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The publication co-financed by the European Union from the European Social Fund

Audit

An Introduction to International Standards on Auditing

Piotr Staszkiewicz

Warsaw School of Economics
JUNE 2015

To
Imtruda Cyga
and Adela Mrozowska
who differently believe the same values

Contents

Acknowledgment

I am grateful to Prof. E. Mączyńska for his support in all of my activities. I extend my gratitude to Prof. M. Bryx for the project recommendation.

I met a number of outstanding researchers at RMIT who contributed to my views on auditing. I would like to thank Prof. L. Parker for the highly inspiring discussion on dashboard. To Prof. S. Dellaportas I am thankful for the alternative perspective. I would like to acknowledge the help of Prof. B. O'Connell in widening the landscape of the international processes. I appreciate Dr. M. Kend's support with the range of the technical issues on auditing.

I would like to express my gratitude to Prof. K. Marecki and Mr. M. Krajewski for the admin support and project arrangements. I pass my gratitude to A. Rek for all the out-of-office arrangements.

I would like to acknowledge the contribution of my students for the years 2013/14 and 2014/15, for their feedback and textbook requests, which have guided me a lot during this engagement.

Many thanks to Ken and Eryc, as well as to Ev for the companionship and carrots.

The continuing support and commitment of Lucia, Richard and Igor makes me a happy person.

Irrespective of my gratitude to the people mentioned above, any uncorrected errors in this text are solely my responsibility.

Melbourne, April 2015.

Introduction

This book is an extension of *Finance. An quantitative introduction*[1] in respect of the chapter five. It presents a detailed discussion on the International Standards on Auditing.

Audience

This is an intermediate-level textbook for those students taking courses in accounting and auditing, PhD students involved in audit research and professional auditors. The book is composed of three relatively independent sections. All of the chapters except two are split into sections entitled overview, requirements and revision. While the overview introduces the topic from a practical and application point of view, requirements consists mainly of rephrased core parts of the relevant standards and revision is a self-study tool. This format enables an introduction to the auditing standards by reference to the overview parts of the chapters, for intermediate courses the textbook might be used in sequence, while for advanced readers the requirements and revision might be the preferred strategy.

Standards construction

The typical construction of standards is as follows:

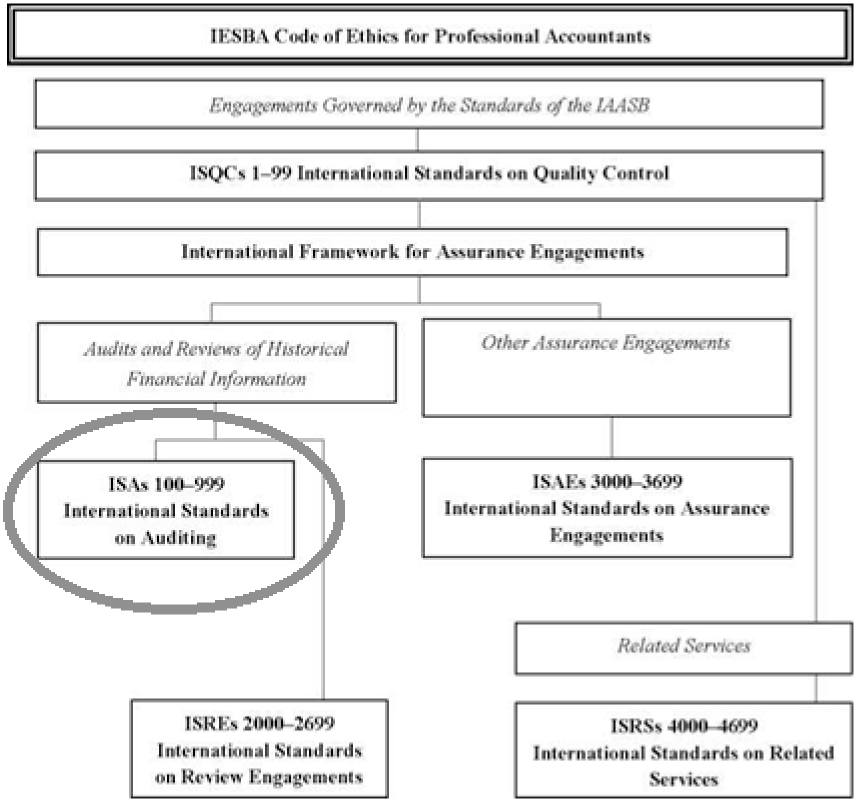
- Standard metadata, goals and effective date
- Actual requirements
- Explanation and attachments.

Since this is an intermediate-level book, the metadata and explanation are skipped as they do not constitute the core requirements of the standards. Parts of the metadata, such as definitions, are included in the overview section or requirements. The majority of the relevant definitions are presented as an appendix to allow for learning of the standard conceptual framework. The standards have been rephrased to be free from technical and legal jargon and allow for smoother comprehension.

This book relates to the set of procurements and standards issued by the International Auditing and Assurance Standard Board (IAASB), set up by the International Federation of Accountants (IFAC)[2].

1 P. Staszkiewicz and L. Staszkiewicz, *Finance. An Quantitative introduction Vol. I & Vol. II*, I. Amsterdam: Elsevier Science, Academic Press, 2015, Vol. I, Chapter 5, point 5.10., p. 87.

2 IFAC, *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*, 2014.



Source: Structure of pronouncement issued by the international auditing and assurance standards board, IFAC 2014,p. 5.

This book does not discuss any standards other than the ISA standards.

The International Standards on Auditing are as follows:

200-299 General Principles and Responsibilities

ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing

ISA 210, Agreeing the Terms of Audit Engagements

ISA 220, Quality Control for an Audit of Financial Statements

ISA 230, Audit Documentation

ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements

ISA 260, Communication with Those Charged with Governance

ISA 265, Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

300-499 Risk Assessment and Response to Assessed Risks

ISA 300, Planning an Audit of Financial Statements
ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
ISA 320, Materiality in Planning and Performing an Audit
ISA 330, The Auditor's Responses to Assessed Risks
ISA 402, Audit Considerations Relating to an Entity Using a Service Organization
ISA 450, Evaluation of Misstatements Identified during the Audit

500-599 Audit Evidence

ISA 500, Audit Evidence
ISA 501, Audit Evidence—Specific Considerations for Selected Items
ISA 505, External Confirmations
ISA 510, Initial Audit Engagements—Opening Balances
ISA 520, Analytical Procedures
ISA 530, Audit Sampling
ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
ISA 550, Related Parties
ISA 560, Subsequent Events
ISA 570, Going Concern

600-699 Using the Work of Others

ISA 600, Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)
ISA 610 (Revised 2013), Using the Work of Internal Auditors
ISA 620, Using the Work of an Auditor's Expert
700-799 Audit Conclusions and Reporting
ISA 700, Forming an Opinion and Reporting on Financial Statements
ISA 705, Modifications to the Opinion in the Independent Auditor's Report
ISA 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs
in the Independent Auditor's Report
ISA 710, Comparative Information—Corresponding Figures and
Comparative Financial Statements
ISA 720, The Auditor's Responsibilities Relating to Other Information in
Documents Containing Audited Financial Statements

800-899 Specialized Areas

ISA 800, Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

ISA 805, Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement

ISA 810, Engagements to Report on Summary Financial Statements

When referencing to standards dots are used to indicate the level of the standard.

Thus.

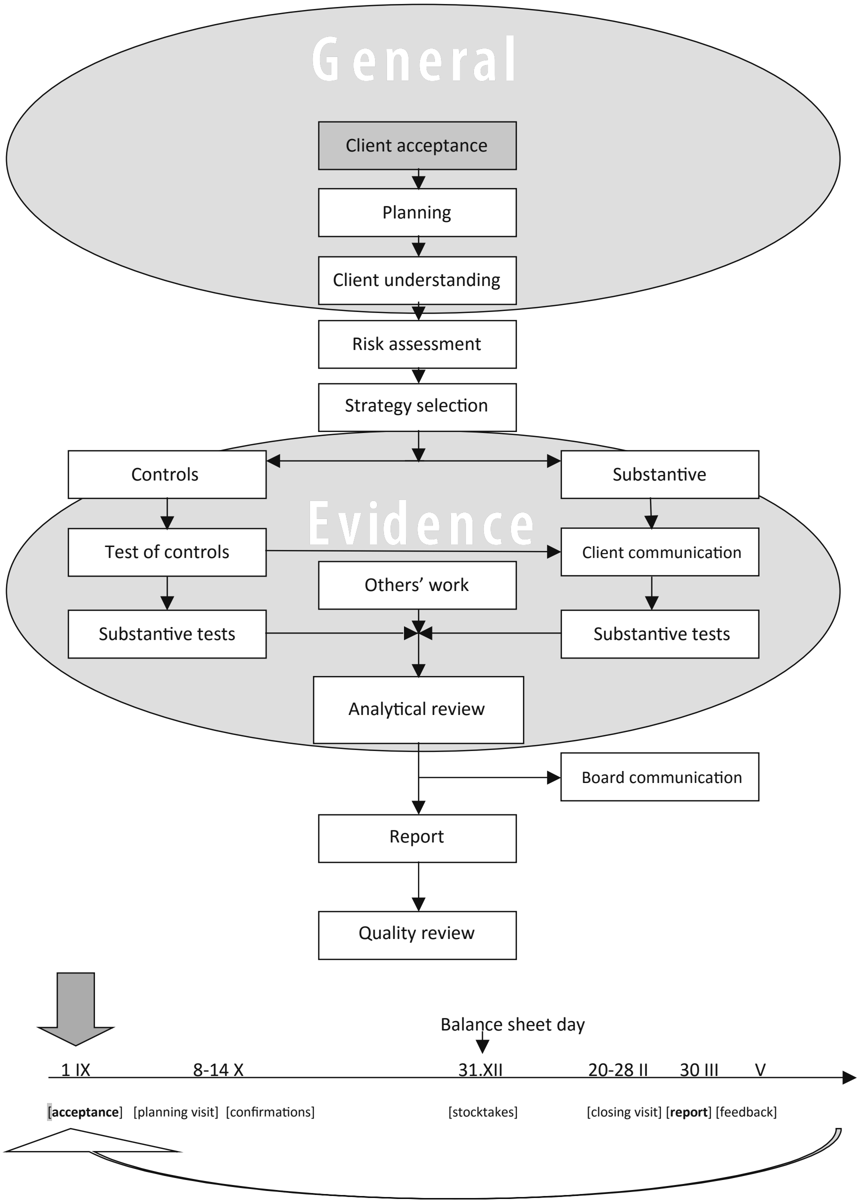
ISA.810.15.b

denotes International Standard on Auditing 810 Engagements to Report on Summary Financial Statement section 15 letter b.

Allocation of standards to chapters.

Some standards are fully devoted to action at a specific time, e.g. ISA.700 Forming an Opinion, while others are visible at almost every stage of the audit process, e.g. ISA.230 Documentation. Thus, the standards are discussed in the chapter they contribute to most; this, however, is a judgemental decision of author. Prior to the overview section each chapter lists the standard applicable to the stage of the audit process to be discussed. The standards discussed in the chapter are given in bold type while italics indicate that the standard is discussed in detail in another chapter.

Typical structure of the chapter.



The audit process diagram stage is highlighted for the specific chapters. The timeline arrow indicates the majority of the activities related to the chapter on the timeline. The graphic is used consistently through all chapters to aid navigation. The shadowed part of the graphic shows the place of the standards discussed within the audit process. There is an assumption in the diagram that the financial statement year-end is the end of December and the reported period is the preceding consecutive 12 months.

The structure of the book mimics the audit process as shown on the flowchart. The audit process is quite different to the inherent structure of standards. The standards are discussed following the audit process; this selection is subjective because some of the standards relate to the entire process or a substantial part of the process.

All nine chapters are standardized in terms of the major structure to help comprehension and flow of the presentation. Standards on the testing of controls and substantive testing are not presented separately as the requirements of the relevant standards are presented in other chapters.

Chapter structure

The text is structured as follows:
- Graphics
- Learning goal
- Standards involved
- Link to previous chapters
- Overview
- Requirements
- Revision

Graphics - intended to show the position in the audit process and timeline.

Learning goal - indicates the main aim of the chapter.

Standards involved - this section shows the standards which have a significant impact on the topic of the chapter. Not all of the standards are discussed; those standards discussed are given in bold.

Link to previous chapters - shows the relationship between the standards among the chapters; standards discussed in the current chapter are shown in bold, while italics indicate that the standard is addressed in another chapter. As the standards address different stages in the audit process, they are usually discussed at the stage where they are most involved. Thus, in the other stages references have been used to allow for process dynamics.

Overview - this section introduces the idea of the standards with significant simplification. It is a beginner-level context with a basic definition structure.

Requirements - this section presents the main body of the standards requirements in a rephrased format. As this is an intermediate-level text, there are no appendices presented (except when used within an example) and explanations to requirements. The requirements are reformatted and rephrased to ensure they can be easily communicated and understood; attempt has been made, however, to retain the structure of the standards.

Revision - this section is devoted to knowledge consolidation. It starts with a brief summary of the chapter and keywords are used as the main framework definition summarized in lexicon (together with the full standard reference index). By using the keywords, the student is asked to recall their meaning and relevance to the chapter. The short 'yes' or 'no' questions allow a quick review of the requirements, while the issues to consider provide open-ended problems and a revision strategy. The revision section ends with a case study. The structure of revision is shown below:

- Summary
- Keywords
- Y/N Questions
- Issues to consider
- Case study [Case study name]

Special characteristics within the chapters are pairs of examples and solutions; these are mainly used in the overview section to link the topic to practical usage or to highlight its usage. In rare cases annotations are used to explain the details. Some standards do not include definitions of terms (conceptual framework) – this is why the definition part varies among chapters. Therefore, the appendix was constructed with the most relevant definition including the full standard reference. The case studies have been translated and modified, if necessary, from another author's position "*Audyt. Zbiór zadań z rewizji finansowej*".

The book is enhanced with the auditing framework and selection of further readings with papers and books devoted to more detailed aspects of the context presented in the book.

Reconciliation

Reconciliation to the Warsaw School of Economics syllabus for Auditing lecturing is shown in the table below.

Reconciliation to the SGH syllabus for course number 230081 Auditing

	Syllabus item	**Chapters of the textbook**								
		1	2	3	4	5	6	7	8	9
1	The goal and the subject of the audit and corporate laws necessitate audit.	X	X							
2	Auditor - requirements, accountability, audit ethics and standards.		X	X						
3	Audit opinion, audit report and audit documentation.	X							X	
4	Audit methods, audit techniques and audit procedures.	X	X	X	X	X	X	X		X
5	Materiality and audit risk.		X	X						
6	Audit and assessment of accounting system, audit and assessment of internal control.			X		X				
7	Audit of balance reliability and groups of transactions.				X					
8	Organizing (preparing and planning) and steps of audit.	X	X							X
9	Statistics methods in auditing of financial statements.		X							
10	Financial analysis in auditing of financial statements.		X				X			
11	Audit of financial statement in information technology environment and observation and audit of inventory system.				X					

12	Audit of assets, liabilities and equity.				X					
13	Audit of costs, revenues and taxes.				X					
14	Audit of post-balance sheet event and audit of going concern.				X					
15	The auditor‘s other services.									X

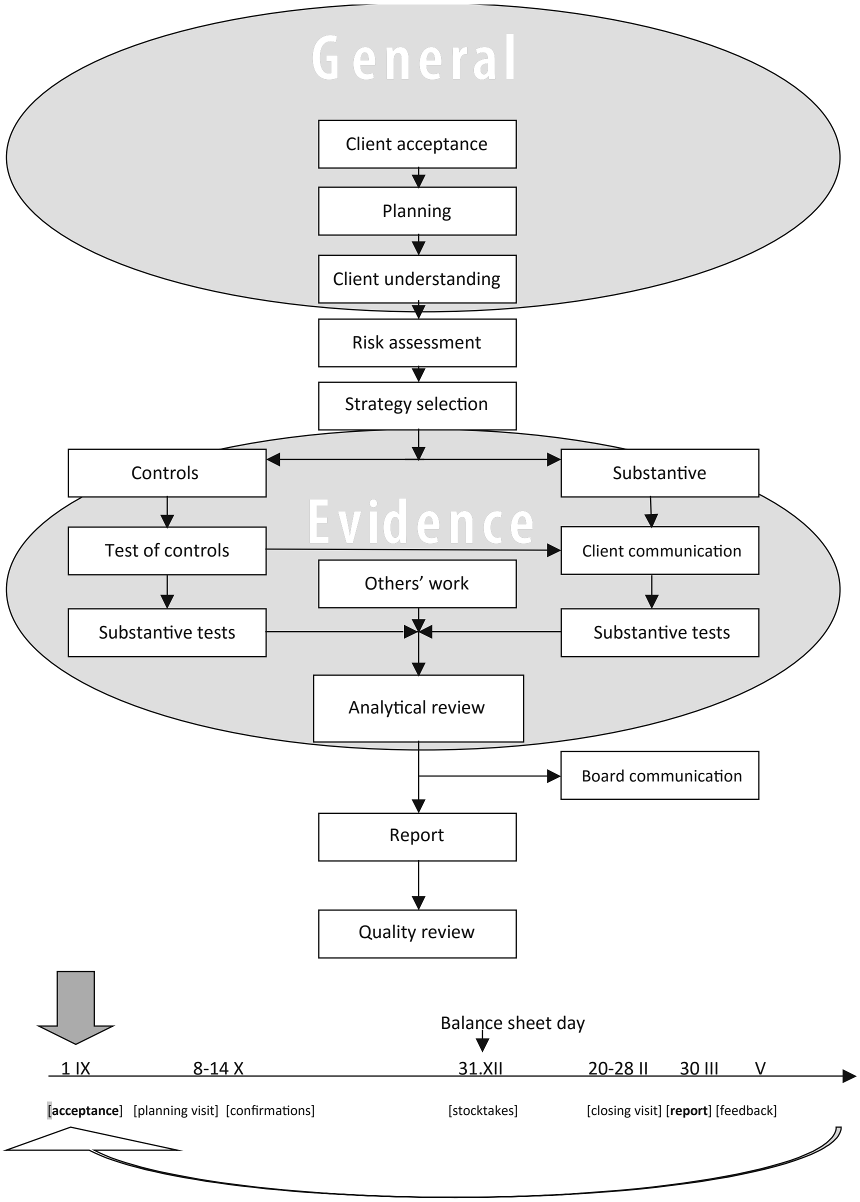
Discussion on standards is shown based on the core standard text. The Application and Other Explanatory Material is, by definition, limited and is given only in the form of examples or notes to keep the student on track.

To keep the book within a reasonable size, some compromises were taken; discussion on controls was limited to one subsystem. The reader might reconcile further reading for detailed analysis.

Text of the standards effective as of December 2014. Any comments on this book please address to pstasz@sgh.waw.pl.

Chapter 1

General



Learning goal

To introduce audit objectives, quality control and documentation.

Standards involved

ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
ISA 210 Agreeing the Terms of Audit Engagements
ISA 220 Quality Control for an Audit of Financial Statements
ISA 230 Audit Documentation
ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements
ISA 260 Communication with Those Charged with Governance
ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

Link to previous chapters

This is the first chapter and introduces the basic framework and standards which provide indication and equipment thought the entire audit process. This chapter presents ISA.200, ISA.220 and ISA.230. Chapter 2 addresses ISA.210, ISA.240, whilst ISA.265 is examined in Chapter 8.

General overview

This chapters address general issues during audit engagement, namely:

- Goals
- Quality
- Documentation

In the audit process chart these form part of the set-up stages carried out in parallel with the audit proposal, client acceptation and project budgeting. The chapter begins with a basic overview of the audit.

Introduction

External audit is 'the independent examination and expression of opinion on the financial statements of an entity'.

The primary purpose of auditing is to certify that the financial statements are true and fair based on prescribed accounting and auditing standards.

Example

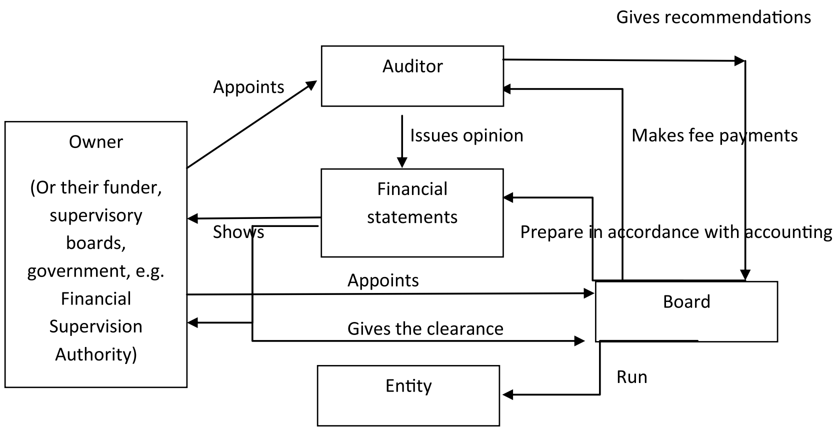
Suppose you are a rich man and you do not want to work. A professional comes to you and offers to run a car rental office. For this he needs 100k USD and promises you a 10% return each year if you agree for him to be the manager. If you are not going to be involved (say you are going hiking in Nepal for the next 7 months) how you are going to reconcile that the manager has delivered that what he promised? You might set up a limited company, pay in the capital of 100k USD and become one 100% owner (say majority shareholder), employ the manger on a contract to run the business and go on vacation. After a year, you return from vacation and you ask the manger to show the financial statements. But how you can be sure that those financial statements are true if they have been prepared by the manager whose remuneration is based upon their contents?

Solution

You might employ a specialist (let us call him/her an auditor). This individual probably needs to be skilled at accounting and account checking (call this skills auditing), who on your behalf will have access to all business documentation (suppose he or she will agree to keep in confidence all information he/she gains during the examination) and gives you an answer to the question of whether the information presented in the financial statements is fair. If so, you will probably have no problems with paying the manager as agreed, subject to him meet his promises to you.

The above scenario provides an idea of how auditing stems from agency theory. Thus, the auditor provides information on the agent's behavior. In reality, there could be a significant number of owners (e.g. investors in a public company) a number of managers, and the auditor might be a huge company employing thousands of professional staff. The basic idea, however, will remain the same.

The concept of audit can be summarized as follows:



The ultimate owner of the residual assets of the company (shareholders) appoints the auditor, typically is up to the supervisory board (or audit committee) to recommend to management the signing off of contracts with the auditor. The board prepares financial statements based on the prescribed legal (or standards, or practice) rules. The auditor uses the standards on auditing, takes into account the accounting standards (legal format) voted by the management and performs the audit and issues an opinion. Financial statements with the audit opinion are shown at the ordinary annual meeting of shareholders. On this basis and the report of the performance the management board asks the owners (general meeting) a clearance for the business running. If clearance is obtained then based on the law, the management ceases to be liable for the business matter for the cleared period. Otherwise, the shareholders might claim damages to the business done by managers from their private assets. After issuing opinion, the managers who signed the contract on behalf of the owners with the auditor, authorise the final invoices for services (audit fees) payments. In the meantime the auditor uses a letter of recommendation to advise the board on how to improve the non-material weaknesses of the business.

The auditor expresses him/herself to the owner via the audit report (also referred to in practice as audit opinion). The report has a well-defined form.

Example

Draw a template for the auditor report.

Solution

INDEPENDENT AUDITOR'S REPORT [Appropriate Addressee]

Report on the Financial Statements[3]

We have audited the accompanying financial statements of ABC Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's[4] Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such

[3] The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

[4] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

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

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

There are a few basic concepts used in the presented example of the template of the audit report, namely:

- in all **material** respects
- *give a **true and fair** view of (fairly)*

Materiality means that the financial statements contain errors. However, those errors or omissions are irrelevant for the users of financial statements' decision. This is due to the fact that giving a 100% assurance is an expensive (if not impossible) task. Recall the example with you on a hiking vacation in Nepal. Suppose that your manger was wrong and instead of showing a profit of $30,004 he has shown an overstated profit (by $100) of $30,104. Would you change your mind on this and withdraw from the management contract? Probably not, which is why, in practice we do not necessarily need a 100% assurance. But of course you might want to be very sure on the cash balance position; this is why, besides statutory audits, there are also other assurance engagements.

The second concept is that of true and fair view, which is actually an accounting standard concept not defined in the auditing standards, and which might differ from standard to standard.

As the audit does not provide for ultimate assurance, this level of assurance given by the ordinary year-end audit is called "reasonable assurance" and is less than absolute assurance. Reducing assurance engagement risk to zero is very rarely achievable or cost beneficial as a result of the following factors:

- The use of sampling
- The inherent limitations of internal control
- Much of the evidence available is persuasive rather than conclusive
- The use of judgement in gathering and evaluating evidence and forming conclusions based on that evidence.

A weaker form of "reasonable assurance" (e.g. statutory audit) is "limited assurance" (e.g. a half-year review). While reasonable assurance gives a positive indication that "all material aspects are fair", limited assurance gives the negative indication "nothing has come to our attention that". The stronger the type of assurance the more work has been carried out and the more expensive the service will be.

Example

Consider and list the limitations of statutory audit.

Solution

- Audit report uneasy to follow and understand due its technicality
- Audit is judgemental
- There is a time lag between the date of the balance sheet, date of approval, the financial statements of managers, date of issue of the audit opinion, date of the release of financial statements and audit opinion to the public
- Internal control systems are never perfect
- Not all items are tested
- Audit evidence tends to be more persuasive than conclusive

There are other different assurance engagements exempt from the statutory year-end audit which do not necessary comprise the entire financial statements.

'An assurance engagement is an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.' *[International Framework for Assurance Engagements]*

All assurance engagements are performed in a similar way:

- Agree the scope of work to be performed
- Formalise all of the terms of engagement in a contract (engagement letter)
- Plan the work. The level of work should be based on the risk and level of assurance desired
- Obtain sufficient appropriate evidence on which to base the conclusion
- Perform overall review and form opinion
- Issue report to the client.

Examples of assurance engagements include:

- Annual external audit of financial statements ('statutory' assurance)
- Half-year review of results
- Going concern review
- Review of effectiveness of an entity's IT system
- Review of the custody of assets
- Review of compliance with corporate governance requirements

This book discusses mainly the standards applicable to the statutory audit of historical information. The standards on assurance engagement are beyond the scope of this book.

The basic conceptual framework of auditing standards is laid down in the following terms:

- Historical financial information is information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.
- Management is the person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.
- Misstatement is a difference between the amount, classification, presentation or disclosure of a reported financial statement item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted is that management and, where appropriate, those charged with governance have acknowledged and understand that they have the following responsibilities that are fundamental to the conduct of an audit in accordance with ISAs. That is, responsibility:

1) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation;
2) For such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
3) To provide the auditor with:
    i. Access to all information of which management and, where appropriate, those charged with governance are aware is relevant to the preparation of the financial statements such as records, documentation and other matters;
    ii. Additional information that the auditor may request from management and, where appropriate, those charged with governance for the purpose of the audit; and
    iii. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

- Risk of material misstatement is the risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:
    a) Inherent risk - The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
    b) Control risk - The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected and corrected, on a timely basis by the entity's internal control.

Those charged with governance are the person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

Quality control

Suppose that the auditor performs the audit by him/herself, he or she has to perform all of the planned procedures, e.g. debtors confirmation, request for the bank confirmation, checking the mathematical correctness of ledgers, discussion with management, formulate opinion, invoice, and propose services to other clients. Some of those activities are simple but monotonous; some of them are of a delicate nature, such as management discussions and offers negotiation. Some of them are highly profitable and risky, some of them are rather low fee at minimum risk. Thus, the auditor hires staff to be trained as prospective auditors (professional staff) and administration staff (such as clerks, office personnel) to allocate different tasks to different classes of activity. Those working on agreement could be professional staff trainees (non-audit practising certificate holders), experts and auditors (professionals holding the professional designation), and among the professionals there should be one that is privately responsible for the engagement (let it be called the responsible auditor). If the work is outsourced or dedicated to anyone other than the registered auditor, he or she might be sufficiently skilled or experienced to judge upon the evidence obtained. There must therefore must be a system of internal control which safeguards the quality of the engagement.

If the auditor is not acting as a sole trader but rather in partnership with the limited liability company then there are two subjects of responsibilities: one is the partner (auditor) in charge of the engagement, the second is the partnership or company. To safeguard a uniform level of service and quality among the partners within the company, the company itself should develop an internal system of control including the cools reviews[5] of independent partners (for risky engagements).

The basics elements to be controlled are:

- Independence from client of all the team members
- Professional and ethical behaviour
- Quality of the judgement and procedures carried out
- Compliance with standards and the law
- Budget and performance
- Client satisfaction and team assessment

Documentation

One might believe that audit is about documentation. Actually nowadays, documentation tends to consist of evidence in electronic formats. The auditor should document matters which are important in providing audit evidence to support the auditor's opinion and evidence that the audit was carried out in accordance with ISAs.

Specific ISAs indicate the required minimum level of documentation. This is why they are referred to in discussion of specific topics.

The basic type of documents produced during the audit are working papers. They are usually prepared by the audit team and:

- Assist in the planning and performance of the audit
- Assist in the supervision and review of audit work
- Enable the audit team to be accountable for its work (as they need sign-offs)
- Retain a record of matters of continuing significance to future audits
- Enable quality control reviews to be performed.

Typically a working paper should:

[5] Review after the audit opinion is issued.

- Be sufficiently complete and detailed as to enable an experienced auditor with no previous connection with the audit to subsequently ascertain from them what work was performed and to support the conclusions reached.
- Record information on the auditor's planning of the audit, the nature, timing and extent of the audit procedures performed, and the results thereof, and the conclusions drawn from the audit evidence obtained.
- Contain the auditor's reasoning on all significant matters requiring exercise of judgement, with the auditor's conclusions thereon.

A good working paper:

Is understandable on first sight, logical, clean and properly referenced.

Example

Mark has prepared the following working paper

Prepared by: Mark
Relate: Debtors reconciliation

Object

To ensure that the trade debtors balance is fairly stated.

Work done
Audit plan step #77. Key debtors reconciliation.

Results
Debtor Simens PLC Balance recorded: 5000 Balance confirmed 5000
Debtor Dot Ltd Balance recorded: 77000 Balance confirmed 73000

Total sample size 82000 balance confirmed 78 000, balance unconfirmed 4000 below the TE limit.

The clerk fail to reconcile the y/e confirmation for Dot Ltd.

Conclusion

Trade debtors not fairly stated.

Make a judgement upon the quality of the paper.

Solution

The paper is neat, clear to understand, however a number of basic controls have been missed:

a) There are no sign-offs on the paper (used for quality review confirmation).
b) The paper exempt from the Audit programme is not referenced to other part of the auditor documentation and does not have its own reference number.
c) The paper is not dated (no date stamp).

The proposed corrections are underlined.

Prepared by: Mark
Date: 1/2/20X8
Reviewed by: Miki
Date 6/2/20X8
Approved by: Star
Date 15/3/20X8

D7/1

Relate: Debtors reconciliation

Object
To ensure that the trade debtors balance is fairly stated.

