evidence that the auditor may wish to consist when carrying out his overall review of the financial statements of the enterprise. It is also of importance in considering the continuing commercial viability of company. As the evidence is from a source independent of the company considered to be reliable, but it must be borne in mind that newspaper reports be based upon hearsay and not just fact. The quality of the evidence could be improved by discussing the matter with management or considering volumes sales in recent months.

iv) The letter provides evidence that the company is a going concern. As the evidence is from a source external to the company, it is reliable, but would be more so if the letter had been sent direct to the auditors. To substantiate the evidences the normal bank letter would be sent.

v) Attendance at a client's inventory count and performance of test counts provide evidence as to the existence and valuation of inventories. As the evidence documentary, was prepared by a member of the audit firm, and is based on physical inspection, it is very reliable. To support the evidence obtained, the items would need to be traced through to the final inventory valuation.

vi) Direct confirmation from a customer provides evidence as to the accuracy of the receivables figure included in the balance sheet. As the evidence is documentary and from a source external to the company, it is reliable. To further support the evidence, the receipt of cash from the customer, after the year-end, could be checked.

b) If items of evidence are inconsistent, then the reliability of each remains in doubt until the inconsistency had been resolved. With respect to the example given, the auditor would need to find evidence to explain the increased useful life from, for example, trade journals, etc.

WORKING PAPERS

Recording the audit process.

ISA 230 documentation states that the auditors should document matters which are important in providing evidence to support the audit opinion and evidence that the audit was carried out in accordance with ISAs'. Working papers should be 'sufficiently complete and detailed to provide an overall understanding of the audit.' They should record:

a) planning information
b) the work done and when it was done
c) results and conclusions

The extent of working papers is a matter of professional judgement and it is neither necessary nor practical to record every matter the auditor considers. It may be useful to consider what would be necessary to provide another auditor who had no previous experience with the audit with an understanding of the work performed and the basis of principal decisions, but not the detailed aspects of the audit.

Audits are required to record all matters which are important in supporting the report and in particular their reasoning and sufficient matters that requires the exercise of judgement. It is in areas such as these that the auditor may subsequently be questioned, often with the benefit of hindsight, and it is important for the auditor to be able to show what he knew at the time.

Working papers should be made available to third parties without client consent and extracts from the papers can be made available to the client entirely at the discretion of the auditor. However the auditor's working papers are not a substitute for proper accounting records!

ISA 230 required that appropriate procedures should be undertaken to maintain the confidentiality and safe custody of working papers and for their retention for a sufficient period to meet regulatory requirements.

Contents of working papers

a) Information likely to be of continuing importance on requiring audits i.e permanent file information such as the company's constitutional documents and other information concerning the legal and organisational structure of the entity.
b) Auditing planning information e,g audit planning memoranda and time budgets
c) Details of internal control and the accounting systems of the business, including the auditor's evaluation and assessment of risk.
d) Details of audit work carried out, including notes of errors, action taken and conclusions drawn, including work carried out by other auditors.
e) Evidence of review of audit work
f) Supporting schedules of financial statements
g) Audit summary including significant and unusual mattes
h) Copies of approved financial statements and auditors' reports, letter of representation, engagement letters, and reports to management on weaknesses in internal controls

Standardisation of working paper

Standardisation of working papers offers several advantage

a) It improves the efficiency of the preparation and review of working papers
b) If facilitates the delegation and review of work

AUDIT EVIDENCE

SAS 400 Audit evidence requires that auditors "obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. Sufficiency and appropriateness are interrelated and apply to audit evidence obtained from both tests of control and substantive procedures.

Sufficiency is the measure of the quantity of audit evidence appropriateness is the measure of the quality or reliability of audit evidence and its relevance to a particular assertion.

Usually audit evidence is persuasive rather than conclusive and auditors therefore often seek audit evidence from different sources or of a different nature to support the same assertion.

Sufficient, appropriate audit evidence:

The auditor will use judgement to decide what is sufficient and appropriate in the particular circumstances since he seeks to provide reasonable, net absolute, assurance that the financial statements are free from material misstatements.

