NATIONAL UNIVERSITY OF LIFE AND ENVIRONMENTAL SCIENCES OF UKRAINE

FACULTY OF ECONOMICS

DEPARTMENT OF ACCOUNTING AND AUDIT

“APPROVED”

Dean of the faculty of Economics

_______________/Anatolij Dibrova/

“_____”_________________2015

REVIEWED AND APPROVED

At the meeting of the department

of Accounting And Audit

Minute #___ from “__” ___ 2015

Head of the Department

________________ /Tetiana Kaminska/

SYLLABUS

Academic Discipline “Organisation and methods of audit”
for ED “Master” 8.03050901

Specialty- Accounting and Audit

Syllabus compiled by: Assistants Professor Olga Ilchak

Kyiv, 2015

Curriculum of Academic Discipline “Organisation and methods of audit” for ED “Master” specialty 8.03050901 “Accounting and Audit” is reviewed and approved

„_18_” ____05____, 2015 р. – 16 с.

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Head of the Department ____________________ (_T.G. Kaminska_)
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Minute from “_19_”_____05_____2015 р. 3 _5_

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(підпис) (прізвище та ініціали)

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CURRICULUM

Academic Discipline “Organisation and methods of audit” for ED “Master” 8.03050901

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1. Academic discipline description

« Organisation and methods of audit »

Field of knowledge, direction, specialty, educational degree		
Educational degree	Master	
Specialty	"Accounting and Audit"	
Area of training	"Accounting and Audit"	
Characteristics of training programme		
Type		
The total number of academic hours	120	
Number of ECTS credits allocated	4	
Number of modules	2	
Forms of cotrol	exam	

Indicators of academic discipline for full-time and part-time forms of training course		
	Full-time	**Part-time**
Year (course)	2	
Semester	3	
Number of lectures	20	
Number of seminars, practical classes	20	
Laboratory sessions (activities)	-	
Independent study	80	
Individual lessons	-	
Number of weekly in-class academic hours for full-time forms of training	4	

2. Goal and objectives of academic discipline

Goal is formation of basic theoretical knowledge and practical skills for organization and methods of auditing, organization of audit firm activity and auditor's work.

Learning objectives are

- Studying of theoretical basis of audit functioning as independent financial control in Ukraine;
- Exploring of normative legal acts, which regulate audit and bank activity;
- Training of practical skills for organization;
- Reasoning of general methodological bases of audit organization at enterprises in accordance with regulatory acts under conditions of market and competition;
- Expanding students' knowledge of the system of economic control methods for control of business activity and financial reporting;
- Training in using modern technical receptions, methods, forms of auditing, their systematic perfection, in accordance with the changes of economic conditions of

business;

- Generalization of practical experience of auditing of the leading auditing firms and its implementation in educational process;
- Exploring of specialized audit software and automatized auditor ‘s workstation creation.

Learning outcomes :

Upon completion of this course, students should be:

competent in:

- essence of audit under the market conditions, its importance, tasks and development trends;
- legal and organizational basis of audit in Ukraine and abroad;
- organizational and methodical aspects of financial reports audit and providing of related services;
- international experience in organization and methods of financial audit;
- methods of internal and external auditing of financial and tax enterprise reporting
- particular features of the auditing of joint stock companies, small enterprises and enterprises with foreign investments

be skilled in:

- organization of audit firm, composition its founding documents, its registration for acquisition of rights to perform audit activities;
- planning of audit firm work, development of strategy and general auditing plan, auditing program, audit firm employee job description;
- organization of normative and legal, informational, technical and other types of auditor’s work providing;
- choice of optimal methods of audit treatment and organization of its compliance;
- drawing up of current and final auditing documents;
- analyzing of collected during auditing information, preparing of auditor’s and audit firm’s reporting for client and Audit Chamber of Ukraine
- organizing of internal audit system;
- organizing of cooperation between auditors and client-enterprise employees during the audit treatments;
- objectively evaluation the information, collected during the auditing evidence and facts analysis, preparing of conclusions and recommendations, reporting on the results of auditing of efficiency;
- preparing of independent auditor’s report.

3. The structure of the curriculum of academic discipline for full-time form of training

Topic		Amount of hours			
		Lecture	Seminar	Self-study	Total
Theme module 1. Basis of audit and audit of assets and capital equity					
1.	Subject, method and objects of organization and methods of audit.	2		4	6
2.	Organization of activity and quality control for work of audit firm and auditors.	2		4	6
3.	Organization of financial reporting and its informational providing audit.	2		4	6
4.	Audit of founding documents, accounting policy and equity.	2	2	4	8
5.	Audit of property, plant and equipment and investments.		2	6	8
6.	Audit of cash and receivables.		2	6	8
7.	Audit of inventories and construction in progress.		2	6	8
Total with theme module		8	8	34	50
Theme module 1. Audit of liabilities and audit completing					
8.	Audit of employee work and benefits.		2	8	10
9.	Audit of long-term and short-term liabilities.		2	8	10
10.	Audit of expenses and cost.	2	2	6	10
11.	Audit of income and financial results forming.	2	2	6	10
12.	Audit of tax accounting and payments.	2	2	6	10
13.	Completing of audit and generalization of financial reporting audit results.	2	2	4	8
14.	Challenges in terms of financial reporting, particulars types of audit and audit services.	2		4	6
15.	Internal audit for business entities.	2		4	6
Total with theme module		12	12	46	70
Total academic hours		**20**	**20**	**80**	**120**

4. Themes of laboratory activities

#	Name of theme	Number of hours
1	Audit of founding documents, accounting policy and equity.	2
2	Audit of property, plant and equipment and investments.	2
3	Audit of cash and receivables.	2
4	Audit of inventories and construction in progress.	2
5	Audit of employee work and benefits.	2
6	Audit of long-term and short-term liabilities.	2
7	Audit of expenses and cost.	2
8	Audit of income and financial results forming.	2
9	Audit of tax accounting and payments.	2
10	Completing of audit and generalization of financial reporting audit	2
Totally		**20**

5. Independent study

#	Name of theme	Number of hours
1	Subject, method and objects of organization and methods of audit.	6
2	Organization of activity and quality control for work of audit firm and	6
3	Organization of financial reporting and its informational providing audit.	6
4	Audit of founding documents, accounting policy and equity.	8
5	Audit of property, plant and equipment and investments.	8
6	Audit of cash and receivables.	8
7	Audit of inventories and construction in progress.	8
8	Audit of employee work and benefits.	10
9	Audit of long-term and short-term liabilities.	10
10	Audit of expenses and cost.	10
11	Audit of income and financial results forming.	10
12	Audit of tax accounting and payments.	10
13	Completing of audit and generalization of financial reporting audit	8
14	Challenges in terms of financial reporting, particulars types of audit and	6
15	Internal audit for business entities.	6
Totally		**80**

6. Test questions for final assessment

1. What is the objective of an audit?

A. An audit is a process, a structured series of tasks, the purpose of which is to provide evidence to support the claim that the financial statements are fairly stated (give a true and fair view).

B. To be fairly stated, the statements must conform to accepted accounting principles (whether these principles are set by government, private organisation s or custom).

C. The audit process must be planned, staffed and carried out, and the evidence must be gathered, in a manner that is consistent with professional auditing standards.

D. All answers are right.

2. Identify the two components of audit quality.

A. technical quality element
B. organisation quality element
C. methods quality element
D. functional quality element

3. What is the independence in fact?

A. exists when the accountant is able to maintain an unbiased attitude throughout the audit, so being subjective and partial;

B. is the result of ISA Board's interpretations of this independence;

C. exists when the accountant is able to maintain an unbiased attitude throughout the audit, so being objective and impartial;

D is the result of others' interpretations of this independence.

4. Indefinite subject matter.

A. a company that orders audit related services;
B. the audit firm, which provide audit and audit related services;
C. the auditor, who process the audit;
D. the topic about which the assurance is conducted.

5. What are the major sources of client information auditors have available?

A. their experience with the client;
B. publicly available information;
C. gossip, rumours about client;
D. from the client themselves.

6. What components of the audit risk exist independently of the audit?

A. Inherent risk
B. Audit risk
C. Control risk
D. Detection risk

7. Describe the four objectives of internal control.

1 operations – ____;
2 financial reporting – ____________________________________;
3 compliance – ____;
4 safeguarding of assets – _________________________________.

8. In assessing going concern list three financial indicators, three operating indicators and three other indicators.

Financial Indications

1.____
2.____

3.____

Operating Indications

1.____

2.____

3.____

Other indications

1.____

2.____

3.____

9. List the six evidence-gathering techniques in order of cost from highest to lowest.

1. confirmation
2. ____
3. analytical procedures.
4. inquiry
5. ____
6. observation

10. What type of opinion is issued when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of his report is not adequate to disclose the misleading or incomplete nature of the financial statements?

A. an adverse opinion
B. a disclaimer of opinion
C. a qualified opinion
D. standard unqualified opinion

Questions

1. What may an auditor do if positive confirmations were not replied to on the second mailing?

2. The following are 8 audit procedures taken from an audit program:

1. Review board of directors' minutes to verify approval of equipment purchases.
2. Review sales, cash receipts and sales returns cutoffs.
3. Examine the initials on vendors' invoices that indicate internal verification of pricing, extensions (price X units), and footing by a clerk.
4. Reconcile marketable security summary schedules to general ledger.
5. Compare the balance in payroll tax expense with previous years; taking into consideration any changes in payroll tax rates.
6. Count a sample of inventory and check against inventory sheets.
7. Account for a sequence of checks in the cash disbursements journal to determine whether any have been omitted.
8. Confirm accounts payable balances in writing with a sample of vendors.

REQUIRED

A. For each of the above audit procedures, give the audit area (accounts receivable, cash, etc.), and an example of an audit objective and a financial statement assertion.