Work done
Audit plan step #77. Key debtors reconciliation.

Results
Debtor Simens PLC Balance recorded: 5000 Balance confirmed 5000
Debtor Dot Ltd Balance recorded: 77000 Balance confirmed 73000

Total sample size 82000 balance confirmed 78 000, balance unconfirmed 4000 below the TE limit. Transferred to A9/SAD (error reported in the schedule of unadjusted differences)

The clerk fail to reconcile the y/e confirmation for Dot Ltd. Transfer to the management letter section A11

Conclusion
Trade debtors not fairly stated.

There are usually different types of document produced during the audit. As a matter of custom the audit documentation is filed in accordance with the audit process.

The permanent files consists of the most important documents, such as: engagement letters (contracts), legal documents such as prospectuses, leases, sales agreement, details of the history of the client's business (e.g. the company house reports), previous year's signed accounts, analytical review and management letters, accounting systems description, previous year's control questionnaires.

The engagement file is likely to contain:

- Financial statements
- Accounts checklists

- A summary of unadjusted errors
- Review notes
- Audit planning memorandum
- Time budgets and summaries
- Letter of representation
- Management letter
- Notes of board minutes
- Communications with third parties
- A lead schedule including details of the figures to be included in the accounts
- Problems encountered and conclusions drawn
- Audit programmes
- Analytical review
- Details of substantive tests and tests of control

Local legislation usually determines the period and scope of storage of the audit documentation; it is typically in the region of five years. The auditor is obligated to maintain confidentiality, safe custody, integrity, accessibility and irretrievability of documentation, using, for example, passwords to restrict access to electronic documentation to authorised users:

- Back-up routines
- Confidential storage of hard copy documentation.

Technicalities

The application of electronic documentation raises a few new practical questions:

Originality.

Number of copies and breaching of confidentiality.

Track changes and subsequent modifications.

Conflict reconciliation.

Electronic documentation also has positive impacts in the form of:

1) Less costly to archive
2) Quick access to engagement file
3) Enhanced possibility of remote working
4) Online reviewing procedures
5) Easier time and process management
6) Automatic templates

Specific Audit Documentation Requirements in Other ISAs

The following documentation is required by the standards, as a minimum:

- ISA 210 Agreeing the Terms of Audit Engagements - paragraphs 10–12
- ISA 220 Quality Control for an Audit of Financial Statements - paragraphs 24–25
- ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements - paragraphs 44–47

- ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements - paragraph 29
- ISA 260 Communication with Those Charged with Governance - paragraph 23
- ISA 300 Planning an Audit of Financial Statements - paragraph 12
- ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment - paragraph 32
- ISA 320 Materiality in Planning and Performing an Audit - paragraph 14
- ISA 330 The Auditor's Responses to Assessed Risks - paragraphs 28–30
- ISA 450 Evaluation of Misstatements Identified during the Audit - paragraph 15
- ISA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures - paragraph 23
- ISA 550 Related Parties - paragraph 28
- ISA 600 Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors) - paragraph 50
- ISA 610 (Revised 2013), Using the Work of Internal Auditors - paragraph 36–37

Requirements

Overall

An Audit of Financial Statements

The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with ISAs and relevant ethical requirements enables the auditor to form that opinion.

The financial statements subject to audit are those of the entity, prepared by management of the entity with oversight from those charged with governance. ISAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with ISAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

As the basis for the auditor's opinion, ISAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance because there are inherent limitations to an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor's opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

The ISAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The ISAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable law or regulation.

The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, in relation to matters arising from the audit. These may be established by the ISAs or by applicable law or regulation.

Overall Objectives of the Auditor

In conducting an audit of financial statements, the overall objectives of the auditor are:

a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

b) To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the ISAs require that the auditor disclaim an opinion or withdraw (or resign) from the engagement, where withdrawal is possible under applicable law or regulation.

Ethical Requirements Relating to an Audit of Financial Statements

The applicable financial reporting framework is the financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

Detection risk is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Financial statements are a structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.

The auditor is the person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an ISA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used. "Engagement partner" and "firm" are to be read as referring to their public sector equivalents where relevant.

The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements.

Professional Skepticism

Professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

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

Professional Judgment

Professional judgment is the application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

The auditor shall exercise professional judgment in planning and performing an audit of financial statements.

Sufficient Appropriate Audit Evidence and Audit Risk

Audit evidence is information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For the purpose of the ISAs:

i) Sufficiency of audit evidence is the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.
ii) Appropriateness of audit evidence is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Reasonable assurance in the context of an audit of financial statements is a high, but not absolute level of assurance.

To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

Conduct of an Audit in Accordance with ISAs

Complying with ISAs Relevant to the Audit

The auditor shall comply with all ISAs relevant to the audit. An ISA is relevant to the audit when the ISA is in effect and the circumstances addressed by the ISA exist.

Objectives Stated in Individual ISAs

To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant ISAs in planning and performing the audit, having regard to the interrelationships among the ISAs, to:

- Determine whether any audit procedures in addition to those required by the ISAs are necessary in pursuance of the objectives stated in the ISAs;
- Evaluate whether sufficient appropriate audit evidence has been obtained.

Complying with Relevant Requirements

The auditor shall comply with each requirement of an ISA unless, in the circumstances of the audit:

- The entire ISA is not relevant; or
- The requirement is not relevant because it is conditional and the condition does not exist.

In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an ISA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement.

Failure to Achieve an Objective

If an objective in a relevant ISA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the ISAs, to modify the auditor's opinion or withdraw from the engagement (where withdrawal is possible under applicable law or regulation). Failure to achieve an objective represents a significant matter requiring documentation in accordance with ISA 230.

Quality control

System of Quality Control and Role of Engagement Teams

Quality control systems, policies and procedures are the responsibility of the audit firm. The firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and
b) Reports issued by the firm or engagement partners are appropriate in the circumstances.

Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

Leadership Responsibilities for Quality on Audits

The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

An engagement partner is the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body. A partner is any individual with authority to bind the firm with respect to the performance of a professional services engagement. Personnel are partners and staff. Staff are those professionals, other than partners, including any experts, employed by the firm. A suitably qualified external person is an individual outside the firm with the competence and capabilities to act as an engagement partner, for example, a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits of historical financial information or of an organization that provides relevant quality control services. Administration are non-professional employees and contractors.

Relevant Ethical Requirements

Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team.

If matters come to the engagement partner's attention, through the firm's system of quality control or otherwise, that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action.

Engagement team means all partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform audit procedures on the engagement. This excludes an auditor's external expert engaged by the firm or a network firm. The term "engagement team" also excludes individuals within the client's internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of ISA 610.

Independence

The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

- Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is possible under applicable law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

The firm is a sole practitioner, partnership or corporation or other entity of professional accountants. A network firm is a firm or entity that belongs to a network. While the network means a larger structure that is aimed at cooperation, and that is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.

Acceptance and Continuance of Client Relationships and Audit Engagements

The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate.

If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

Assignment of Engagement Teams

The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:

- Perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements; and
- Enable an auditor's report that is appropriate in the circumstances to be issued.

Engagement Performance

Direction, Supervision and Performance

The engagement partner shall take responsibility for:

- The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements;
- The auditor's report being appropriate in the circumstances.

Reviews

The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.

On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

Consultation

The engagement partner shall:

- Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;
- Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;
- Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted;
- Determine that conclusions resulting from such consultations have been implemented.

Engagement Quality Control Review

Engagement quality control review is a process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report. The engagement quality control review process is for audits of financial statements of listed entities and those other audit engagements, if any, for which the firm has determined an engagement quality control review is required.

An engagement quality control reviewer is a partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report.

A listed entity is an entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.

For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

a) Determine that an engagement quality control reviewer has been appointed;

b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
c) Not date the auditor's report until the completion of the engagement quality control review.

The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve:

a) Discussion of significant matters with the engagement partner;
b) Review of the financial statements and the proposed auditor's report;
c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and
d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate.

For audits of financial statements of listed entities, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:

- The engagement team's evaluation of the firm's independence in relation to the audit engagement;
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations;
- Whether audit documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached.

Differences of Opinion

If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

Monitoring

Monitoring is a process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to provide the firm with reasonable assurance that its system of quality control is operating effectively.

An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement.

Documentation

The auditor shall include in the audit documentation:

- Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.
- Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.
- Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.
- The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.

The engagement quality control reviewer shall document, for the audit engagement reviewed, that:

- The procedures required by the firm's policies on engagement quality control review have been performed;
- The engagement quality control review has been completed on or before the date of the auditor's report; and
- The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate.

Documentation

Nature and Purposes of Audit Documentation

Audit documentation that meets the requirements of this ISA and the specific documentation requirements of other relevant ISAs provides:

- Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor;
- Evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.

Audit documentation serves a number of additional purposes, including the following:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with ISA 220.2.
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections.

- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

The objective of the auditor is to prepare documentation that provides:

a) A sufficient and appropriate record of the basis for the auditor's report;

and

b) Evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.

The documentation (evidences) are gathered into the audit file.

An audit file is one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

Timely Preparation of Audit Documentation

Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used).

The auditor shall prepare audit documentation on a timely basis.

Documentation of the Audit Procedures Performed and Audit Evidence Obtained Form, Content and Extent of Audit Documentation

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

- The nature, timing and extent of the audit procedures performed to comply with the ISAs and applicable legal and regulatory requirements;
- The results of the audit procedures performed, and the audit evidence obtained; and
- Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

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

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

The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

If the auditor identifies information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency.

Departure from a Relevant Requirement

If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in an ISA, the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure.

Matters Arising after the Date of the Auditor's Report

If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document:

a) The circumstances encountered;
b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and
c) When and by whom the resulting changes to audit documentation were made and reviewed.

Assembly of the Final Audit File

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

In circumstances where the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor shall, regardless of the nature of the modifications or additions, document:

- The specific reasons for making them; and
- When and by whom they were made and reviewed.

Revision

Summary

The primary responsibility of the audit is independence, it assures objectivity. The product of the audit is a report, in which the auditor expresses opinion on the fairness of the financial statements contained within it. The quality and documentation of the audit are interconnected areas. The auditor must document his findings and evidence. The audit engagement requires quality monitoring and review, especially if performed by the audit team. The responsible auditor is the person in charge of the audit; he/she has a number of professional responsibilities assigned to them. The audit work must be documented by the auditor and the timing of the audit documentation is important. The audit file may be in electronic or hard copy form, or a combination of the two.

Key words

Historical financial information, Management, Misstatement, Risk of material misstatement, Those charged with governance, Independence, Acceptance, Review, Consolations, Monitoring, Documentation, Audit file, Experienced auditor.

Y/N Questions

No	Issue	Y/N
1	The auditor might comply with relevant ethical requirements.	Y/N
2	On or before the date of the auditor's report, the engagement partner shall perform a review of the audit documentation.	Y/N
3	The engagement quality control review process is for audits of financial statements of listed entities.	Y/N
4	An effective system of quality control includes substantial tests.	Y/N
5	The auditor shall assemble the audit documentation in the office.	Y/N
6	The auditor cannot perform new or additional audit procedures after the date of the auditor's report.	Y/N
7	Engagement team means all partners and staff.	Y/N
8	The firm has an obligation to establish and maintain a system of quality control.	Y/N
9	The engagement partner shall take responsibility for the overall quality of each of his audit engagements.	Y/N
10	Audit documentation is a record of the audit procedures performed.	Y/N

Issues to consider

1) Recall definitions of the key words and link them to the context of chapter.
2) Describe the impact to the standards involved on the context of the chapter.
3) Suppose Stephan is the sole trader auditor running a small audit practice. What kind of in-house procedures would you advise to Stephan in order to safeguard the continuity of the practice in case of illness or accident?
4) During fieldwork, your audit files were stolen on the journey back to the office, consider what action you would take as a responsible auditor.
5) As the managing partner of an audit practice you are considering the introduction of electronic format documents for your audit files, using Google Drive functionality. State the potential risks of such a decision.

Case study Johnatan Firecat

Mr Jonathan Firecat is the chancellor of the Parliament Commission for Business. The Commission is currently discussing liberalisation procedures for the business in respect of auditing. Member of the Commission have presented the following views thereon:

i) Arnold Radziwił: Due to the increasing number of frauds on the market the responsibility of the auditors should be enhanced to cover the losses of frauds to shareholders.
ii) Maria Siepko: The auditor examinations should be abolished, they restrict access to the profession for young people. If they are abolished unemployment will be lower.
iii) John Smith: Because we can observe an increasing number of errors in tax filing, the government is recording an increase in the liquidity gap. The auditor's requirements should thus be imposed over all taxpayers.
iv) Andrzej Mikołajczyk: Because of the number of errors in audit reports, we should systematically change the system and, instead of the audit requirements, we should impose insurance requirements on the financial statements.
v) Alex Chiou: We recommend introducing full acceptance of foreign audit licence-holders. This will increase competition in local markets and lead to reduced audit fees.
vi) Michał Korek: By creating one association and chamber of auditors, this chamber tends to protect its members at the cost of the business. In order to limit this negative action it is proposed to allow the auditors to create as many professional chambers as they feel are relevant. Because of competition between the chambers the pressure on the business will be limited.
vii) Anita Wojtko: The auditing examination review should be changed. In the case of dispute between the student and examination body the court make the technical resolution.

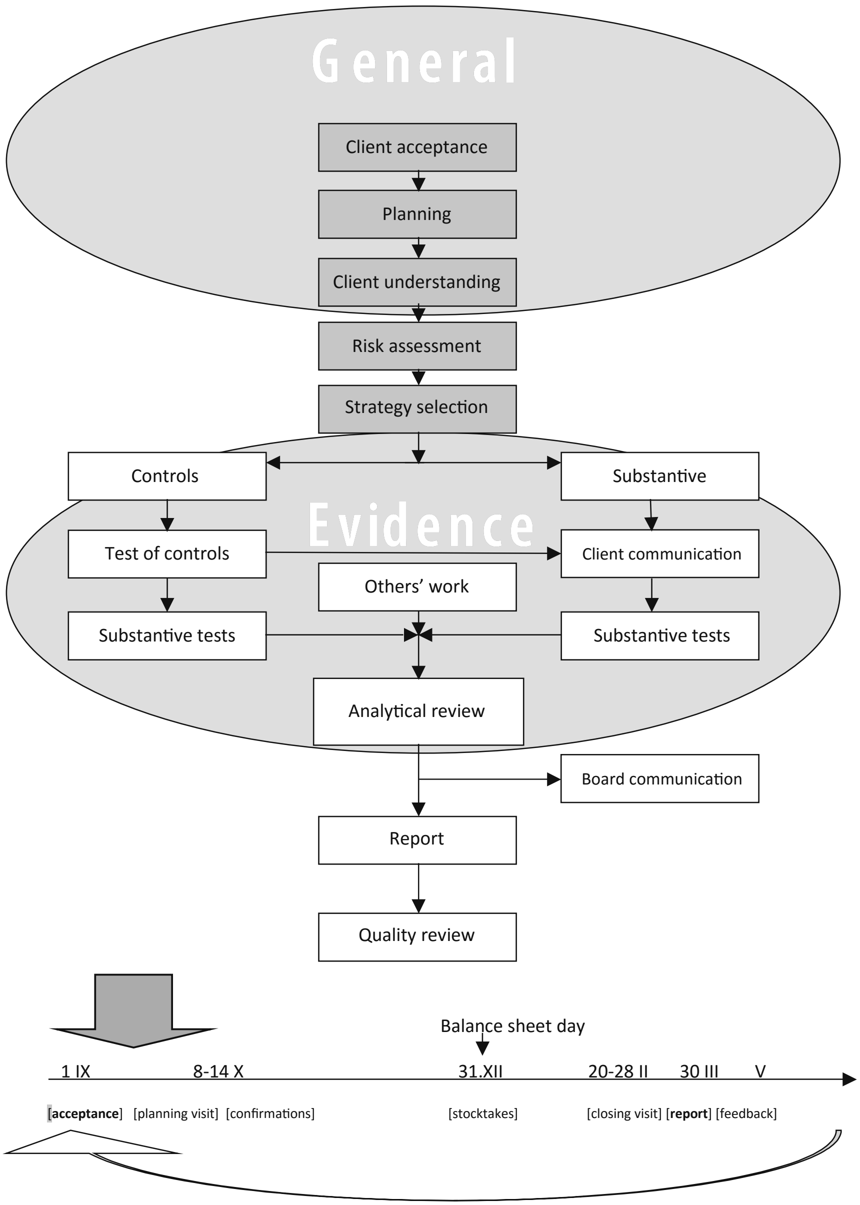
You are an economics university graduate specialising in auditing and finance and you are Mr Firecat's new assistant. The Commission is due to present the draft of bill on auditors next week.

You are required to:

(a) Show the arguments for and against each of the opinions (i-vii)
(b) Describe your local legal system of auditing based on Internet research
(c) Draw the draft bill.

Chapter 2

Client acceptance, planning, understanding and risk assessment



Learning goal

To understand acceptance, planning and risk evaluation.

Standards involved

ISA 210 Agreeing the Terms of Audit Engagements
ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements
ISA 300 Planning an Audit of Financial Statements
ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
ISA 320 Materiality in Planning and Performing an Audit
ISA 330 The Auditor's Responses to Assessed Risks
ISA 420 Audit Considerations Relating to an Entity Using a Service Organization
ISA 450 Evaluation of Misstatements Identified during the Audit
ISA 520 Analytical Procedures

Link to previous chapters

This chapter lays down the basics of audit. Here, the basic, acceptance and planning procedures are shown together with planning materiality and analytical procedures, which are referred to in later chapters for substantive and control testing and reporting. ISA.330 and .420 relate mainly to the formulation of audit strategy and are transferred to the separate chapter. ISA.450 is a part of the risk management standards, however, its application is visible at the formulation of opinion and thus its details are dealt with in a later chapter. ISA.520 and ISA.320 are fundamental standards, which will be referred to in strategy formulation, in the testing chapters and at the reporting stage.

Overview

Client acceptance

As a general rule the engaging of an auditor should be confirmed in writing. This limits potential discussion on term and dates. Before making a commitment the auditor needs to make sure that he/she is able to perform the audit taking into account its required timing, its current portfolio of clients and the auditor's knowledge and skills of the client's business and industry. The auditor must be aware of the specific legal requirements relating to the client's business and must estimate the likelihood of the fraud. The agreed terms of services must not be conditioned by the type of opinion issued. The auditor should not become engaged in contracts where his/her independence might be impaired, where there are insufficient resources to properly conduct the project or the agreed price is not fair enough to safeguard the execution of the expended audit procedures. Numbers of practical indication are developed from the auditors' ethical standards. Discussion of this, however, is beyond the scope of this textbook.

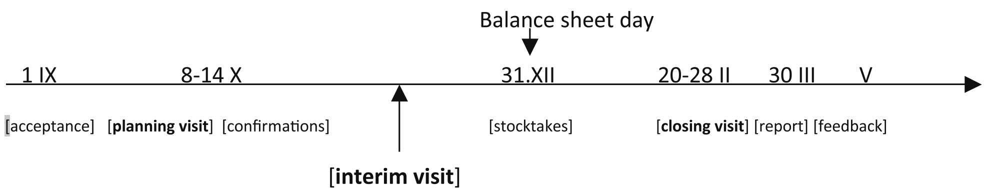
Planning

Planning is a must.

Audit fieldwork is usually split into two phases:

- Planning visit
- Final (closing) visit

An interim visit may take place between the planning and final visits (depending on specific strategy and needs), or the planning visit may be substituted with an interim visit (often the case for recurring engagements)



Planning and interim visits typically include:

- Analytical procedures
- Tests of controls
- Debtors, creditors, banks and other confirmations
- Updating risk assessments
- Review of relevant internal audit reports, other authorities reports (tax, supervisors, etc.)
- Substantive testing (of transactions in the first part of the year)
- Stocktakes observation (if before year-end)
- IT general controls and application-specific controls, tests and assessments

During the final audit the following procedures are usually performed:

- Completion of tests of controls and substantive tests of transactions started at interim
- Roll forwards
- Balances recompilations
- Lead schedules
- Analytical procedures on financial statements
- Substantive testing of financial statements.

Client understanding

Process

Planning and client understanding are integrated activities, the first element of planning is to understand the client. Once an understanding has been achieved, detailed planning is required.

The basic flow of the activities looks like this:

Start planning
Understand client
Design tests
End planning
Execute tests

Tools

There are numerous techniques to assist in the client understanding stage, which revolve around gaining an in-depth understanding of the client's entity and operating environment. These techniques include Porter five forces analysis, SWOT analyses, mega and critical processes review, key success indicator structure, business model, etc. Irrespective of the techniques used, following execution of the client understanding stage the auditor should be able to refer to the basic interaction of the auditee in terms of:

- Nature of the business
- Vision goals and strategy of the business
- Business culture
- Remuneration and success measurement methods
- Key performance indicator
- Structure and design of the internal control
- Environmental relation

ISA

The basic ISA requirement for risk assessment is the performance of:

- Enquiries of management and others within the entity
- Analytical procedures
- Observation and inspection.

Fraud

Basic enquiries are related to the likelihood of fraud. The auditor should understand how those charged with governance exercise oversight over the identification of fraud risks and what controls have been implemented.

Analytical review

Analytical procedures include comparisons of:

- Prior periods

- Budgets and forecasts
- Industry information
- Predictive estimates
- Relationships between elements of financial information, e.g. ratio analysis
- Relationships between financial and non-financial information, e.g. payroll costs to the number of employees
- Other ratios (e.g. capital requirements)

Analytical review can also be used as a source of substantive audit evidence when their use is more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions.

Example

Renson plc has provided you with the following extract from its financial statements:

	Current (draft)	Previous (actual)
Long-term assets	200	300
Out of it intangibles	30	130
Current assets		
Stock	50	20
Receivables	50	20
Other	50	60
Cash	30	50
Total	380	450
Net equity	50	50
Long-term liabilities	100	150
Short-term liabilities	200	170
Other	30	80
Total	380	450
Sale	500	600
Cost of sales	(250)	(330)
Operating profit	250	270
Other revenues	60	70
Other costs	(50)	(50)
	260	290
Financial revenues	5	6
Financial costs	(15)	(71)
Profit before taxation	250	225
Tax	(50)	(150)
Net profit	200	75
Dividends	(200)	(75)
Retained	0	0

Perform an analytical review and highlight the area for further investigations.

Solution

	Current	Previous	Current	Previous	Change	Notes
Long-term assets	200	300	**53%**	67%	-14%	
Out of it intangibles	30	130	8%	29%	-21%	
Current assets			0%	0%	0%	
Stock	50	20	13%	4%	9%	
Receivables	50	20	**13%**	4%	9%	(i)
Other	50	60	13%	13%	0%	
Cash	30	50	8%	11%	-3%	
Total	380	450	100%	100%	0%	
					0%	
Equity net	50	50	13%	11%	2%	
Long-term liabilities	100	150	26%	33%	-7%	
Short-term liabilities	200	170	**53%**	38%	**15%**	(ii), (iii)
Other	30	80	8%	18%	-10%	
Total	380	450	100%	100%	0%	
Sale	500	600	100%	100%	0%	
Cost of sales	-250	-330	-50%	-55%	5%	
Gross profit	250	270	50%	45%	5%	
Other revenues	60	70	12%	12%	0%	
Other costs	-50	-50	-10%	-8%	-2%	
	260	290	52%	48%	4%	
Financial revenues	5	6	1%	1%	0%	
Financial costs	-15	-71	-3%	-12%	9%	
Profit before taxation	250	225	**50%**	38%	**13%**	(iv)
Tax	-50	-150	-10%	-25%	15%	
Net profit	200	75	40%	13%	**28%**	(v)
Dividends	-200	-75	-40%	-13%	-28%	
Retained	0	0	0%	0%	0%	

Significant changes detected:

(i) There is a substantial increase in liabilities, either sales push up, lack of the obsolete stock provision or other factors to be investigated.

(ii), (iii) Substantial change in the short-term liabilities and increase in overall balance sheet structure.

(iv) Changes in profit before taxation mainly resulting in changes of financial costs.

(v) Net profit changes, to be reconciled with profit before taxation, changes to tax rules and deferred taxation.

The above preliminary indication are strength with the ratio analysis:

Ratio Analysis

			Current	Previous
Gearing				
	Total equity / Total liabilities		50 / 330	50 / 400
			0.15	0.125
Profitability				
Net margin	EBIT / Sales		260 / 500	290 / 600
			0.52	0.48
Gross margin	Gross profit / Sales		250 / 500	270 / 600
			0.5	0.45
RoCE	EBIT / Share capital + reserves +nc liabilities		260 / 150	290 / 200
			1.73	1.45
Liquidity				
Current ratio	Current assets / Current liabilities		180 / 230	150 / 250
			0.8	0.6
Inventory days	Inventory / COS	x 365 days	50 / 250	20 / 330
			73	22
Debtors days	Debtor / Sales	x 365 days	50 / 500	20 / 600
			37	12
Creditor days	Creditors / COS	x 365 days	200 / 250	170 / 330
			292	188

Part of client understanding is a description of the client processes and systems of control.

The auditor is obligated to use analytical procedures such as:

- risk assessment procedures
- response to assessed risks
- substantive procedures (“substantive analytical procedures”)

and
- near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

Risk assessment

The risk assessment process consists of:
- Identifying risks to the entity and its environment
- Relating the identified risks to what can go wrong at the assertion level
- Assessing the significance and likelihood of the risks
- Establishing materiality
- Developing expectations for use when performing analytical procedures
- Designing and performing further audit
- Evaluating the sufficiency and appropriateness of audit evidence

Risk can be split into two elements:
a) Business risk assessment - this is the general risk associated with the running of the business, which might have affect the financial statements.
b) Audit risk assessment - this is the risk of poor auditing assessment procedures.

Business risk

Business risks 'result from significant conditions, events, circumstances or actions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies' [ISA 315]. It is usually split into financial risk, operational risk and compliance risk. The auditor should obtain an understanding of the entity's process for identifying business risk relating to financial reporting.

Business risk can be subject to other standards, such as the Basle framework in the banking industry, which actually reduces the risk of the entity into three elements:
- credit risk;
- market risk; and
- operational risk.

Example

Jane is manager at the Lehman Uncle Bank. The following activities were identified:

There was a fixed rate loan at 7% per annum granted on 7 March to Simon and Brother Ltd when the national bank reference rate was 5.5%. On 14 March the national bank reference rate rose to 8.25%.

The bank invested 26% of the equity stake into Offshore Limited on 1 January, and on 5 May Offshore declared bankruptcy.

As of 7 April a fake account introduced by the vice chief accountant was identified.

Allocate the case to the risk classes from both the Basel framework and general risk.

Solution

Basel: a) market risk, b) credit risk, c) operational risk,

General: a) financial risk, b) operational risk, c) compliance risk

Audit risk

Idea

Suppose that all the accounting entries for the entire year have been repeated and every transaction has been checked. Does this mean that the financial statements are fair? Not necessarily, because such an approach does not state which transactions were omitted from the books. The above-mentioned approach is a full audit – non-risk approach. Another approach would be to select areas from all the financial statements where there could be a material error or omission and focus attention thereon, assuming the rest to be relatively safe (this is risk-based auditing). Note that none of above-mentioned strategies provide functional conclusions, just persuasive ones.

Full audit is not allowed by the ISA.

The auditor must perform a risk analysis of the financial statements to be audited. To reduce the identified risk the auditor should plan and execute the audit to reduce the risk below the materiality threshold. In this context the risk is the chance that the auditor expresses inappropriate opinion when the financial statements are materially misstated. The audit risk is itself not an integrated term, it could be traced down to its components.

Risk model

The basic model of risk could be expressed as follows:

$$AR = IR \times CR \times DR$$ [6]

or

$$AR = IR \times CR \times (SR \times NSR)$$

Where:

AR = Audit risk

CR = Control risk

DR - Detection risk

Note that detection is a product of the SR - sampling risk and NSR - non sampling risk.

[6] For detailed disscussion on the link between the audit risk model and Basel risk model refere to: P. Staszkiewicz, *Sprawozdawczość ostrożnościowa i finansowa firm inwestycyjnych*, I. Warszawa: Wolters Kluwer, 2014.

Example

Why do we use the product instead of the sum in the audit risk formula?

Solution

Product means that the adverse factors must come together to result in the risk to be crystallized and indicate the independence of the factors. If it were a sum, then only one factor would be needed to put the audit risk at an untenable level.

Inherent risk

Inherent risk is abstract from the entity control environment, and address the risk of misstatement caused by those factors independent of managerial influence, such as changes in law, competition, technology and customer and creditor behaviour.

Control risk

Control risk relates only to those factors within the control of management. It captures the changes that occur as a result of the control designed and executed by the management either not working or being wrongly designed.

Detection risk

Is the attribute of the risk which describes the auditors' ability to detect the misstatements. Its comprise the risk that the auditor performing audit as planned cannot detect misstatement, can lack of expertise, or underestimate the sample size to be check.

The combination of control and inherent risk form the so-called "risk of material misstatement"; the detection risk (indicating the level of auditor preciseness) is the external factor thereon.

Materiality

Materiality dimensions:

1) Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.
2) Material are: errors, omissions and misstatements. Both the amount (quantity) and nature (quality) of misstatements need to be taken into account.
3) Auditor has to set his own materiality levels – this will always be a judgement.
4) The level of materiality impacts:
   i) Type, timing and extent of audit procedures,
   ii) Forming opinion process.

Standards do not discuss how the materiality should be calculated. Thus, practice has developed the indication, which varies from auditor to auditor. Those indications are based on the financial statements major aggregates, e.g.:

	Range
Net profit	5–10%
Sales	0.5–1%
Net equity	3–7%
Total assets	0.1–1%

The impact is usually assessed on the aggregate of uncorrected misstatements. This is normally documented on a schedule of unadjusted differences (called SAD - summary of audit differences). However the materiality should be reconsidered before arriving at final conclusions.

Another steering parameter linked with materiality is the tolerable error. This is the maximum error in the population (e.g. a specific balance in the financial statements) that auditors are willing to accept and still conclude that the audit objective has been achieved. Tolerable error is normally set as a percentage of planning materiality. It is also used to help determine the size of samples. The reporting level is usually set as a percentage of materiality and indicates the level above which the error or omission is aggregated in the schedule of the unadjusted differences. It is set up to prevent the recording of small issues and errors which are not relevant and the sum of which does not impact the fairness of financial statements.

Example

Using the following extract from the financial statements of Renson plc, calculate: planning materiality, tolerable error, SAD limit, base your judgement.

Solution

		Range	
Net profit	200	5–10%	10–20
Sales	500	0.5–1%	2.5–5
Net equity	50	3–7%	1.5–3
Total assets	380	0.1–1%	0.38–3.8

As the net profit and total assets show significant variation, sales change while the net equity becomes stable, the materiality is based on the net equity at the level 3 which is a value within the range of sales and total assets. Thus:

Materiality - 3

Tolerable error 70% of materiality - 2.1

SAD limit 10% of materiality - 0.3

Standards requirements overview
Client acceptance

Acceptance basic framework

Client acceptance is guided by the International Standard on Auditing number 210: Agreeing the Terms of Audit Engagements.