The auditors judgement as to what is sufficient audit evidence is influenced by such factors as:

- The assessment of the nature and degree of risk of misstatement of both the financial statement level and the account balance or class of transactions level.
- The nature of the accounting and internal control systems, including the control environment
- The materiality of the item being examined
- The experience gained during previous audits and the auditors' knowledge of the business and industry;

- The findings from audit procedures, and from any audit work carried out in the course of preparing financial
statements, including indications of fraud or error; and
- The source and reliability of information available
If unable to obtain sufficient appropriate audit evidence, auditors, auditors consider the implications for their report.

Since the assessment of risk affects the amount of audit evidence required enough evidence need to be gathered in specific areas of risk such as:
- where the auditor may have found material errors in the past, and the lacks confidence in those preparing records;
- where the company is approaching insolvency and is helping to impress potential financial backers by showing the
figures in a better light.
- where any bonus to be paid to management may be based on reported results
- where an amount has been derived as an estimate based on subjective procedures

Accounting and Internal Control Systems
The aspects of the relevant parts of accounting and internal control systems about which auditors seek to obtain audit evidence are:-
a) Design: the accounting and internal control systems are capable of preventing or detecting material misstatements; and
b) Operation: the systems exist and have operated effectively throughout the relevant period.

The audit approach will broadly comprise either
i) a systems based approach where the auditor obtains comfort on the adequacy of the system by means of tests of controls, supplemented by a reduced level of substantive/testing or
ii) a wholly substantive approach in which extensive detailed testing is performed. (common for small business where the accounting and control systems are weak and the auditor needs to use this method to obtain sufficient and appropriate evidence).

Accounting system
Means a series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyse, calculate classify, record, summarise and report transactions and other events.

The internal control system
Includes all the polices and procedures adopted by the directors and management of an entity to assist in achieving their objective of ensuring as far as practicable, the orderly and efficient conduct of its business, including adherence to internal policies, the safeguarding of assets, the prevent on and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

The auditor should make a preliminary assessment of control risk and then plan and perform tests of control to support that assessment. e.g if the preliminary assessment of controls over creditors is low risk (the system of controls over creditors appears to be good at the planning stage) tests of control show that the controls are in fact good (proper posting, checkings and authority) it may be possible to reduce the sample of creditors selected for circularisation or reconciliation at the year end.

Where control risk is assessed as less than high, auditors must document the basis for that conclusion and that it is often necessary to assess inherent risk and control risk together. Effective controls may lead the auditor to reduce the controls.

Deviations from prescribed controls may result from change in personnel, human error or charges in the volume of transactions.
The auditor cannot excuse failure of a control on the grounds that the amounts involved are small; a control that fails for small amounts will fail with significant amounts as well.

The ideas of an exception is an important one; the auditor will not be able to take comfort from the operation of controls if he has found any exceptions - rules he can satisfy that the exception is an isolated departure where the exceptions found are unacceptably high, the effect is to require a reassessment of the control risk since the ICS cannot be relied upon to the extent originally envisaged. Control risk is therefore increased and therefore the substantive testing will need to be increased. In addition the nature of errors found may result in the auditor concluding that his initial assessment of the inherent risk is incorrect. You need to appreciate that the auditor in planning the audit is not in possession of detailed facts about the company's operations and the testing procedures provided him with further information that may be his original opinion.

Note that in practice it can be difficult to distinguish between a series of isolated deviations from the application of a control procedure and the non-functioning of that procedure as a whole.

Substantive procedures - relevance:
These are those tests of transactions and balances, and other procedures such as analytical review, which seek to provide audit evidence as to financial statements assertions such as completeness, Existence, valuation, presentations, disclosures etc.

The relevance of the audit procedure should be considered in relation to the overall audit objective of forming an opinion and reporting on the financial statements.

Existence: That an asset or liability exists at a given date.
Auditors spend a great deal of time on this assertion confirming the existence of assets such tangible fixed assets, stocks, debtors and cash clearly this is a fundamental assertion and management is in a way stating that the items are not wrongly stated and that the enterprise has no other rights or obligations relating to the assets or liabilities.