B. For each audit procedure, list a technique for gathering evidence used (inquiry of client personnel, inspection, observation, examination of documents, reperformance, confirmation, analytical procedures and physical examination.)

7. Teaching methods

Lectures are conducted with using media teaching aids. Laboratory work and independent work are conducted by means of information and communication technologies in education. Synchronized the projector and audio equipment are used.

8. Forms of control

Evaluation and grading

At the end of each theme module students' knowledge is monitored by the writing a test. Final control: examination.

Grading system: National and ECTS

National grade	Grade ECTS	Grade according to national system	Percentage score
passed	**A**	Excellent	90 – 100
	B	Very good	82-89
	C	Good	74-81
	D	Satisfactory	64-73
	E	Satisfactory enough	60-63
Not-passed	**FX**	Unsatisfactory	35-59
	F	Unsatisfactory– serious work is needed	0-34

9. Technology and methodological requirements

Methodical recommendations and tasks for practical classes and self-studying for students of specialty 8.03050901 "Accounting and Audit" by author edition. Recourses of Educational, scientific and production laboratory "Information technology in the accounting" are used during the lectures and seminars.

10. Required and recommended literature

Basic literature

1) Hayes R., Dassen R., Schilder A., Wallage Ph. (2008) *PRINCIPLES OF AUDITING An Introduction to International Standards on Auditing*. Pearson Education Limited, Edinburgh Gate.

Supplemental materials

1) *ACCA Paper F8 (INT/UK). Audit and Assurance. Essential Text.* Kaplan Publishing UK Unit 2 The Business Centre.

Normative literature

1) Code of Ethics for Professional Accountants
https://www.ifac.org/system/files/publications/files/ifac-code-of-ethics-for.pdf
2) International Accounting Standards and International Financial Reporting Standards
http://www.minfin.gov.ua/control/uk/publish/article?showHidden=1&art_id=408095&cat_id=408093&ctime=1423500775962
http://www.ifrs.org/IFRSs/Pages/IFRS.aspx
3) International Standards on Audit
http://www.aasc.org.ph/downloads/isa/isa.php
http://apu.com.ua/files/temp/Audit_2013_1.pdf
http://apu.com.ua/files/temp/Audit_2013_2.pdf

IT resources

Materials of official sites:

1) Audit Chamber of Ukraine http://apu.com.ua/
2) Ministry of Finance of Ukraine http://www.minfin.gov.ua/
3) Ernst & Yang http://www.ey.com/UA/uk/Home
4) Deloitte http://www2.deloitte.com/ua/uk.html
5) PricewaterhouseCoopers http://www.pwc.com/ua/uk/index.jhtml
6) KPMG http://www.kpmg.com/ua/uk/pages/default.aspx

LECTURE NOTES

Topic 1

Subject, method and objects of organization and methods of audit

Objects

- Relate some of the early history of auditing.
- Discuss some of the audit expectations of the general public.
- Identify organizations that affect international accounting and auditing.
- Name the standards set by International Auditing and Assurance Standards Board.
- Give an overview of the IFAC International Standards on Auditing (ISA).
- Understand the basic definition of auditing in an international context.
- Distinguish between audit risk and business risk
- Differentiate the different types of audits.
- Distinguish between the types of auditors and their training, licensing and
- authority.
- Name and categorize the key management assertions.
- Give the components of the audit process model.
- Describe how international accountancy firms are organized and the
- responsibilities of auditors at the various levels of the organization.

Auditing predates the Christian era. Anthropologists have found records of auditing activity dating back to early Babylonian times (around 3000 BC). There was also auditing activity in ancient China, Greece and Rome. The Latin meaning of the word “auditor” was a “hearer or listener” because in Rome auditors heard taxpayers, such as farmers, give their public statements regarding the results of their business and the tax duty due.

■ Scribes of Ancient Times

Auditors existed in ancient China and Egypt. They were supervisors of the accounts of the Chinese Emperor and the Egyptian Pharaoh. The government accounting system of the Zhao dynasty in China included an elaborate budgetary process and audits of all government departments. From the dawn of the dynastic era in Egypt (3000 BC) the scribes (accountants) were among the most esteemed in society and the scribal occupation was one of the most prestigious occupations.

Egyptian Pharaohs were very severe with their auditors. Each royal storehouse used two auditors. One counted the goods when they came in the door and the second counted the goods after they were stored. The supervisor looked at both accounts. If there was a difference, the auditors were both killed.

Bookkeeping as a support mechanism for the determination of profit or wealth, or as a decision support system for achieving profit maximization, was basically unknown in ancient cultures like the Mesopotamian, Egyptian, Greek or Roman. Auditing in Englishspeaking countries dates to 1130 AD. Then, although they had highly developed economic systems, registration of economic facts or events was limited to the recording of single transactions whose sole purpose was to support the short-term memory of the trading partner.

Rational maximization of wealth or profit did not fit into the systems of these cultures. Wealth was not a function of keen entrepreneurship or of smart cost–benefit trade-offs. It was merely a reward for one's loyalty to the government or for living in accordance with religious and moral principles and rules.

At the same time, companies across the world experienced growth in technology, improvement in communications and transportation, and the exploitation of expanding worldwide markets. As a result, the demands of owner-managed enterprises for capital rapidly exceeded the combined resources of the owners' savings and the wealth-creating potential of the enterprises themselves. It became necessary for industry to tap the savings of the community as a whole. The result has been the growth of sophisticated securities markets and credit-granting institutions serving the financial needs of large national, and increasingly international, corporations.

The flow of investor funds to the corporations and the whole process of allocation of financial resources through the securities markets have become dependent to a very large extent on financial reports made by company management. One of the most important characteristics of these corporations is the fact that their ownership is almost totally separated from their management. Management has control over the accounting systems. They are not only responsible for the financial reports to investors, but they also have the authority to determine the way in which the information is presented.

Investors and creditors may have different objectives than management (e.g., management prefers higher salaries and benefits (expenses), whereas investors wish higher profits and dividends). Investors and creditors must depend on fair reporting of the financial statements. To give them confidence in the financial statements, an auditor2 provides an independent and expert opinion on the fairness of the reports, called an audit opinion.

■ Auditing Expertise

Ordinarily, considerable expertise is needed to perform the auditing function. The auditor must be as competent in financial accounting as the most competent of his clients. He must be an expert in deciding what evidence is necessary to satisfy the assertions of the financial statements.

With the explosion in the use of information technology the auditor needs sufficient expertise, coupled with the knowledge of his client's affairs, to enable him to obtain and interpret all the evidence needed to provide reasonable assurance that the financial statements are fairly presented. The new auditing environment will demand new skills of auditors if they are to be reporters and assessors of governance and measurements. They must have a questioning mind and be able to analyze and critically assess evidence.

■ Future of Auditing

In the future, as is the case today, the annual report, financial statements, notes and auditors' reports will be required. In addition to these, however, there will also be a management report,6 a director's report on corporate governance7 (including effectiveness of internal control systems,8 going concern, and adherence to Codes of Best Practice), and presumably an environmental management report.9 These new reports come from the widespread concern about corporate governance resulting from major accounting scandals in the beginning of the twenty-first century. (See Chapters 2 and 14 for further discussion.)

Professor P. Percy, a partner in Grant Thornton and professor at Aberdeen University, outlined a perspective on the auditor's future. He predicted that auditors will account for information not only in financial but also non-financial terms. Furthermore, only retrospective, but more and more prospective information will be in the annual report. The public desire will be for external and internal assessors on the board of directors. External assessors will appraise the integrity of information and business conduct, and internal assessors will appraise the efficiency and effectiveness of systems and their adequacy. Independent directors or assessors working on behalf of the shareholders within the board will ensure proper governance is being observed.

■ International Financial Reporting Standards (IFRS)

Financial accounting standards are unique and separate from audit standards. By its nature, auditing requires that the real-world evidence of financial transactions be compared to financial standards. The standards to which an international auditor compares financial statements are generally standards in the reporting country (e.g. FAS in the USA, or national standards in European Union (EU) Member States which are based on EU Directives. In the future, companies and auditors in the EU and other countries will use International Financial Reporting Standards (IFRS), formerly called International Accounting Standards (IAS), which are set by the International Accounting Standards Board (IASB).

In March 2001, the IASC Foundation was formed as a not-for-profit corporation. The IASC Foundation is the parent entity of the International Accounting Standards Board, an independent accounting standard setter based in London, UK. In April 2001, the International Accounting Standards Board (IASB) assumed accounting standard setting responsibilities from its predecessor body, the International Accounting Standards Committee.11 New standards issued by the IASB will be called International Financial Reporting Standards (IFRS). The EU has agreed to apply most of the IFRS from 2005 onwards.

Topic 2

Organization of activity and quality control for work of audit firm and auditors

Objects

- Know the financial statement certification requirements of the chief
- executive officer and chief financial officer under the Sarbanes-Oxley Act.
- Understand the basic elements of the auditor's report: contents and form.
- Explain the contents and importance of the unqualified audit opinion.
- Distinguish between the different types of opinions given in audit reports on
- financial statements.
- Describe the circumstances that may result in modifications of an audit
- report on financial statements containing an unqualified opinion.
- State the two circumstances that require an auditor's report containing an
- opinion other than an unqualified one.
- Understand how some uncertainties lead to qualification of opinions in the
- audit report on financial statements.
- Give the procedures required to finalize the audit.
- Discuss the audit matters of governance interest arising from the audit of
- financial statements that the auditor must communicate to those charged
- with governance of an entity.
- Give details contained in the long-form audit report.
- Address the new developments in reporting brought about by XBRL and the
- possibility of continuous reporting.

The demand for audit services may be explained by several different theories. Some theories like the Theory of Inspired Confidence and Agency Theory have been well researched and reported on. Other theories based on public perceptions such as the Policeman Theory and the Lending Credibility Theory serve more as a point of reference than a researched construct.