General framework for the acceptance of the engagement:

An auditor can accept or continue an audit engagement only when:

a) The preconditions for an audit are present; and

b) There is a common understanding between the auditor and management (ISA.210.3).

While:

"Preconditions for an audit" - The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

"Management" is "management and, where appropriate, those charged with governance."

Auditor obligation

An auditor has several obligations stemming from the standard, namely:

i) To confirm that the financial reporting framework is appropriate.

ii) To set up an agreement with management that states the management responsibility.

iii) If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so (ISA.210.7).

Note that obligation (ii) actually requires the drafting of an audit service contract.

Example

Alan Ltd is an audit company. Mark is an assistant to the audit partner Frank in charge of the Bike plc's engagements. Frank turns to Mark to draft the main points of the management responsibilities. What does Mark draw down?

Solution

- Access to all information for the auditor
- Right to additional information that the auditor may request
- Unrestricted access to staff

The agreement should at least constitute the following items:

a) The objective and scope of the audit of the financial statements;
b) The responsibilities of the auditor;
c) The responsibilities of management;
d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

Form: writing contract or letter unless local regulation stipulates other form.

Example

David, an audit partner at W&D, called John, an audit partner at P&W, to immediately conduct an audit on Steel sp. z o.o. on behalf of the parent company's board. What should John do before sending staff off to the field?

Solution

Fax the engagement letter to the board of Steel sp. z o.o. and request the sign-off in reverse fax. In addition, for the local system request a copy of the Supervisory Board (or General Meeting) with the auditor selection resolution.

Other Factors Affecting Audit Engagement Acceptance

Reason for non-acceptance of the engagement:

- the preconditions for an audit are not present
- the financial reporting framework to be applied in the preparation of the financial statements is unacceptable
- the agreement with management that states management's responsibility was not agreed
- if local standards and auditor report formulation are so different as to be misleading, the auditor should not accept the engagement under ISA unless the risk is mitigated.

Fraud considerations

Fraud consideration is both an aspect of the client's acceptance procedure and a part of the risk assessment and evidence gathering. The high-level review is carried out during the client acceptance procedure and contract negotiation, while actual risk assessment is performed as part of the interim procedures. At the final stage the biased and mixed results are supported with additional management representation and, if needed, additional testing.

Characteristics of Fraud

Fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. The auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor:

- misstatements resulting from fraudulent financial reporting

and

- misstatements resulting from misappropriation of assets.

The auditor does not make legal determinations of whether fraud has actually occurred.

Responsibility for the Prevention and Detection of Fraud

The primary responsibility for the prevention and detection of fraud rests with management.

Management should be committed to:

- creating a culture of honesty and ethical behaviour,
- reviewing the potential for override of controls or other inappropriate influence over the financial reporting process, and
- preventing efforts by management and subordinates to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

Responsibilities of the Auditor

An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. The risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism. The objectives of the auditor are:

- To identify and assess the risks of material misstatement of the financial statements due to fraud;
- To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

- To respond appropriately to fraud or suspected fraud identified during the audit.

Basic indications:
- The auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, irrespective of prior experience.
- Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine.
- Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

Discussion among the Engagement Team

The Standards require a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion.

Example

When should the discussion take place?

Solution

It is likely that the discussion should be a sort of high level kick-off meeting, preferably before or during the interim visit.

Risk Assessment Procedures and Related Activities

The risk assessment procedures should include the following considerations, at least in respect of identifying the risks of material misstatement due to fraud:
- Management and Others within the Entity
  Inquiries of management or staff regarding:
  i) Management's assessment of the risk that the financial statements may be materially misstated due to fraud.
  ii) Management's process for identifying and responding to the risks of fraud in the entity.
  iii) Management's communication, if any, to those charged.
  iv) Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.
  v) Management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.
  vi) For those entities that have an internal audit function, the auditor shall make inquiries of appropriate individuals.

- Charged with Governance
  Unless all of those charged with governance are involved in managing the entity, the auditor shall:
  i) obtain an understanding of how those charged exercised oversight of management's processes,
  ii) make inquiries of those charged to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.
- *Unusual or Unexpected Relationships Identified*
  The auditor shall evaluate unusual or unexpected relationships that have been identified in performing analytical procedures.
- *Other Information*
  It should be considered whether other information obtained by the auditor indicates risks of material misstatement due to fraud.
- *Evaluation of Fraud Risk Factors*
  The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present.

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

The auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures (IAS.315).

Responses to the Assessed Risks of Material Misstatement Due to Fraud

The auditor shall:
- Assign and supervise personnel taking significant engagement responsibilities.
- Evaluate whether the selection and application of accounting policies by the entity may be indicative of fraudulent financial reporting.
- Allow for unpredictability in the selection of the nature, timing and extent of audit procedures.

The auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.

Audit Procedures Responsive to Risks Related to Management Override of Controls

These procedures are usually called the general audit procedures as they constitute the core minimal inquiries and test for the fraud detection risk.

As a minimum the auditor should:

a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:

i) Make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;
ii) Select journal entries and other adjustments made at the end of a reporting period; and
iii) Consider the need to test journal entries and other adjustments throughout the period.

b) Review accounting estimates for biases and evaluate whether the circumstances producing the bias, at least:
   i) Evaluate whether the judgments and decisions made by management in making the accounting estimates included in the financial statements indicate a possible bias on the part of the entity's management that may represent a risk of material misstatement due to fraud.
   ii) Perform a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year.
c) For significant transactions that are outside the normal course of business for the entity, the auditor shall evaluate the business rationale (or lack thereof) of the transactions.
d) Consider the need to perform other audit procedures in addition to those specifically referred to above.

Evaluation of Audit Evidence

By formulating opinion, the auditor should take into account the previously unrecognized risk of material misstatement due to fraud. The identified misstatements, or not, of material should be judged upon if there is a potential risk of fraud and particularly the reliability of management representations. If the auditor confirms that the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit especially if the audit is feasible.

Auditor Unable to Continue the Engagement

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor is unable to conduct the engagement, the auditor shall:

i) Determine the professional and legal responsibilities (e.g. the requirement to report to whom made the audit appointment, to regulatory authorities)
ii) Decide if to withdraw from the engagement, if the auditor withdraws:
   - Discuss with the appropriate level of management;

   and
   - Determine whether there is a professional or legal requirement to report.

Written Representations

The auditor shall obtain written representations (called a representation letter) from management and ensure that:

a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
b) They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;
c) They have disclosed to the auditor their knowledge of fraud, or suspected fraud, affecting the entity involving:
   i) Management;
   ii) Employees who have significant roles in internal control; or
   iii) Others where the fraud could have a material effect on the financial statements; and
d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (ISA. 240.39)

Example

Suppose Mr. Auditor, during the audit, forgot to take the representation letter from management. Just after issuing a clear audit opinion it turns out that the sales director in connection with the chief accountant issued fictitious invoices resulting in substantial material losses due to the fraud. What would be the typical answer to a question such as 'Why you did not elaborate to the auditor on your suspicions of the sales manager?' of a management board member at court in an attempt to shift the liability for professional misconduct over to the auditor?

Solution

They have never asked.

Representation letter, as the best-practice rule, should be signed off by all board members and those who might represent the entity externally.

Communications to Management and with Those Charged with Governance

In general, as the auditor identifies fraud or the likelihood of fraud, it should be communicated to management. If management is involved (or is likely to be involved) in the fraud, the auditor shall communicate these suspicions to those charged with governance (e.g. supervisory body, non-executive directors or shareholders' general meeting - the exact level depends on the legal and organizational structure of the entity).

Communications to Regulatory and Enforcement Authorities

If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances.

Example

Auditor of IMD Broker-Dealer Group, quoted on the Warsaw Stock Exchange, has identified a material fraud on the client's assets in custody. The fraud involved cooperation between the investment advisors employed by the entity and the Local Authority Financial Controller. The auditor is about to issue the qualified opinion. List the basic regulatory reporting requirements.

Solution

Report to the Polish Financial Authority the fact that the qualified opinion is going to be issued.

Documentation

The document shall include:

At planning stage:

- Decision derived from the engagement team discovering the risk of fraud.
- The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

At concluding audit:

- The overall responses to the assessed risks of fraud at the financial statement level and at the assertion level.
- The results of the audit procedures.
- Communications about fraud made to management, those charged with governance, regulators and others.
- If fraud risk is not applicable in the circumstances of the engagement, the reasons for that conclusion.

Consideration of Laws and Regulations in an Audit of Financial Statements

The law and regulation must be considered by the auditor, however this consideration is through the impact of the financial statements. According to ISA.250 the auditor does not perform the legal compliance review for the entity, thus separation of responsibilities between the auditor and those who run the entity is vital. The auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations. The auditor is liable, however, for not detecting the financial material non-compliance. Thus, the auditor's objectives are:

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

Note that the standards require evidence in 'direct' relation, thus remote, indirect relation and potential coincidences of events are outside of the standards' requirements but do fall within good practice and reputable management procedures.

Effect of Laws and Regulations

Non-compliance is an act of omission or commission by the entity, either intentional or unintentional, which is contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements. The non-compliance might result both from direct and indirect regulation.

Direct regulation can include:

- Specific provision in accounting standards and regulation for financial institutions, chemical industry, charities, political parties, broker-dealers, Basel reconciliation for bank industry, etc.
- Direct regulation such as taxation, pensions law.
- Auditing standards and country-specific regulation, e.g. obligation to report in front of the audit opinion non-publication of financial statements.

Indirect regulation can include:

- General business operation law, such as occupational health and safety, equal opportunities employment.
- Industry critical obligation, e.g. authorities licence for broadcasting, operating on regulated markets (banks, insurances, financial intermediates, telecoms, mines).

Non-compliance may also affect the going concern assumption, thus substantial procedures such as solicitors and in-house lawyers inquires constitute the basic techniques for auditing.

In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- There are many laws and regulations, relating principally to the operating aspects of an entity, which typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.
- Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.
- Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognize the non-compliance.

The standard distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations, as follows:

I. The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and pension laws and regulations;
II. Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements.

For I. the auditor's responsibility is to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations.

For II. the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

Note that this is the reason for the specific and not historical financial information, additional services conducted by the auditors[7]

[7] For example there is a requirement for the broker-dealers to report as agreed upon procedures project the compliance with the safeguarding the clients assets under custody (an equipment for specific additional report in Polish environment).

The Auditor's Consideration of Compliance with Laws and Regulations consists of:

- The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates;
- How the entity is complying with that framework.

The audit evidence should indicate compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements.

The following minimum audit procedures are required by the standard:

- Inquiring of management whether the entity is in compliance with such laws and regulations;
- Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.
- To provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

In addition, if non-compliance is suspected:

- An understanding of the nature of the act and the circumstances in which it has occurred; and
- Further information to evaluate the possible effect on the financial statements.
- The auditor shall discuss the matter with management and if they do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.
- If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

Reporting levels

The following reporting levels should be considered:

- identified or suspected non-compliance,
- non-compliance to those charged with governance,
- non-compliance in the Auditor's Report on the Financial Statements,
- non-compliance to Regulatory and Enforcement Authorities.

As a general rule the auditor should communicate the non-compliance to the next highest level of authority or anyone that the auditor believes is appropriate. The communication should be as soon as is practicably possible. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall:

- express a qualified opinion,

in case of limited the access to evidence:

- limitation of the scope or an adverse opinion on the financial statements.

If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

Documentation

The auditor shall include in the audit documentation identified or suspected non-compliance with laws and regulations and the results of discussion with management.

Planning

For efficiency of the audit engagement, planning is a critical activity, thus the standards themselves require the auditor to plan the engagement. This constitutes the link to the project management activity. ISA.300, Planning an Audit of Financial Statements, is fully devoted to planning. The objective of the auditor is to plan the audit so that it will be performed in an effective manner. It is set in the context of recurring audits, while the initial audit engagement requires in addition:

- Performing procedures of the acceptance of the client relationship and the specific audit engagement;
- Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements.

The Role and Timing of Planning

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning helps the auditor to:

- devote appropriate attention to important areas of the audit,
- identify and resolve potential problems on a timely basis,
- properly organise and manage the audit engagement so that it is performed in an effective and efficient manner,
- assist in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them,
- facilitate the direction and supervision of the engagement team members and the review of their work,
- assist, where applicable, in coordination of work done by auditors of components and experts.

Requirements

The standard essentially requires the involvement of key engagement team members: the engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members.

Preliminary Engagement Activities

The current audit engagement should start with:

- Performing procedures regarding the continuance of the client relationship and the specific audit engagement;
- Evaluating compliance with relevant ethical requirements, including independence;
- Establishing an understanding of the terms of the engagement.

Planning Activities

The auditor shall establish:

- an overall audit strategy that sets the scope, timing and direction of the audit, and;
- the audit plan.

In establishing the overall audit strategy, the auditor shall:

- Identify the characteristics of the engagement that define its scope;
- Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
- Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
- Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
- Ascertain the nature, timing and extent of resources necessary to perform the engagement.

An audit plan consists at least of:

- The nature, timing and extent of planned risk assessment procedures;
- The nature, timing and extent of planned further audit procedures at the assertion level;
- Other planned audit procedures.

The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

Documentation

The basic documentation includes:

- the overall audit strategy;
- the audit plan;
- any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

Client understanding

This is probably one of the most neglected areas in professional auditing. An audit typically takes place on a recurring basis and making assumptions based upon past performance and activities therefore becomes the source of routine mistakes. An understanding of the client's business in terms of its nature, development and consequences for the risk of material misstatement is crucial for palnning, effective audit execution and value-added services. Efficiency is enhanced through a thorough understanding of the entity and its environment, including the entity's internal control.

The conceptual framework consists of:

- Assertions - Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.
- Business risk - A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
- Internal control - The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.
- Risk assessment procedures - The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
- Significant risk - An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Requirements

Risk Assessment Procedures and Related Activities

The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

Risk assessment procedures include the following:

- Inquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error
- Analytical procedures

- Observation and inspection.

The information obtained from the auditor's client acceptance or continuance process should be used for identifying risks of material misstatement. If the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement. Where the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion.

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

For the entity and its environment the following areas should be considered:

1) Relevant industry, regulatory and other external factors including the applicable financial reporting framework.
2) The nature of the entity, including:
   - its operations;
   - its ownership and governance structures;
   - the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
   - the way that the entity is structured and how it is financed.
3) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
4) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
5) The measurement and review of the entity's financial performance.

For the entity's internal control the auditor shall obtain an understanding of internal control relevant to the audit. Most controls relevant to the audit are likely to relate to financial reporting, but not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. When obtaining an understanding of controls the auditor evaluates the design of those controls and determines whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel.

Components of Internal Control and Control environment

As part of obtaining this understanding of the control environment, the auditor shall evaluate whether:

- Management has created and maintained a culture of honesty and ethical behaviour,
- The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

The entity's risk assessment process

The auditor checks if the entity operates a process for:

- Identifying business risks relevant to financial reporting objectives,
- Estimating the significance of the risks,
- Assessing the likelihood of their occurrence,
- Deciding about actions to address those risks.

called: "risk assessment process".

If the risk assessment process fails or is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed.

The information system, including the related business processes, relevant to financial reporting, and communication

The auditor obtains an understanding of the information system, including the following areas:

The classes of transactions in the entity's operations that are significant to the financial statements;

- The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
- How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures;
- Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

The auditor should understand how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including:

- Communications between management and those charged with governance; and
- External communications, such as those with regulatory authorities. Control activities relevant to the audit.

The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance and disclosure in the financial statements or to every assertion relevant to them.

In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT.

Monitoring of controls

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control relevant to financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls.

If the entity has an internal audit function, the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, its organizational status, and the activities performed, or to be performed.

The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose.

Identifying and Assessing the Risks of Material Misstatement

The auditor identifies and assesses the risks of material misstatement at:

- the financial statement level;
- the assertion level for classes of transactions, account balances and disclosures.

To provide a basis for designing and performing further audit procedures the auditor shall:

- Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances and disclosures in the financial statements;
- Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test;

- Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Risks that Require Special Audit Consideration

The auditor shall determine whether any of the risks identified are a significant risk. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- Whether the risk is a risk of fraud;
- Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
- The complexity of transactions;
- Whether the risk involves significant transactions with related parties;
- The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk.

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them.

Revision of Risk Assessment

The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly.

Documentation

The auditor should document at least:

- The discussion among the engagement team and the significant decisions reached;

- Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and of each of the internal control components; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
- The identified and assessed risks of material misstatement at the financial statement level and at the assertion level;
- The risks identified, and related controls about which the auditor has obtained an understanding.

Analytical procedures

"Analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Substantive Analytical Procedures

When designing and performing substantive analytical procedures, the auditor is obligated to:

i) Determine:
   - the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;
   - the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

Analytical Procedures that Assist When Forming an Overall Conclusion

The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion on financial statements.

Investigating Results of Analytical Procedures

If analytical procedures performed in accordance with this ISA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses;
b) Performing other audit procedures as necessary in the circumstances.

Risk assessment

Materiality[8]

Materiality in the Context of an Audit

Materiality is a key term in the accounting and auditing standards. Materiality seen through accounting might be interpreted as:

- Level of preciseness at preparation and presentation of financial statements;
- Misstatements, including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Thus, materiality originates with accounting standards and procedures.

Performance materiality is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Example

An auditor sets up planning materiality at 100, the tolerable error at 70 and the value of singular error or omission which is not relevant at 10. Identify the performance materiality.

Solution

70 is the performance materiality.

The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of the users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

8 ISA.320. The materiality standard is short but powerful, the planning materiality level is the yardstick for the routine audit operating and strategic decision, thus the alerting of the quantitative level should be seriously considered.

- Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- Understand that financial statements are prepared, presented and audited to levels of materiality;
- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- Make reasonable economic decisions on the basis of the information in the financial statements.[9]

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Example

Dorn Audit is the auditor of BigM company, planning materiality was based on the interim accounts, where the annualized profit was 100, total assets 200 and net equity 20. The materiality was based on 5% of the annualized profit at 5. After the financial statements closing process and booking all agreed with the management journal entries. The revised profit is 200, while the total assets and net equity stayed as the same level. Explain how an error in dispute should be treated with management of a total value of 6 in respect of the opinion.

Solution

It is likely that the true materiality should be 10 (5% at 200) thus, if the error in dispute is isolated, the auditor after reconsideration of the materiality level might not necessarily qualify the accounts.

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for:

a) Determining the nature, timing and extent of risk assessment procedures;
b) Identifying and assessing the risks of material misstatement; and
c) Determining the nature, timing and extent of further audit procedures.

The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Although it is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature, the auditor considers not only the size but also the nature

[9] Note: *homo economicus* assumption on the users of the financial statements is slightly contradictory to the current development of behavioural finance. Thus, this assumption should be interpreted in the context of the users of the financial statements expectations rather than actual behaviour.

of uncorrected misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements.

Determining Materiality and Performance Materiality When Planning the Audit

When establishing the overall audit strategy, the auditor set up materiality for the financial statements as a whole. For isolated groups or classes of transaction are to be influence of users' decisions, materiality should be specific materiality levels should be applied to those groups or classes. The materiality should be set realistically soon to serve as the control for assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.

Revision as the Audit Progresses

The auditor shall revise in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. If the auditor concludes that a lower materiality than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Documentation

The following must be documented:

- Materiality for the financial statements as a whole;
- If used, the materiality level or levels for particular classes of transactions, account balances or disclosures;
- Performance materiality;
- Any revision to the above as the audit progresses.

Revision

Summary

The auditor might not accept all clients and the auditor must have sufficient recourses to deliver the audit service. After the proposal has been accepted the auditor must confirm in writing the basic terms of engagement and willingness of the management team to take responsibility for the preparation of the financial statements. Understanding of the client engagement and proper planning are key success elements for auditing. Analytical review of the financial statements of the past year and current year preliminary statements is the key to proper risk assessment. The audit risk model comprises inherent, control and detection risk and it is a product of those risks. Materiality guides the auditor through the substantive, control test procedures and applies for the assessment of final finding.

Key words

Preconditions for an Audit, Management, Fraud, Fraud Risk Factors, Non-Compliance, Assertions, Business Risk, Internal Control, Risk Assessment Procedures, Significant Risk, Performance Materiality, Assessment Procedure, Substantive Procedure, Complementary User Entity Controls, User Entity, User Auditor, Subservice Organization, Service Organization's System, Service Organization, Service Auditor, Type 2 Report, Type 1 Report

Y/N Questions

No	Issue	Y/N
1	Auditor can always accept or continue an audit engagement.	Y/N
2	The risk of the auditor not detecting a material misstatement resulting from management fraud is lower than for employee fraud.	Y/N
3	The auditor shall update and change the overall audit strategy and the audit plan continuously.	Y/N
4	The auditor shall obtain an understanding of control activities on all the business areas.	Y/N
5	The auditor's assessment of the risks of material misstatement at the assertion level should not change during the course of the audit.	Y/N
6	The auditor shall design and perform analytical procedures near the end of the audit.	Y/N
7	"analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.	Y/N
8	When establishing the overall audit strategy, the auditor sets up materiality for the financial statements as 5% of net profit.	Y/N
9	The auditor obtains an understanding of the information system during test of controls.	Y/N
10	The identified and assessed risks of material misstatement at the financial statement level and at the assertion level must be documented.	Y/N

Issues to consider

1) Recall definitions of the key words.
2) Describe the impact to the standards involved on the context of the chapter.
3) Consider the consequences of the wrong assessment of the client business model for the audit engagement.
4) After the planning stages it turned out the part of the management board members were sentenced for tax avoidance on private accounts. Discuss the impact for the audit procedures.
5) What is the difference between audit risk and statistical confidence level?

Case study: Romek, Tomek i Atomek

Romek, Tomek i Atomek are a trio of frieds who are audiotrs. They set up their audit company RTS. The friends are meeting as usual on Monday and discussing the projects oppotunities:

i) Romek was asked by their long-term client English Bank A.G. to provide due dilligence on Krakowski Chleb S.A. the contract terms: value 200 thousand of PLN payable as a lump sum after the delivery of the report.
ii) Tomek met his wfie Marta, she wants the financial statements of ThomosnMasters S.A. – their own buisness – to be audited by RTZ with a deadline of Feburary 17. The contract terms are: fee 80 thousand of PLN, Polish auditing standards, financial statements prepared in accordance with IFRS.
iii) Atomek has audited the financial statement of Janusz S.A, where the controlling intrest is held by Janusz (60%) and the minority by his wife (40%). During the audit Atomek found out that Janusz S.A. had not dislosed a related party transaction. Janusz S.A. has rented a luxury downtown flat for Marta, a very close friend of Janusz. Janusz, as the CEO, did not allow the disclosure of this transaction, claiming that this kind of disclusre might jeopardise his marrage, as Janusz's wife is the head of the audit committee of Janusz S.A.

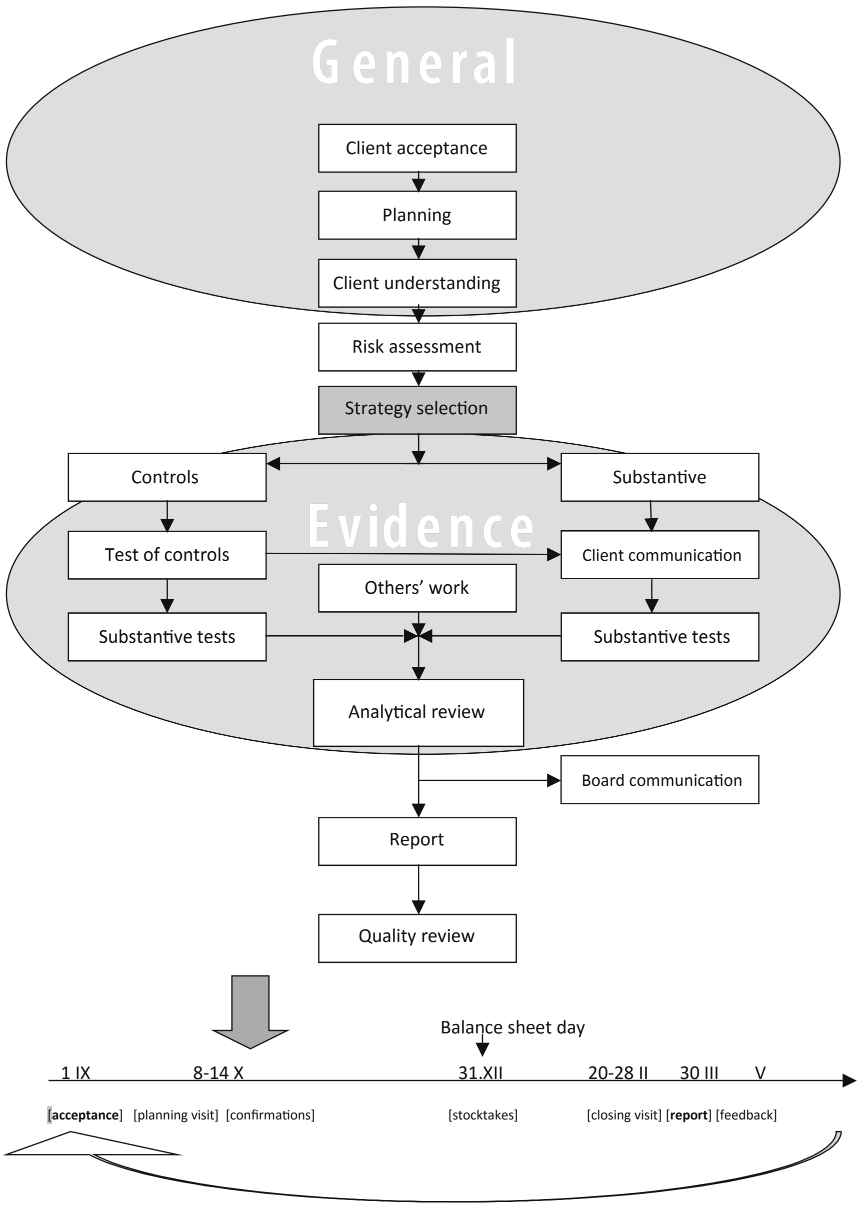
Due to above matters RTZ as turned to you for advice.

You are required to:

(a) Assess whether, based on the ethics code, the Krakowski Chleb engagment can be conducted.
(b) Write a draft of the company board resolution regarding ThomsonMasters outlining the principles of contranct acceptance.
(c) Advise Atomek what to do with disclosure issue.

Chapter 3

Strategy formulation



Learning goal
To formulate the audit strategy as the response to the risk identified.

Standards involved

ISA 230 Audit Documentation
ISA 330 The Auditor's Responses to Assessed Risks
ISA 420 Audit considerations relating to entities using service organisations

Link to previous chapters

From chapter one these standards carry forward the rules for audit documentation. The building strategy is now discussed in details. What is important is that the strategy and its consideration must be properly documented in accordance with ISA. The strategy will then be executed either in the form of control testing or substantive testing or a combination of both of these.

Overview
Response: Audit strategy

After understanding the client's business the job of the auditor is to decide which audit strategy to select. It might either:

- Perform only substantial testing on balances (substantive testing)

or

- Combine testing of controls and testing of balances.[10]

Substantive procedure is an audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

- Tests of details (of classes of transactions, account balances and disclosures); and
- Substantive analytical procedures.
- Test of controls is an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Suppose the auditor identified the only significant balance of debtors, which constituted 20 000 small balances to individual credit customers. The total value of the balance is $700 000, the planning materiality $5000. Suppose the auditor calculated the sample size to be checked to achieve persuasive evidence to confirm the sample:

- If after the testing of controls, the controls are effective, than say the sample size to be checked will be 800[11] individual balances.
- If only the substantial testing must be executed (at moderate control risk would be 2200)

[10] Note: there is no obligation to always conduct testing of controls.
[11] This is an artifical illustration - no real calculation has been shown or executed.

The comparison of the sample size is summarised below

Controls effective	800
Substantive control moderate (preliminary)	2200
Substantive control weak (preliminary or final)	No sampling alternative allowed

There are substantial differences in the audit work (to be done usually at final visit) depending on the initial assessment of the control environment and final testing. This sample size is easily translatable into the project timing and costs.

Thus, the auditor faces the follow strategic decision: invest the time during the interim (less expensive time) and test the controls. If the controls turn out to be effective then at the final visit substantial savings are to be achieved due to lowering of the sample size necessary to draw the conclusions. If the opposite is the case, after testing the controls turn to be ineffective (loss of the time invested during interim), the auditor will be penalized (in addition) with the inability of sampling.

After understanding the system control, assessment before testing could be as follows:

a) Reliable designed system.
b) Not effective not reliable.

Only if the system is preliminarily judged as reliable (or part of it) might the control strategy be applied. Once the system is assessed as not effective the auditor communicates this to the client (to help business development - this is added value shared with the client).

There are different types of companies, where only a substantial testing strategy is applicable (e.g. a small start-up company, without a developed system of internal control) or only control strategy is applicable (e.g. a global bank, with billions' worth of daily interest charges to its costumers - until the control risk is not effective the sample size goes towards population size and there is no guarantee on the homogeneity of the population).

The audit strategy is a judgemental decision. It should be properly documented.

Typically the audit strategy memo (ASM) is the document which address the following areas besides the testing strategy:

- Scope
- Financial reporting standards
- Client location (or location of subsidiaries)
- Reporting objectives (dates, communication with those charged with governance)
- Materiality level (and its base for set-up)
- Preliminary identification of risk areas and material balances
- Decision of the control testing
- Recourses necessary to conduct the engagement (staffing, experts, consultation, etc.)
- Timing (budget, deliverables, communication)
- Key project management task (briefings, reviews, indications)
- The strategy should be signed off by key engagement staff including the principle auditor.

Memorandum are usually attached to the audit strategy:

a) detailed planning calculations
b) analytical review
c) in the case of consolidation - the parent company auditor instructions

Once the audit strategy is approved the audit plan is developed. The audit plan is the set of specific tasks to be performed (it could be long - a few thousand actions, or short depending on the nature of the project). The audit plan is usually allocated to an interim and final visit. The part allocated to the final visit is usually organised according to the major items of the balance sheet and profit and loss, while the disclosure and financial statements closing process procedures are allocated as general closing activities. This solution is indicative, however, and depends on the internal system of control of a given audit company. The plan consists of detailed instructions, time budget, etc.

Audit considerations relating to entities using service organisations
The entity might outsource to another entity part of its operations, typically:
- Internet services and backroom IT infrastructure
- maintenance of accounting records
- payroll
- credit control
- data entry/information processing

The auditor should:
- assess the significance of the service organisation's activities to audit
- assess the risk of misstatement due to service organisation
- assess the extent of control risk associated with the service organisation
- consider whether information held by the entity is sufficient
- if necessary, request the service organisation's auditor to perform additional procedures or visit the service organisation to perform tests of controls
- consider any implications for the auditor's report.

Requirements
Response to risk
Having performed the risk assessment the auditor should link the assessment with the audit plan and audit strategy. The response basically places the balance between the scope of the substantive procedures and tests of controls.

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level
When carrying out design and performance of further procedures the auditor shall take into account the reasons for risk of material misstatement and the scale of the persuasive-

ness of evidence against the risk detected. The auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.