Valuation: That the asset or liability is recorded at an appropriate carrying value: i.e the initial cost or valuation plus additions or revaluations, minus depreciation, write downs or disposals.

Rights and obligations (ownership)
That an asset or liability belongs or pertains to the entity at a given date.
The auditor must ensure that it is the business which owns the asset at the balance sheet date and belongs to no one else and identify situations when the asset is on the business premises but belongs to a different entity altogether.

Occurrence: That a transaction or event occurred during the relevant accounting period. The auditor ensures that proper cut off procedures have been executed.

Completeness: That there are no unrecorded assets or liabilities, transactions or events. The auditor must ensure that all these items are correctly stated.

Measurement: That the transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period. (This assertion refers to profit and loss account items and prepayments and accruals).

Presentation and disclosure: That an item is disclosed, classified and described in accordance with the applicable reporting framework (e.g relevant legislation and applicable accounting standard).
Authorisation. That all transactions are properly authorised.

Audit evidence is usually obtained to support each financial statement assertion. Audit evidence regarding one assertion (e.g existence of stocks) does not compensate for failure to obtain audit evidence regarding another assertion (e.g valuation). Tests may, however, provide audit evidence about more than one assertion (e.g testing subsequent receipts from debtors may provide some evidence regarding both their existence and valuation.

Two of the most important assertion tests are for the completeness and existence. These tests go on in opposite directions to each other (directional testing); If the auditor wishes to test for completeness of creditors, he should take a sample of source documents such as GRN's and trace them through the related invoices, day books and ledgers to the financial statements in the form of creditors. However to test existence of debtors, the auditor starts at the other end with a sample of debtors from the ledgers, day books and invoices to the source documentation such as the orders or despatch notes.

The risk is to understate expenses and liabilities and overstate assets and income. Therefore if the trial balances, and the auditor discovers an overstated debit, there must also be either an overstated credit or an understated debit. If he discovers an understated credit, there must also be either an understated debit or an overstated credit.

Just because an asset exists does not mean that it belongs to the reporting entity and documentary evidence should be sought to prove ownership.

The nature, timing and extent of substantive procedures depend amongst other factors, on the auditors' assessment of the control environment and accounting systems generally and on the inherent and control risks relating to each assertion, as well as on any evidence obtained from audit work performed during the preparation of the financial statements. Where tests of control provide satisfactory evidence as to the effectiveness of accounting and internal control systems, the extent of relevant substantive procedures may be reduced, but not entirely eliminated.

Substantive procedures may be incorporated within other procedures e.g tests of control may be designed as dual purpose tests to provide evidence of a substantive nature, and such evidence may be obtained as part of the nature, and such evidence may be obtained as part of the work carried out to make preliminary assessments of risks of error.

Substantive procedures - relevance.
The reliability of audit evidence is influenced by its source; internal or external, and by its nature; visual, documentary or oral. While the reliability of audit evidence is dependent on individual circumstances, the following generalisations may help in assessing that reliability.

1- Audit evidence from external sources (e.g confirmation received from a third party) is more reliable than that obtained from the entity's records especially where the external source is independent.
2- Audit evidence obtained from the entity's records is more reliable when the related accounting and internal control systems operates effectively.
3- Evidence obtained directly by auditors such means as analysis and physical inspection is more reliable than evidence obtained by or from the entity.
4- Evidence in the form of documents and written representations is more reliable than oral representations

5- Original documents are more reliable than photocopies telexes or facsimiles

Documentary evidence created by a third party and held by the auditor is more reliable than that created by the third party and held by the entity or that created by the entity and held by the entity.

Audit evidence is more persuasive when items of evidence from different sources or of a different nature are consistent. When the audit evidence from one source is inconsistent with that from another, auditors determine additional procedures necessary to resolve the inconsistency. Where the individual items of evidence relating to a particular matter are all consistent, the auditor obtains a cumulative degree of assurance higher than that which he obtains from the individual items. This is a form of 'synergy'.