■ The Policeman Theory

Is an auditor responsible for discovering fraud, like a policeman? Think of this idea as the Policeman Theory. Up until the 1940s it was widely held that an auditor's job was to focus on arithmetical accuracy and on prevention and detection of fraud. However, from the 1940s until the turn of the century there was a shift of auditing to mean verification of truth and fairness of the financial statements. Recent financial statement frauds such as those at Ahold, Xerox, Enron, Tyco, etc. have resulted in careful reconsideration of this theory. There now is an ongoing public debate on the auditor's responsibility for detection and disclosure of fraud returning us to the basic public perceptions on which this theory derives.

■ The Lending Credibility Theory

Another public perception is that the primary function of auditing is the addition of credibility to the financial statements. We may think of this as the Lending Credibility Theory. Audited financial statements are used by management to enhance the stakeholders' faith in management's stewardship. If stakeholders such as stockholders, government, or creditors have to make their judgments based on the information they receive, they must have faith that this is a fair representation of the economic value of the firm. In audit research terms this reduces the "information asymmetry". However, there is an efficient markets theory that holds that audited information does not form the primary basis for investors' investment decisions.

■ The Theory of Inspired Confidence

This theory was developed in the late 1920s by the Dutch professor Theodore Limperg. In contrast to the preceding theories, Limperg's theory addresses both the demand and the supply of audit services. According to Limperg, the demand for audit services is the direct consequence of the participation of outside stakeholders (third parties) in the company. These stakeholders demand accountability from the management, in return for their contribution to the company. Since information provided by management might be biased, because of a possible divergence between the interests of management and outside stakeholders, an audit of this information is required. With regard to the level of audit assurance that the auditor should provide (the supply side), Limperg adopts a normative approach. The auditor should act in such a way that he does not disappoint the expectations of a "rational outsider", while, on the other hand, he should not arouse greater expectations in his report than his examination justifies. So, given the possibilities of audit technology, the auditor should do everything to meet reasonable public expectations.

■ Agency Theory

In the agency theory, originally proposed by Watts and Zimmerman,3 a reputable auditor – an auditor who is perceived to meet expectations – is appointed not only in the interest of third parties, but also in the interest of management. A company is viewed as the result of more or less formal "contracts", in which several groups make some kind of contribution to the company, given a certain "price". Company management tries to get these contributions under optimum conditions for management: low interest rates from bankers, high share prices for stockholders, low wages for employees.

In these relationships, management is seen as the "agent," trying to obtain contributions from "principals" such as bankers, stockholders and employees. Costs of an agency relationship are monitoring costs (the cost of monitoring the agents), bonding costs (the costs, incurred by an agent, of insuring that agents will not take adverse actions against the principals), and residual loss (effective loss that results despite the bonding and monitoring costs incurred).

How is the auditor evaluated in the market place? In line with other service providers, auditors are evaluated based on technical and functional quality elements. Technical audit quality is defined as the degree to which an audit meets a consumer's expectations with regard to the detection and reporting of errors and irregularities regarding the audited company and its financial statements. Hence, technical audit quality addresses the quality of the outcome of the audit process: how good is the auditor at finding errors in the financial statements, or at detecting fraud or going concern problems?

Functional audit quality is defined as the degree to which the process of carrying out the audit and communicating its results meets a consumer's expectations. This aspect of audit quality represents not the outcome, but the process itself. Dassen found, in his study of the Dutch audit market,8 that clients do not just appreciate the detection ability of auditors (technical quality), but also the auditor's ability to identify points of interest to management regarding corporate finance, internal control, or general business management, as a by-product to giving their opinion on the accuracy of the financial statements. Furthermore, they appreciate an auditor's empathy (does the auditor understand the client's business and language, does he know his client's needs?) and communication skills.

Quality and Length of Tenure

An interesting engagement characteristic is the length of tenure. Mostly, first-year audit engagements are perceived as less thorough, since it takes some time to identify all potential audit risks for a new client. However, after a long period, the auditor might lose his professional skepticism if the length of tenure exceeds 10 to 15 years. The abovementioned relationships have been subjected to many different research techniques with mixed results.

Fee Determination

As is very often the case, quality represents just one side of the coin. The other side is fee level. Fee setting by auditors has often been studied in audit research. Important determinants of audit fees are:

- the size of the auditee and the geographical dispersion;
- the size of the audit firm (Big Four firms seem to demand a fee premium);
- the level of consulting services;
- the quality of the auditee's internal control system;
- the type of fee contract (fixed fee versus variable fee).

Topic 3

Organization of financial reporting audit and its informational providing audit

Objects

- To describe practical methods used to collect audit evidence.

Audits, reviews and examination (special purpose engagements) of historical financial information are assurance engagements that have as their subject matter historical financial information.

■ Engagements to Audit Financial Statements

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. The expression of a conclusion

by an auditor is designed to enhance the degree of confidence intended users can have about historical financial statements. Audit engagements standards include ISA 120 to ISA 300. The rest of this book is about audit engagements, so these will not be discussed here.

■ Engagements to Review Financial Statements (ISRE 2000–2699)

A review of financial statements is similar to an audit in the way it requires terms of an engagement, planning, consideration of work performed by others, documentation, and paying attention to subsequent events. These concerns are discussed throughout this book, especially Chapter 5 on client acceptance, Chapter 6 on planning, Chapter 11 on completing the audit, and Chapter 11 which considers the appendix on documentation. Where reviews of financial statements differ most from a financial statement audit is that in a review report only limited procedures are performed (primarily inquiry of management and analytical procedures).

The objective of a review of financial statements is to enable an auditor to state whether (based on procedures that are not as extensive as would be required in an audit) anything has "come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework." This way of expressing an opinion is called negative assurance.

Limited Audit Procedures

Sufficient appropriate evidence for a financial statement review is limited to inquiry, analytical procedures, limited inspection and, in certain cases only, additional evidence gathering procedures. Inquiry (discussed in Chapter 10 on substantive procedures) consists of seeking information of knowledgeable persons inside or outside the entity. Analytical procedures (discussed in Chapter 9) consist of the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or deviate from predictable amounts. Inspection (in Chapter 10), which consists of examining records, documents, or tangible assets, is carried out on a limited basis.

A review of financial statement engagement, unlike an audit, usually does not involve collecting evidence about the design and operation of internal control, or obtaining evidence to back up the findings from inquiries or analytical procedures (i.e. corroborating evidence). Review engagements do not employ the evidence gathering techniques used in a financial statement audit such as observation, confirmation, recalculation, reperformance or extensive inspection.

Review of Financial Statements Report

The report on a review of financial statements should contain the following basic elements, ordinarily in the following layout.

(a) Title;

(b) Addressee;

(c) Opening or introductory paragraph including:

(i) Identification of the financial statements on which the review has been performed; and

(ii) A statement of the responsibility of the entity's management and the responsibility of the auditor;

(d) Scope paragraph, describing the nature of a review, including:

(i) A reference to the International Standard on Auditing applicable to review engagements, or to relevant national standards or practices;

(ii) A statement that a review is limited primarily to inquiries and analytical procedures; and

(iii) A statement that an audit has not been performed, that the procedures undertaken provide less assurance than an audit, and that an audit opinion is not expressed;

(e) Statement of negative assurance;

(f) Date of the report;

(g) Auditor's address; and

(h) Auditor's signature.

Review Conclusion

The review conclusion will be either an unqualified, qualified or adverse opinion. The unqualified opinion offers negative assurance, as we have discussed. If matters that impair a true and fair view in accordance with the identified financial reporting framework have come to the auditor's attention, the auditor may express a qualification of the negative assurance provided; or give an adverse opinion. When the effect of the matter is so material and pervasive to the financial statements that a qualification is not adequate an adverse statement states that the financial statements do not give a true and

fair view (or “are not presented fairly, in all material respects”) in accordance with the identified financial reporting framework.
The auditor should date the review report as of the date the review is completed, which includes performing procedures relating to events occurring up to the date of the report. However, the auditor should not date the review report earlier than the date on which the financial statements were approved by management.

■ Examination of Historical Financial Information such as Special
Purpose Engagements (ISA 800)

Standard audit reports are based on the financial statements “taken as a whole.” However, sometimes the auditor may have a request for a financial statement based on historical financial information, but which is not based on the financial statements as a whole or on IFRS or the requisite national standard. This is called examination of historical financial information, the prime example being special purpose engagements. Auditors may examine historical financial information for special purpose reports. An auditor may be called upon to report on components of the financial statements, such as when a bank requests an audit of accounts receivable in anticipation of financing. Sometimes there are audits that give an opinion on compliance with legal agreements required of a company. For instance, a subcontractor may ask for an audit to give comfort to a main contractor. Management or the board of directors may request a summarized financial statement. Small businesses are generally not required to comply with IFRS or a national standard. Small businesses may want to have financial statements based on the cash basis, an income tax basis, or a basis required by regulatory agencies.
The auditor’s report on a special purpose audit engagement, except for a report on summarized financial statements, should include the following basic elements. Like the audit review engagement described above, the report would include a title; addressee; opening or introductory paragraph; date of the report; auditor’s address; and auditor’s signature. The scope paragraph (describing the nature of an audit) and the opinion paragraph are different than that of a review. The scope paragraph describes the work the auditor performed, but does not say it is limited to inquiries and analytical procedures. The opinion paragraph contains a positive expression of opinion (not a negative assurance as in the review of financial statements) on the financial information.
Other comprehensive financial reporting frameworks may include:

■ that used by an entity to prepare its income tax return;
■ the cash receipts and disbursements basis of accounting;
■ the financial reporting provisions of a government regulatory agency.