Tests of Controls

The test of controls are to be designed and performed if:

- The risk assessment leads the auditor to expect that the controls are operating effectively[12]

or

- Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

Nature and Extent of Tests of Controls

In designing and performing tests of controls, the auditor shall:

- Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls,
- Determine whether the controls to be tested depend upon other controls (indirect controls), and, if so, is there a need to test indirect controls.

Timing of Tests of Controls

The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls. If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:

- Obtain audit evidence about significant changes to those controls subsequent to the interim period;
- Determine the additional audit evidence to be obtained for the remaining period (roll forward the effectiveness).[13]

Using audit evidence obtained in previous audits

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

- The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;
- The risks arising from the characteristics of the control, including whether it is manual or automated;

[12] Note: virtually there are types of the entities where without efficient controls the financial statements are virtually unlikely to be reliable, e.g. banking.

[13] The chance of significant change to the controls procedures is usually remote, therefore the testing of controls is the domain of the interim visit, and thus the costs of auditing at the prime time (busy season) are reasonably reduced. A second potential gain of control testing investment is its potential to be reused for a recurring engagement.

- The effectiveness of general IT controls;
- The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
- Whether the lack of a change in a particular control poses a risk due to changing circumstances;
- The risks of material misstatement and the extent of reliance on the control.

If the auditor plans to use audit evidence from a previous audit than he should ensure the continuing relevance of that evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:

- If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit.
- If there have not been such changes, the auditor shall test the controls at least once in every third audit. If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the **current period**.

Evaluating the Operating Effectiveness of Controls

When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.

If deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

- The tests of controls that have been performed provide an appropriate basis for reliance on the controls;
- Additional tests of controls are necessary; or
- The potential risks of misstatement need to be addressed using substantive procedures.

Substantive Procedures

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure.

The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures.[14]

[14] Note: the requirement is not to perform the external confirmation, but to consider its relevance. For example the auditor might decide to perform confirmation on the receivables and not to execute the confirma-

Substantive Procedures Related to the Financial Statement Closing Process

The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

Agreeing or reconciling the financial statements with the underlying accounting records; and

Examining material journal entries and other adjustments made during the course of preparing the financial statements.

Substantive Procedures Responsive to Significant Risks

If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

Timing of Substantive Procedures

If substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:

a) substantive procedures, combined with tests of controls for the intervening period; or
b) if the auditor determines that it is sufficient, further substantive procedures only,

that provide a reasonable basis for extending the audit conclusions from the interim date to the period end.

If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified.

Adequacy of Presentation and Disclosure

The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures,[15] is in accordance with the applicable financial reporting framework.

Evaluating the Sufficiency and Appropriateness of Audit Evidence

Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate.

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tion of payables (e.g. due to the nature of the major risk on the side of assets overstatement, while liabilities understatement).

15 Note: This why the presentation and disclosure checklist are so popular and growing with the enlargement of the accounting standards.

The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, he shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements.

If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, he shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, than the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.

Documentation

The following documentation is required:

- The overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed;
- The linkage of those procedures with the assessed risks at the assertion level; and
- The results of the audit procedures, including the conclusions where these are not otherwise clear.

If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor shall include in the audit documentation the conclusions reached about relying on such controls that were tested in a previous audit. The auditor's documentation shall demonstrate that the financial statements agree or reconcile with the underlying accounting records.[16]

Service organisation-specific provision

Some entities outsource their function to other companies. For example the Research and Develop Lab might decide to ask a professional accountant to maintain its books and keep all the records with the tax office. The basic reasons for such an outsourcing is the cost of in-house staff and specific expertise of the outsourcing services provider. The outsourcing (more generally service organisation) provides the services for the client but on the client account. Thus, the consequences of the services are shown in the accounts.

Services provided by a service organisation are relevant to the audit of a user entity's financial statements when those services are part of the user entity's information system when these services affect any of the following:

- The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;
- The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

[16] Note: the accounts reconciliation, their reconciliation of the trail balance to underlying analytics is an example of the basic reconciliation.

- The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;
- How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;
- The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures; and
- Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

Those requirements does not apply to services provided by financial institutions that are limited to processing, for an entity's account held at the financial institution, transactions that are specifically authorised by the entity, such as the processing of checking account transactions by a bank or the processing of securities transactions by a broker. In addition, the standards do not apply to the audit of transactions arising from proprietary financial interests in other entities, such as partnerships, corporations and joint ventures, when proprietary interests are accounted for and reported to interest holders.

The objectives of the user auditor, when the user entity uses the services of a service organisation, are:

- To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and
- To design and perform audit procedures responsive to those risks.

Definitions (conceptual framework used for the service organisation provision)

Complementary user entity controls - Controls that the service organisation assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of its system.

Type 1 report - Report on the description and design of controls at a service organisation - A report that comprises:

i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and implemented as at a specified date; and
ii) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.

Type 2 report - Report on the description, design, and operating effectiveness of controls at a service organisation - A report that comprises:

a) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and
b) A report by the service auditor with the objective of conveying reasonable assurance that includes:
    a) The service auditor's opinion on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
    b) A description of the service auditor's tests of the controls and the results thereof.

Service auditor - An auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.

Service organisation - A third-party organisation (or segment of a third- party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

Service organisation's system - The policies and procedures designed, implemented and maintained by the service organisation to provide user entities with the services covered by the service auditor's report.

Subservice organisation - A service organisation used by another service organisation to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.

User auditor - An auditor who audits and reports on the financial statements of a user entity.

User entity - An entity that uses a service organisation and whose financial statements are being audited.

Obtaining an Understanding of the Services Provided by a Service Organisation, Including Internal Control

When obtaining an understanding of the user entity, the auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including:

- The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;
- The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
- The degree of interaction between the activities of the service organisation and those of the user entity;

- The nature of the relationship between the user entity and the service; organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

When obtaining an understanding of internal control relevant to the audit the user auditor shall evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation. If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures:

- Obtaining a type 1 or type 2 report, if available;
- Contacting the service organisation, through the user entity, to obtain specific information;
- Visiting the service organisation and performing procedures that will provide the necessary information about the relevant controls at the service organisation; or
- Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organisation.

Using a type 1 or type 2 Report to Support the User Auditor's Understanding of the Service Organisation. In determining the sufficiency and appropriateness of the audit evidence provided by a type 1 or type 2 report, the user auditor shall be satisfied as to:

- The service auditor's professional competence and independence from the service organisation; and
- The adequacy of the standards under which the type 1 or type 2 report was issued.

If the user auditor plans to use a type 1 or type 2 report as audit evidence to support the user auditor's understanding about the design and implementation of controls at the service organisation, the user auditor shall:

a) Evaluate whether the description and design of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;
b) Evaluate the sufficiency and appropriateness of the evidence provided by the report for the understanding of the user entity's internal control relevant to the audit; and
c) Determine whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtain an understanding of whether the user entity has designed and implemented such controls.

Responding to the Assessed Risks of Material Misstatement

In responding to assessed risks, the user auditor shall:

- Determine whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and, if not,
- Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

Tests of Controls

When the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively, the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures:

- Obtaining a type 2 report, if available;
- Performing appropriate tests of controls at the service organisation; or
- Using another auditor to perform tests of controls at the service organisation on behalf of the user auditor.

Using a Type 2 Report as Audit Evidence of Controls at the Service Organisation

If the user auditor plans to use a type 2 report as audit evidence that controls at the service organisation are operating effectively, the user auditor shall determine whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls to support the user auditor's risk assessment by:

- Evaluating whether the description, design and operating effectiveness of controls at the service organisation is at a date or for a period that is appropriate for the user auditor's purposes;
- Determining whether complementary user entity controls identified by the service organisation are relevant to the user entity and, if so, obtaining an understanding of whether the user entity has designed and implemented such controls and, if so, testing their operating effectiveness;
- Evaluating the adequacy of the time period covered by the tests of controls and the time elapsed since the performance of the tests of controls; and
- Evaluating whether the tests of controls performed by the service auditor and the results thereof, as described in the service auditor's report, are relevant to the assertions in the user entity's financial statements and provide sufficient appropriate audit evidence to support the user auditor's risk assessment.

Fraud, Non-Compliance with Laws and Regulations, and Uncorrected Misstatements in Relation to Activities at the Service Organisation

The user auditor shall inquire of management of the user entity whether the service organisation has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity. The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report.

Reporting by the User Auditor

The user auditor shall modify the opinion in the user auditor's report if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements.

The user auditor **shall not refer** to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion. If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion.

Revision

Summary

The strategic decision is to test or not to test controls. The testing of controls is expensive in terms of time at initial engagement, while the investment pays off, if efficient, with lower sampling size and limited work for recurring engagement. Testing solely of the control does not provide persuasive evidence on the fairness of the specific balances, thus substantive testing should always be carried forwards in addition to testing of controls. Testing of the service organisation controls relevant to the client process require cooperation with the service organisation auditor.

Key words

Audit Strategy, Controls, Test Of Controls, Substantive Testing, Service Organisation, Type 1 Report, Type 2 Report, Service Auditor, Service Organisation, Service Organisation's System, Subservice Organisation, User Auditor, User Entity

Y/N Questions

No	Issue	Y/N
1	The tests of controls are to be designed and performed if the risk assessment allows to expect that the controls are operating effectively.	Y/N
2	The auditor shall test controls at the year-end.	Y/N
3	If the auditor plans to use audit evidence from a previous audit then the auditor shall test the controls at least once in every third year.	Y/N
4	The user auditor shall refer to the work of a service auditor in the clean audit report.	Y/N
5	The auditor's documentation shall demonstrate that the financial statements agree with the management representation.	Y/N
6	The auditor shall determine whether the controls to be tested depend upon other controls.	Y/N
7	A service auditor is an auditor who, at the request of the auditor in charge, provides an assurance report on the controls of a service organisation.	Y/N
8	Performing the test of control always results in substantial time savings.	Y/N
9	The responsible auditor is in charge of accepting the audit strategy.	Y/N
10	The audit strategy should be concluded before materiality calculation.	Y/N

Issues to consider

1. Recall definitions of the key words.
2. Describe the impact to the standards involved on the context of the chapter.
3. You are engaged for the Camazon Group auditing – list the major risk areas resulting from the consolidation schedule.
4. Suppose you decided to perform the test of control on sales ledger – consider the period of testing more suited to the cut-off risk.
5. After the preliminary testing of controls on the purchase ledger it turns out that the results of the tests are non-conclusive. What would you do if your audit strategy was the testing of controls?

Case study Statistica S.A. (strategy)

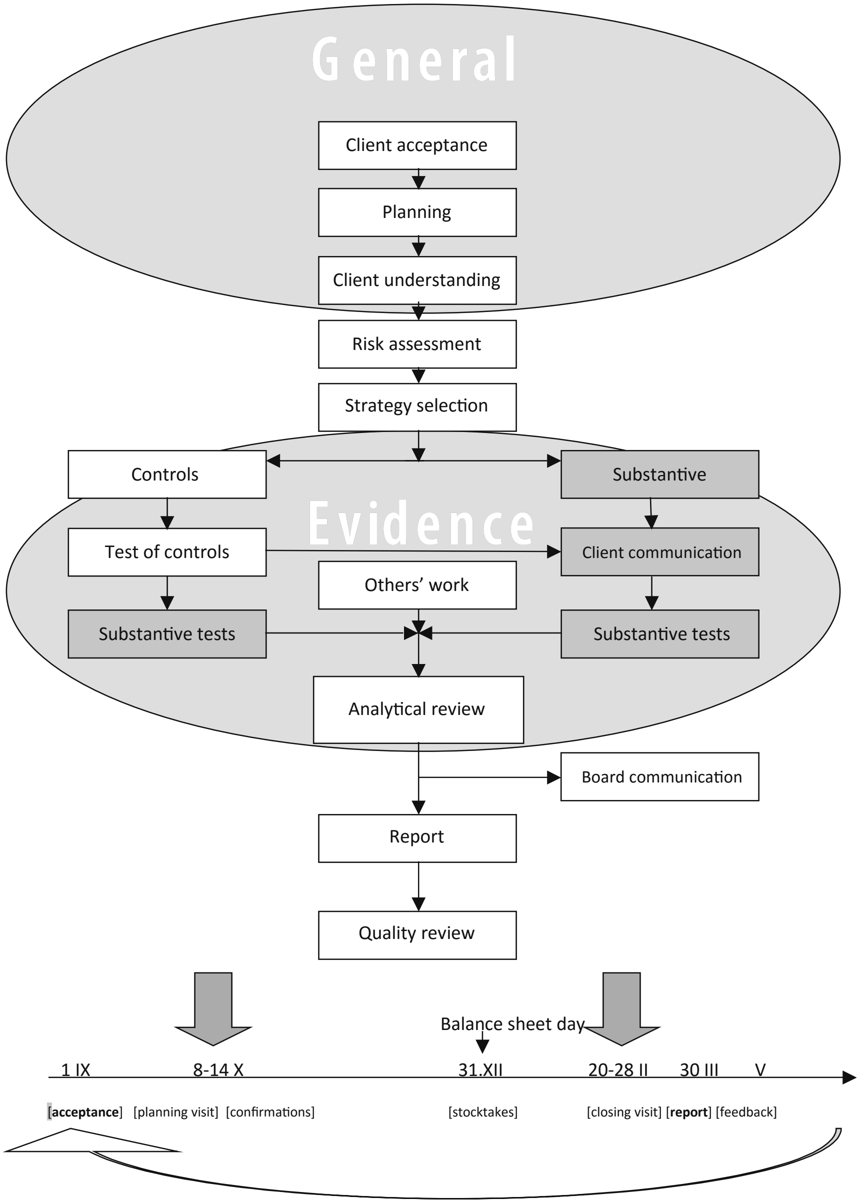
	20X7	20X6
Assets	1000	960
Fixed assets	400	330
Current assets	600	630
Total assets	1000	960
Equity	200	160
Liability and provisions	800	800
Total liabilities	1000	960
Revenue	2000	3000
Cost of sales	1990	2900
Managerial costs	200	300
Selling costs	100	50
Gross profit	(310)	(250)
Other operating result	500	400
Financial results	200	(20)
Profit before tax	390	130
Tax	(400)	0
Net profit	(10)	130

You are required

(a) Calculate the planning materiality.
(b) Make an analytical review.
(c) Assess the risk areas.
(d) Make a decision on the audit strategy.
(e) Draft the audit strategy memorandum.

Chapter 4

Substantive testing



Learning goal

To understand the type and execution of substantive testing.

Standards involved

ISA 230 Audit Documentation
ISA 220 Quality Control for an Audit of Financial Statements
ISA 330 The Auditor's Responses to Assessed Risks
ISA 402 Audit Considerations Relating to an Entity Using a Service Organization
ISA 520 Analytical Procedures
ISA 530 Audit Sampling

Link to others chapters

This chapter, in contrast to other chapters does not introduce new standards; the idea here is to discuss the obligation arising from different standards in terms of substantive testing. The chapter shows the basic procedures which might be considered for different classes of assets. The ISAs 230 and 220 were discussed in Chapter 1, while ISAs 402 and 520 were discussed in Chapter 2. The auditor's response to the assessment of risk is shown in Chapter 3. This chapter links all of those standards towards the execution of the substantive testing. At the moment the sampling selection procedures are taken aside, as the discussion relating to these will be presented in Chapter 6.

Overview

A. Non-current assets	C. Liabilities and provision for labialise
B. Current assets	D. Equity

If the management is remunerated based on the company's results, than there is a natural conflict of interest between the fairness of the financial statements and management's tendency to improve results in order to be rewarded. In such a situation there is tendency for assets to be over-valuated and liabilities and provision to be under-valuated. From the perspective of an overstatements of assets, what is presented is something more than there in fact is, which is relatively easy to audit. On the other hand, liabilities and provision have a tendency to be unrecognized, thus the auditor focuses on identifying those unrecorded liabilities and provisions. From the perspective of audit engagement for the management and organization, the assets side tends to be delegated to relatively less-experienced staff, while the liability and financial statements closing process is the domain of those charged with engagement. Typically, the substantive audit procedures are concentrated on the balance sheet position, while confirming the fairness of all balance sheet positions the profit or loss value becomes merely an arithmetical exercise, while the key assertions left to the profit and loss (or statement of recognized gains and losses) are the presentation and disclosure. Nowadays, as the number of qualitative disclosures increases, the notes to the accounts tend to consume a substantial proportion of the auditing time budget, they are addressed on the level of the general audit procedures (compare our discussion on audit evidence). The actual design of the audit program is interlinked with the auditing framework used the by the entity, however, there are a number of typical procedures which are common across different frameworks.

Each engagement requires tailoring the audit tests and procedures to the risk assessment and the nature of the business, thus the number of potential tests is infinite. Below is provided an overview of the typical procedures organized in accordance with basic section of balance sheet.

A. *Non-current assets*

A.1 Intangible non-current assets

The capitalized cost might be in the form of development and research expenditures, interest costs, foreign exchanges differences, etc. In case of capitalization the assets must have a future economic benefit, there must be intention to complete the assets (this means adequate planning, recourses, technological feasibility) and the value must be measurable and testified.

A typical test on intangibles consists of:

- Reviewing the accounting records to ensure that expenditure can be readily measured, e.g., separate cost centre or nominal ledger code.
- Reviewing invoices to verify materials expenditure on the project.
- Performing physical observation of the assets under construction or preview of the templates for the intangibles (e.g., software shoot screen, alfa-beta versions).
- Reviewing contracts for capital commitments.
- Obtaining confirmation from third parties on their assessment of the project feasibility
- Verifying wage costs to supporting documentation such as time sheets.
- Discussing the technical feasibility with the company's engineers or technical staff.
- Considering the probability of future economic benefits and the ability to sell or use the asset in relation to market research results, advance orders, budgets and forecasts.
- Reviewing budgeted revenues and costs; ensuring that they are reasonable based on results to date, discussion with directors, production forecasts, and advance orders.
- Reconciling the existence of the software license used for the intangibles.
- Reviewing cash flow forecasts to ensure that adequate resources exist to complete the project. Discuss any shortfalls with the directors.
- Obtaining representations from management of their intention to complete the intangible asset and to either use or sell it.

Note that, depending on the accounting framework, some of the computer software might be classified as tangible assets.

A.1 Tangible non-current assets

The basic disclosure for tangible assets is the movement schedule.

		Land	Buildings	Machinery	Cars	Furniture	Total
Gross value							
	Gross value opening	500	1600	300	120	60	2580
	Restatements	0	-2	0	3	0	1
	Additions	100	210	400	20	0	730
	Revaluation	5	15	0	0	0	20
	Disposals	-40	-18	-220	-50	-5	-333
	Gross value closing	565	1805	480	93	55	2998
Accumulated depreciation							
	Acc dep. opening	0	750	130	60	15	955
	Additions	0	32	45	16	5	98
	Disposals	0	-9	-68	-35	0	-112
	Acc dep. Closing	0	773	107	41	20	941
Net book value							
At the beginning of the year		500	850	170	60	45	1625
At the end of the year		565	1032	373	52	35	2057

Based on the above movement, some basic audit procedures can be performed:

1) Reconciliation of the schedule to the trail balance and financial statements and last-year financial statements.
2) Testing of sample of addition to the source documents (such as invoices contracts).
3) Performing an analytical review of the depreciation charge for the period according to assets class.
4) Discussing the reason for balance restatements with management.
5) Reconciliation of the accumulated depreciation additions and disposal to the profit and loss positions.
6) Reviewing the last stocktake of assets report for unexpected results.
7) Performing a physical observation of major fixed assets.
8) Confirmation of assets held in custody.
9) Inquiries with production staff on the utilization of assets.

Example

Allocate the above test to the assertions: **E**xistence, **R**ights and Obligations, **C**ompleteness, **A**llocation and **V**aluation

Solutions

1.C, A, 2. R&O, V, 3.C, A, V 4. A, 5. A, V, 6. E, R, O, 7. E., 8. E, 9.V

B. Current assets

B.1 Inventories

Among current assets, in industrial companies the auditing of the stock, especially work in progress and finished goods, requires higher technical competences. This is due to the fact that cost allocation procedures applied in companies might differ significantly depending on the type of company and industry.

Because the value at the balance sheet is a product of the quantity of stock and its itemized value, thus the uncertainty on the year end quantity, might, without an efficient system of control, yield in the modification of the auditor report. Thus, the basic procedure is the year-end stock observation. The procedures at the stocktake are two-fold:

- First, the auditor observes the procedure performed by the client to assess its compliance with internal regulations and efficiency.
- Second, the auditor makes his own recalculation of the count sheet, both from the sheet to the field and reverse.

Suppose stock is held in custody by a third party (e.g., cars in a car dealer or broker), then the typical audit procedure will be a confirmation request on eventual quantity and value.

In case of a continuous stocktake the auditor must ensure the reliability of the system.

Having fixed the quantity and reconciled the sample from the stocktakes to the year-end register, the auditor might examine the allocation of costs to the unit value, thereafter the value of stock is the product of both of the above.

The value of stock is its production value or net realizable value, whichever is smaller.

To test the production value the auditor checks the record basis of valuation used and test material costs by:

- Checking individual invoices
- Ensuring FIFO or an appropriate basis is being used
- Checking quantities used in WIP/FG

For labor costs typical tests are:

- Checking calculations against supporting documentation
- Reviewing costing against actual labor and production

For overheads

- Ensuring only production overheads are included
- Ensuring calculations are based on normal levels of activity

Due to the movement in inventories, there is usually significant risk of cut-offs errors, resulting from, e.g., slow processing of documents. Thus, the auditor usually selects the just before and just after disposal from stock and acquisitions to stock and reconciles these to the purchase and sales invoices, to ensure transactions were recorded in proper period.

B.2 Receivables

Receivables are amounts which will eventually be cashed or settled or should otherwise be provided. Therefore, the basic form of testing receivables is tracing the year-end balance to the subsequent payments, which is particularly feasible if a substantial part of the receivables were repaid between the year-end date and the date of the audit. Unfortunately, it is a time-consuming exercise. In the case of third party debtors the auditor might ask for written confirmation of the balances. As this is an independent and written confirmation it is classified high in the quality ranking of audit evidence (called debtors' circularization).

Receivable are the balance sheet items, however they are interconnected with sales on the profit and loss side, and with bad debt provision expense.

Example

John has sent the debtors confirmations of fife balances the four returns with the agreed amount but on the 5th debtor there was no answer, after telephone call the debtor said that has not time for admin. What can John do?

Solution

Agree an opening balance on account with last year's closing balance.
Verify outstanding items to back up documentation.
Check the fair value of the debt on the market.
Review cash received after year end.
Discuss with company official.

B.3 Cash and bank

On the one hand cash and bank is one of the most sensitive positions on the balance sheet but on the other hand, it is one which is subject to numerous controls and usually includes the substantial amount of money which the company holds with the financial institution. As a routine process the financial institution sends a year-end confirmation of balances, thus reconciliation of cash is relatively easy.

Assertions	**Typical test**
Existence	- Trace recorded assets and liabilities to bank confirmation of balances. - observe the stocktake.
Rights and obligations	- Review bank letter - Review bank confirmation - Trace to the bank agreement
Completeness/ Allocation and valuation	- Count petty cash balance. - Check sample of bank reconciliations. - Review cash book for unusual items

The bank confirmation circularized during the audit is exempt from the assets confirmation as it is a tool for checking the potential liabilities, loans disclosed, and contingences. So, in fact, the bank confirmation can be a long list of questions asked by the auditor to the bank.

C. Liabilities & provisions

C1. Provision and contingences

The most typical test for the provision is time series analysis. Classically, the auditor compares the opening and closing balances for the provision section to search for atypical movements (realize provision without proper grounds).

A second strategy is to understand the risks of the client business model and to trace them back to the accounts.

A third strategy is to review post-balance sheet events and ensure that all the risk which originated during the year has been properly provided.

The most standardized approach is to use the potential provision checklist and discuss with the management the reasons for not providing, e.g., guarantee costs, jubilee bonuses, bad debt, slow-moving stock, impairment of assets, cultivation (in mining), etc.

An effective strategy is to incorporate in the confirmation level a question on contingences or capital commitments and to reconcile it back to the disclosure and provision section.

Other procedures will be:

- Review of correspondence and other documentation relating to the booked provisions. Review of correspondence with solicitors, banks, customers, insurance company and suppliers both pre- and post-year end. Review evidence of past practices, published policies and statements made.
- Checking whether any payments have been made in the post-balance sheet period in respect of the provisions.
- Sending a letter to the solicitor to obtain their views (where relevant).
- Discussing the position with similar past provisions with the directors. Were these provisions eventually settled?

The contingent value disclosed must be rational, thus the auditor is likely to:

- Recalculate provisions made.
- Compare the amount provided with any post-year end payments and with any amount paid in the past for similar items.
- In the event that it is not possible to estimate the amount of the provision, check that this contingent liability is disclosed in the accounts.
- Obtain opinions from independent experts.
- Check that the management representation relating contingences and provision is included in the management letter.

Example

Dimond is the senior auditor in the CrisBridge Ltd audit engagement project and during review of the company lease agreement, he learned that the lease for the office premises requires the client to restore the office space to its original condition. After physical review of the office plot it turns out that heavy rebuilding work was carried out for the showroom and server hot site. After discussion with the technical staff the estimated costs of restoring the office space back to its original condition is approximately 250k Euros. The lease contract was signed four years ago for a period of six years. Calculate the expected provision to be included in the accounts.

Solution

Retained earnings

Dr. Retain earnings	167	
Cr. Provision for restoration		167

4/6 * 250 = 167 the value of the contingent allocated to the past periods

Dr. Other cost	42	
Cr. Provision for restoration		42

Current year addition.

C.2 Liabilities

This includes both short-term and long-term liabilities such as: trade creditors, bank loans, debentures, and other loans repayable in the year after the balance sheet date.

To ensure existence of the liabilities it is typical for a bank and creditors' confirmation to be used. Rights and obligations are ensured with circularization to trade debtors and reconciliation to goods and services delivered. A typical test for completeness is a search for unrecorded liabilities; the auditor traces the post-balance sheet significant payments to the original invoices and ensures that the invoices (or contracts) were properly provided in the proper period. Accuracy is mainly reviewed during the liabilities recalculation (split between interests and capital, etc.). Classification and understandability is ensured with repayments schedules and credit conditions.

D.Equity

Equity is specific, because the shareholder capital is subject to registration, thus it is shown in historical nominal values as per the relevant register. On the other hand, the capital section contains the number of other reserves resulting from both the accounting practice (e.g., fixed assets revaluation, reserves, and financial instrument revaluation) and from the corporate deeds (e.g., investments and development reserve constituted from the retained profit). Thus, the audit procedures here are the results of other sections or need confirmation of the company deeds and resolutions. More advanced procedures in terms of equity are needed for the consolidated financial statements where consolidation correction is likely to be carried out. In practice, the shareholding capital requires substantial disclosure and information on capital declared, authorized as paid, and contributed. In terms of contributions in kind, the fair value of the contributed assets needs to reconciled. For the financial institution the disclosures and recalculation of the capital requirements tends to be a risky area.

Revision

Summary

Substantive testing provides evidence on the balances. The major risk with assets is linked with their overstatement, while for liabilities the major risk is understatement. Typical procedures for assets confirmation in the custody of a third party is the balance or quantity confirmation sent directly to the auditor. Liabilities are typically checked from the post-year payments back to the financial statements. Provision and contingences are tested by reference to legal letters, management and staff discussion, disclosure checklist and comparison of time series. Shareholder capital should be reconciled to the official registers.

Keywords

Confirmation, Stocktake, Lawyer Letter, Bank Statements, Search For Unrecorded Liabilities, Assets In Custody

Y/N Questions

No	Issue	Y/N
1	Physical observation of the assets under construction is done during the stocktake.	Y/N
2	Performing physical observation of major fixed assets confirms valuation.	Y/N
3	The overheads check aims to ensure that costs are attributed at reasonable capacity usage.	Y/N
4	Tracing the bank balance to the bank agreement ensures existence.	Y/N
5	Obtaining opinions from independent experts ensures the value of the provision.	Y/N
6	The current shareholders are reconciled to the shareholder book.	Y/N
7	Profit and loss disclosure are checked with the checklist.	Y/N
8	Capital commitments are usually reconciled back to invoices.	Y/N
9	Financial assets valuation is reconciled to the market quoting.	Y/N
10	Existence of stock held by a third company is checked against payroll.	Y/N

Issues to consider

1. Recall definitions of the keywords.
2. Describe the impact to the standards involved on the context of the chapter.
3. Suppose you audit a bus travel office which operate 200 buses around Europe. How would you check the existence of fixed assets in terms of buses as of the year end?
4. The auditor signed the contract on the audit after the year-end. What can be done to ensure the quantity of stock at the year end?

5. The bank issued convertible bonds on the market, what would the procedures be to check the undervaluation of the loan in the bank books?

Case study: Joahim Gauss S.C.

Joahim Gauss is a limited partnership of auditors; during the audit of Kurnik Polski Pls there 25 balances of clients were randomly selected and agreed to the supporting documentation and confirmation. The errors identified are shown in the table below.

Customer	Balance as per client	Balance as per auditor	Difference
Kowalski s.a.	582218	597595	-15378
RTDT s.a.	890111	912924	-22814
Oramas sp. z o.o.	379564	286505	-93059
Kariabik s.c.	827956	860679	-32723
Topola s.kom.	42953	178808	-135855
Wyjście s.a.	660065	665256	5190
Element s.c.	869434	842310	27124
Kostrzewa Adam	331267	352151	-20884
John Smith	166144	141369	24775
Sum	4 749 712	4837597	-263623

Total value of the trade debtors amounts to €8 276 345,25; value in sample 5 123 437. Total value of receivables disclosed on the face of the balance sheet amounts to € 8 076 245,25.