All the same, the reliability of evidence is very much a matter for the auditor's judgement of each situation in its own right, using his experience and knowledge of the client.

The auditor should always consider whether or not the evidence that he has would be sufficient to defend himself in a court of law.

The auditor should consider the relationship between the cost of obtaining audit evidence and the usefulness of the information obtained. However, the existence of difficulty or expense is not in itself a valid basis for omitting a necessary procedure.

Procedure for obtaining audit evidence
Auditors obtain audit evidence by procedures the choice of which is dependent, in part, upon the period of time during which the audit evidence sought is available and the form in which accounting records are maintained. The procedures include:-

1- **Inspection**
This consists physical review or examination of record, documents or tangible assets. Inspection of records and documents provides audit evidence of varying degrees of reliability depending on their nature and source and the effectiveness of the ICS over their processing.
A test of control would involve say examination of copy sales invoices for authorisation whereas a substantive procedure would involve checking of the physical existence of a tangible asset i.e inspection of a tangible assets provides reliable audit evidence about its existence but not necessary as to its ownership or value.

2- **Enquiry**
Consists seeking relevant information from knowledgeable persons inside or outside the enterprise, whether formally or informally, orally or in writing.. The reliability of this technique depends on the qualification and integrity of the source. E.g formal representations of management on the value of a material subsidiary company in an overseas country.

3- **Confirmation**
Confirmations consists of the response to an enquiry to corroborate information contained in the accounting records e.g communication with debtors.

Responses to enquires may provide auditors with information not previously possessed or with corroborative audit evidence.

4- **Computation**

Consists of checking the arithmetical accuracy of source documents and accounting records or performing independent calculations.

5- **Re-performances**

Of controls such as the bank reconciliation to ensure they were performed correctly

Analytical procedures

Consists of the analysis of relationships between items of financial data, or between items of financial and non financial data, deriving from the same period, or between comparable financial information deriving from different periods or different entities, to identify consistencies and predicted patterns or significant fluctuations and unexpected relationships and the results of investigations therefrom.

These procedures provide good overall evidence as to the accuracy of a balance or class of transactions. Analytical procedures are commonly performed on management accounts to avoid the possibility of auditing are set of information and reporting on another.

Where any significant fluctuation or unexpected relationships are identified, the auditor must investigate, obtain explanations to support the deviation from the expected outcome and obtain corroboratory evidence to support the deviation.

Analytical procedures are widely used by are limited by the adequately of ICS (if weak the information is not reliable).

The relevance and reliability and additional procedures regarding given evidential matters

1. Flowcharts of the company's payroll routine prepared by the audit assistant backed up by tests of control. Flowcharts provide evidence of the system in operation and, as they were prepared by the audit staff, the value of the evidence is good. The tests of control have demonstrated that the system does infact operate as recorded and, if it is felt necessary, this could be further substantiated by walk through tests.
2. An overall statement by the production director that the expected working life of plant acquired during the year is 10 years.

The statement provides evidence as to the accuracy of the depreciation change in the profit and loss account and the net book value of plant in the balance sheet. As it is oral evidence from someone within the enterprises, it is not particularly reliable. Further evidence could be obtained by considering the useful lives of similar items of plant in the past or consulting trade journals which may detail the relevant information.

1. A news paper report that new technology is expected to have an adverse effect on the sales of products representing 20% of the company's turnover.

The newspaper report provides evidence that the auditor may wish to consider when carrying out his overall review of the financial statements of the enterprise. It is also important in considering the continuing commercial viability

of the company. As the evidence is from a source independent of the company, it is considered to be reliable, but it
must be borne in mind that newspaper reports can be based upon hear say and not just fact,. The quality of the
evidence could be improved by discussing the matter with management or considering volumes of sales in recent
months.

2. A letter to the managing director from the company's bank manager indicating that the bank intends to extend overdraft facilities for a period of one year.

The letter provides evidence that the company is a going concern. As the evidence is from a source external to the
company, it is reliable, but would be more so if the letter had been sent direct to the auditors. To substantiate
evidence, the normal bank letter would be sent.