Topic 4

Audit of founding documents, accounting policy and equity

Objects

- To identify and explain areas of risk.
- To apply procedures to obtain appropriate audit evidence

The main concern with share capital and reserves is that the company has complied with the law. The issued share capital as stated in the accounts must be agreed in total with the share register. An examination of transfers on a test basis should be made in those cases where a company handles its own registration work. Where the registration work is dealt with by independent registrars, auditors will normally examine the reports submitted by them to the company, and obtain from them at the year-end a certificate of the share capital in issue. Auditors should check carefully whether clients have complied with local legislation about share issues or purchase of own shares. Auditors should take particular care if there are any movements in reserves that cannot be distributed, and should confirm that these movements are valid.

AUDIT PLAN:

CAPITAL AND RELATED ISSUES SHARE EQUITY CAPITAL

x Agree the authorised share capital with the statutory documents governing the company's constitution.

x Agree changes to authorised share capital with properly authorised resolutions.

ISSUE OF SHARES

x Verify any issue of share capital or other changes during the year with general and board minutes.

x Ensure issue or change is within the terms of the constitution, and directors possess appropriate authority to issue shares.

x Confirm that cash or other consideration has been received or receivable(s) is included as called-up share capital not paid.

TRANSFER OF SHARES

x Verify transfers of shares by reference to:

– Correspondence
– Completed and stamped transfer forms
– Cancelled share certificates
– Minutes of directors' meeting

x Review the balances on shareholders' accounts in the register of members and the total list with the amount of issued share capital in the general ledger.

DIVIDENDS

x Agree dividends paid and proposed pre year-end to authority in minute books and reperform calculation with total share capital issued to ascertain whether there are any outstanding or unclaimed dividends.

x Agree dividend payments with documentary evidence (say, the returned dividend warrants).

x Test that dividends do not contravene distribution provisions by reviewing the legislation.

x Inspect tax returns to insure that imputed tax has been accounted for to the taxation authorities and correctly treated in the accounts.

RESERVES

x Agree movements on reserves to supporting authority.

x Ensure that movements on reserves do not contravene the legislation and the company's constitution by reviewing the legislation

x Confirm that the company can distinguish distributable reserves from those that are non-distributable.

x Ensure appropriate disclosures of movements on reserves are made in the company's accounts by inspection of the financial statements.

Chapter Roundup

x The largest figure in current liabilities will normally be trade accounts payable which are generally audited by comparison of suppliers' statements with purchase ledger accounts.

x Non-current liabilities are usually authorised by the board and should be well documented.

x The accounting treatments for provisions and contingencies are complex and involve judgement and this can make them difficult to audit.

x The main concern with share capital and reserves is that the company has complied with the law.

Quick Quiz

1 What are the two primary objectives of year-end work on liabilities?

(1) ………………………………………………………

(2) ………………………………………………………

2 Give two instances where trade accounts payables' confirmation is required.

(1) ………………………………………………………

(2) ………………………………………………………

3 State four issues auditors should consider when carrying out analytical review on wages and salaries.

(1) ………………………………………………………

(2) ………………………………………………………

(3) ……………………………………………………….
(4) ……………………………………………………….
The following audit plan can be used in the audit of provisions.
AUDIT PLAN: PROVISIONS/CONTINGENCIES
x Obtain details of all provisions which have been included in the accounts and all contingencies that have been disclosed.
x Obtain a detailed analysis of all provisions showing opening balances, movements and closing balances.
x Determine for each material provision whether the company has a present obligation as a result of past events by:
– Review of correspondence relating to the item
– Discussion with the directors. Have they created a valid expectation in other parties that they will discharge the obligation?
x Determine for each material provision whether it is probable that a transfer of economic benefits will be required to settle the obligation by:
– Checking whether any payments have been made in the post year-end period in respect of the item by reviewing after-date cash
– Review of correspondence with solicitors, banks, customers, insurance company and suppliers both pre and post year-end
– Sending a letter to the solicitor to obtain his views (where relevant)
– Discussing the position of similar past provisions with the directors. Were these provisions eventually settled?
– Considering the likelihood of reimbursement
x Recalculate all provisions made.
x Compare the amount provided with any post year-end payments and with any amount paid in the past for similar items.
x In the event that it is not possible to estimate the amount of the provision, check that a contingent liability is disclosed in the accounts.
x Consider the nature of the client's business. Would you expect to see any other provisions e.g. warranties?
x Consider the adequacy of disclosure of provisions, contingent assets and contingent liabilities in accordance with IAS 37.
The audit of provisions is notoriously complex because of the degree of judgement used and the availability of sufficient appropriate audit evidence. This is likely to be tested in a mini scenario type question so you must be able to apply your knowledge to the circumstances in the question.

Topic 5

Audit of non-current assets and investments

Objects

- To determine areas of risk in intangible and tangible assets and investments.
- To obtain appropriate audit evidence.

It highlights the key objectives for each major component of non-current assets. You must understand what objectives the various audit tests are designed to achieve in relation to the financial statement assertions. Objectives of particular significance for tangible non-current assets are rights and obligations (ownership), existence and valuation. Valuation is the other important assertion. The auditors will concentrate on testing any external valuations made during the year, and also whether other values appear reasonable given asset usage and condition. A very important aspect of testing valuation is reviewing depreciation rates. A topic we covered using the work of an expert, may well be important in the audit of non-current assets in respect of valuation.

Exam guide

In the audit of non-current assets you may be asked to list and explain audit procedures you would perform to confirm specific assertions set out in the question. When doing so, you must explain why you are carrying out that procedure.

The December 2015 paper had a four mark part in question 2 on four assertions relevant to the audit of tangible non-current assets and an audit procedure for each assertion listed.

1 Tangible non-current assets

Key areas when testing tangible non-current assets are:

x Confirmation of ownership

x Inspection of non-current assets

x Valuation by third parties

x Adequacy of depreciation rates

1.1 Audit objectives for tangible non-current assets

Financial statement assertion	Audit objective
Existence and occurrence	– Additions represent assets acquired in the year and disposal represent assets sold o scrapped in the year
	– Recorded assets represent those in use at the year-end
Completeness	– All additions and disposals that occurred in the year have been recorded
	– Balances represent assets in use at the year-end

Rights and obligations	– The entity has rights to the assets purchased and those recorded at the year-end
Accuracy, classification and valuation	– Non-current assets are correctly stated at cost less accumulated depreciation
	– Additions and disposals are correctly recorded
Assertions relating to presentation and disclosure (occurrence and rights and obligations, completeness, classification and understandability, accuracy and valuation)	– Disclosures relating to cost, additions and disposals, depreciation policies, useful lives and assets held under finance leases are adequate and in accordance with accounting standards

The non-current asset register is a very important aspect of the internal control system. It enables assets to be identified, and comparisons between the general ledger, non-current asset register and the assets themselves provide evidence that the assets are completely recorded.

Another significant control is procedures over acquisitions and disposals, that acquisitions are properly authorised, disposals are authorised and proceeds accounted for.

Other significant aspects are whether:

x Security arrangements over non-current assets are sufficient.

x Non-current assets are maintained properly.

x Depreciation is reviewed every year.

x All income is collected from income-yielding assets

The key assertions relating to intangibles are existence (not so much 'do they exist?', but 'are they genuinely assets?') and valuation. They will therefore be audited with reference to criteria laid down in the financial reporting standards. As only purchased goodwill or intangibles with a readily ascertainable market value can be capitalised, audit evidence should be available (purchase invoices or specialist valuations). The audit of amortisation will be similar to the audit of depreciation.

Chapter Roundup

x Key areas when testing tangible non-current assets are:

– Confirmation of ownership

– Inspection of non-current assets

– Valuation by third parties

– Adequacy of depreciation rates

x Key assertions for intangible non-current assets are existence and valuation

AUDIT PLAN: TANGIBLE NON-CURRENT ASSETS COMPLETENESS

x Obtain or prepare a summary of tangible non-current assets showing how:

– Gross book value
– Accumulated depreciation
– Net book value
reconcile with the opening position.
x Compare non-current assets in the general ledger with the non-current assets register and obtain explanations for differences.
x For a sample of assets which physically exist agree that they are recorded in the non-current asset register.
x If a non-current asset register is not kept, obtain a schedule showing the original costs and present depreciated value of major non-current assets.
x Reconcile the schedule of non-current assets with the general ledger.
EXISTENCE
x Confirm that the company physically inspects all items in the non-current asset register each year.
x Inspect assets, concentrating on high value items and additions in-year. Confirm that items inspected:
– Exist
– Are in use
– Are in good condition
– Have correct serial numbers
x Review records of income-yielding assets.
x Reconcile opening and closing vehicles by numbers as well as amounts.
VALUATION
x Verify valuation to valuation certificate.
x Consider reasonableness of valuation, reviewing:
– Experience of valuer
– Scope of work
– Methods and assumptions used
– Valuation bases are in line with accounting standards
x Reperform calculation of revaluation surplus.
x Confirm whether valuations of all assets that have been revalued have been updated regularly (full valuation every five years and an interim valuation in year three generally) by inquiries of Finance Director and inspection of previous financial statements.
x Inspect draft accounts to check that client has recognised in the statement of comprehensive income revaluation losses unless there is a credit balance in respect of that asset in equity, in which case it should be debited to equity to cancel the credit. All revaluation gains should be credited to equity.

Topic 6

Audit of cash and receivables

Objects

- To determine areas of risk in the audit of trade receivables.
- To describe the procedure of confirmation by direct communication.