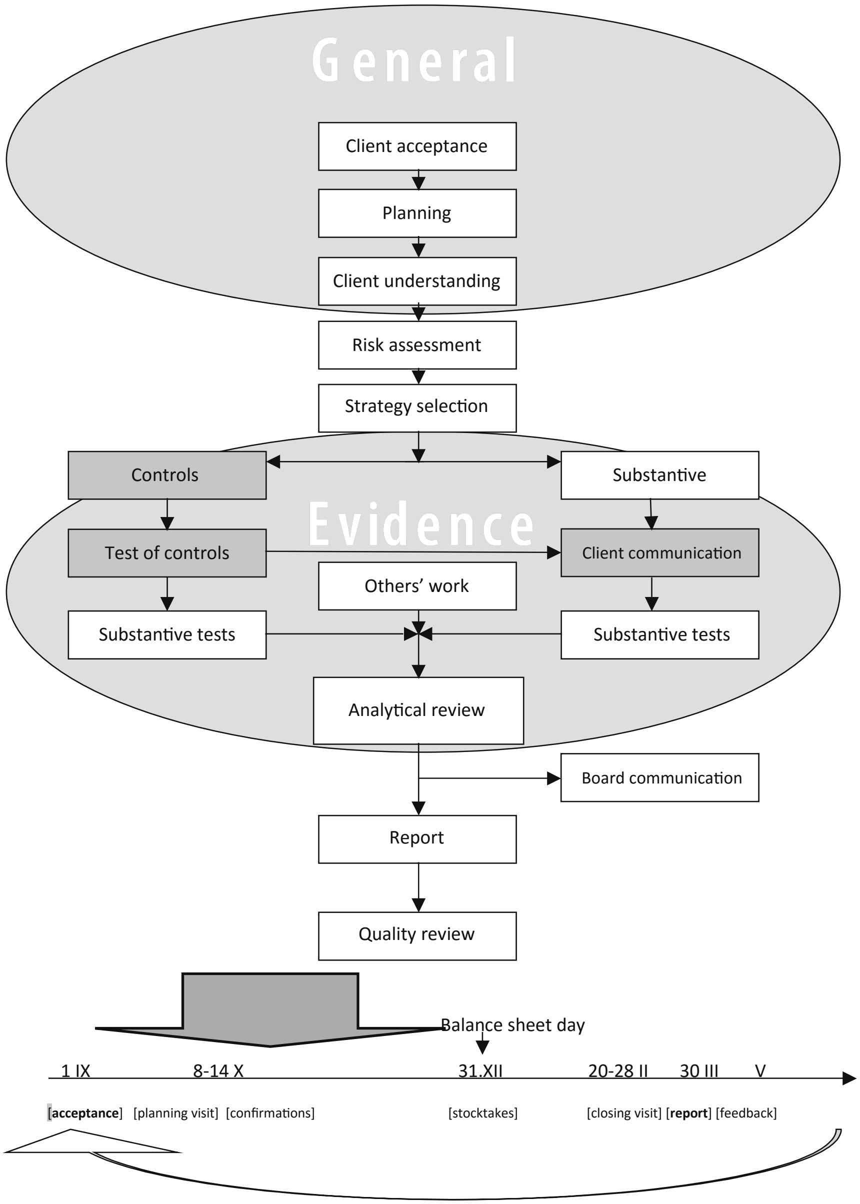
Engagement materiality is €1.7 million, tolerable error €1million, the SAD limit is €100k.

You are required to:

(a) Show the value of identified error.
(b) Describe how to estimate the value of error against the entire trade debtors.
(c) Approximate the total value of errors in the whole trade debtor population.
(d) Assess the appropriateness of debtors' provision.
(e) Point out the different audit procedures you might apply to trade debtors to ensure fairness of the total population.

Chapter 5

Control testing



Learning goal

The goal of this chapter is to understand control and its testing.

Standards involved

ISA 530 Audit Sampling
ISA 230 Audit Documentation
ISA 220 Quality Control for an Audit of Financial Statements
ISA 330 The Auditor's Responses to Assessed Risks
ISA 520 Analytical Procedures

Link to previous chapters

The standards involved in substantive and control testing are pretty similar, however, the goals of the test are different. In term of substantive testing, the auditor makes sure that the balance is correct (mainly value), while with control testing the auditor makes sure that the control is executed as prescribed.

Audit documentation, quality control and analytics were introduced in chapter 2. Analytics and sampling are the basic tools for the selection of controls. ISA.530 sampling will be discussed in chapter 6 to combine the discussion of the sampling used for both substantive and control testing.

Overview

In contrast to the previous chapters there is no one specific standard devoted solely to the control environment and control testing. ISA.220, .230, .330, .520 and .530 include the relevant indication. This chapter summarizes the practice while elements of the requirements are presented in other chapters.

At the level of client understanding, the auditor initially obtains a high-level overview of the client's business and describes the internal system of control. The exact level of preciseness in the description often depends on a preliminary view of the possible strategy. However, as a minimum the auditor should obtain a basic understanding of the system.

Controls

Internal control, by definition, is the process designed and effected by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

The internal control system may be broken down into the following components:

- The control environment - the attitude toward control in the entity (the climate for it) and the way it is communicated and enforced.

- Risk assessment – who assesses the risk, how and when is it carried out, what are the consequences of such an assessment, and how are decisions reached and taken.
- IT and information systems - both hardware and software, system of information reporting and data accumulation.
- Controls - what are actual controls, what is the split of responsibilities, how does management ensure integrity of controls, what are the physical controls and what is their integration with IT and logical controls?
- Controls maintenance and review - is this a routine or ad hoc process, are there sufficient skills devoted to maintenance and review, what is the scope and function of the internal controls. These are the issues to be addressed at this stage of the process.

These components of the process are subject to the auditor understanding ISA.315. The auditor should obtain an understanding of internal control relevant to the audit. This is used to:

- Identify types of potential misstatements;
- Consider factors that affect the risks of material misstatement;
- Design the nature, timing and extent of further audit procedures.

Management is the owner of the internal control process. The basic method of understanding the system is to interview those responsible for its supervision. At the low accounting level the basic backbone of the financial control system is usually designed by the chief accountant.

Example

Joana is assistant to the auditor and a member of the audit team. The field supervisor has asked them to interview the chief accountant on the purchase system of the company. Joana presented the following notes after interview.

The purchase orders are originated at the production desk, the order is issued to the main desk at the accounting department, and after checking the quantity and value of orders against the budgeting system, accounting Clerk A approves the order in the IT system. For A-type clients the system automatically generates an order request and sends it as an e-mail to the supplier. For non-A clients/suppliers the clerk issues the order manually. Once delivery of the order is executed it is shipped to the main warehouse. The warehouse issues a Receipt of Goods Note and enters the quantity into the system; if the quantity is different from that which was ordered then the shipment is withheld unless cleared by Clerk A and the order originator. The moment the shipment is released it is accepted to the warehouse. Upon receipt of the electronic (for type-A suppliers) or hard copy invoice, it is scanned and entered into the system and is then sent to the originator for approval and control. The original document is stored at the accounting department. Following approval the invoice is scheduled for batch payments; the payments are approved by Clerk B.

What should Joana do to confirm her understanding of the system's operation?

Solution

Joana might trace a previously executed purchase transaction back from the time of payment to order origination to confirm her understanding of the system. Such a procedure is called a walk-though and is neither a test of control nor substantive testing, but a confirmation of the internal control system layout.

The auditor needs to obtain an understanding of the control activities relevant to assessing risks of material misstatement at the assertion level. Thus, only the descriptive form of the system is likely to be insufficient for risk assessment at the assertion level (accuracy (AC), completeness (CO), cut off (CO), allocation (AL), classification/understandability (CU), occurrence (OC), valuation (VA), existence (EX), rights and obligations (RO)). Thus, the descriptive form of the system is enhanced with additional dimensions: Stage, possible risks and controls which address those risks.

Example

Following Joana's description of the system identify "what could go wrong" within the system, the relevant controls and specific financial statement assertions.

Solution

What could go wrong	**Control in place**	**Assertions**	**Communication**
The order is originated by the sales department	Reconciliation of the order to the budget	OC, EX	
The wrong quality of good might be delivered	No control identified	CO, VA	Potential notification to client
The accounting clerk is ill	No substitute identified	CO, RO	Potential notification to client
The IT system crashed and the order is not automatically processed to the supplier	The manual route of processing is possible.	OC, CO, AL, CU	
...			

Having identified "what could go wrong" with the relevant controls the auditor might take a decision on the further strategy to be taken.

The auditor has no duty to report any weaknesses in control systems to the shareholders or stakeholders, however ISA.260 requires the auditor to communicate "audit matters of governance interest" to those charged with governance of the entity.

The matters to be communicated include:

- Approach and scope of audit;
- Selection of, or changes in, accounting policies;

- Audit adjustments that could have a material effect on the entity's financial statements;
- Material uncertainties that may cast doubt on the entity's ability to continue as a going concern;
- Material weakness in internal control;
- Questions regarding management integrity and fraud involving management.

Example

Help Joana to draft a communication to those charged with governance of the entity on the lack of relevant control for "The wrong quality of good might be delivered."

Solution

Observation

During the course of our work we discovered that it was the stores' practice to accept goods before a quality check had been performed.

Implication

There is therefore the possibility of expenses being incurred due to a lack of quality of the supplies.

Supervisor's view

Mr. Ypsylon stated that similar controls were in place; however they were suspended due to staff shortages.

Auditor recommendation

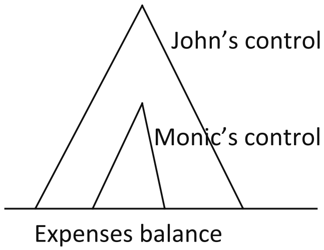
We recommend reinstatement of the control to avoid excessive repair and maintenance provision at the year-end.

Some of the controls implemented in the client organization are strong and effective and some of them are weak. Testing of each possible control is not a particularly cost-effective solution. In consequence, when performing his assessment upon the control system the auditor seeks general and strong controls, the execution of which provide plausible evidence of the system control.

Example

Monic is the clerk at the payroll department. Each month she checks the tax identification number for employee files. John is the controlling officer and each month he reconciles actual staff expenses to the budget and staff number and traces any discrepancies. Illustrate graphically the impact of Monic's and John's control over the year-end profit and loss wage expenses.

Solution



Supposing John's control works effectively, there is no need to perform testing and assessment of Monic's control as it is wholly covered within John's scope.

Taking the example above, the description of the system is relatively easier than assessment and selection of the controls to rely on.

Irrespective of the testing strategies the controls have some limitations; among these are:

- Poor judgement in decision-making;
- Human factor;
- Staff rotation;
- Management overriding controls;
- The occurrence of unpredictable events.

Thus, even if the controls after testing turn out to be effective, some substantive testing on the accounts (as more persuasive evidence) should still be carried out.

Nowadays, the entity's system of control is typically a mix between a manual and an IT system of control. Since growing importance is attached to the efficiency of system implementation across the organization, more substantial controls are transferred to the IT environment. As a consequence there are two spheres of IT system. The first relates to:

- the fundaments of the operating system; the person in control of the operating system might control the rights and access to other applications;

and

- the second level of control is to be found at the level of the particular application.

In order to rely on the IT system both general logical and physical IT controls must be in place.

General controls comprise:

- Control over physical access to the server room, application of hot and cool sites, back up procedures, the business continuance plan, network access, and low-level data access.
- Changes to system updates, acquisition, maintenance versioning, licensing, etc.[17]
- Control over the logical and physical users' access to the system recourses.

[17] Including the system maintenance control accounts and access to them.

Application controls are those controls within the specific software, e.g., how the payroll program calculates gross salary deductions. There are various types of controls within these controls:

Controls over input

Batch controls (controls executed on packages of data); the input data will only be accepted by the system when it meets the pre-determined totals. Information which is typically checked includes:

- Number of documents;
- Net amount;
- Gross amount;
- Hash totals for due dates and codes;
- Type of field data (e.g., data, numeric, alphanumeric, etc.).

Range/limit checks which specify maximum and minimum expected values. Existence checks that will only allow data to be inputted for valid account codes or valid format. Check digits which give codes a mathematical pattern and data will not be accepted for codes which do not match this pattern, e.g., the first few digits of personal numbers must comply with a given function. These are used to prevent transposition errors. Sequence checks will highlight gaps in data both within and between batches, and continuity of the data master key, sequence fields, etc. Controls over processing and computer data files and certification of the executable data providers (e.g., control against the viruses modifications). The control techniques used over input may also be used to output, however, output data have some different controls due to their nature.

Controls over output

The basic control is the level of data and information access via the profiles of user accounts and user access to data, both logical and physical.

There are a number of other control processors, such as:

- Sums and checks against the input data (e.g., number of employees in the batch and number of payments orders generated by the system).
- Reconciliation of report totals to general ledger accounts.
- Use of programmed control procedures (e.g., login with specific authorisation key).

Controls over standing data (master files)

Amendments to standing data should only be made by authorised persons.

This can be achieved either through:

- Passwords, prenumbered forms, or digital calculator for one-off passwords.
- Regular printouts of data authorised by the upper-level authority.
- Review of the log files for data access on a periodic basis.

Controls testing

Tests of controls are performed to obtain audit evidence about the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.[18]

The application of the test of control aims to ensure that the control:

i) Is properly designed;
ii) Exists;
iii) Was properly executed throughout the period.

Any deviations should be recorded and investigated irrespective of the materiality. Based on the investigation, the auditor assesses if deviations are isolated departures[19] or indicate the existence of errors in accounts.

Tests of controls might consist of:

- Examination of evidence of management reviews (minutes of board meetings, resolution, general meetings of shareholders, etc.);
- Observation;
- Testing of the control activities performed by a computer system;
- Performance of the application of a control to ensure it was performed correctly.

Inspection of documents supporting controls or events

Example

Frank would like to make sure that the debtors' confirmation procedure in ACCB Ltd is working effectively. Help Frank to design appropriate tests of controls.

Solution

Frank might wish to observe the entire procedure performed by the clerk, he might ensure that the debtors' ledger used for reconciliation is reconciled back to the trial balance and that the appropriate control is in place. Frank might select numbers of the confirmation run and investigate if the reconciliation was properly recorded. Frank might want to use the fictitious debtors to check if the control system will pick up such an instance. In addition, Frank might want to review the log files of the application control to ensure that the exceptions are followed up.

The nature of control testing.

The tests must answer the basic question of "does the control work as intended?" Thus, the answer is yes or no. This is in contrast to balance testing when the question is if the balance error falls within a reasonable range. A quite different strategy to sampling is the test of one. Suppose the system application control works in such a way that for each employee on the payroll 5% of their gross pay is deducted for a donation contribution. Having such a pro-

[18] This implies that the description of controls should refer to the assertions it covers.

[19] This, however, involves professional judgment and experience.

cedure documented, the output will be the payroll; in many instances it will be sufficient to test one instance to confirm the application procedure, or eventually to obtain the electronic version of the payroll and recalculate the entire payroll and search for any divergences. Assuming an electronic output of evidence, a test of the entire population is more persuasive than a test of one.

Control selection

This encompasses the area of the working experience and the quality of client understanding. The audit team will actually focus on the most general and most persuasive controls, for example, the budget and forecast reconciliation to the actual performance. The auditor usually takes the perspective of those charged with management, looking for the key control they execute to make sure the business is running efficiently.

Example

Dim Xu is the manager of the Car-Dealer in the west of Numberg. During an initial discussion, Anne, the partner in charge of the engagement, asks Dim to list the basic activities he performs on a daily basis to make sure that the business is running well. Dim states:

„*In the morning when I arrive at the office I ask Joan for coffee, the first thing I do is look through my glass window towards the showroom; if it is crowded the business is running well. Joan usually brings me the coffee with my Finazial Zeitung, the first thing I look at is the US Dollar/Euro exchange rate; if it's above 1.2 I am happy as no significant revaluation losses on purchases can be expected. At 10 o'clock I go to visit the workshop; there should be at least 10 stations occupied otherwise we might have daily workload problems. If this is the case I look for Ery the chief mechanic. If he is ill I must address the problems myself - so a busy day in front of me....*"

Identify Key Performance Indicators (KPI) and advise how to test them.

Solution

Average daily visitors - compare to the daily sales figures.

Dollar/Euro daily exchange rate - compare to the unrealized gains and losses account.

Workshop utilization rate - compare the costs of repairs, goods despatch notes

Key staff absence - compare with the unutilized holiday rates, cost of overtime charges.

Revision

Summary

The control is to be tested only if the preliminary assessment is efficient. The auditor should select for testing those controls which answer the wider range of assertions and cover most of the balance sheet or profit and loss balances. The test of control differs from balance testing as the approximation of results against the process is simplified. Once the tests have been completed and the environment is effective, this means substantial saving for the recurring and current audit engagement. The opposite is the case if, after testing, the controls are ineffective; this leads to more intensive and substantial testing.

Key words
Test Of Control, Critical Process, Efficiency, Execution ff Control, Error Rate.

Y/N Questions

No	Issue	Y/N
1	For all engagement the same control testing must be carried out.	Y/N
2	The result of the control testing is either effective or not.	Y/N
3	Reconciliation of the order to the budget checks occurrence.	Y/N
4	Observation, Implication, Supervisors view, Auditor recommendation are typical headings for the deficiency of control reporting.	Y/N
5	KPI are used to identify the significant controls.	Y/N
6	There are a number of entities where an inefficient system of controls makes the balances unreliable and not possible to be tested using a substantial approach.	Y/N
7	For testing, the most specific control should be selected.	Y/N
8	The auditor tests all controls in a given process.	Y/N
9	If efficient the control should be tested every three years.	Y/N
10	The critical controls cannot be tested infrequently.	Y/N

Issues to consider
1. Recall definitions of the keywords.
2. Describe the impact of the standards involved on the context of the chapter.
3. Coca supplies to the stock exchange its quarterly budget forecast, how would this be considered for the test of control program?
4. Mark Pls is outsourcing all of its accounting to a professional accounting company run by a chartered accountant. Describe how you would ensure the efficiency of the accountant's system of control.
5. Alan controls the payroll reconciliation process; it turns out to be properly designed but not properly executed due to the supervisor's absence. How would you formulate your report to those charged with running the company?

Case study: Number Stock Exchange Plc

During the audit the management of Numberg Stock Exchange Plc provided its audit team with the following procedures relating to stocktakes.

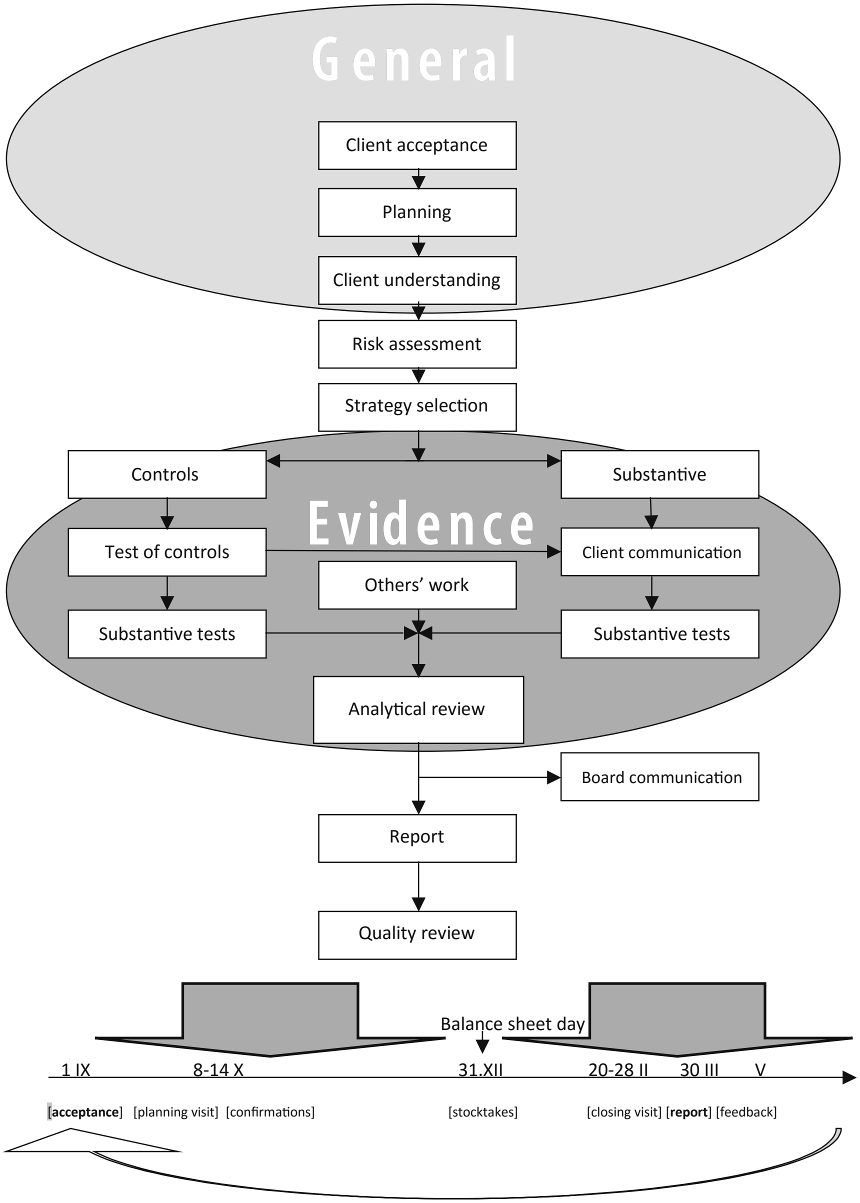
i) Stocktakes of investor are held once a year; the chief stock-keeper and his deputy lead the stocktake committee.
ii) The stock take of assets held by external parities is done based on telephone interview with the external stock-keeper, the procedure is carried by a clerk with at least four months of working experience.
iii) The stocktake team compile a stocktake list of quantity and compare it to the computer-generated stock ledger; in case of discrepancies the quantity is corrected and the chief of the stocktake committee signs it off.
iv) The work in progress completion rate is checked with the main technology office.
v) After the stocktake is finished the stocktake documentation is archived in the marketing department.

You are required to:

(a) Demonstrate the weaknesses of the specific procedures (i) to (v).
(b) Recommend changes in the procedures (i) to (v).
(c) Propose an audit strategy to be applied for Numberg Stock Exchange Plc.

Chapter 6

Audit evidence



Learning goal

To understand the scope of the evidence required.

Standards involved

ISA 500 Audit Evidence
ISA 501 Audit Evidence—Specific Considerations for Selected Items
ISA 505 External Confirmations
ISA 510 Initial Audit Engagements—Opening Balances
ISA 520 Analytical Procedures
ISA 530 Audit Sampling
ISA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
ISA 550 Related Parties
ISA 560 Subsequent Events
ISA 570 Going Concern
ISA 580 Written Representations

Link to previous chapters

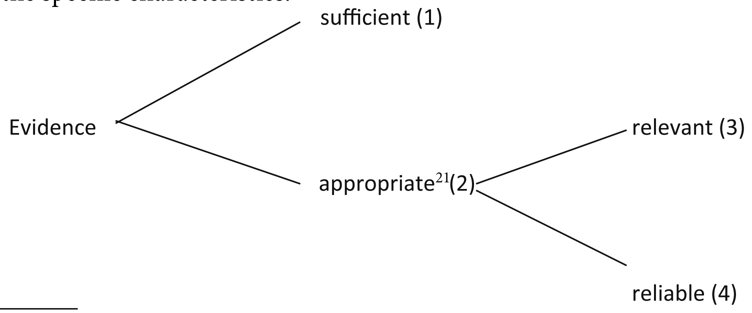
The analytical procedures were introduced in Chapter 2 and are heavily used at the control, substantive and financial statements closures (reporting) stages. ISA 450, Evaluation of Misstatements Identified during the Audit, and ISA 580, Written Representations are part of the evidence, engagement review, quality control and process of audit report (opinion) formulation. However, they are combined with the reporting chapter.

Overview

Introduction to evidence

Audit evidence is information obtained by the auditor in arriving at the conclusions on which the audit opinion is based.

Thus, evidence does not necessarily comprise solely audit documentations.[20] Evidence must have the specific characteristics:



[20] The majority of audit evidence is, however, in the form of audit working papers.

[21] In formal terms: Appropriateness (of audit evidence) - The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

1) Sufficiency[22] means that all evidence must give grounds to formulate the auditor report (opinion). On the contrary, there is no need to accumulate (or copy) any documents or evidence obtained during the audit. Over-sufficiency leads to over-auditing, which in turn place too much burden on the client and makes the audit unnecessarily expensive.
2) Appropriation has two characteristics - relevance and reliability.
3) Relevant evidence as a whole must cover all of the assertions in the financial statement.
4) The reliability of the evidence is graded according to the power of persuasiveness.

The rank of evidence based on its reliability or written documents:

- Evidence generated by the auditor
- The evidence of third parties, independent from the entity, addressed to the auditor
- Other third party evidence
- The business's documents (invoices, deeds)
- The management writing representation
- Other internal documents

Beside the writing documents, evidence might be copies, faxes or oral representation, which are ranked at the end. Practically, there are not exclusive limits to the kinds and types of evidence the auditor might consider for the formulation of their opinion. Evidence is gathered during all of the stages of the audit process, however the majority of it relates to the risk assessment, control testing and substantive testing.

The typical procedures which produce the audit evidence are:

- Observation
- Inspection
- Enquiry
- Recalculation
- Analytical reviews

The evidence supports the assertions of the financial statements Assertions are the representations of the directors which are incorporated in the financial statements. Assertions are used for classes of transactions, account balances and disclosure as a basis for:

- Assessing risks,
- Designing audit procedures.

The following assertions are used:

- Accuracy
  Amounts and other data relating to recorded transactions and events have been recorded appropriately.
- Allocation
  Assets, liabilities and equity interests are recorded in the correct class of account

[22] The formal definition is as follows: Sufficiency (of audit evidence) - The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

- Classification/understandability
  Transactions and events have been recorded in the proper accounts.
- Occurrence
  Transactions and events that have been recorded have occurred and relate to the entity.
- Valuation
  Assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation is appropriately recorded.
- Completeness
  All transactions that should have been recorded have been recorded.
- Cut-off
  Transactions and events have been recorded in the correct accounting period.
- Existence
  Assets, liabilities and equity interests exist.
- Rights and obligations
  The entity holds or controls the rights to the assets and liabilities of the entity.

The assertions related to the income statements are: occurrence, completeness, accuracy, cut-off and classification, while existence, rights and obligations, completeness, valuation and allocation typically relate to account year-end balances (balance sheet).

Example
Frank is constructing the current audit program. He plans the following procedures:

Perform debtors' circularisation for the key items above 50% of planning materiality at the year end.
Perform the search for unrecorded liabilities selected 20 biggest cash payment close to the final visit.
Reconcile the 10 biggest intangibles acquisition to the licence contract.
Fill in the standard disclosure checklist.

Allocate to the program the assertions it relates to.

Solution

Perform debtors' circularisation for the key items above 50% of planning materiality at the year end.	E, O, C, Cu,V,R
Perform the search for unrecorded liabilities selected 20 biggest cash payment close to the final visit.	C, V, R, Cu, Com
Reconcile the 10 biggest intangibles acquisition to the licence contract.	R, A, C
Fill in the standard disclosure checklist.	C, Com

Standards refers to accounting records as the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

The management's expert is defined as an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

Confirmations

External confirmation is audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

The auditor might seek for:

- Positive confirmation request - A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
- Negative confirmation request - A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

As a result the auditor might obtain:

- Positive response - the information is correct.
- Non-response - a failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.
- Exception - a response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

The auditor's use the external confirmation procedures to obtain audit evidence.

The reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained. Audit evidence is more reliable when it is:

- obtained from independent sources outside the entity
- obtained directly by the auditor and is more reliable than audit evidence
- obtained indirectly or by inference
- in documentary form, whether paper, electronic or other medium.

Thus, audit evidence in the form of external confirmations received directly by the auditor from confirming parties may be more reliable than evidence generated internally by the entity.

The external confirmations are used in different situations, for example, for:

- debtor year-end balance confirmations
- creditor year-end balance confirmations
- cash in bank and bank loans confirmation
- stock quantities in third parties' premises confirmation
- authorities' requirements confirmations
- securities in custody confirmations

- long-term contract percentage of completion

Example

Frank performs the debtor circularisation and is about to fill in the following template.

[Debtor address]
[Date]
Dear Sirs
Please confirm your liability to us AuditiedEntity Plc as of 31 December, 20X6 of the total amount of [insert amount of the debtor], by filling in the attached strip and send it back to us. In case you disagree please provide copies of the underlying documents and your reason for disagreement
Regards
[Client signature]
Fill in and send back to us
We [Debtor name]
___ Agree with the balance.
___ Do not agree with the balance and send attached our reconciliation and the supporting documents.
Review the presented template.

Solution

The basic error of the template is the answer is likely to be directed towards the audited company instead of the auditor's office.

Opening balances

Opening balances are those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and the events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

The auditor might either be reappointed for another period or carry forward the audit from the predecessor auditor (initial audit engagements).[23]

Initial audit engagement is an engagement in which either:

- The financial statements for the prior period were not audited;

or

- The financial statements for the prior period were audited by a predecessor auditor.

In an initial audit engagement the auditor has the responsibilities relating to opening balances. The auditor satisfies that in financial statements except for opening balances they include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments. When the financial statements include comparative financial

[23] The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

information it includes additional requirements and guidance regarding activities prior to starting an initial audit (compare later chapter).

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

- Opening balances contain misstatements that materially affect the current period's financial statements;
- Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

The basic strategy for the opening balances is to reconcile them to the signed off audited financial statements of the previous year. The auditor should satisfy himself that the procedures performed by the former auditor meet his/her requirements. If not, adequate procedures should be designed and executed during the audit.[24]

Sampling

The objective of the auditor, when using audit sampling, is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Audit sampling (sampling) is the application of audit procedures to less than the total number of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

Population[25] is the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. A sampling unit is the individual items constituting a population.

Drawing conclusions about the population from the sample is subject to both sampling and non-sampling risk. Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion reached if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it

[24] Therefore, the auditing of long-term contract is an expensive and risky engagement because accounting techniques allow for gathering costs throughout numerous accounting periods, which does not necessarily make the audit of opening balances an easy exercise.

[25] Population can be split into homogenous groups. Stratification is the process of dividing a population into subpopulations, each of which is a group of sampling units which have similar characteristics (often monetary value).

does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Non-sampling risk is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk (e.g., mathematical error).

The conclusion drawn from a sample might be affected by an anomaly. This is a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

The auditor might use:

- statistical sampling
- judgmental (non-statistical) sampling.

Statistical sampling is any approach to sampling that has the following characteristics:

- random selection (each unit the same chance of appearing in the sample) of a sample,
- use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have the above attributes is considered a non-statistical sampling approach.

The auditor can then either:

a) Perform a test of the entire population (all items selected); this is feasible for small populations (full testing)
b) Select a sample of the population, test it and thereafter make a judgment upon the characteristic of the entire population.
c) Split the population into two sides and perform full testing on the first and selection (sampling) on the second.

Regarding a)

The application of full testing to all accounts is contradictory to the risk analysis strategy, therefore is not likely in ISA engagement. However, for small engagements, for example the audit of a newly established company, it might be feasible but then, even if performed, risk assessment must be conducted.

Regarding b)

Suppose that in the 1.5 million balance of debtor the audit picked up a random sample of 20 items, the value of the sample was 300k, and the value of errors identified was 20k. What is the expected error of the debtor balance? The solution to this issue is as follows:

$$\frac{\textit{error in sample}}{\textit{sample value}} \times \textit{value of the population}$$

Thus

$$\frac{20}{300} \times 1\,500\,000 = 100\,000$$

The preciseness of the calculation depends on the sample size. If the auditor takes all of the balances and checks them, the result will be functional, otherwise it is subject to estimation correctness (or confidence level).

Regarding c)

Suppose the auditor split the debtor balance into two parts. In one there is accumulated the 10 biggest debtors (say key items) on the total value of 700k, he tested all the biggest items and a sample from the remaining part of 200k. He concludes that the error in key items amounts to 10k and in the sample, 20k. Estimate the sample total error in population.

Total population value		1 500 000
Key item value		700 0000
Random selection from population of		800 000
Sample value	200 000	
Sample error	20 000	
Expected error on reduced population		800 000 @ 10% = 80 000
Error in key item population		10 000
Total error in the population		90 000

Again, the confidence level of the error in population is unknown.