3. List of items of stock control by a member of your firm of certified accountants during observation of the company's stock count.

Attendance at a client's stock take and performance of tests counts provide evidence as to the existence and
valuation of stock. As the evidence is documentary, was prepared by a member of the audit firm, and is based on
physical inspection, it is very reliable. To support the evidence obtained, the items would need to be traded through
to the final stock valuations.

4. A letter from a debtor to your firm in reply to a confirmation request indicating agreement with the balance as recorded in the books of the client.

Direct confirmation from a debtor provides evidence as to the accuracy of the debtors figure included in balance
sheet. As the evidence is documentary, and from a source external to the company, it is reliable. To further support
the evidence, the receipt of cash from the debtors, after the year-end, could be checked.

WORKING PAPERS

Working paper are the material that auditors prepare or obtain, and retain in connection with the performance of the audit. Working papers may be in form of data stored on paper, film, electronic media or other media. Working papers support amongst other thins, the statement in the auditors' report as to the auditors' compliance or otherwise with auditing standards, and this record compliance with auditing standards to the extent that this is important in supporting their report. "Auditors should document in their working papers matters which are important in supporting their report"). In short working papers record;

a) the planning and performance of the audit
b) the supervision and review of the audit work; and
c) the audit evidence resulting from the audit work performed which the auditors consider necessary and which they have relied to support their report.

Recording the audit process:

Auditors should record in their working papers their reasoning on significant matters that require exercise of judgement. It is such areas that the auditor may subsequently be questioned, often with the benefit of hind sign, in such circumstances it is important that the auditor demonstrates the relevant facts that were known at the time the auditor drew his conclusion.

Working papers should provide an experienced auditor with no previous connection with the audit with an understanding of the work performed and the basis of decision taken.

Form and control of working papers
The form and content of working papers are affected by matters such as;
- the nature of the engagement;
- the form of the auditors report;
- the nature and complexity of the entity's business.
- the nature and condition of the entity's accounting and internal control system
- the needs in the particular circumstances for direction, supervision of the work of members of the audit team, and
- the specific methodology and technology of auditors use.

The following are general guidelines to be followed in the preparation of working papers;
- permanent ink should be used;
- descriptions should be given of audit symbols used
- All working papers must be prepared neatly and tidily so that they clearly concisely and logically show the schedules, results of tests etc. They should be headed with the client's name and file number, period end, subject of working paper reference of working paper within files, initials of preparers and date of preparation plus initials of reviewer and date of review.

Working papers are usually divided between two files;-

a) **The current file:**

The current file will contain the work performed for the current period; Typical contents need not be memorised but it is important to understand the type of information held on this file.

All working papers which records tests must be concluded by the person undertaking the test with a summary of the result of the test and a conclusion (opinion) on its effectiveness.

Schedules supporting a figure in the balance sheet or profit and loss account should
- consist of a summarised schedule (a lead schedule) showing the make-up of the figures in the balance sheet, an be supported by backing schedules showing the make-up of those figures on the lead schedule;
- have extensive cross-referencing between the backing schedules, lead schedules and the accounts themselves to facilitate explanation of any figure in the accounts or working paper,
- give comparative figures for the previous year so that the auditor can explain and satisfy himself on movement differences between the years
- Be adjusted if any final adjustments are made to the accounts
- Show the tests carried out to verify the figures on the schedules.

Note:

If the client on his own does not, but could, prepare schedules, he should be encouraged to do so and the auditor will only have to satisfy himself as to their reliability. This saves on audit time and costs.

Where matters are raised during audit, the replies thereof must be recorded and the fact that the query has been cleared for audit purposes indicated.