Study guide
Intellectual level
The audit of specific items:
(a) receivables
(i) Direct confirmation of accounts receivables
(ii) Other evidence in relation to receivables and prepayments
(iii)The related income statement entries
x Explain the purpose of substantive procedures in relation to financial statement assertions
x Explain the substantive procedures used in auditing each balance 2
x Tabulate those substantive procedures in a work program 2
Exam guide
You may be asked to list and explain audit procedures you would perform to confirm specific assertions relating to receivables. In June 2015, question 1 had 14 marks worth relating to the confirmation of receivables, in terms of financial statement assertions and choosing a sample for confirmation. The June 2015 paper had four marks in question 1 on audit procedures for receivables.
1 Introduction
Receivables are usually audited using a combination of tests of details and analytical procedures. The audit of receivables is important as this is likely to be a material area. A combination of analytical procedures and tests of details are used, with sales also being tested in conjunction with trade receivables. The following table sets out the assertions that apply to receivables. The audit procedures in the remainder of this chapter are used to provide evidence for these assertions.
Audit procedures for receivables
Existence, completeness and valuation are key assertions relating to the audit of receivables.
Audit procedures for receivables are set out in the table below. This covers the audit of sales and prepayments as well as trade receivables. Receivables are often tested in conjunction with sales. The key assertions for sales are occurrence, completeness and accuracy. The receivables' confirmation is used as an audit procedure in the table below and is described in more detail in section 3. Section 4 contains additional information on the audit of sales.

AUDIT PLAN: RECEIVABLES
COMPLETENESS
x Agree the balance from the individual sales ledger accounts to the aged receivables' listing and vice versa.
x Match the total of the aged receivables' listing to the sales ledger control account.
x Cast and cross-cast the aged trial balance before selecting any samples to test.
x Trace a sample of shipping documentation to sales invoices and into the sales and receivables' ledger.
x Complete the disclosure checklist to ensure that all the disclosures relevant to receivables have been made.
x Compare the gross profit % by product line with the previous year and industry data.
x Compare the level of prepayments to the previous year to ensure the figure is materially correct and complete.
x Review detailed statement of financial position to ensure all likely prepayments have been included.
EXISTENCE
x Perform a receivables' circularisation on a sample of year-end trade receivables (see section 3 for details of how to undertake the receivables' circularisation).
x Follow up all balance disagreements and non-replies to the receivables' confirmation.
x Perform alternative procedures for any exceptions and nonreplies to the receivables' confirmation, such as:
x Review after-date cash receipts by inspecting bank statements and cash receipts documentation.
x Examine the customer's account and customer correspondence to assess whether the balance outstanding represents specific invoices and confirm their validity.
x Examine the underlying documentation (purchase order, dispatch documentation, duplicate sales invoice etc).
x Inquire from management explanations for invoices remaining unpaid after subsequent ones have been paid.
x Observe whether the balance on the account is growing and if so, find out why by discussing with management.
RIGHTS AND OBLIGATIONS
x Review bank confirmation for any liens on receivables.
x Make inquiries of management, review loan agreements and review board minutes for any evidence of receivables being sold (eg to factors).
Bank confirmation procedures

The audit of bank balances will need to cover completeness, existence, rights and obligations and valuation. All of these assertions can be audited directly by obtaining third party confirmations from the client's banks and reconciling these with the accounting records, having regard to cut-off.
This type of audit evidence is valuable because it comes directly from an independent source and, therefore, provides greater assurance of reliability than that obtained solely from the client's own records. The bank letter is mentioned as a source of external third party evidence in ISA 505 External confirmations, and guidance to auditors is provided in IAPS 1000 Inter-bank confirmation procedures.
Cash balances/floats are often individually immaterial but they may require some audit emphasis because of the opportunities for fraud that could exist where internal control is weak and because they may be material in total.
However in enterprises such as hotels and retail organisations, the amount of cash-in-hand at the periodend could be considerable. Cash counts may be important for internal auditors, who have a role in fraud prevention.
Auditors will be concerned that the cash exists, is complete, and belongs to the company (rights and obligations) and is stated at the correct value.
The bank confirmation letter can be used to ask a variety of questions, including queries about outstanding interests, contingent liabilities and guarantees.
The auditors should decide from which bank or banks to request confirmation, having regard to such matters as size of balance, volume of activity, degree of reliance on internal control, and materiality within the context of the financial statements.
The auditors should determine which of the following approaches is the most appropriate in seeking confirmation of balances or other information from the bank:
x Listing balances and other information, and requesting confirmation of their accuracy and completeness, or
x Requesting details of balances and other information, which can then be compared with the requesting client's records In determining which of the above approaches is the most appropriate, the auditors should weigh the quality of audit evidence they require in the particular circumstances against the practicality of obtaining a reply from the confirming bank.
Difficulty may be encountered in obtaining a satisfactory response even where the client company submits information for confirmation to the confirming bank. It is important that a response is sought for all confirmation requests. Auditors should not usually request a response only if the information submitted is incorrect or incomplete.

Topic 7

Audit of inventories and construction in progress

Objects

- To identify and explain areas of risk.
- To apply procedures to obtain appropriate audit evidence.

Exam guide

You may be asked to list and explain audit procedures you would perform to confirm specific assertions relating to inventory. As inventory is often the most difficult area in practice for auditors it is also very important in the syllabus. The December 2015 paper had two marks in question 1 on audit procedures to perform before attending the inventory count and two marks for stating a substantive audit procedure at the inventory count.

1 Introduction to auditing inventory

The key assertions relating to inventory are:

x Existence

x Completeness

x Rights and obligations

x Valuation

x Cut-off

The audit of inventory can pose problems for auditors as a result of its nature and potential material value on the statement of financial position. The audit approach taken depends on the auditor's assessment of the controls in place. In this chapter we focus on the substantive audit of inventory.

The following table demonstrates the audit objectives for inventory and the related financial statement assertions. The audit procedures described in the remainder of this chapter are undertaken to provide audit evidence to support these assertions.

The valuation and disclosure rules for inventory are laid down in IAS 2 Inventories. Inventory should be valued at the lower of cost and net realisable value.

Cost is defined by IAS 2 as comprising all costs of purchase and other costs incurred in bringing inventory to its present location and condition.

Net realisable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale.

Production costs (costs of conversion) include:

(a) Costs specifically attributable to units of production

(b) Production overheads

(c) Other overheads attributable to bringing the product or service to its present location and condition

3 Audit procedures for inventory

The following table sets out audit procedures to test year-end inventory. The physical inventory count is discussed in detail in section 4 of this chapter, and cut-off and valuation are expanded upon in sections 5 and 6.

Physical inventory count procedures are vital as they provide evidence which cannot be obtained elsewhere or at any other time about the quantities and conditions of inventories and work-in-progress.

ISA 501 Audit evidence – specific considerations for selected items provides guidance to auditors on attending the physical inventory count to obtain evidence regarding the existence and condition of inventory.

It states that where inventory is material, auditors shall obtain sufficient appropriate audit evidence regarding its existence and condition by attending the physical inventory count (unless this is impracticable) to do the following:

x Evaluate management's instructions and procedures for recording and controlling the result of the physical inventory count.

x Observe the performance of the count procedures.

x Inspect the inventory.

x Perform test counts.

The auditor shall also perform audit procedures over the entity's final inventory records to determine whether they accurately reflect the count results.

Attendance at the inventory count can serve as either substantive procedures or tests of controls, depending on the auditor's risk assessment, planned approach and specific procedures carried out.

Factors to consider when planning attendance at the inventory count include the following:

x The risks of material misstatement of inventory

x Internal controls related to inventory

x Whether adequate procedures are expected to be established and proper instructions issued for counting.

x The timing of the count

x Whether the entity maintains a perpetual inventory system

x Locations at which inventory is held (including materiality at different locations)

x Whether the assistance of an auditor's expert is required

4.1 The inventory count

A business may count inventory by one or a combination of the following methods.

(a) Physical inventory counts at the year-end From the viewpoint of the auditor this is often the best method.

Attendance at inventory count

During the count the auditors should observe whether the count is being carried out according to instructions, carry out test counts, and watch out for third party inventory and slow moving inventory and cut-off problems.

AUDIT PLAN: ATTENDANCE AT INVENTORY COUNT

x Observe whether the client's staff are following instructions as this will help to ensure the count is
complete and accurate.

x Perform test counts to ensure procedures and internal controls are working properly.

x Ensure that the procedures for identifying damaged, obsolete and slow-moving inventory operate properly; the auditors should obtain information about the inventory's condition, age, usage and in the case of work-in-progress, its stage of completion to ensure that it is later valued appropriately.

x Confirm that inventory held on behalf of third parties is separately identified and accounted for so that inventory is not overstated.

x Conclude whether the count has been properly carried out and is sufficiently reliable as a basis for determining the existence of inventories.

x Consider whether any amendment is necessary to subsequent audit procedures.

x Gain an overall impression of the levels and values of inventories held so that the auditors may, in due course, judge whether the figure for inventory appearing in the financial statements is reasonable.

When carrying out test counts the auditors should select items from the count records and from the physical inventory and check one to the other, to confirm the accuracy of the count records. These two way tests provide evidence for completeness and existence. The auditors should concentrate on high value inventory. If the results of the test counts are not satisfactory, the auditors may request that inventory is recounted.

The auditors' working papers should include:

x Details of their observations and tests

x The manner in which points that are relevant and material to the inventory being counted or measured have been dealt with by the client

x Instances where the client's procedures have not been satisfactorily carried out

x Items for subsequent testing, such as photocopies of (or extracts from) rough inventory sheets

x Details of the sequence of inventory sheets

x The auditors' conclusions

After the count the auditors should check that final inventory sheets have been properly compiled from count records and that book inventory has been appropriately adjusted.

After the count, the matters recorded in the auditors' working papers at the time of the count or measurement should be followed up. Key tests include the following.

Topic 8

Audit of employee work and benefits

Objects

- To determine areas of risk in the audit of employee work and benefits.
- To obtain appropriate audit evidence for audit purposes.