Example

Consider what the auditor's decision would be on sampling b) and c) above, if

(i) Planning materiality was equal to 200 000, and project TE is set at 48% of PM.

(ii) Planning materiality was equal to 50 000, and project TE is set at 70% of PM.

Solution

In the case of (i) the tolerable error (TE) is equal to 48%*200 000 = 96 000, so in point b) the total error is equal to 100 000 and is above the TE, therefore the auditor must obtain additional evidence to ensure that the balance is correct. In scenario c) the estimated error in population is lower than the TE so the auditor might conclude that the balance is fairly stated.

In the case of (ii) the tolerable error (TE) is equal to 70%*50 000 = 35 000, so in point b) the total error is equal to 100 000 and is above the TE, therefore the auditor must obtain additional evidence to ensure that the balance is correct. In scenario c) the estimated error in population is higher than the TE so the auditor will have to obtain additional audit evidence to support the balance.

Instead of the tolerable error (used in practice for both kinds of testing) the standard uses the following terms:

- Tolerable misstatement - A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

And

- Tolerable rate of deviation - A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

The preciseness of the approximation is ruled by the statistical sampling theory; there is an interconnection between the sample size and the confidence level. One of the important parts of this assessment is the planning materially which actually sets up the general boundary for sampling and error calculation. Once the required confidence level is set the sample size may be calculated. Unlike in classical sampling the characteristic of the unit is the value of the error in balance, thus the actual items which constitute the population (e.g., invoices themselves) are less important than the value they carry forward (compare one invoice of 100 and a second one of 3000 dollars, which one is more likely to have material error?). Therefore, the sampling strategy might be rearranged to another method called Monetary Sampling Units (MUS), thus the balance (say debtors) is not viewed as the composition of the individual debtors, but as the collection of dollars, which combined together gives the debtor population value. In contrast to classical sampling MUS yields with a smaller sampling size. The basic idea behind MUS is to set up a monetary distance, say 20 dollars, and pick up to the sample each 20th.

Example

Paul is going to select a sample to test the trade-debtor balance of a total value of $615 000. The planning materiality on the project is 90 000. Pauls aims to apply the MUS strategy. The following data are available:

Debtor no	Balance o/s
1	12000
2	54000
3	79000
4	102000
5	23000
6	11000
7	141000
8	20000
9	5000
10	130000
11	14000
12	24000
	615000

Determine which debtor is to be included in the sample.

Solution

Debtor no	Balance o/s	Cumulative	PM = 90 000	Included
1	12 000	12 000		N
2	54 000	66 000	90 000	Y
3	79 000	145 000		N
4	102 000	247 000	180 000	Y
5	23 000	270 000	270 000	Y
6	11 000	281 000		N
7	141 000	422 000	360 000	Y
8	20 000	442 000		N
9	5 000	447 000		N
10	130 000	577 000	450 000	Y
11	14 000	591 000	540 000	Y
12	24 000	615 000	630 000	N
	615 000			

There are pros and cons for MUS application. It essentially requires the data in electronic format as manual calculation is tedious. MUS ensures all key items (above PM) will be selected. MUS fails to cope with negative balances and overstatements of the population, the population must be randomized, which is unlikely if the data are sorted, e.g., by debtor balance size or geographical origin.

In contrast to balance value sampling and testing (substantive sampling), sampling for the test of controls does not requires error estimation, as the test concerns the rate of error.

Example

Damian has performed tests of controls on a sample of 50 items and has found 5 instances of control does not work, what should be his conclusion thereon?

Solution

This represents an error rate of 10% (5/50 x 100%). Damian must decide if an error of this size is acceptable (in practice unlikely to be accepted).

Note that computer-assisted audit techniques (CAATS) involve using a computer to perform audit work. Computers can be used to perform either substantive tests or tests of controls.

Accounting estimates

Accounting estimate is an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this ISA addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.

Nature of Accounting Estimates

Some financial statement items cannot be measured precisely, but can only be estimated. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias.

The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as "marketplace participants" or equivalent) in an arm's length transaction, rather than the settlement of a transaction at some past or future date.

A difference between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.[26]

Accounting estimates are also risky because they are estimates and depend on one's views. Thus, the auditing of estimates requires judgment and discussion with the entity's management. The basic yardstick for the auditing of estimates is the plausibility of the assumptions taken.

The typical estimates are:

- Depreciation allowance
- Impairment provisions
- Provisions for liabilities
- Debtors and stock provision (value adjustments)
- Long-term contracts estimations (e.g., percentage of completion)
- Financial instruments valuation for non-liquid markets

The risk of misstatement and manipulation with estimates is huge because small changes to the input parameters might result in significant changes in accounting values.

The following audit procedures are typically used:

- Describe, review and test the process applied to yield the estimates (control approach)
- Perform the analytical review
- Recalculate

[26] Thus, from an auditing perspective the key issue is the existence of the estimate, rather than the explicit valuation.

- Apply an independent service (work of others) to recalculate or re-estimate the management values (e.g., ask actuary to recalculate the provision of the retirement bonuses and pay)
- Review the post-balance sheet or subsequent evidence that the provided estimates are crystallised in amounts provided.

Example

Magic Plc reports a provision of 30 000 for bad debt. The company typically sells at a credit term of 14 days. During the audit Adrian received the following information.

Debt aging is shown below. The long-term stable debtors days is 22.

Current	Overdue 115 days	16-30 days	30-90	90-180	Above 180
250000	15000	10000	16000	2000	8000

Advise Adrian how to assess the reasonableness of the trade debt provision.

Solution

As the company has 22 debtors days, and average credit, then the typical range is 22-14 - this is 8 days. The payments overdue above 3xrange[27] this is 24 days are unlikely to happen, thus for the overdue period 1-15 and 16-30 it is reasonable to assume that the receivables are still collectable, for those over 30 the chances dramatically diminish. Thus, as the matter of auditing judgment overdue in 30-90 should be written off in 50% in 90-180 at 80% and above 180 all.

	Current	Overdue 1-15 days	16-30 days	30-90	90-180	Above 180	Total
	250000	15000	10000	16000	2000	18000	
Rate	0%	0%	0%	50%	80%	100%	
Values	0	0	0	8000	1600	8000	27600
Client reported							30000
Difference							2400

The judgement upon difference depends upon the PM and TE. The results are usually discussed with the client. However, unlike sampling for the sample estimation, the auditor should allow for:

- A higher degree of changeability. The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate is called an auditor's point estimate (or auditor's range).

And

[27] This is dervied from the normal distribution 3σ rules, while instead of the standard deviation (σ) it is used the allowed credit term.

- estimation uncertainty - the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

The approximation of the estimates is done by the management, so there may be a lack of neutrality by management in the preparation of information (management bias). The auditor and management's point of estimate[28] might be different. And finally, the outcome of an accounting estimate (the actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate) might be different than the estimation in the financial statements, which do not necessarily indicate misstatements of the fairness.

Related parities

A related party is a party that is either:

i) A related party as defined in the applicable financial reporting framework;

or

ii) Where the applicable financial reporting framework establishes minimal or no related party requirements:

a) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
b) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
c) Another entity that is under common control with the reporting entity through having:
    i) Common controlling ownership;
    ii) Owners who are close family members; or
    iii) Common key management.

However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources with one another to a significant extent.

The risk with a related party is as follow.

The entity might enter into the business transaction, which is not an arm's length transaction (a transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests) - thus the transaction values reported in financial statements might be significantly different than the fair value of such a transaction. Therefore, the majority of the accounting frameworks require disclosure of the information on transaction values and their fair value.

Many related party transactions take place within the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related

[28] Management's point estimate - The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example:

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Because related parties are not independent of each other, many financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions and balances to enable the users of financial statements to understand their nature and actual or potential effects on the financial statements. Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework. Even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

- Achieve fair presentation (for fair presentation frameworks); or
- Are not misleading (for compliance frameworks).

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- Management may be unaware of the existence of all related party relationships and transactions, particularly if the applicable financial reporting framework does not establish related party requirements.
- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

Planning and performing the audit with professional skepticism is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions.

Subsequent events

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.

Date of the financial statements is the date of the end of the latest period covered by the financial statements. Date of the auditor's report is the date the auditor dates the report on the financial statements.

Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:

a) Those that provide evidence of conditions that existed at the date of the financial statements;

and

b) Those that provide evidence of conditions that arose after the date of the financial statements.

The date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.

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.

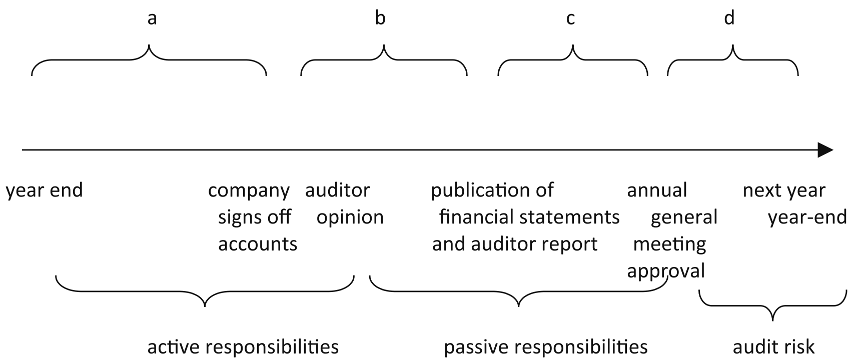
Actually, there are different periods of auditors' responsibilities:

a) Between the year-end date and the date of the financial statements approval by the management.
b) Between the date of management approval and issuance of the audit report.
c) Between the date of publication (issue) of the financial statements with audit report and financial statements approval
d) Between the financial statements approval and the next period year-end.

Date of approval of the financial statements is the date on which all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Date the financial statements are issued is the date that the auditor's report and audited financial statements are made available to third parties.

Those periods might be presented on the time line as follows:



This is why in practice the date of the financial statement and the date of the auditing report are close to each other.

For the period a) the following procedures should be performed as a minimum to search for material events after the year end:

- Discuss with management subsequent events.
- 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 reports.
- Obtain evidence concerning any litigation or claims from the company's solicitors.
- Obtain written representation that all events occurring subsequent to the period-end which need adjustment or disclosure have been adjusted or disclosed.

Example

As of 31 December the company reports the total value of its office building to be 300 000, while the project materiality is 50 000. After the year end part of the building was destroyed by fire and the insurance company covered the damages on 2 February the following year. The management showed the original amount in the balance sheet because the damage to the building was cleared by the insurer. What is the consequence for the year-end opinion?

Solution

Unless management disclose the fire combined with the insurance post-balance sheet coverage, there is no need to modify the opinion.

For the period b).

Facts discovered after the date of the auditor's report but before:

- auditor report is released to the entity,
- the financial statements are issued.

If the auditor becomes aware of a fact which may materially affect the financial statements, the auditor should consider whether the financial statements need amendment, should discuss the matter with management, and should take the action appropriate in the circumstances. If management does not amend the financial statements in circumstances where the auditor believes they need to be amended (and the audit report has not been released to the entity), the auditor should express a qualified or adverse opinion.

For periods c) and d)

The auditor does not have any obligation to perform procedures, or make enquiries regarding the financial statements, after the date of the report (providing it was issued to the client). But if the auditor becomes aware of such instances they should discuss the situation with management, assess the need for changes to the financial statements, and if the management does not change the statements, consider action to prevent reliance on the auditor's report.

Example

The auditor issued a clear opinion to the financial statements. After publication of the financial statement it turned out that the management representations in terms of bill of exchange are intentionally wrong. What might the auditor do to prevent reliance on the auditor's report?

Solution

The auditor might, for example, withdraw their opinion and place a public advertisement thereon.

If management decide to amend the financial statements, the auditor shall carry out procedures necessary on the amendment and review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements is informed. The auditor shall also issue a new or amended auditor's report which will include an explanatory paragraph (known as an emphasis of matter paragraph or other matter paragraph).

Going concern

Going concern is an accounting concept which assumes that an entity's assets and liabilities would be realised in the normal course of its business.

Thus:

The going concern assumption of an entity is the view that the entity will continue in business for the foreseeable future.

Supposing the company files for bankruptcy protection, then its long-term assets (e.g., buildings) must be tendered and the price achieved by the urgent procedure will be different than the price of the arm's length transaction which would be achieved without time pressure on the normal course of business. This is why the assessment of going concern may heavily impact the valuation and disclosure of the financial statements, because distressed assets and liabilities have a current realizable value irrespective of their future cash flow.

When reviewing the going concern assumption the auditor should be alert to the following indications:

From a financial perspective:
- Excessive net liability
- Fixed-term borrowings maturity with expected liquidity gap
- Financing long-term assets with short-term liabilities
- Breach of the entity's credit covenants
- Negative operating cash flows
- Failing to meet the capital requirements (financial industry)

From an operational perspective
- Loss of key management
- Loss of a major market, licence, suppliers, customers
- High staff turnover
- Increased supplier power
- Entrance of competitors

Example

Luna TV is the nationwide broadcasting enterprise. Kida is a member of the audit team and during an interview with top management she has learned that the broadcasting license expires in two years' time and that the management have completed an administrative request to continue the license, however, no decision has been made as of the audit report date. Help Kida to consider the implications of this fact.

Solution

As the license is the key element for the broadcasting business like Luna TV, the lack of a valid licence might force the company to cease operating. The following scenarios should be considered:

Ref	Scenario	Auditor action
A	Management intention to liquidate or cease operations. Going concern assumption appropriate but material uncertainty which is adequately disclosed	Emphasis of matter paragraph, report unqualified
B	Going concern assumption appropriate but material uncertainty which is not adequately disclosed	Modify opinion
C	Use of going concern assumption inappropriate	Adverse opinion
D	Management unwilling to make or extend its assessment	Limitation in scope

Therefore, if uncertainty prevails on the date of the auditing report and the possibilities of a license extension are not feasible, Kida should consider modification of the report.

Requirements

Audit Evidence

I General principles

The auditor must obtain sufficient and appropriate audit evidence and should consider the relevance and reliability of the information to be used as audit evidence.

If information to be used as audit evidence has been prepared using the work of a management expert, the auditor shall, having regard to the significance of that expert's work for the auditor's purposes:

- Evaluate the competence, capabilities and objectivity of that expert;
- Obtain an understanding of the work of that expert;
- Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, in terms of accuracy and completeness of the information, and evaluate if the information is sufficiently precise and detailed for the auditor's purposes.

Selecting Items for Testing to Obtain Audit Evidence

When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.

Inconsistency in, or Doubts over Reliability of, Audit Evidence

If:

- audit evidence obtained from one source is inconsistent with that obtained from another;

or

- the auditor has doubts over the reliability of information to be used as audit evidence,

the auditor shall determine what modifications or additions[29] to audit procedures are necessary to resolve the matter.

II. Specific consideration on evidences

Inventory

If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

- Attendance at the physical inventory counting, unless impracticable, to:
    i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;

[29] This actually is a direct requirement to alert the audit plan, therefore the actual audit plan has the recurring characteristic. The standard rather recommend to add up the procedures than to amend existing one (except from the increase of the sampling size) this is rather the indication drawn from the practice, as maintaining the audit trail and consistency through the audit files is easier for add ups than for procedures modifications.

ii) Observe the performance of management's count procedures;
iii) Inspect the inventory;
iv) Perform test counts;

- Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

If:

1) physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded (roll forwards or roll backs).
2) the auditor is unable to attend the physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.[30]
3) attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory.
4) it is not possible to do so, the auditor shall modify the opinion in the auditor's report.
5) inventory under the custody and control of a third party is material to the financial statements, then the auditor should:
   - Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.
   - Perform inspection or other audit procedures appropriate in the circumstances.

Litigation and Claims[31]

To make evidence for the litigations and claims the auditor undertakes the following:

- Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
- Review of the minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- Review of the legal expense accounts.

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. If law, regulation or the respective legal professional body prohibits

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[30] This requirement is subject to the design of the system of internal control and the cost method used in the audited entity.

[31] Note that the procedures on the inventory are subject to the materiality, but the procedures to claim and litigation are not subject to the materiality threshold, this is due to the different nature on risk of assets and liabilities (understatement).

the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.

If:

a) management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding;

and

b) the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures,

the auditor shall modify the opinion.

Written Representations[32]

The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

Segment Information

The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information by:

a) Obtaining an understanding of the methods used by management in determining segment information,

and:

- Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework;
- Where appropriate, testing the application of such methods.

b) Performing analytical procedures or other audit procedures appropriate in the circumstances.[33]

External Confirmations

External Confirmation Procedures

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

- Determining the information to be confirmed or requested;
- Selecting the appropriate confirming party;
- Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor;

[32] Refer to the reporting chapter for further discussion.

[33] Standard does not stipulate any substantive testing on segment information.

- Sending the requests, including follow-up requests when applicable, to the confirming party.

If management refuses to allow the auditor to send a confirmation request, the auditor shall:

- Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
- Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures;
- Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, he shall communicate with those charged. The auditor shall also determine the implications for the audit and the auditor's opinion.

Reliability of Responses to Confirmation Requests

If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts.

If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

Non-Responses

In the case of each non-response, the auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence.[34]

When a Response to a Positive Confirmation Request Is Necessary to Obtain

Sufficient Appropriate Audit Evidence

If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does not obtain such confirmation, the auditor shall determine the implications for the audit and the auditor's opinion.

Exceptions

The auditor shall investigate exceptions to determine whether or not they are indicative of misstatements.

[34] E.g. post-year cash payments.

Negative Confirmations

Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous account balances, transactions or conditions;
c) A very low exception rate is expected; and
d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

Evaluating the Evidence Obtained

The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether further audit evidence is necessary.

Opening balances

Opening Balances

The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated;
- Determining whether the opening balances reflect the application of appropriate accounting policies;

and

- Performing one or more of the following:
    i) Where the prior year financial statements were audited, reviewing the predecessor auditor's working papers to obtain evidence regarding the opening balances;
    ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances;
    iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If he concludes that such misstatements exist in the current period's financial statements, he shall communicate the misstatements with the appropriate level of management and those charged with governance.

Consistency of Accounting Policies

The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Relevant Information in the Predecessor Auditor's Report

If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements.

Opening Balances

If the auditor:

- is unable to obtain sufficient appropriate audit evidence regarding the opening balances – *he/she shall express a qualified opinion or disclaim an opinion.*
- concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not appropriately accounted for or not adequately presented or disclosed – *he/she shall express a qualified opinion or an adverse opinion.*

Consistency of Accounting Policies

If the auditor concludes that:

a) the current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework;

or

b) a change in accounting policies is not appropriately accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,

the auditor shall express *a qualified opinion or an adverse opinion.*

Modification to the Opinion in the Predecessor Auditor's Report

If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements.

Sampling

Sample Design, Size, and Selection of Items for Testing

When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

Performing Audit Procedures

The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.

If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item.

If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control in the case of tests of controls, or a misstatement in the case of tests of details.

Nature and Cause of Deviations and Misstatements

The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.

In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Projecting Misstatements

For tests of details, the auditor shall project misstatements found in the sample to the population.

Evaluating Results of Audit Sampling

The auditor shall evaluate:

a) The results of the sample;
b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

Estimates

Risk Assessment Procedures and Related Activities

When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

- The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures.
- How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new estimates or the need to revise existing accounting estimates.
- How management makes the accounting estimates, and an understanding of the data on which they are based, including:
  - i) The method, including where applicable the model used in making the accounting estimate;
  - ii) Relevant controls;
  - iii) Whether management has used an expert;
  - iv) The assumptions underlying the accounting estimates;
  - v) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why;
  - vi) Whether, and if so, how management has assessed the effect of estimation uncertainty.

The auditor shall review the outcome of accounting estimates included in the prior period's financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period's financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at the time.

Identifying and Assessing the Risks of Material Misstatement

In identifying and assessing the risks of material misstatement, the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate.

The auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

Responses to the Assessed Risks of Material Misstatement

Based on the assessed risks of material misstatement, the auditor shall determine:

- Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate;
- Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in

the method for making them from the prior period are appropriate in the circumstances.

In responding to the assessed risks of material misstatement, the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate:

- Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.
- Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether:
  i) The method of measurement used is appropriate in the circumstances;
  ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.
- Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- Develop a point estimate or a range to evaluate management's point estimate. For this purpose:
  i) If the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate.
  ii) If the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

In responding to the assessed risks of material misstatement, the auditor shall consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence.

Further Substantive Procedures to Respond to Significant Risks

For accounting estimates that give rise to significant risks the auditor shall evaluate the following:

- How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.
- Whether the significant assumptions used by management are reasonable.
- Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate.

Recognition and Measurement Criteria

For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence about whether:

- Management's decision to recognize, or to not recognize, the accounting estimates in the financial statements was reasonable;
- The selected measurement basis for the accounting estimates is in accordance with the requirements of the applicable financial reporting framework.

Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements

The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated.

Disclosures Related to Accounting Estimates

The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.

Indicators of Possible Management Bias

The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates.

Written Representations

The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

Documentation

The auditor shall include in the audit documentation:

- The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks;
- Indicators of possible management bias, if any.

Related Parties

Risk Assessment Procedures and Related Activities

As part of the risk assessment procedures and related activities for the auditor to perform during the audit, he shall perform the audit procedures and related activities to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.

Understanding the Entity's Related Party Relationships and Transactions

The engagement team shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.

The auditor shall inquire of management regarding:

- The identity of the entity's related parties, including changes from the prior period;
- The nature of the relationships between the entity and these related parties; and
- Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

The auditor shall inquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to:

- Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
- Authorize and approve significant transactions and arrangements with related parties;
- Authorize and approve significant transactions and arrangements outside the normal course of business.

Maintaining Alertness for Related Party Information When Reviewing Records or Documents

During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- Bank and legal confirmations obtained as part of the auditor's procedures;
- Minutes of meetings of shareholders and of those charged with governance; and
- Such other records or documents as the auditor considers necessary in the circumstances of the entity.

If the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures the auditor shall inquire of management about:

- The nature of these transactions;
- Whether related parties could be involved.

In respect of the related party procedures the auditor shall:

- Share related party information with the engagement team
- Identify and assess the risks of material misstatement associated with related party relationships and transactions; In making this determination, the auditor shall treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks.[35]
- Responses to the risks of material misstatement associated with related party relationships and transactions

Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.

If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

a) Promptly communicate the relevant information to the other members of the engagement team;
b) Where the applicable financial reporting framework establishes related party requirements:
    i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and
    ii) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
c) Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions;
d) Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary;
e) If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit.

[35] If the auditor identifies fraud risk factors when performing the risk assessment procedures and related activities in connection with related parties, the auditor shall consider such information when identifying and assessing the risks of material misstatement due to fraud.

Identified Significant Related Party Transactions outside the Entity's Normal Course of Business

For identified significant related party transactions outside the entity's normal course of business, the auditor shall:

a) Inspect the underlying contracts or agreements, if any, and evaluate whether:
    i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
    ii) The terms of the transactions are consistent with management's explanations; and
    iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
b) Obtain audit evidence that the transactions have been appropriately authorized and approved.

Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's-Length Transaction

If management has made an assertion in the financial statements to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion.

Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions

In forming an opinion on the financial statements the auditor shall evaluate:

a) Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework;
b) Whether the effects of the related party relationships and transactions:
    i) Prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or
    ii) Cause the financial statements to be misleading (for compliance frameworks).

Written Representations

Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that:

- They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware;
- They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

Communication with Those Charged with Governance

Unless all of those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

Documentation

The auditor shall include in the audit documentation the names of the identified related parties and the nature of the related party relationships.

Subsequent events

Events Occurring between the Date of the Financial Statements and the Date of the Auditor's Report

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:

Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

- Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- Reading the minutes, if any, of meetings of the entity's owners, management and those charged with governance that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- Reading the entity's latest subsequent interim financial statements, if any.

If, as a result of the procedures performed, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements in accordance with the applicable financial reporting framework.

Written Representations

The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Facts Which Become Known to the Auditor after the Date of the Auditor's Report but before the Date the Financial Statements Are Issued

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- Discuss the matter with management and, where appropriate, those charged with governance;
- Determine whether the financial statements need amendment and, if so,
- Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall: carry out the audit procedures necessary in the circumstances on the amendment, extend the audit procedures to the date of the new auditor's report. The new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

Where law, regulation or the financial reporting framework do not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent event or events causing that amendment and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events to that amendment. In such cases, the auditor shall either:

- Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements;

or

- Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter paragraph that conveys that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

In some jurisdictions, management may not be required by law, regulation or the financial reporting framework to issue amended financial statements and, accordingly, the auditor need not provide an amended or new auditor's report. However, if management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then:

- If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion and then provide the auditor's report;

or

- If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

Facts Which Become Known to the Auditor after the Financial Statements Have Been Issued

After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements.

However, if, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- Discuss the matter with management and, where appropriate, those charged with governance;
- Determine whether the financial statements need amendment; and, if so,
- Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall:

- Carry out the audit procedures necessary in the circumstances on the amendment.
- Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.
- Extend the audit procedures to the date of the new auditor's report, and date the new auditor's report no earlier than the date of approval of the amended financial statements; and

The auditor shall include in the new or amended auditor's report an Emphasis of Matter paragraph or Other Matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, that the auditor will seek to prevent future reliance on the auditor's report. If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

Going Concern

Going Concern Assumption

Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework for which the going concern basis is relevant (for example, the going concern basis is not relevant for some financial statements prepared on a tax basis in particular jurisdictions). When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Responsibility for Assessment of the Entity's Ability to Continue as a Going Concern

Some financial reporting frameworks contain an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. For example, International Accounting Standard (IAS) 1 requires management to make an assessment of an entity's ability to continue as a going concern. The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may also be set out in law or regulation.

In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, since the going concern assumption is a fundamental principle in the preparation of financial statements, the preparation of the financial statements requires management to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.

Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about uncertain future outcomes of events or conditions. The following factors are relevant to that judgment:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

Responsibilities of the Auditor

The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. This responsibility exists even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

However the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Risk Assessment Procedures and Related Activities

When performing risk assessment procedures the auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:

- If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or
- If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern assumption, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

Evaluating Management's Assessment

The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. If management's assessment of the entity's ability to continue as a going concern covers less than 12 months from the date of the financial statements as defined in ISA 560, the auditor shall request management to extend its assessment period to at least 12 months from that date. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

Period beyond Management's Assessment

The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern.

Additional Audit Procedures When Events or Conditions Are Identified

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

- Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
- Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
- Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future action:
    - i) (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and
    - ii) (ii) Determining whether there is adequate support for the assumptions underlying the forecast.
- Considering whether any additional facts or information have become available since the date on which management made its assessment.
- Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

Audit Conclusions and Reporting

Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for:

- In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements; or
- In the case of a compliance framework, the financial statements not to be misleading.

Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists

If the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

- Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and
- Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report to:

- Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and
- Draw attention to the note in the financial statements that discloses the matters.

If adequate disclosure is not made in the financial statements, the auditor shall express a qualified opinion or adverse opinion. The auditor shall state in the auditor's report that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.

Use of Going Concern Assumption Inappropriate

If the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, the auditor shall express an adverse opinion.

Management Unwilling to Make or Extend Its Assessment

If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report.

Communication with Those Charged with Governance

Unless all those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. Such communication with those charged with governance shall include the following:

a) Whether the events or conditions constitute a material uncertainty;
b) Whether the use of the going concern assumption is appropriate in the preparation of the financial statements; and
c) The adequacy of related disclosures in the financial statements.

Significant Delay in the Approval of Financial Statements

If there is significant delay in the approval of the financial statements by management or those charged with governance after the date of the financial statements, the auditor shall inquire as to the reasons for the delay. If the auditor believes that the delay could be related to events or conditions relating to the going concern assessment, the auditor shall perform those additional audit procedures necessary, as well as consider the effect on the auditor's conclusion regarding the existence of a material uncertainty.

Revision

Summary

The auditor gathers evidences to support his opinion. Beside the testing of controls and substantive testing there are a number of procedures independent of the strategy taken called general audit procedures. Irrespective of the reporting framework, the auditors should make sure that the audit has considered application of third parties' confirmation, satisfies him of the opening balances and reviewed subsequent events. When gathering evidence the auditor seldom checks all of the population but instead applies statistical or non-statistical sampling. A properly applied sampling provides the basis for generalisation of the results over the population. The typical key risk areas are estimations, related parties, and going concern. The common attribute of this area is the substantial level of judgement required in their evaluation. The auditor is obligated to perform a number of procedures to safeguard the correctness of the opinion issued.

Keywords

Accounting records, Appropriateness (of audit evidence), Audit evidence, Management's expert, Sufficiency (of audit evidence), External confirmation, Positive confirmation request, Negative confirmation request, Non-response, Exception, Initial audit engagement, Opening balances, Predecessor auditor, Audit sampling (sampling), Population, Sampling risk, Non-sampling risk, Anomaly, Sampling unit, Statistical sampling, Stratification, Tolerable misstatement, Tolerable rate of deviation, Accounting estimate, Auditor's point estimate or auditor's range, Estimation uncertainty, Management bias, Management's point estimate, Outcome of an accounting estimate, Related party, Going concern.

Y/N Questions

No	Issue	Y/N
1	If inventory is material to the financial statements, the auditor shall obtain sufficient audit evidence regarding its existence by his attendance at the physical inventory counting.	Y/N
2	If the auditor determines that a response to a confirmation request is not reliable, the auditor shall perform the control check.	Y/N
3	The auditor must always determine a sample size with statistical software.	Y/N
4	If the auditor identifies related parties that management has not previously identified or disclosed to the auditor, the auditor shall promptly communicate this to management.	Y/N
5	If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion.	Y/N
6	After the financial statements have been issued, the auditor has an obligation to perform some audit procedures regarding such financial statements.	Y/N
7	If the financial statements are based on the other financial reporting frameworks the auditor does not have an obligation to review the going concern.	Y/N
8	In identifying and assessing the risks of material misstatement the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate.	Y/N
9	Date the financial statements are issued is the date that the auditor's report and audited financial statements are made available to third parties	Y/N
10	All audit evidence must be documented in writing.	Y/N

Issues to consider

1. Recall definitions of the keywords.
2. Describe the impact to the standards involved on the context of the chapter.
3. Suppose the client's accounting department was damaged due to the fire, how would you gather the audit evidence?
4. After the year end the company announced a merger with a competitor, what kind of audit evidence should be accumulated in the current audit year file?
5. One of the subsidiaries of the group is located in an area of war conflict. What kind of evidence would you expect to assess the fairness of the investment?

Case study Alan Star

Alan Star, a private company owned by its directors, manufactures tables and plastic chairs. It has prepared draft accounts for the year ended 31 December 20X9 and you are concerned that they indicate serious going concern problems. The statements of comprehensive income and statements of financial position for the last five years are given below.