TYPICAL CURRENT AUDIT FILE'S CONTENTS

Section	Title	Information contained
1	Index	
2	Accounts	I) Copy of draft accounts ii) Copy of final signed accounts
3	Reports and final papers	I) Copies of all draft and final reports issued to client ii) Comments received from client and letter of representation iii) Points on accounts and paints carried forward to next year iv) Management letters v) Final journal entries vi) Company accounts chechlist - Directors' report vii) Reporting partner's review viii) Audit completion report
4	Job administration and planning	I) Planning programme ii) Budget and fee estimate iii) Time and cost summary iv) Briefing notes v) copy of planning letter to client vi) Points forward from previous years
5	Balance sheet profit and loss account and cash flow statement	I) Lead schedules ii) Audit programmes iii) Detailed working papers and conclusions iv) Company accounts and accounting standard checklists v) Queries raised and explanations received vi) Third party confirmations and certificates
6	Systems testing	I) Audit programmes (tests of control and substantive) ii) Detailed working papers and conclusions iii) Queries raised and explanations received iv) Weaknesses identified and copy of letters of weakness to client
7	Accounts preparation	I) Schedules ii) Trial balance iii) Cross-reference to audit work performed
8	Extracts from minutes	I) Directors' meetings ii) Members' meetings
9	Statistical information	Performance indicates collected which have a bearing on the

extent, nature, timing of substantive tests
(permanent audit files
should be updated accordingly).

PERMANENT FILE:
Contains that information which is more static and/or is of recurring value to the audit. It will be updated with new information of continuing importance.

Typical permanent audit file contents

Section	File	Information contained
1.	Index	-
2	Constitution	I) Copies of MOA and AOA detailing the legal form, business objects, borrowing powers ii) Partnership agreement or iii) Trust deed
3	Background and organisation	I) Nature and history of business ii) Ownership iii) Registered office iv) Management structure - including organisation chart, client's v) Industry - size, economic factors affecting the industry, seasonal fluctuations and demands. v) Premises and plant - Locations, extent of facilities, owned or leased, age, capital expenditure budgets. vi) Products - Volumes, main suppliers vii) Sales - volumes, main customers, methods of distribution, pricing policies, exports viii) Personnel - numbers, analyses, by departments, or function, method of remuneration, contracts, union agreements, person schemes.
4	Systems (For large audits	I) Detailed method of - Manual, EDP

	this section could be held on a separate file)	accounting ii) List of accounting records and where kept iii) Flow charts and specimen of accounting documents and accounting codes iv) Accounting manuals v) Statistical information how they	- Costing systems - Composition of reserves arose and movements - A 5 year comparison of performance indicators (major accounting ratios) - Industry statistics
6	Contracts agreements minutes	I) Leases ii) Title deeds inspected annually by auditor iii) Royalty agreements iv) Minutes of continuing importance v) Prospectuses vi) Stock exchange undertakings	- Extracts - Details - Extracts - Directors' meetings - Members' meetings - Copies - Copy
7	Group	I) Group structure ii) Primary/secondary auditors	
8	Taxation	I) Special concessions with inland revenue ii) VAT information iii) Group elections	
9	Other professional advisors	I) Bankers ii) Solistors iii) Stock brokers iv) Registrars	
10	Job administration	I) Letter of engagement ii) Letter of authority iii) Job administration - Time budgets and costing	
11	Control	I) Control schedule of rotation tests ii) Control view branch and site visits iii) Deed examination iv) Review of other auditors on group audits v) Copies of management letters	
12	Miscellaneous	Details of other client information of a permanent nature.	

STANDARDISED WORKING PAPERS

These offer the following advantages:-

a) They improve the efficiency of the preparation and review of working papers
b) They facilitate the delegation of work
c) They provide a means of control of the quality of work
d) They are useful for routine documentation such as checklists for financial reporting standards, statements of standard accounting practice and specimen letters. However, it is never appropriate to follow mechanically a standard approach to the conduct and documentation of the audit without regard to the needs to exercise professional judgement.

Confidentiality, safe custody and ownership of working papers
SAS 230.4 states that "Auditors should adopt appropriate procedures for maintaining the confidentiality and safety of their working papers.'

There are no specific statutory requirements regard the period of retention of audit working papers. Auditors exercise judgement to determine the appropriate period of retention bearing in mind possible needs of their client, for example prospectus at some future date, and their own needs, including any regulatory requirements.