AUDIT PLAN: ACCOUNTS PAYABLES AND ACCRUALS

COMPLETENESS

x Obtain a listing of trade accounts payables and agree the total to the general ledger by casting and cross-casting.

x Test for unrecorded liabilities by inquiries of management on how unrecorded liabilities and accruals are identified and examining post year-end transactions.

x Obtain selected suppliers' statements and reconcile these to the relevant suppliers' accounts.

x Examine files of unmatched purchase orders and supplier invoices for any unrecorded liabilities.

x Perform a confirmation of accounts payables for a sample

x Complete the disclosure checklist to ensure that all the disclosures relevant to liabilities have been made.

x Compare the current year balances for trade accounts payables and accruals to the previous year.

x Compare the amounts owed to a sample of individual suppliers in the trade accounts payables listing to amounts owed to these suppliers in the previous year.

x Compare the payables' turnover and payables' days to the previous year and industry data.

x Reperform casts of payroll records to confirm completeness and accuracy.

x Confirm payment of net pay per payroll records to cheque or bank transfer summary.

x Agree net pay per cashbook to payroll.

x Inspect payroll for unusual items and investigate them further by discussion with management.

x Perform proof-in-total (analytical review) on payroll and compare to figure in draft financial statements to assess reasonableness.

EXISTENCE

x Vouch selected amounts from the trade accounts payables listing and accruals listing to supporting documentation such as purchase orders and suppliers' invoices.

x Obtain selected suppliers' statements and reconcile these to the relevant suppliers' accounts.

x Perform a confirmation of accounts payables for a sample.

x Perform analytical procedures comparing current year balances to the previous year to confirm reasonableness, and also calculating payables' turnover and comparing to the previous year.

RIGHTS AND OBLIGATIONS

x Vouch a sample of balances to supporting documentation such as purchase orders and suppliers' invoices to obtain audit evidence regarding rights and obligations.

VALUATION AND ALLOCATION

x Trace selected samples from the trade accounts payables listing and accruals listing to the supporting documentation (purchase orders, minutes authorising expenditure, suppliers' invoices etc).

x Obtain selected suppliers' statements and reconcile these to the relevant suppliers' accounts.

x For a sample of accruals, recalculate the amount of the accrual to ensure the amount accrued is correct.

x Compare the current year balances for trade accounts payables and accruals to the previous year.

x Compare the amounts owed to a sample of individual suppliers in the trade accounts payables listing to amounts owed to these suppliers in the previous year.

x Compare the payables' turnover and payables' days to the previous year and industry data.

CUT-OFF

x For a sample of vouchers, compare the dates with the dates they were recorded in the ledger for application of correct cut-off.

x Test transactions around the year-end to determine whether amounts have been recognised in the correct financial period.

x Perform analytical procedures on purchase returns, comparing the purchase returns as a % of sales or cost of sales to the previous year.

ACCURACY

x Recalculate the mathematical accuracy of a sample of suppliers' invoices to confirm the amounts are correct.

x Recast calculation of remuneration.

x Reperform calculation of statutory deductions to confirm whether correct.

x Confirm validity of other deductions by agreeing to supporting documentation.

x Recast calculation of other deductions.

OCCURRENCE

x For a sample of vouchers, inspect supporting documentation such as authorised purchase orders.

x Agree individual remuneration per payroll to personnel records, records of hours worked, salary agreements etc.

x Confirm existence of employees on payroll by meeting them, attending wages payout, inspecting personnel and tax records, and confirmation from managers.
x Agree benefits on payroll to supporting correspondence.
CLASSIFICATION AND UNDERSTANDABILITY
x Review the trade accounts payables listing to identify any large debits (which should be reclassified as receivables or deposits) or long-term liabilities which should be disclosed separately.
x Read the disclosure notes relevant to liabilities in the draft financial statements and review for understandability.
ACCURACY AND VALUATION
x Read the disclosure notes to ensure the information is accurate and properly presented at the appropriate amounts.

Topic 9

Audit of long-term and short-term liabilities

Objects

- To determine areas of risk in the audit of loans and other liabilities.
- To obtain appropriate audit evidence including bank reports for audit purposes.

In this chapter we will examine the substantive audit of trade payables and accruals, long-term liabilities and provisions and end with a brief look at capital. Purchases are often tested in conjunction with the audit of trade payables and so are included in the section on trade payables. The following table sets out the financial statement assertions to which audit testing is directed.

Assertions about classes of transactions

– All purchase transactions recorded have occurred and relate to the entity (occurrence)

– All purchase transactions that should have been recorded have been recorded (completeness)

– Amounts relating to transactions have been recorded appropriately (accuracy)

– Purchase transactions have been recorded in the correct period (cut-off)

– Purchase transactions are recorded properly in the accounts (classification)

Assertions about period-end account balances

– Trade payables and accrued expenses are valid liabilities (existence)

– Trade payables and accrued expenses are the obligations of the entity (rights and obligations)

– All liabilities have been recorded (completeness)

– All liabilities are included in the accounts at appropriate amounts (valuation and allocation)

Assertions about presentation and disclosure

– All disclosed events and transactions relating to liabilities have occurred and relate to the entity (occurrence and rights and obligations)

– All disclosures required have been included (completeness)

– Financial information is appropriately presented and described and disclosures clearly expressed (classification and understandability)

– Financial information is disclosed fairly and at appropriate amounts (accuracy and valuation)

The largest figure in current liabilities will normally be trade accounts payable which are generally audited by comparison of suppliers' statements with purchase ledger accounts.

2.1 Audit procedures

As with accounts receivable, accounts payable are likely to be a material figure in the statement of financial position of most enterprises. The tests of controls on the purchases cycle will have provided the auditors with some assurance as to the completeness of liabilities. Auditors should however be particularly aware, when conducting their work on the statement of financial position, of the possibility of understatement of liabilities to improve liquidity and profits (by understating the corresponding purchases). The primary objective of their work will therefore be to ascertain whether liabilities existing at the year-end have been completely and accurately recorded. As regards trade accounts payable, this primary objective can be subdivided into two detailed objectives.

x Is there a satisfactory cut-off between goods received and invoices received, so that purchases and trade accounts payable are recognised in the correct year?

x Do trade accounts payable represent the bona fide amounts due by the company?

Before we ascertain how the auditors design and conduct their tests with these objectives in mind, we need to establish the importance of the list of balances.

Where the entity has strong controls in place to ensure that all liabilities are recorded, the confirmation will focus on large balances.

Where the auditor is concerned about the presence of unrecorded liabilities, regular suppliers with small or zero balances on their accounts and a sample of other accounts will be confirmed as well as large balances.

Auditors use a positive confirmation referred to as a blank or zero-balance confirmation. This confirmation does not state the balance owed but requires the supplier to declare the amount owed at the year-end and to provide a detailed statement of the account. When the confirmation is received back, the amount must be reconciled with the entity's records.

Many suppliers provide monthly statements to their customers. These may therefore be available in the entity for examination. Because they are a source of documentary evidence originating outside of the entity, they are a reliable source of evidence to support suppliers' balances and provide evidence as to the existence, completeness and valuation of balances.

Having said this, auditors do still need to be cautious when using them as they may have been tampered with by the entity. The auditor should not rely on photocopies or faxed statements. If there is any doubt, the auditor should request a copy directly from the supplier or confirm the balance with the supplier.

When selecting accounts for testing, the auditor should consider the volume of business during the year, not the balance outstanding at the year-end, because the risk is understatement of balances. Most differences between balances on suppliers' statements and the year-end accounts payables' listing are likely to be due to goods and cash-in-transit and disputed amounts, however all differences need to be investigated thoroughly.

Non-current liabilities

Non-current liabilities are usually authorised by the board and should be well documented.

We are concerned here with non-current liabilities comprising debentures, loan inventory and other loans repayable at a date more than one year after the year-end.
Auditors will primarily try and determine:
x Completeness: whether all non-current liabilities have been disclosed
x Accuracy: whether interest payable has been calculated correctly and included in the correct accounting period
x Classification and understandability: whether long-term loans and interest have been correctly disclosed in the financial statements
The major complication for the auditors is that debenture and loan agreements frequently contain conditions with which the company must comply, including restrictions on the company's total borrowings and adherence to specific borrowing ratios.
AUDIT PLAN: NON-CURRENT LIABILITIES
x Obtain/prepare schedule of loans outstanding at the year-end date showing, for each loan: name of lender, date of loan, maturity date, interest date, interest rate, balance at the end of the period and security.
x Compare opening balances to previous year's papers.
x Test the clerical accuracy of the analysis.
x Compare balances to the general ledger.
x Agree name of lender etc, to register of debenture holders or equivalent (if kept).
x Trace additions and repayments to entries in the cash book.
x Confirm repayments are in accordance with loan agreement.
x Examine cancelled cheques and memoranda of satisfaction for loans repaid.
x Verify that borrowing limits imposed by agreements are not exceeded.
x Examine signed Board minutes relating to new borrowings/repayments.
Under IAS 37 Provisions, contingent liabilities and contingent assets, an entity should not recognise a contingent asset or a contingent liability. However if it becomes probable that an outflow of future economic benefits will be required for a previous contingent liability, a provision should be recognised. A contingent asset should not be accounted for unless its realisation is virtually certain; if an inflow of economic benefits has become probable, the asset should be disclosed.
Examples of the principal types of contingencies disclosed by companies are:
x Guarantees (for group companies, of staff pension schemes, of completion of contracts)
x Discounted bills of exchange
x Uncalled liabilities on shares or loan inventory
x Lawsuits or claims pending
x Options to purchase assets

Topic 10

Audit of expenses and cost

Objects

- To describe practical methods used to collect audit evidence.

Every business requires auditing procedures to assess financial health. Expenses can be considered as anything that the company pays money for in return for income. These can be contractual expenses such as rent, invoiced expenses such as the cost of supplies or reimbursable expenses such as travel charges incurred by an employee. Audit procedures are designed to evaluate these expenses to make sure they are necessary and in line with internal policies.