STATEMENT OF COMPREHENSIVE INCOME

	20X5	20X6	20X7	20X8	20X9
	€'000	€'000	€'000	€'000	€'000
Sales	625	787	989	1403	1613
Cost of sales	-478	-701	-962	-1326	-1510
Gross profit	147	86	27	77	103
Other expenses	-88	-86	-161	-240	-288
Interest	-6	-9	-58	-90	-117
Net profit/(loss)	53	-9	-192	-253	-302

STATEMENT OF FINANCIAL POSITION

	20X5	20X6	20X7	20X8	20X9
	€'000	€'000	€'000	€'000	€'000
Assets					
Current assets Inventory	37	133	281	407	478
Trade accounts receivable	121	240	103	113	325
	158	373	384	520	803
Net other assets	89	161	344	408	587
Total assets	247	534	728	928	1390
Liabilities and shareholders' funds Current liabilities Trade accounts payable	90	317	355	390	641
Bank overdraft	10	65	111	269	365
Lease creditor	14	28	98	30	59
	114	410	564	689	1065
Non-current loan	0	0	100	200	300
	114	410	664	889	1365
Shareholders' funds Share capital	17	17	17	17	17
Reserves	116	107	47	22	8
	133	124	64	39	25
Total liabilities and shareholders' funds	247	534	728	928	1390

The company has been in business for about 20 years. In March 20X6 it decided to build a new factory in Greenspans city which would allow a major increase in sales. This new factory with new equipment was completed a year later. The factory was financed by a non-current loan of €300,000 payable in instalments as a contract for construction and maintenance from an investment bank and an increase in bank overdraft.

The loan from the bank is secured by a promissory note and the charge on the current assets and the bank overdraft is charged on the management's private property, and the right for the land.

The company purchases its main raw material, wood, from timber wholesalers and plastic from BAFS Ltd. It sells around 75% of its production to IKEA. The remaining sales are mainly to smaller chains of local networks with a very few sales to retailers.

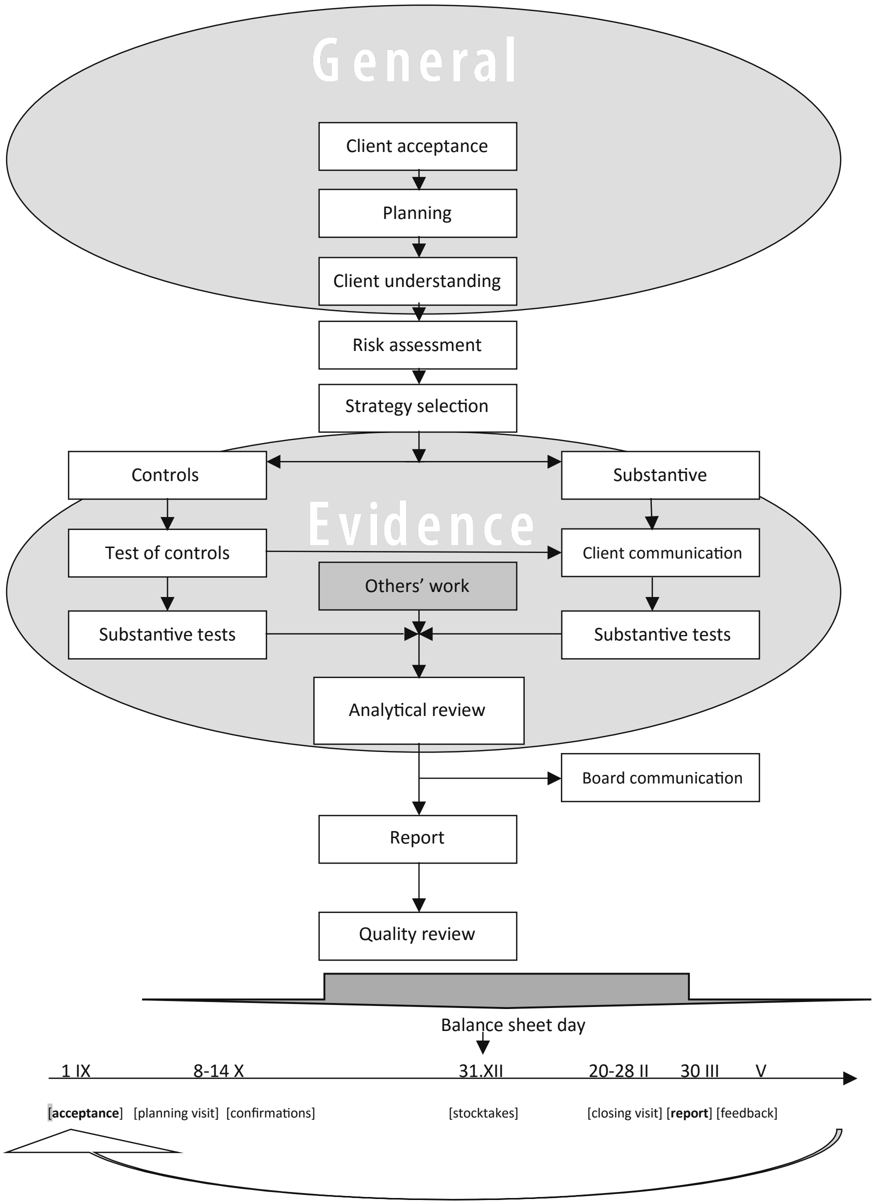
Required

(a) Is the company going concern justified? Illustrate your answer with appropriate calculations.

(b) State the test the auditor is likely to perform to assess the significance of the going concern risk.

Chapter 7

Works of others



Learning goal

To understand the contribution of other professionals to the audit process.

Standards involved

ISA 600 Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)
ISA 610 Using the Work of Internal Auditors
ISA 620 Using the Work of an Auditor's Expert

Links to previous chapters

Section 600 comprises the part of the audit evidence gathered by the other third-party professionals hired by the auditor as experts, other in-house experts of the company – internal auditors – or members of the professional community who perform specific procedures (e.g., reporting package auditing) on behalf of the auditor in charge. These professionals possess experience in the skills of their field of expertise Section 600 is rather isolated from the other standards, thus the links are based on general audit principles.

Overview

Groups

The group audit is performed by the group auditor, who usually takes full responsibility for the group opinion; thus, in case specific components of the group are audited by another auditor (e.g., an overseas subsidiaries) then the group auditor must satisfy himself with proper and persuasive evidence that the picture of the entire group, including material from subsidiaries, is fair and true.

The group produces the group financial statements in a process referred to as "the consolidation process," which includes:

- The recognition, measurement, presentation, and disclosure of the financial information of the components in the group financial statements by way of consolidation, proportionate consolidation, or the equity or cost methods of accounting; and
- The aggregation in combined financial statements of the financial information of components that have no parent but are under common control.

The group audit procedures can be applied either to:

- group audits, in particular those that involve component auditors

or

- if the auditor involves other auditors in the audit of financial statements that are not group financial statements. For example, an auditor may involve another auditor to observe the inventory count or inspect physical fixed assets at a remote location.

A component auditor is an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit. A component is an entity or business activity for which the group or component management prepares financial information that should be included in the group financial statements. The group is all of the components whose financial information is included in the group financial statements. The group audit is the audit of group financial statements and group audit opinion is the audit opinion on the group financial statements.

A component auditor may be required by statute, regulation or for another reason to express an audit opinion on the financial statements of a component. The group engagement team may decide to use the audit evidence on which the audit opinion on the financial statements of the component is based to provide audit evidence for the group audit.

The group engagement partner is required to be satisfied that those performing the group audit engagement, including component auditors, collectively have the appropriate competence and capabilities. The group engagement partner is also responsible for the direction, supervision, and performance of the group audit engagement.

Audit risk is a function of the risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatements. In a group audit, this includes the risk that the component auditor may not detect a misstatement in the financial information of the component that could cause a material misstatement of the group financial statements,[36] and the risk that the group engagement team may not detect this misstatement. The group engagement team considers when determining the nature, timing, and extent of its involvement in the risk assessment procedures and further audit procedures performed by the component auditors on the financial information of the components.

Communication with the component auditor should be in writing.

Example

David is the engagement partner on BigGroup Plc year-end auditing. He has asked you to prepare a draft engagement letter to LittleAuditor, the auditor of BigGermany's subsidiary in the group. Design the template of this documentation.

Solution

[headed paper of David's company]

[Date, Place]

Reg: Engagement letter for BigGermany subsidiary reporting package for LittleAuditor

Dear Sirs,

We engage you to perform the audit procedures on the consolidation package for BigGroup Plc for the subsidiary BigGermany as of 31 Dec 20X15 until [date of the auditor communication].

[36] This is still detection risk but the detection of the component auditor, which turn in the inherent risk of the group auditor unless specific quality control procedures are not imposed.

Group audit scope

We are engaged to perform the year-end audit of the consolidated financial statements of BigGroup Plc in accordance with the IFRS. We run our audit in accordance with ISA. [...]

Group business model

[Basic information on the group basic model, key staff and key activities]

Group time table

- Planning and interim visit until 15 November 20X15
- Interim communication on significant matters to the group auditor based on the template provided in appendix A until 22 November 20X15
- Stocktake procedures will take place as of 27 December 20X15
- Final visit not later than 22 January 20X16
- Package clearance together with the auditor opinion thereon until 28 January 20X16
- Management letters and post-audit communication based on appendix B until 1 March 20X16.

Group materiality

Please find calculation of the group materiality attached in appendix C. We do not expect you to report to us misstatements below 2 million Euros.

Significant risk and preliminary assessment of the group.

- Accounts receivables - [...]
- Deferred tax - [...]
- Related parties' transactions - [...]

Local subsidiary address and key management staff

[Full address of the subsidiary]
[List of the key staff for the contact purposes]
[Other matters]
[Signatures]

Appendices
A. Reporting template and package
B. Management letter template
C. Group materiality

The group strategy memorandum should include the information on:

- Component management information on management responsible for the preparation of the financial information of a component.

- Component materiality information – the materiality for a component determined by the group engagement team.
- List of significant components – A component is identified by the group engagement team according to: (i) that it is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

Internal audit

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

The internal audit function is a function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes

The board has a legal liability to set up an internal system of control which safeguards the entity's assets. The auditor is subject to local law and might seek the direct assistance of internal auditors (this means the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor).

The internal audit helps to review and preserve the internal system of controls. The internal audit is different in nature to the external audit.

	Internal audit	External audit
Goal	Assure compliance with internal system of controls	True and fairness of financial reporting
Addressee	Management	Ultimate owner
Level of independence	Moderate to low	High
Qualification	In-house	Formal - legal - regulated service

The internal audit can basically be split into two groups of the engagement; classical financial internal audit (similar to external audit) and operational internal audit. Operational audits are audits of the operational process of the organisation. Their prime objective is the monitoring of management's performance, ensuring company policy is adhered to. They can also be called management or efficiency audits.

Internal audits are more of a performance audit than a statutory audit. In contrast to the statutory audit, which is focused on the fairness of the reporting, the internal audit focuses on the issue of whether the processes are economic, efficient and effective (three „es“). The three *e*'s are generally referred as the audit for value.

Limitation of the internal audit and its scope of service

Internal audits are not subject to legally binding regulation (except for those carried out in public authorities).

On a practical level the key professional responsibilities of the internal auditor, such as due care, independence and objectivity might be overridden by the goal and needs of the manager they report to.

Independence of the internal auditor might be achieved by the right to present findings to the top level of management, e.g. the Chief Operating Officer (CFO), but in practice they are quite busy people thus this function is often weak.

In consequence the internal auditing function is often outsourced. Outsourcing has various advantages:

- Increased independence of internal auditors.
- Relevant accounting and auditing skills.
- Increased reliability.

And disadvantages:

- Cost to the company.
- Limited knowledge of specific entity.
- Independence issues if external auditor also provides internal audit function.

In contrast to external audit reporting, which is rather standardized, there are no standard and prescribed forms of internal audit reports.

Consider the following example of an internal audit report.

An extract from the report is shown below.

==

To: Mangers of ABC Ltd

From: Internal audit department

Subject: Review of sales system

Period of fieldwork: May 20X9

Terms of Reference

The scope of the assignment was to carry out a thorough review of the sales system according to the annual internal control plan point 7/20X9.

This involved carrying out tests of controls on the existing controls to determine whether the controls were operating effectively. In addition, we considered the key risks surrounding the sales function and identified any risks for which we found no related controls.

Executive Summary

The main findings from our review are:

- the sales system, on the whole, comprises adequate controls.
- some specific control weaknesses were identified and recommendations are given in Appendix I.

[Report detailed text.]

Follow-up

Responsibilities have been allocated for introducing/improving control procedures which we found to be deficient.

A follow-up review will take place in eight months' time.

Date,

Signature

==

During the course of their planning, the external auditors should perform an assessment of the internal audit function to determine if they consider that it may be possible and desirable to rely on some of the internal auditor's work. If the external auditor can rely on the work conducted by the internal auditor, the volume of detailed work undertaken by the external auditor may be significantly reduced.

When deciding on the strategy to use or not use the internal auditor's work, the auditor should consider the following aspects of the internal audit functions:

- Organisational status, i.e. degree of independence
- Scope of function
- Technical competence
- Due professional care.

When the external auditor intends to use the specific work of internal auditing, the external auditor should evaluate and perform audit procedures on that work to confirm its adequacy for the external auditor's purposes. He should cooperate closely with the internal auditor to compare the results obtained by internal audit with those produced by his own staff and if necessary, re-examine transactions and balances. The external auditor should consider whether he should report separately to management any weaknesses / irregularities discovered by the internal audit.

Auditor's report

The external auditor cannot make reference to work done by the internal auditor in his auditor's report.

Experts

Expert means a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing (e.g. actuary, financial advisor, lawyer, tax advisor, architect, etc). When using the work performed by an expert, the auditor should obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit.

When planning to use the work of an expert the auditor should evaluate the objectivity and professional competence of the expert by considering the expert's:

- Professional certification or licensing by, or membership in, an appropriate professional body.
- Experience and reputation in the field in which the auditor is seeking evidence.

Example

Erick is engaged with a year-end audit for the railways. During the audit planning it transpired that the management had booked a material amount to the assessment under construction, which is a feasibility study on the automatic bridge system. The audit team have also discovered a substantial capital commitment required to wind up the project. Erick is unsure how to ascertain that Sigmund the chief specialist on the bridge techniques and approve him as the auditor expert. Help Erick to decide.

Solution

Erick might want to ask for Sigmund's professional CV in order to reconcile any similar projects before moving forward. Sigmund might present the past record of the court expertise he took part in. If Sigmund claims to be a member of a professional body his status can be checked with that body, i.e. his membership, valid practicing certificate, honours and penalties record.

The expert report, if issued, must be evaluated by the auditor, and this evaluation builds up the audit evidence. It is likely that the expert's report will be checked against reasonableness of assumptions for the data source used, results obtained and its relations to the other audit procedures carried out. When issuing a cleared audit report, the auditor should not refer to the work of an expert.

Requirements
Groups

Responsibility

The group engagement partner is responsible for:

- the direction,
- supervision

and

- performance of the group audit engagement in compliance with professional standards and applicable legal and regulatory requirements, and whether the auditor's report that is issued is appropriate in the circumstances.

As a result, the auditor's report on the group financial statements shall not refer to a component auditor, unless required by law or regulation to include such reference. If such reference is required by law or regulation, the auditor's report shall indicate that the reference does not diminish the group engagement partner's or the group engagement partner's firm's responsibility for the group audit opinion.

Acceptance and Continuance

The group engagement partner shall determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained in relation to the consolidation process and the financial information of the components on which to base the group audit opinion. For this purpose, the group engagement team shall obtain an understanding of the group, its components and their environments that is sufficient to identify components that are likely to be significant components. Where component auditors perform work on the financial information of such components, the group engagement partner shall evaluate whether the group engagement team will be able to be involved in the work of those component auditors to the extent necessary to obtain sufficient appropriate audit evidence.

If the group engagement partner concludes that:

- it will not be possible for the group engagement team to obtain sufficient appropriate audit evidence due to restrictions imposed by group management;
- the possible effect of this inability will result in a disclaimer of opinion on the group financial statements,

the group engagement partner shall either:

- in the case of a new engagement, not accept the engagement, or, in the case of a continuing engagement, withdraw from the engagement, where withdrawal is possible under applicable law or regulation;

or

- where law or regulation prohibits an auditor from declining an engagement or where withdrawal from an engagement is not otherwise possible, having performed the audit of the group financial statements to the extent possible, disclaim an opinion on the group financial statements.

Overall Audit Strategy and Audit Plan

The group engagement team shall establish an overall group audit strategy and shall develop a group audit plan in accordance with ISA.300.

The group engagement partner shall:

- agree on the terms of the group audit engagement,
- review the overall group audit strategy and group audit plan.

The group engagement team shall:

- understanding the Group, Its Components and Their Environments;
- identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment;
- enhance its understanding of the group, its components and their environments, including group-wide controls, obtained during the acceptance or continuance stage;
- obtain an understanding of the consolidation process, including the instructions issued by group management to components;
- obtain an understanding that is sufficient to:
    a) confirm or revise its initial identification of components that are likely to be significant;

b) assess the risks of material misstatement of the group financial statements, whether due to fraud or error.

Understanding the Component Auditor

If the group engagement team plans to request a component auditor to perform work on the financial information of a component, the group engagement team shall obtain an understanding of the following:

- Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent.
- The component auditor's professional competence.
- Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.
- Whether the component auditor operates in a regulatory environment that actively oversees auditors.

If a component auditor does not meet the independence requirements that are relevant to the group audit, than that auditor should be excluded from the group audit work.

Materiality

The group engagement team shall determine the following:

- Materiality for the group financial statements as a whole when establishing the overall group audit strategy.
- If there is necessity for particular classes of transactions, account balances or disclosures, the level of materiality to be applied thereon.
- Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit.
- The threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.

Where component auditors will perform an audit for purposes of the group audit, the group engagement team shall evaluate the appropriateness of performance materiality determined at the component level.

If a component is subject to audit by statute, regulation or other reason, and the group engagement team decides to use that audit to provide audit evidence for the group audit, the group engagement team shall determine whether:

a) materiality for the component financial statements as a whole; and
b) performance materiality at the component level meet the requirements of this ISA.

Responding to Assessed Risks

The group engagement team shall determine the type of work to be performed by the group engagement team, or the component auditors on its behalf, on the financial information of the components. The group engagement team shall also determine the nature, timing and extent of its involvement in the work of the component auditors.

Determining the Type of Work to Be Performed on the Financial Information of Components

Significant Components

For a significant component the group engagement team, or a component auditor on its behalf, shall perform an audit of the financial information of the component using component materiality.

For a component that is significant because it is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances, the group engagement team, or a component auditor on its behalf, shall perform one or more of the following:

- An audit of the financial information of the component using component materiality.
- An audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks of material misstatement of the group financial statements.
- Specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements.

Components that are not Significant Components

For components that are not significant components, the group engagement team shall perform analytical procedures at group level.

The group engagement team shall vary the selection of components over a period of time.

Involvement in the Work Performed by Component Auditors Significant Components—Risk Assessment

If a component auditor performs an audit of the financial information of a significant component, the group engagement team shall be involved in the component auditor's risk assessment to identify significant risks of material misstatement of the group financial statements. The nature, timing and extent of this involvement are affected by the group engagement team's understanding of the component auditor, but at a minimum shall include:

- Discussing with the component auditor or component management those of the component's business activities that are significant to the group;
- Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error; and
- Reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements. Such documentation may take the form of a memorandum that reflects the component auditor's conclusion with regard to the identified significant risks.

Identified Significant Risks of Material Misstatement of the Group Financial Statements—Further Audit Procedures

If significant risks of material misstatement of the group financial statements have been identified in a component on which a component auditor performs work, the group engagement team shall evaluate the appropriateness of the further audit procedures to be performed to respond to the identified significant risks of material misstatement of the group financial statements.

Consolidation Process

The group engagement team obtains an understanding of group-wide controls and the consolidation process, including the instructions issued by group management to components. The group engagement team (or component auditor) tests the operating effectiveness of group-wide controls on the nature, timing and extent of the work to be performed on the consolidation. The group engagement team shall:

- design and perform further audit procedures on the consolidation process to respond to the assessed risks of material misstatement of the group financial statements arising from the consolidation process.
- evaluate the appropriateness, completeness and accuracy of consolidation adjustments and reclassifications,

and

- evaluate whether any fraud risk factors or indicators of possible management bias exist.

If the financial information of a component has not been prepared in accordance with the same accounting policies applied to the group financial statements, the group engagement team shall:

- evaluate whether the financial information of that component has been appropriately adjusted for purposes of preparing and presenting the group financial statements.
- determine whether the financial information identified in the component auditor's communication is the financial information that is incorporated in the group financial statements.

If the group financial statements include the financial statements of a component with a financial reporting period-end that differs from that of the group, the group engagement team shall evaluate whether appropriate adjustments have been made to those financial statements in accordance with the applicable financial reporting framework.

Subsequent Events

Where the group engagement team or component auditors perform audits on the financial information of components, the group engagement team or the component auditors shall:

- perform procedures designed to identify events at those components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements, and that may require adjustment to or disclosure in the group financial statements.

- request to notify the group engagement team if they become aware of subsequent events that may require an adjustment to or disclosure in the group financial statements.

Communication with the Component Auditor

The group engagement team shall communicate its requirements to the component auditor on a timely basis. The communication shall include at least the following:

- A request that the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, confirms that the component auditor will cooperate with the group engagement team.
- The ethical requirements that are relevant to the group audit and, in particular, the independence requirements.
- In the case of an audit or review of the financial information of the component, component materiality (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.
- Identified significant risks of material misstatement of the group financial statements due to fraud or error that are relevant to the work of the component auditor. The group engagement team shall request the component auditor to communicate on a timely basis any other identified significant risks of material misstatement of the group financial statements, due to fraud or error, in the component and the component auditor's responses to such risks.
- A list of related parties prepared by group management and any other related parties of which the group engagement team is aware. The group engagement team shall request the component auditor to communicate on a timely basis related parties not previously identified by group management or the group engagement team. The group engagement team shall determine whether to identify such additional related parties to other component auditors.

The group engagement team shall request the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit. Such communication shall include:

- Whether the component auditor has complied with ethical requirements that are relevant to the group audit, including independence and professional competence;
- Whether the component auditor has complied with the group engagement team's requirements;
- Identification of the financial information of the component on which the component auditor is reporting;
- Information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group financial statements;

- A list of uncorrected misstatements of the financial information of the component;
- Indicators of possible management bias;
- Description of any identified significant deficiencies in internal control at the component level;
- Other significant matters that the component auditor communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud involving component management, employees who have significant roles in internal control at the component level or others where the fraud resulted in a material misstatement of the financial information of the component;
- Any other matters that may be relevant to the group audit, or that the component auditor wishes to draw to the attention of the group engagement team, including exceptions noted in the written representations that the component auditor requested from component management; and

The component auditor's overall findings, conclusions or opinion.

The group engagement team shall evaluate the component auditor's communication. The group engagement team shall:

- Discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate; and
- Determine whether it is necessary to review other relevant parts of the component auditor's audit documentation.

Sufficiency and Appropriateness of Audit Evidence

The auditor is required to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. The group engagement team shall evaluate whether sufficient appropriate audit evidence has been obtained from: the audit procedures performed on the consolidation process; the work performed by the group engagement team and the component auditors on the financial information of the components, on which to base the group audit opinion.

The group engagement partner shall evaluate the effect on the group audit opinion of any uncorrected misstatements (either identified by the group engagement team or communicated by component auditors) and any instances where there has been an inability to obtain sufficient appropriate audit evidence.

Communication with Group Management

The group engagement team shall determine which identified deficiencies in internal control to communicate to those charged with governance and group management. If fraud has been identified by the group engagement team or brought to its attention by a component auditor or information indicates that a fraud may exist, the group engagement team shall communicate this on a timely basis to the appropriate level of group management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities.

A component auditor may be required by statute, regulation or for another reason, to express an audit opinion on the financial statements of a component. In this case, the group engagement team shall request group management to inform component management of any matter of which the group engagement team becomes aware that may be significant to the financial statements of the component, but of which component management may be unaware. If group management refuses to communicate the matter to component management, the group engagement team shall discuss the matter with those charged with governance of the group. If the matter remains unresolved, the group engagement team, subject to legal and professional confidentiality considerations, shall consider whether to advise the component auditor not to issue the auditor's report on the financial statements of the component until the matter is resolved.

Communication with Those Charged with Governance of the Group

The group engagement team shall communicate the following matters with those charged with governance of the group:

- An overview of the type of work to be performed on the financial information of the components.
- An overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on the financial information of significant components.
- Instances where the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work.
- Any limitations on the group audit, for example, where the group engagement team's access to information may have been restricted.
- Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or others where the fraud resulted in a material misstatement of the group financial statements.

Documentation

The group engagement team shall include in the audit documentation the following matters:

- An analysis of components, indicating those that are significant, and the type of work performed on the financial information of the components.
- The nature, timing and extent of the group engagement team's involvement in the work performed by the component auditors on significant components including, where applicable, the group engagement team's review of relevant parts of the component auditor's audit documentation and conclusions thereon.
- Written communications between the group engagement team and the component auditors about the group engagement team's requirements.

Internal Auditors

In some jurisdictions, the external auditor may be prohibited, or restricted to some extent, by law or regulation from using the work of the internal audit function or using internal auditors to provide direct assistance. ISAs do not override laws or regulations that govern an audit of financial statements.[37]

Many entities establish internal audit functions as part of their internal control and governance structures. The objectives and scope of an internal audit function, the nature of its responsibilities and its organizational status, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. Depending on whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competency of the internal audit function, and whether the function applies a systematic and disciplined approach, the external auditor may also be able to use the work of the internal audit function in a constructive and complementary manner.

The External Auditor's Responsibility for the Audit

The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement.

Evaluating the Internal Audit Function

The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:

- The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors;
- The level of competence of the internal audit function; and
- Whether the internal audit function applies a systematic and disciplined approach, including quality control.

The external auditor shall not use the work of the internal audit function if the external auditor determines that:

- The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
- The function lacks sufficient competence;

or

- The function does not apply a systematic and disciplined approach, including quality control.

[37] This generally confirms the nature of the standard. Even if introduced in the legal form, the standards will be treated as the servant requirements in contrast to the other direct legislation. The only penalty is the lack of the reference for standard conformity.

As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan.

The external auditor shall make all significant judgments[38] in the audit engagement and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly.

- The more judgment is involved in:
    - i) Planning and performing relevant audit procedures; and
    - ii) Evaluating the audit evidence gathered;
- The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant;
- The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and
- The lower the level of competence of the internal audit function.

The external auditor shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

The external auditor shall, in communicating with those charged with governance, inform how he has planned to use the work of the internal audit function.

Using the Work of the Internal Audit Function

If the external auditor plans to use the work of the internal audit function, the external auditor shall discuss the planned use of its work with the function as a basis for coordinating their respective activities.[39] The external auditor shall read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.

The external auditor shall perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit, including evaluating whether:

- The work of the function had been properly planned, performed, supervised, reviewed and documented;
- Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and

[38] The calculation of planning materiality can definitely not be outsourced to the internal audit, as this constitute the critical parameter of the audit process.

[39] As the internal auditor is not subordinated to the external auditor, the usage of the function and recourses must be agreed, the enmity reserve the right to disapprove the planned involvement, thus as the matter of custom such a possibility should be included in the engagement letter (contract).

- Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed.

The nature and extent of the external auditor's audit procedures shall be responsive to the external auditor's evaluation of:

- judgment involved;
- risk of material misstatement;
- the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors;
- the level of competence of the function;

Determining Whether Internal Auditors Can Be Used to Provide Direct Assistance for Purposes of the Audit

The external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors.

If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. The external auditor's evaluation of the existence and significance of threats to the internal auditor's objectivity shall include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity.

The external auditor shall not use an internal auditor to provide direct assistance if:

- There are significant threats to the objectivity of the internal auditor;

or

- The internal auditor lacks sufficient competence to perform the proposed work.

Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance

In determining the nature and extent of work that may be assigned to internal auditors and the nature, timing and extent of direction, supervision and review that is appropriate in the circumstances, the external auditor shall consider:

a) The amount of judgment involved in:
    i) Planning and performing relevant audit procedures;
    ii) Evaluating the audit evidence gathered;
b) The assessed risk of material misstatement;
c) The external auditor's evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors who will be providing such assistance.

The external auditor shall not use internal auditors to provide direct assistance to perform procedures that:

- Involve making significant judgments in the audit;

- Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited;
- Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
- Relate to decisions the external auditor makes in accordance with this ISA regarding the internal audit function and the use of its work or direct assistance.

Having appropriately evaluated whether and, if so, to what extent internal auditors can be used to provide direct assistance on the audit, the external auditor shall, in communicating with those charged with governance an overview of the planned scope and timing of the audit, communicate the nature and extent of the planned use of internal auditors to provide direct assistance so as to reach a mutual understanding that such use is not excessive in the circumstances of the engagement.

The external auditor shall evaluate whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed.

Using Internal Auditors to Provide Direct Assistance

Prior to using internal auditors to provide direct assistance for the purposes of the audit, the external auditor shall:

- Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and
- Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement. In so doing:

- The nature, timing and extent of direction, supervision and review shall recognize that the internal auditors are not independent of the entity;
- The review procedures shall include the external auditor checking back to the underlying audit evidence for some of the work performed by the internal auditors.

The direction, supervision and review by the external auditor of the work performed by the internal auditors shall be sufficient in order for the external auditor to be satisfied that the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

Documentation

If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:

- An evaluation of:
    i) Whether the function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors;
    ii) The level of competence of the function; and
    iii) Whether the function applies a systematic and disciplined approach, including quality control;
- The nature and extent of the work used and the basis for that decision; and
- The audit procedures performed by the external auditor to evaluate the adequacy of the work used.

If the external auditor uses internal auditors to provide direct assistance on the audit, the external auditor shall include in the audit documentation:

- The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance;
- The basis for the decision regarding the nature and extent of the work performed by the internal auditors;
- Who reviewed the work performed and the date and extent of that review
- The written agreements obtained from an authorized representative of the entity and the internal auditors
- The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

Experts

The Auditor's Responsibility for the Audit Opinion

The auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert.

Determining the Need for an Auditor's Expert

If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert.[40]

[40] Actually, there is difference between the expert used by the management, and the expert applied by the auditor. For example, the management might decide to use an actuarial service for the jubilee provision evaluation, while the auditor might decide to rely on it, or to use his own actuary to evaluate the provision as the audit evidence. The difference lies with the materiality and auditor's judgment.

Nature, Timing and Extent of Audit Procedures

In determining the nature, timing and extent of those procedures, the auditor shall consider matters including:

- The nature of the matter to which that expert's work relates;
- The risks of material misstatement in the matter to which that expert's work relates;
- The significance of that expert's work in the context of the audit;
- The auditor's knowledge of and experience with previous work performed by that expert; and
- Whether that expert is subject to the auditor's firm's quality control policies and procedures.

The Competence, Capabilities and Objectivity of the Auditor's Expert

The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes. The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to:

- Determine the nature, scope and objectives of that expert's work for the auditor's purposes; and
- Evaluate the adequacy of that work for the auditor's purposes.

Agreement with the Auditor's Expert

The auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert:

- The nature, scope and objectives of that expert's work;
- The respective roles and responsibilities of the auditor and that expert;
- The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and
- The need for the auditor's expert to observe confidentiality requirements.