Prior to their destruction, auditors consider whether there is likely to be a need to refer to them again.
Working papers are the property of the auditors. They are not a substitute for, nor part of, the entity's accounting records.

Auditors comply with ethical guidance as to the confidentiality of working papers. Portions of, or extracts from, the working papers may be made available to the entity at the discretion of the auditors, provided such disclosure does not undermine the independence or the validity of the audit process. Information is generally not made available to other third parties (including parent comaries or subsidiary undertakings or their auditors without the permission of the entity.

QUALITY CONTROL AND REVIEW PROCEDURES:
SAS 240.1 requires that quality control policies and procedures should be implemented both at the level of the audit firm and on individual audits.

The audit firms should establish and monitor quality control policies and procedures designed to ensure that all audits are conducted in accordance with the auditing standards and should communicate those policies and procedures to their personnel in a manner designed to provide reasonable assurance that the policies and procedures are understood and implemented (SAS 240.2)

The nature, timing and extent of auditors' quality control policies and procedures depend on a number of factors such as the size of the practice, geographic dispersion, organisation and appropriate cost/benefit consideration.

The quality control policies to be adopted by auditors usually incorporate the following ;-
a) <u>Professional requirements - i.e ethical requirements</u>
Personnel adhere to the principles of independence, integrity, objectivity, confidentiality and professional
behaviour.

b) <u>Skills and competence</u>
Personnel have attained and maintain the technical standards and professional competence required to enable them

to fulfil their responsibilities with due care. In use should be manuals, standardised documentation and programmes
and regular update of procedures.
Including effective recruitment of personnel with suitable qualifications and any necessary expertise in specialised
areas.
Other facilities include technical libraries, appropriate training arrangements, attendance at professional courses,
professional publications and relevant legislations.

c) **Acceptance and retention of clients**
Prospective clients are evaluated and existing clients are reviewed on an ongoing basis. In making a decision to
accept or retain a client, the auditors' independence and ability to serve the client properly and the client's
management are considered.

d) **Assignment**
Audit work is assigned to personnel who have the degree of technical training and proficiency required in the
circumstances.

e) **Delegation**
Sufficient direction, supervision of work and review at all levels is carried out in order to provide confidence that
the work performed meets appropriate standards of quality.

f) **Consultation**
Whenever necessary within or outside the audit firm occurs with those who have appropriate expertise and

g) **Monitoring**
The continued adequacy and operational effectiveness of quality control policies and procedures are monitored.
This may include periodic review of a sample of the firm's audit files by independent reviewers; the firm having set
levels of competence of or partners and staff who participate in the review, establish procedures to resolve
disagreements which may arise between the reviewers and audit staff and have procedures for selection of particular
audits for review.

Review of audit work takes a number of different forms.

i) **Hot review:** Working papers produced by a member of the audit staff are checked by a more experienced member of the staff who initials the papers.

ii) **Post-audit review (cold review)**
At the end of the audit before the audit report is signed, the manager or partner reviews that audit file an final
accounts

iii) **Audit review department**
This team review in detail the work performed by an audit group and ensures that the audit has been conducted in
accordance with the firm's standard procedures.

iv) **Real review**

One firm of auditors reviews the working practices of another firm and reports to the partners of the investigated
firm on the ways in which their procedures might be improved.

INDIVIDUAL AUDITS

For each audit, the audit engagement partner (person who assumes ultimate responsibility for the conduct of the audit and for issuing an opinion on the financial statements) should apply quality control procedures appropriate to the particular audit which ensures compliance with auditing standards (SAS 240.3).

Any work delegated to assistants should be directed, supervised and reviewed in a manner which provides reasonable assurance that such work is performed competently. The audit engagement partner and personnel with supervisory responsibilities consider the professional competence of assistants performing work delegated to them when deciding the extent of direction, supervision and review appropriate for each assistant.