Internal Controls

Companies have many types of internal controls related to expenses. Some invoices may require certain levels of signatures, and others may require a written contract. One of the first steps in an audit is to evaluate paid expenses against how closely they follow the internal controls. An offshoot of this step is for the auditor to recommend changes should he find loopholes within the controls that may allow an employee to abuse or misuse the process of paying expenses.

Reasonableness

A reasonableness check involves checking expenses to see if they are in line with what is considered ordinary. For example, an invoice of $100 for a small box of pencils would not be reasonable and should raise a red flag. An additional reasonableness step is to make sure that only expenses that are necessary are incurred. Having a bill from two electric companies for one location should also cause an audit flag, as most locations only have one electricity supplier.

Related Reading: Petty Cash Audit Procedures

Timeliness

Expenses must be being received in a timely manner. The last thing a company wants is for expenses to be turned in for something that occurred a year or two ago. A wide time gap makes it harder for companies to make sure the expenses are legitimate and reasonable. The older the invoice, the harder it is to ensure it is legitimate.

Accuracy

Auditors will often randomly select invoices and ask to see all the original paperwork, including contracts if they exist, invoices and signatures. They compare all the original documentation against the amounts paid to find mistakes. Sometimes, this is a simple keying error that may require employee retraining, and in other cases, this could be a payment prior to work being completed.

Vendor

A final check is to ensure that all vendors exist and are real businesses. One of the ways fraudulent transactions occur is for an employee to set up a nonexistEnt vendor and submit made-up bills. This may mean that the vendor has to exist in a business database, such as Dun and Bradstreet, or that verifiable proof of work is submitted with payment requests.

Topic 11

Audit of income and financial results forming

Objects

- To describe practical methods used to collect audit evidence.

Financial statement audits are a routine part of closing your financial books. Audits help to ensure the accuracy of the accounting data used to compile the statements as well as the overall calculations. An income statement audit can help you isolate mathematical errors and ledger discrepancies or give you peace of mind before you file the income statement during closing.

Statement Calculations

The first step in auditing financial statements is to verify the summary calculations. Start with the income section, confirming that the total revenue amount is equal to the sum of the income lines. Repeat this process for the expense category. Manually calculate the difference between the revenue and expense numbers to verify the equity section, as owner's equity is simply the difference between the revenue and expenses.

Income Details

Once you determine that the calculations on the income statement itself are accurate, you need to review the detail that contributes to the figures. Pull summary transaction reports from the general ledger for each revenue account. Review the overall data on the summary reports for accuracy. Run transaction-level reports for the accounts so that you can view the details to confirm that the summary report figures are accurate. Each transaction-level report shows you what has posted to the account. Compare the transactions in the ledger to the hard copy files, such as invoices or check stubs that support the journal entries, to confirm that they were posted correctly.

Related Reading: Revenue Audit Procedures

Expense Review

Pull ledger reports of the transactions in the expense accounts. Review the transaction detail reports for each expense account to confirm that the expense totals on the income statement report are accurate compared to the ledger activity. View the detail level in the ledger for the individual transactions posted in the period to confirm that they were recorded properly. Check the dates on the expenses to be sure that they apply to the period in question, and manually verify the calculations by adding them up yourself,/ to ensure that the recorded totals are correct.

Paper Audit Sampling

When you complete a full audit of the income statement, select a few transactions from each relevant account, such as a few credits posted to each revenue account and a few payments issued from each expense account. Request the documentation of the transactions you selected to complete a sample audit of the account activity. The documentation in question would consist of check stubs and invoices or paperwork filed to support journal entries. Check the calculations of the invoices or the payment vouchers, and verify that the entries in the system match the documentation.

Topic 12

Audit of tax accounting and payments

Objects

- To determine areas of risk in the audit of tax calculation and tax payments.
- To obtain appropriate audit evidence for audit purpose

The purpose of a tax audit or a return examination is to show filings to the IRS and state tax authorities are correct according to tax law. Under the enforcement division, these tax agencies use agents and computer tools to identify and resolve taxpayer errors.

Selection methods

There are several different methods used to select individuals and businesses for examination.

Third party documentation

Employers and financial institutions, among other organizations, are required by law to send documentation (W-2's and 1099's, for example) to the IRS. The IRS uses software to ensure that the numbers on a tax return match the numbers they receive from third parties. If the documentation does not match, the return will be examined.

DIF score

When a tax return is filed, the IRS uses computer software called the Discriminant Index Function System (DIF) to analyze the return for oddities and discrepancies.[5] Once the return has been processed through DIF, it is given a score. If the DIF score is high enough (i.e. a large amount of oddities or discrepancies are found), that tax return may be selected for examination. The formulas the IRS use to create the DIF software and analysis are a closely guarded secret.

UIDIF score

Tax returns that are filed are also subjected to an evaluation called the UIDIF, or the Unreported Income Discriminant Function System. This system analyzes tax returns based on a series of factors to determine a tax return's potential for unreported income. Likewise, along with the DIF score, returns that are found to have a high UIDIF score (i.e. the likelihood of unreported income) may be selected for examination. The IRS formulas used to calculated UDIF are secretive, but it is commonly thought that the IRS uses statistical comparisons between returns to determine UIDIF potential.

Random selection

The IRS selects a certain amount of income tax returns to be audited each year through random selection. No errors need to be found for the Enforcement branch to examine a tax return. Random selection exams tend to be more extensive and time-consuming than other forms of review.

Controversy

The practice of random selection has been a source of controversy for many years, and was even suspended for a short time in the early 2000s amid criticism that the audits were too burdensome and intrusive. The IRS revived the practice in the fall of 2006.

Taxpayer rights & tax audit representation

When a return is selected for examination, the taxpayer has certain rights during the process.

Taxpayer rights

Each state will have its own version with respect to state taxes. With respect to U.S. federal income taxation, the taxpayer has the following rights:

A right to professional and courteous treatment by IRS employees.
A right to privacy and confidentiality about tax matters.
A right to know why the IRS is asking for information, how the IRS will use it and what will happen if the requested information is not provided.
A right to representation, by oneself or by an authorized representative.
A right to appeal disagreements, both within the IRS and before the courts.
A right to be provided with all information concerning with any changes on tax administration
A taxpayer is required only to submit the auditor information relating to the specific year listed in the audit notice.

Tax audit representation

Audit representation, also called audit defense, occurs when a tax or legal professional stands in on behalf of a taxpayer during an examination. Federal law and all states allow a taxpayer to have an authorized representative. The representative must have permission to practice before the IRS or state, and specific credentials are required. The types of representatives who are allowed to represent taxpayers before the IRS in income tax audits include attorneys, certified public accountants (CPAs), and enrolled agents.

Topic 13

Completing of audit and generalization of financial reporting audit results

Objects

- To describe review procedures and the auditor's responsibilities for matters principallyof disclosure including subsequent events and going concern.

1 Subsequent events

Subsequent events are events occurring between the period-end and the date of the auditor's report and also include facts discovered after the auditor's report has been issued. Auditors shall consider the effect of such events on the financial statements and on their audit opinion.

Subsequent events are events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

IAS 10 Events after the reporting period deals with the treatment in the financial statements of events, both favourable and unfavourable, occurring after the period-end. There are two types of event defined by IAS 10:

🎬 Those that provide evidence of conditions that existed at the year-end date (adjusting events)

🎬 Those that are indicative of conditions that arose after the year-end date (non-adjusting events)

You should be familiar with adjusting and non-adjusting events from your financial reporting studies. Here are some examples.

Adjusting events Non-adjusting events

Settlement of a court case Dividends declared after the year-end

Sale of inventory after year-end providing evidence

of its NRV at year-end Fire causing destruction of major plant

Fraud or error showing the accounts are incorrect Announcement of a major restructuring ISA 560 Subsequent events provides guidance to auditors in this area. The objectives of the auditor are:

🎬 To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that need adjustment or disclosure in the financial statements are properly reflected in the financial statements

🎬 To respond appropriately to facts that become known to the auditor after the date of the auditor's report which may have caused the auditor to amend the auditor's report if they were known to the auditor at the date of the report

An article published in April 2011 considers how subsequent events can affect an entity's financial statements, and discusses the auditing requirements Paper F8

candidates need to know. You should read this as part of your F8 study as it makes some very important observations such as stressing the importance of being able to differentiate between an adjusting and a non-adjusting event.
The F8 assessor has also written an article in September 2013 entitled ‘Subsequent Events.’ This article considers the financial reporting aspects of subsequent events using a case study scenario, and discusses in concrete detail how you should approach a scenario-based question on subsequent events in the exam.
Please make sure that you read this article.

1.1 Procedures
Auditors have a responsibility to review subsequent events before they sign the auditor's report, and may have to take action if they become aware of subsequent events between the date they sign the auditor's report and the date the financial statements are issued.
The following time line is helpful when considering subsequent events and the auditor's responsibilities concerning them.
ACTIVE DUTY PASSIVE DUTY
Year-end Auditor's report signed
Financial statements issued
Financial statements approved by members
1.1.1 Events occurring up to the date of the auditor's report
The auditor shall perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.
These procedures should be applied to any matters examined during the audit which may be susceptible to change after the year-end. They are in addition to tests on specific transactions after the period end, eg cut-off tests.
ISA 560 lists procedures to identify subsequent events which may require adjustment or disclosure. They should be performed as near as possible to the date of the auditors' report.
AUDIT PROCEDURES TO TEST SUBSEQUENT EVENTS
Inquiries of management
Status of items involving subjective judgement
Status of items accounted for using preliminary or inconclusive data
Whether there are any new commitments, borrowings or guarantees
Whether there have been any:
- Sales or destruction of assets
- Issues of shares/debentures or changes in business structure
- Developments involving risk areas, provisions and contingencies
- Unusual accounting adjustments

- Major events (eg going concern problems) affecting appropriateness of accounting policies for estimates
- Litigations or claims

Other procedures

Review management procedures for identifying subsequent events to ensure that such events are identified.