Appropriate direction to assistants involves informing them of their responsibilities and the objectives of the procedures they are to perform. This also involves informing them of matters such as the nature of the entity's business and possible accounting or audit problems which may affect the nature, timing and extent of audit procedures. Audit directions may be communicated by manuals or checklists as well as audit programmes and the overall audit plan.

Supervision

Personnel with supervisory responsibilities perform the following functions during the audit;-

- Monitor the progress of the audit to consider whether assistants have the necessary skills and competence to carry on their assigned tasks, understand the audit directions and the work is being carried out in accordance with the overall audit plan and the audit programme.
- Become informed of and address significant accounting and auditing questions raised during the audit, by assessing their significance and modifying the overall audit plan and programme as appropriate and
- Resolve any differences of professional judgement between personnel and consider the level of consultation that is appropriate.

Review

Work performed by each assistant is reviewed by personnel of appropriate experience to consider whether;

- the work was performed in accordance with the audit programme
- the work performed and the results obtained have been adequately documentated
- any significant audit matters have been resolved or are reflected in audit conclusions
- the objective of the audit procedure have been achieved
- the conclusions expressed are consistent with the results of the work performed and support the audit opinion.

The following are reviewed on a timely basis;

The overall audit plan and the audit programme, the assessment of inherent and control risks, the documentation obtained from substantive procedures and conclusions drawn there from including the results of consultations and the financial statements, proposed audit adjustment and proposed auditor's report.

SMALL COMPANY AUDITS

Characteristics

a) These employ very few staff and hence there is very little scope for division of responsibilities
b) The accounting systems are often relatively unsophisticated and possibly dominated by one person.
c) The owners of the business are frequently heavily involved in the day-to-day running of the business.

Internal controls
The restricted scope of division of responsibilities and the domination of the accounting function by one person constrain the effective internal control. However, the extent of management supervision in day-to-day operations is critical.

While the day-to-day supervision is an important check by management employees, there is little check on management itself.

In small but rapidly expanding business, much of the proprietor's time is taken up with steering the business along an expansion path that the extent and effectiveness of day-to-day supervision is very much reduced.

Auditing considerations for small companies:-

1. **The engagement letter**

The remove misunderstandings the client may have as to auditors' responsibilities and to make clear the distinction
between audit and accountancy.

2. **Substantive procedures**

Since controls are weak, tests on debtors and stock verification will be very much intensified though no amount of
substantive procedures will offer the auditor the necessary assurance where controls are very poor e.g where there
are large amounts of cash receipts not accorded accurately. Most of the time audit reports for small companies are
qualified for this reason.

3. **Management representations**

These are to be relied on to a far greater extent. These representations should be backed up by supporting evidence.

4. **Overall review**

Accounting records may be fairly simple and management information such as monthly accounts budgets non
existent and hence limit the extent of analytical procedures.

Audit techniques and small companies
Planning and recording are simple with a small client, but needed. The need to record the work done and evidence obtained is equally great.

<u>Accounting system</u>:- Not well developed
<u>Internal control</u>: Not to be relied on
<u>Audit evidence</u>: Harder to obtain
<u>Review of financial statements</u>: should be reviewed as much as large company.

Audit independence and small companies

The auditor tends to perform more than just the audit. He is looked upon for advise and guidance and may be involved in preparation of accounts for taxation matters. Audit fee is likely to be larger.

Arguments against audit of small companies
1. Audited accounts serve only a compliance function and add little to management's knowledge and understanding of the business.
2. The resources expended by the company on the audit could be used to obtain more useful financial advice.
3. Banks and other financiers are generally in a position to make specific conditions for providing finance, and therefore have little need for a statutory audit.
4. Abbreviated accounts filed ten months after the year end are of little value to trade suppliers and customers in establishing a trading relationship.

Arguments for small company audits:
1. Most auditors consider that it is perfectly possible to audit a small company and produce a satisfactory audit report.
2. If banks and other creditors required their own independent audit, the result might be to increase, not reduce, the costs of a small company.
3. The audit is necessary to protect creditors which is important in view of limited liabilities of the shareholders
4. Shareholders, particularly minority shareholders are entitled to full and reliable information about the position of their company.

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