Read minutes of general board/committee meetings and enquire about unusual items.

Review latest available interim financial statements and budgets, cash flow forecasts and other management reports.

Obtain evidence concerning any litigation or claims from the company's solicitors (only with client permission).

Obtain written representation that all events occurring subsequent to the period-end which need adjustment or disclosure have been adjusted or disclosed.

1.1.2 Facts discovered after the date of the auditor's report but before the financial statements are issued The financial statements are the management's responsibility. They should therefore inform the auditors of any material subsequent events between the date of the auditors' report and the date the financial statements are issued. The auditor does not have any obligation to perform procedures, or make enquires regarding the financial statements, after the date of the report.

Topic 14

Challenges in terms of financial reporting, particulars types of audit and audit services

Objects

- Understand the general definition of assurance services.
- Identify the assurance and non-assurance services normally performed by auditors.
- Explain what an assurance engagement entails.
- Describe the five elements exhibited by all assurance engagements.
- Know the various subject matters that can be covered in an assurance engagement.

Auditor services are work that an audit firm performs for their clients. Except for consulting services, the work that auditors do is under the guidance of engagement standards set by the International Auditing and Assurance Standards Board (IAASB). Consulting services engagements will not be discussed in this chapter.

■ IAASB'S Technical Pronouncements

Illustration 4.1 shows the general structure of IAASB's technical pronouncements.

Code of Ethics and ISQC

All auditor services standards have as their basis the IFAC Code of Ethics2 (discussed in Chapter 3 Ethics for Professional Accountants) and International Standards on Quality Control3 (ISQC) (see Chapter 1 International Auditing Overview). The Code has been employed by IFAC from the early days, but has been recently revised. Quality control standards are currently being created by the IAASB.

Two Audit Services Frameworks – "Assurance" and "Related Services"

Some engagement standards are based on "International Framework for Assurance Engagements" (assurance engagements), and others result from the "Related Services Framework" (related services engagements). Three sets of standards (ISAs, ISREs and ISAEs) share the assurance engagement framework and one standard set (ISRS) is based on the related services framework. ISAs, ISREs, ISAEs and ISRSs are collectively referred to as the IAASB's Engagement Standards.

IAASB's Engagement Standards

The IAASB engagement standards encompass the following:

■ International Standards on Auditing (ISAs) are to be applied, as appropriate, in the audit of historical financial information.

■ International Standards on Review Engagements (ISREs) are to be applied in the review of historical financial information.

■ International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements dealing with subject matters other than historical financial information.
■ International Standards on Related Services (ISRSs) are to be applied to compilation engagements, engagements to apply agreed upon procedures to information, and othern related services engagements as specified by the IAASB.
Assurance Engagements for Audits and Reviews for Historical Financial Information (ISAs and ISREs) International Standards on Auditing (ISA) 1005 "Audits and Reviews of Historical Financial Information" describes the main concepts applicable to audit, review or special purpose engagements. Audit standards are described in ISA 200–799.6 Special Purpose Engagement and other examinations of historical financial information is ISA 800-899.7 Review standards are ISREs 2000-2699.
Assurance Engagements on Subject Matters Other than Historical Financial
Information (ISAEs)
International Standards on Assurance Engagements (ISAE) 3000R9 "Assurance Engagements on Subject Matters Other than Historical Financial Information" describes concepts applicable to assurance services whose subject matter are not related to historical financial information. The ISAE standards are divided into two parts:
1 ISAEs 3000–3399 which are topics that apply to all assurance engagements.
2 ISAEs 3400–3699 which are subject specific standards, for example standards relating to examination of prospective financial information.
The subject matter of ISAEs 3400–3699 now includes only examination of prospective financial information. However, in future it might include non-financial information (e.g. corporate governance, statistical, environmental), systems and processes (e.g. internal control (such as that required under the Sarbanes-Oxley Act), corporate governance, environmental management systems), and behavior (corporate governance, compliance, and human resources practices). Right now, as IAASB does not set standards, reports of social, environmental and economic assurance engagements are commonly based on a whole variety of established criteria, for example, the Global Reporting Initiative (GRI).
Other Engagements Performed by Auditors
Not all engagements performed by auditors are assurance engagements. Other engagements frequently performed by auditors that do not meet the definition of an assurance engagement and which are therefore not covered by the framework for assurance engagements include:
■ engagements covered by International Standards for Related Services (ISRSs);
■ the preparation of tax returns where no conclusion conveying assurance is expressed;
■ consulting engagements such as tax consulting, or engagements in which a practitioner is engaged to testify as an expert witness in accounting, auditing, taxation or other

matters, given stipulated facts.

Related Services Framework (ISRSs)

Engagements covered by International Standards on Related Services ISRS are based on the "Related Services Framework" – a framework that is still in the development stage at the IAASB. Standards under this framework (ISRSs) are applied currently to two audit services: agreed-upon procedures (ISRS 440012) and compilations (ISRS 441013). Compilations offer no assurance whatsoever. Agreed-upon procedures are assurance based on audit procedures in a very limited "agreed upon" area with a proscribed set of users.

Guidance and Practical Assistance Provided by Practice Statements (IAPS, IAEPs, IRSPSs)

The IAASB's Standards contain basic principles and essential procedures together with related guidance in the form of explanatory and other material, including appendices. International Auditing Practice Statements (IAPSs) are issued to provide interpretive guidance and practical assistance to auditors in implementing ISAs for audit, review, and special purpose engagements. International Assurance Engagement Practice Statements (IAEPSs) provide interpretive guidance for ISAEs, and International Related Services Practice Statements (IRSPSs) will provide assistance for auditors implementing ISRSs.

Topic 14

Internal audit for business entities

Objects

- Understand the basic definition of internal control.
- Discuss why internal controls are important.
- Distinguish between the different components of internal control.
- Describe the elements of the control environment.
- Evaluate how management's objectives are related to risk assessment.
- Explain the effects of information and communication on the internal control system.

The following definition of internal auditing was given in Chapter 1, for comparison with other forms of assurance service and providers:

Internal auditing is an appraisal or monitoring activity established within an entity as a service to the entity. It functions by, amongst other things, examining, evaluating and reporting to management and the directors on the adequacy and effectiveness of components of the accounting and internal control systems.

Internal audit is generally a feature of large companies. It is a function, provided either by employees of the entity or sourced from an external organisation, to assist management in achieving corporate objectives. An entity's corporate objectives will vary from company to company, and will be found in a company's mission statement and strategic plan. However, other corporate objectives will not vary so much between companies, and are linked to a key issue we have already discussed on good corporate governance.

1.2 Internal audit and corporate governance

Established codes of corporate governance such as the UK's Combined Code highlight the need for businesses to maintain good systems of internal control to manage the risks the company faces. Internal audit can play a key role in assessing and monitoring internal control policies and procedures.

The internal audit function can assist the board in other ways as well:

x By, in effect, acting as auditors for board reports not audited by the external auditors

x By being the experts in fields such as auditing and accounting standards in the company and assisting in implementation of new standards

x By liaising with external auditors, particularly where external auditors can use internal audit work and reduce the time and therefore cost of the external audit.

One of the principles of the Combined Code that was set out in Chapter 3 is that:

The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles for maintaining an appropriate relationship with the company's auditors.

Part of achieving this principle requires the audit committee to:
x Monitor and review the effectiveness of internal audit activities
x Where there is no internal audit function, to consider annually whether there is a need for this function and make a recommendation to the board
x Where there is no internal audit function, to explain in the annual report the absence of such a function.
Although many of the techniques internal and external auditors use may be similar, the basis and reasoning of their work is different.
The external audit is focused on the financial statements, whereas the internal audit is focused on the operations of the entire business
Business risk
The UK's Turnbull guidance on internal control assists companies in applying the section of the Combined Code relating to internal control. This guidance refers to the management of risks that are significant to the fulfilment of the company's objectives which is known as business risk.
Business risk is a risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

Designing and operating internal control systems is a key part of a company's risk management. This will often be done by employees in their various departments, although sometimes (particularly in the case of specialised computer systems) the company will hire external expertise to design systems.
The role of internal audit
The internal audit department has a two-fold role in relation to risk management.
x It monitors the company's overall risk management policy to ensure it operates effectively.
x It monitors the strategies implemented to ensure that they continue to operate effectively.
As a significant risk management policy in companies is to implement internal controls, internal audit has a key role in assessing systems and testing controls.
Internal audit may assist in the development of systems. However, its key role will be in monitoring the overall process and in providing assurance that the systems which the departments have designed meet objectives and operate effectively.
It is important that the internal audit department retains its objectivity towards these aspects of its role, which is another reason why internal audit would generally not be involved in the assessment of risks and the design of the system.
Responsibility for fraud and error

It is the responsibility of management and those charged with governance to prevent and detect fraud, and in this respect, internal auditors may have a role to play.

Fraud is a key business risk. It is the responsibility of the directors to prevent and detect fraud. As the internal auditor has a role in risk management he is involved in the process of managing the risk of fraud. It is not the responsibility of the external auditors to prevent and detect fraud, although they may unearth fraud as part of their audit of the financial statements, and they shall be aware of the risks of fraud while carrying out the audit.

Although the presence of an internal audit department within an organisation is indicative of good internal control, by its very nature, there are some limitations of the internal audit function. Internal auditors are employed by the organisation and this can impair their independence and objectivity and ability to report fraud/error to senior management because of perceived threats to their continued employment within the company.

To ensure transparency, best practice indicates that the internal audit function should have a dual reporting relationship, i.e. report both to management and those charged with governance (the audit committee). If this reporting structure is not in place, management may be able to unduly influence the internal audit plan, scope, and whether issues are reported appropriately. This results in a serious conflict, limits the scope and compromises the effectiveness of the internal audit function.