Evaluating the Adequacy of the Auditor's Expert's Work

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

- The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence;
- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and
- If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.
- If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

a) Agree with that expert on the nature and extent of further work to be performed by that expert;

or

b) Perform additional audit procedures appropriate to the circumstances.[41]

Reference to the Auditor's Expert in the Auditor's Report

The auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the auditor's opinion. If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion.

Revision

Summary

The auditor in charge of the engagement might use the work of another auditor, e.g. for the performance of audit procedures on the consolidation package. He might decide to rely on the work of internal auditors and might ask a non-accounting professional for their expertise. All of these actions do not limit the auditor's ultimate liability to the users of financial statements for the opinion issued therein. Thus, the standards require the auditor in charge to undertake specific procedures to ensure that the work carried out by external or internal experts meets the required professional quality standard.

Key words

Component Management, Component Materiality, Group, Group Audit, Group Audit Opinion, Group Engagement Partner, Group Engagement Team, Group Financial Statements, Group-Wide Controls, Significant Component, Auditor's Expert, Expertise, Management's Expert.

[41] And only after the auditor might reject the expert work as the relevant audit evidence.

Y/N Questions

No	Issue	Y/N
1	The group engagement team shall determine materiality for the group financial statements as a whole.	Y/N
2	For a component that is significant to the group the team shall perform an audit of the financial information of the component using group materiality.	Y/N
3	If the group financial statements include the financial statements of a component with a financial reporting period-end that differs from that of the group, period adjustments should be always booked.	Y/N
4	The external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors.	Y/N
5	If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation the nature and extent of the work used and the basis for that decision.	Y/N
6	The auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion.	Y/N
7	The external auditor might use internal auditors to provide direct assistance to perform procedures that involve making significant judgments in the audit.	Y/N
8	For group audit the contingences procedures are to be skipped.	Y/N
9	The group engagement team shall include in the audit written communications between the group engagement team and the component auditors about the group engagement team's requirements.	Y/N
10	The auditor shall evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes.	Y/N

Issues to consider

1. Recall definitions of the keywords.
2. Describe the impact of the standards involved on the context of the chapter.
3. Suppose that you are the group auditor and your component auditor qualified account, would you qualify the group audit opinion?
4. The auditor engaged an expert for the actuarial provision recalculation; the expert performed his analysis assuming a 23% rate of return. What the auditor should do if he believes a rate of 12% is appropriate?
5. The internal auditor performed a year-end full scope audit of financial statements, can the external auditor rely on this job?

Case study Gigant Development

You are carrying out the audit of Gigant Development, a quoted company. The company's business is predominantly the construction of roads and highways. During the year ended 31 December 20X9 the company received a substantial claim for damages from GDDiA, the highway network administration, for faults in a bridge that it had constructed. This claim includes the cost of repairs and damages, as the customer claims that the bridge cannot be put into operation because of the faults and another company was hired for the damage recovery. Gigant Development got advice on the likely outcome of this claim from an external solicitor. In the year-end financial statements the fixed assets and land had been revalued by an independent professional and the work in progress has been valued by an employee of the company who is a qualified constructor.

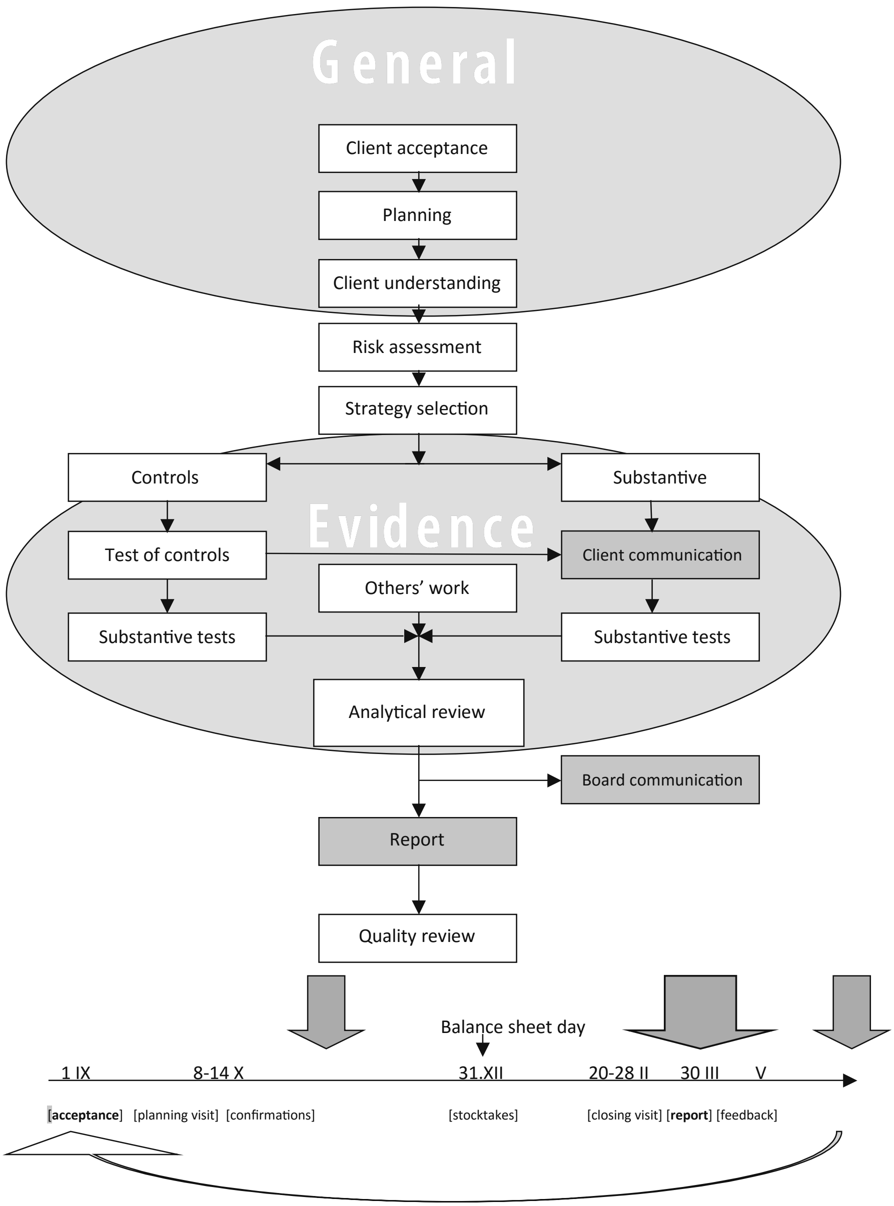
You are required to:

Describe the matters you would consider and the other evidence you would obtain to enable you to assess the reliability of the work of experts in the following cases:

(a) Legal advice obtained from the local solicitor on the outcome of the claim by GDDiA.
(b) Valuation of the properties by the independent professionals.
(c) Valuation of the work in progress by the internal engineer.

Chapter 8

Reporting



Learning goal

The aim of this chapter is to present the process of audit report and opinion formulation.

Standards involved

ISA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
ISA 450 Evaluation of Misstatements Identified during the Audit
ISA 520 Analytical Procedures
ISA 580 Written Representations
ISA 700 Forming an Opinion and Reporting on Financial Statements
ISA 705 Modifications to the Opinion in the Independent Auditor's Report
ISA 706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
ISA 710 Comparative Information—Corresponding Figures and Comparative Financial Statements
ISA 720 The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements

Link to previous chapters

These standards in the 700 group of reporting standards constitute the final touch of the audit process, where the auditor formulates his opinion (report) based on the evidence gathered. The formulation process involved evaluation of misstatements. IAS.450 is presented in this chapter to show the logical track for the formulation of the audit opinion while analytical procedures on the financial statements as a whole were discussed in Chapter 2. The written representation, which is a part of the evidence, is addressed in this section in order to show the basic sequence of the process. As a matter of practice the auditor receives different levels of management statements, oral explanation and assurances, which are gathered prior to the conclusion of the audit into a single paper called Management Representation. This requires written confirmation from the management and those in charge of the business operation and only thereafter can the opinion be issued.

Overview

Management representation

Management representation is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. The "management" is management and, where appropriate, those charged with governance.

The auditor should obtain representations that management acknowledges its collective responsibility for the fair presentation of the financial statements in accordance with the applicable financial reporting framework, and has approved the financial statements.

In case the management does not approve the financial statements and the auditor issues a clean opinion there is miscommunication to the financial statements' users.

If the auditor does not confirm the financial framework with the management then the financial statements may be misleading as different accounting standards apply different solutions to similar matters.

The ISA requires the auditor to obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist. In consequence oral representation does not constitute sufficient evidence. The management representation cannot be substituted with other audit evidence.

Best practice indicates that the obligation to sign off the management representation should be included in the engagement letter (contract for audit service) to avoid unnecessary discussion.

Example

John is about to conclude the audit engagement, prepare for him the draft of the representation letter.

Solution

The below is the example of the management letter included in the standard.

(Entity Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 20XX[42] [43] for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or *give a true and fair view)* in accordance with International Financial Reporting Standards.

We confirm that (to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with International Financial Reporting Standards; in particular the financial statements are fairly presented (or *give a true and fair view*) in accordance therewith.

[42] ISA 570, *Going Concern.*

[43] Where the auditor reports on more than one period, the auditor adjusts the date so that the letter pertains to all periods covered by the auditor's report.

- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. (ISA 540)
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of International Financial Reporting Standards. (ISA 550)
- All events subsequent to the date of the financial statements and for which International Financial Reporting Standards require adjustment or disclosure have been adjusted or disclosed. (ISA 560)
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (ISA 450)
- [Any other matters that the auditor may consider appropriate].

Information Provided

- We have provided you with:
  - » Access to all information of which we are aware that is relevant to the preparation of the financial statements, such as records, documentation and other matters;
  - » Additional information that you have requested from us for the purpose of the audit; and
  - » Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (ISA 240)
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
  - » Management;
  - » Employees who have significant roles in internal control; or
  - » Others where the fraud could have a material effect on the financial statements. (ISA 240)
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (ISA 240)
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (ISA 250)
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (ISA 550)
- [Any other matters that the auditor may consider necessary].

Management Management

In case the entire board is not willing to sign off the representation letter the auditor should follow up the reasons and consider modification of the audit report.

Communication to those charged with governance

The auditor has the responsibility to appropriately communicate significant deficiencies to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements.

Deficiency in internal control exists when:

i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis;

or

ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

Significant deficiency in internal control is a deficiency or combination of deficiencies in internal control that[44] is of sufficient importance to merit the attention of those charged with governance.

The auditor carries out two-fold reporting:

a) The post-interim reporting to the management usually includes the findings relating to the design and weaknesses in the internal system of control.
b) After realease the audtor report - the combined management letter that indicates not material errors and weaknesses observed during the audit.

Both parts of the communication do not have a prescribed format in the standard; as the matter of custom the weaknesses of each are presented on a separate page with the following headings:

- Observation
- Risk
- Recommendation
- Management response (if addressed to those not charged with governance)

Misstatement evaluation

Misstatement is the difference between the amount, classification, presentation or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

[44] In the auditor's professional judgment.

When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

The uncorrected misstatements are misstatements that the auditor has accumulated during the audit and that have not been corrected.

Before concluding the audit the auditor should perform a quality review of the engagement, undertake an analytical review of the financial statements as a whole and consider the schedule of the audit uncorrected misstatements (differences).

Example

Mike is the independent partner of the engagement. He was presented with the following information:

The planning materiality 100k, TE 75k, SAD limit 10k.

The list of the unadjusted audit differences is as follows, as per the audit team.

All in '000

	B/S		P&L		
	Dr	Cr	Dr	Cr	
Net equity as per client					700
Stock	50				
Cost of sale		50			
Revenue			60		
Debtors				60	
					(10)
Cut off error on sales					
Retained earning	50				
Provision for jubilee		50			
					(50)
C/F part of the not set up provisions for employee jubilee payments					
Other operating costs			30		
Provisions		30			
					(30)
Long-term contracts not booked provision for guaranties					
Receivables	60				
Other financial incomes				60	
					60
Wrongly stated receivables					

What would be Mike's likely analyses to judge upon opinion to be issued?

Solution

The total value of unadjusted differences amounts to (30k). The TE is 75k, thus Mike would not expect a modified opinion, and communication with the management letter on findings during the audit.

Opinion

The audit opinion (report) is issued on the financial statements prepared in accordance with the accounting standards. There could be different accounting standards and regulation. The auditing standards named specific standards under the heading "General purpose financial statements" which means that the financial statements are prepared in accordance with a general purpose framework. General purpose framework means a financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework. In contrast the special purposes framework is specifically oriented toward a set of given criteria.

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework;

or

ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.[45]

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.

Unmodified opinion[46] is the opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Reference to "financial statements" in this ISA means "a complete set of general purpose financial statements, including the related notes." The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The requirements of the applicable financial reporting framework determine the form and content of the financial statements, and what constitutes a complete set of financial statements. Reference to "International Financial Reporting

45 This is rather the "substance over form" requirements, so the financial statements are to pass the fair information even if the legal requirements might differ.

46 Informally called a clean opinion.

Standards"[47] in this ISA means the International Financial Reporting Standards issued by the International Accounting Standards Board, and reference to "International Public Sector Accounting Standards" means the International Public Sector Accounting Standards issued by the International Public Sector Accounting Standards Board.

The format of the audit opinion is standardized.

Example

Mark is drafting the audit opinion, and aims to issue unqualified opinion. Help Mark to draft the opinion.

Solution

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards,[3] and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

Or other term that is appropriate in the context of the legal framework in the particular jurisdiction

[47] From a practical point of view this is a different standard than IFRS as adopted by the European Union.

Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards, and for such ..."

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation[4] of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[5] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

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

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address

This specimen of the audit report is split into the following parts:

1) *Title* - identifies the type of reporting
2) *Addressee* - identify to whom the auditor is liable
3) *Report on the Financial Statements* - indicate which financial statements were audited
4) *Management's Responsibility for the Financial Statements* - limit the expectation gap
5) *Auditor's Responsibility* - outlines the auditor's scope of responsibilities
6) *Opinion* - states the opinion
7) *Report on Other Legal and Regulatory Requirements* - other legal matters to be reported
8) *Auditor signature* - shows the legal commitment
9) *Date of issue* - time stamp for liabilities discussion

Sections (4) and (5) are standardized and are unlikely to be modified.

An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the identified financial reporting framework.

Modification

Types of Modified Opinions

This ISA establishes three types of modified opinions, namely:

- a qualified opinion,
- an adverse opinion,
- a disclaimer of opinion.

Thus, modified opinion means a qualified opinion, an adverse opinion or a disclaimer of opinion.

The decision regarding which type of modified opinion is appropriate depends upon:

a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated;

and

b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

The table below summarises types of the audit reports:

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but Not Pervasive	Material and Pervasive
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

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

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

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

or

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

Typically the modification has its own wording in the opinion paragraph.

- If qualified the reason is given before the opinion paragraph and in the opinion there is a phrase "*except for*"
- For an adverse opinion the wording is: "*the financial statements do not*[48]*give a true and fair view of*".
- For disclaimer to opinion: "*Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements*"

An example of the qualification is given below:

[...]

Basis for Qualified Opinion

ABC Company's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at xxx on the statement of financial position as at December 31, 20X1, and ABC's share of XYZ's net income of xxx is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at December 31, 20X1 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material

[...]

The inability to obtain sufficient appropriate evidence is called the limitation on scope. It may occur when the entity:

- does not allow the auditor to perform an audit procedure that he believes is necessary;
- records are inadequate and the auditor is unable to satisfy himself as to their accuracy by other means.

or

The auditor is unable to perform procedures due to circumstances, e.g. when the auditor is appointed too late to attend the inventory count.

Extract of the specimen of the disclaimer opinion.

[....]

Auditor's Responsibility

[48] Note that the difference between unqualified and negative opinion stay in three letters "not".

Our responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with International Standards on Auditing. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

The company's investment in its joint venture XYZ (Country X) Company is carried at xxx on the company's statement of financial position, which represents over 90% of the company's net assets as at December 31, 20X1. We were not allowed access to the management and the auditors of XYZ, including XYZ's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the company's proportional share of XYZ's assets that it controls jointly, its proportional share of XYZ's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, and the elements making up the statement of changes in equity and cash flow statement.

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Emphasis

Emphasis of Matter paragraph is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Whilst

Other Matter paragraph is a paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

An auditor's report may be enhanced by adding an emphasis of matter paragraph or other matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements which more extensively discusses the matter or to respond to the juristic requirements.

This highlights the matters which the user of the financial statements should take into account when making a judgement on them. It is usually used for

- a material matter regarding a going concern problem
- showing other uncertainties which may affect the financial statements

The additional paragraph should be added after the opinion paragraph. This paragraph will start by stating, "Without qualifying our opinion…". It will then go on to describe the issue and make a reference to the note in the financial statements which explains the issue further. The emphasis of matter does not change the auditor's opinion (either unqualified or qualified). It is used to highlight something significant that may or may not affect the entity in the future. In practice, however, there are instances where the emphasis of matter is used as the hidden qualification.

An example of the emphasis of matter combined with the qualification is shown below:

[...]

Basis for Qualified Opinion

The company's short-term marketable securities are carried in the statement of financial position at xxx. Management has not marked these securities to market but has instead stated them at cost, which constitutes a departure from International Financial Reporting Standards. The company's records indicate that had management marked the marketable securities to market, the company would have recognized an unrealized loss of xxx in the statement of comprehensive income for the year. The carrying amount of the securities in the statement of financial position would have been reduced by the same amount at December 31, 20X1, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects (or give a true and fair view of) the financial position of ABC Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Emphasis of Matter

We draw attention to Note X to the financial statements which describes the uncertainty related to the outcome of the lawsuit filed against the company by XYZ Company. Our opinion is not qualified in respect of this matter.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

Comparatives

The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two broadly different approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

The essential audit reporting differences between the approaches are:

- For corresponding figures, the auditor's opinion on the financial statements refers to the current period only;

Whereas:

- For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

Thus:

Comparative information is the amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

And:

Corresponding figures are comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures"). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

While:

Comparative financial statements provide comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

The auditor should obtain reasonable assurance on comparatives. To achieve this goal might inquire with a former auditor on professional matters relevant to the current year's audit procedures.[49] In the absence of such a possibility, the auditor should gather sufficient evidence to satisfy himself on the fairness.

[49] An ethical issue remains if the proceeding auditor is entitled to charge the fees to the clients or new auditor for the opening balances review. In practice both free exempted and charged services are used.

Other

Standards deal with the auditor's responsibilities relating to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion does not cover other information and the auditor has no specific responsibility for determining whether or not other information is properly stated. However, the auditor reads the other information because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. The "documents containing audited financial statements" refers to annual reports (or similar documents) that are issued to owners (or similar stakeholders), containing audited financial statements and the auditor's report thereon. This should be applied to other documents containing audited financial statements, such as those used in securities offerings and supervision filing.

Other information means financial and non-financial information (other than the financial statements and the auditor's report thereon) which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor's report thereon.

Inconsistency is when other information that contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence.

Example

ABC Company reports continuous net losses of €200m in the current year and €160m in the previous year.

In the directors' report a statement such as the following would be included:

"Our company performed very well, as the cash balance raised from €74m to €190m."

What should the auditor's action be?

Solution

Alert the management to change the wording of the directors' report as it give a contradictory explanation of the current financial situation.

However, misstatement of fact is other information that is unrelated to matters appearing in the audited financial statements that are incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing the audited financial statements.

Depending on the legal system the auditor might be bound to report on other legal matters in the audit report; these could be, for example:

a) Confirmation, or not, that the company has published it financial statements.
b) That the management discussion on the annual report made proper and meaningful reference to the financial statements.

An example paragraph is given below:

Report on Other Legal and Regulatory Requirements

Company XYZ did not publish its financial statements for the years ended 2012, 2013, 2014 in the Journal of Financial Statements Publication in accordance with the par. XYZ of Act...

Requirements

Management representations

Written Representations as Audit Evidence

Audit evidence is the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfilment of management's responsibilities, or about specific assertions.

Management from whom Written Representations Requested

The auditor shall request written representations:

- from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.
- to provide a written representation that management has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as set out in the terms of the audit engagement.
- that it has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement.
- that all transactions have been recorded and are reflected in the financial statements.

Description of Management's Responsibilities in the Written Representations

Management's responsibilities shall be described in the written representations in the manner in which these responsibilities are described in the terms of the audit engagement.[50]

Other Written Representations

Other ISAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements

[50] This is to limit the management and auditor expectation gap of the service provided.

or one or more specific assertions in the financial statements, the auditor shall request[51] such other written representations.

Date of and Period(s) Covered by Written Representations

The date of the written representations shall be as near as practicable to, <u>but not after</u>, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Form of Written Representations

The written representations shall be in the form of a representation letter addressed to the auditor.

Doubt as to the Reliability of Written Representations

If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general. In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

Requested Written Representations Not Provided

If management does not provide one or more of the requested written representations, the auditor shall:

a) Discuss the matter with management;
b) Revaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
c) Take appropriate actions, including determining the possible effect on the opinion.

Written Representations about Management's Responsibilities

The auditor shall disclaim an opinion on the financial statements if:

- The auditor concludes that there is sufficient doubt about the integrity of management

or

- Management does not provide the written representations

[51] In consequence the points of the representation letter are gathered though the audit continuously, thus the representation letter date is as close as possible to the date of the auditor report (opinion) so as to limit the period not represented.

Deficiency reporting

The auditor has the responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. The auditor is required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances,[52] but not for the purpose of expressing an opinion on the effectiveness of internal control. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit.

The auditor shall determine whether he has identified one or more deficiencies in internal control. If the auditor has identified one or more deficiencies in internal control, he shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. The auditor shall communicate in writing[53] significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.

The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis:

- In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances;

and

- Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

The auditor shall include in the written communication of significant deficiencies in internal control:

a) A description of the deficiencies and an explanation of their potential effects;

and

b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that:
    i) The purpose of the audit was for the auditor to express an opinion on the financial statements;

52 This is because for the entire set of available controls, the auditor picks up those with substantial coverage of the misstatement risk and the selection is subjective, therefore there is no representation of the entire population of controls to safeguard the organization's needs. As a consequence of the above there should be no positive or negative assurance given for the internal system of control as a whole.

53 The written form is an obligation as per the standards, thus oral communication with subsequent protocol of meeting does not satisfy the requirements of the ISA.

ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Misstatements evaluation

The auditor shall accumulate misstatements identified during the audit,[54] other than those that are clearly trivial.

Consideration of Identified Misstatements as the Audit Progresses

The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:

- The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material;

or

- The aggregate of misstatements accumulated during the audit approaches materiality

If management has examined a class of transactions, account balances or disclosures and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain.[55]

Communication and Correction of Misstatements

The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

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54 From a practical point of view the auditor might start the audit procedures on a non-closed trial balance. However, if a new revision is then accepted there is a need for the reconciliation of the working one to the revised one. In consequence the accumulated misstatements must be reconciled back to the revised trial balance.

55 Typically, reconciliation of the unadjusted and adjusted trial balance is done. In extreme cases such a reconciliation can be a long-standing spreadsheet document. Irrespective of the number of attempts the audit documentation (fieldwork) should be tied up with the final financial statements and trial balance.

Evaluating the Effect of Uncorrected Misstatements

Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality to confirm whether it remains appropriate in the context of the entity's actual financial results. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

- The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and
- The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Communication with Those Charged with Governance

The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Written Representations

The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

Documentation

The auditor shall include in the audit documentation:

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

Opinion

Forming an Opinion on the Financial Statements

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

- whether sufficient appropriate audit evidence has been obtained;
- whether uncorrected misstatements are material, individually or in aggregate;

The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

- The financial statements adequately disclose the significant accounting policies selected and applied;
- The accounting policies selected and applied are consistent and appropriate;
- The accounting estimates made by management are reasonable;
- The information presented in the financial statements is relevant, reliable, comparable and understandable;
- The financial statements provide adequate disclosures;
- The terminology used in the financial statements, including the title of each financial statement, is appropriate;
- When the financial statements are prepared in accordance with a fair presentation framework. The auditor's evaluation as to whether the financial statements achieve fair presentation shall include consideration of:
    i) The overall presentation, structure and content of the financial statements;
    ii) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

Form of Opinion

The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

If the auditor:

i) concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement;

or

ii) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,

the auditor shall modify the opinion in the auditor's report.

If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion. When the financial statements are prepared in accordance with a compliance framework, the auditor is not required to evaluate whether the financial statements achieve fair presentation. However, if in extremely rare circumstances the auditor concludes that such financial statements are misleading, the auditor shall discuss the matter with management and, depending on how it is resolved, shall determine whether, and how, to communicate it in the auditor's report.

Auditor's Report

The auditor's report shall be in writing.

Auditor's Report for Audits Conducted in Accordance with International Standards on Auditing shall have:

- **Title** - The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.
- **Addressee** -The auditor's report shall be addressed as required by the circumstances of the engagement.
- **Introductory Paragraph** - The introductory paragraph in the auditor's report shall:
  a) Identify the entity whose financial statements have been audited;
  b) State that the financial statements have been audited;
  c) Identify the title of each statement that comprises the financial statements;
  d) Refer to the summary of significant accounting policies and other explanatory information; and
  e) Specify the date or period covered by each financial statement comprising the financial statements.
- **Management's Responsibility for the Financial Statements** - This section of the auditor's report describes the responsibilities of those in the organization that are responsible for the preparation of the financial statements. The auditor's report need not refer specifically to "management," but shall use the term that is appropriate in the context of the legal framework in the particular jurisdiction. In some jurisdictions, the appropriate reference may be to those charged with governance. The auditor's report shall include a section with the heading "Management's [or other appropriate term] Responsibility for the Financial Statements." The auditor's report shall describe management's responsibility for the preparation of the financial statements. The description shall include an explanation that management is responsible for the preparation of the financial statements in accordance with the applicable financial reporting

framework, and for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. Where the financial statements are prepared in accordance with a fair presentation framework, the explanation of management's responsibility for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view," as appropriate in the circumstances.

- **Auditor's Responsibility**- The auditor's report shall include a section with the heading "Auditor's Responsibility." The auditor's report shall state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit. The auditor's report shall state that the audit was conducted in accordance with International Standards on Auditing. The auditor's report shall also explain that those standards require that the auditor comply with ethical requirements and that the auditor planned and performed the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. The auditor's report shall describe an audit by stating that:
  a) An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements;
  b) The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of internal control; and
  c) An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness of accounting estimates made by management, as well as the overall presentation of the financial statements.

Where the financial statements are prepared in accordance with a fair presentation framework, the description of the audit in the auditor's report shall refer to "the entity's preparation and fair presentation of the financial statements" or "the entity's preparation of financial statements that give a true and fair view," as appropriate in the circumstances. The auditor's report shall state whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

- **Auditor's Opinion** - The auditor's report shall include a section with the heading "Opinion." When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

a) The financial statements present fairly, in all material respects, ... in accordance with [the applicable financial reporting framework];

or

b) The financial statements give a true and fair view of ... in accordance with [the applicable financial reporting framework].

When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

If the reference to the applicable financial reporting framework in the auditor's opinion is not to International Financial Reporting Standards issued by the International Accounting Standards Board or International Public Sector Accounting Standards issued by the International Public Sector Accounting Standards Board, the auditor's opinion shall identify the jurisdiction of origin of the framework.

- **Other Reporting Responsibilities** - If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibility under the ISAs to report on the financial statements, these other reporting responsibilities shall be addressed in a separate section in the auditor's report that shall be subtitled "Report on Other Legal and Regulatory Requirements," or otherwise as appropriate to the content of the section. If the auditor's report contains a separate section on other reporting responsibilities, the headings, statements and explanations shall be under the subtitle "Report on the Financial Statements." The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Financial Statements."
- **Signature of the Auditor**[56]
- **The auditor's report shall be signed.**[57]
- **Date of the Auditor's Report** - The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that:
  a) All the statements that comprise the financial statements, including the related notes, have been prepared; and
  b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

[56] As the matter of custom the auditor report in line with ISA and IFRS might be signed off with the name of the auditing company, in contrary for the local standards, the way of expression must be reconciled to appropriate legal provision.

[57] The standards does not prevent from making the signature with the name of the auditor company. However, the sign off must be in hand by a physical person.

- **Auditor's Address** - The auditor's report shall name the location in the jurisdiction where the auditor practices.

Auditor's Report Prescribed by Law or Regulation

If the auditor is required by law or regulation of a specific jurisdiction to use a specific layout or wording of the auditor's report, the auditor's report shall refer to International Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements:

a) A title;
b) An addressee, as required by the circumstances of the engagement;
c) An introductory paragraph that identifies the financial statements audited;
d) A description of the responsibility of management for the preparation of the financial statements;
e) A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:
   - A reference to International Standards on Auditing and the law or regulation; and
   - A description of an audit in accordance with those standards;
f) An opinion paragraph containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements
g) The auditor's signature;
h) The date of the auditor's report; and
i) The auditor's address.

Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards of a Specific Jurisdiction and International Standards on Auditing

An auditor may be required to conduct an audit in accordance with the auditing standards of a specific jurisdiction (the "national auditing standards"), but may additionally have complied with the ISAs in the conduct of the audit. If this is the case, the auditor's report may refer to International Standards on Auditing in addition to the national auditing standards, but the auditor shall do so only if:

a) There is no conflict between the requirements in the national auditing standards and those in ISAs that would lead the auditor: (i) to form a different opinion, or (ii) not to include an Emphasis of Matter paragraph that, in the particular circumstances, is required by ISAs; and
b) The auditor's report includes, at a minimum the above, the auditor uses the layout or wording specified by the national auditing standards. Reference to law or regulation shall be read as reference to the national auditing standards. The auditor's report shall thereby identify such national auditing standards.

When the auditor's report refers to both the national auditing standards and International Standards on Auditing, the auditor's report shall identify the jurisdiction of origin of the national auditing standards.

Supplementary Information Presented with the Financial Statements

If supplementary information that is not required by the applicable financial reporting framework is presented with the audited financial statements, the auditor shall evaluate whether such supplementary information is clearly differentiated from the audited financial statements. If such supplementary information is not clearly differentiated from the audited financial statements, the auditor shall ask management to change how the unaudited supplementary information is presented. If management refuses to do so, the auditor shall explain in the auditor's report that such supplementary information has not been audited.

Supplementary information that is not required by the applicable financial reporting framework but is nevertheless an integral part of the financial statements because it cannot be clearly differentiated from the audited financial statements due to its nature and how it is presented shall be covered by the auditor's opinion.

Modification

Circumstances When a Modification to the Auditor's Opinion Is Required

The auditor shall modify the opinion in the auditor's report when:

- The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement;
- The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Qualified Opinion

The auditor shall express a qualified opinion when:

- The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Adverse Opinion

The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Disclaimer of Opinion

The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation. If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

- If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
- If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
    i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or
    ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

If the auditor withdraws as contemplated by paragraph 13(b)(i), before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion

Other Considerations Relating to an Adverse Opinion or Disclaimer of Opinion

When the auditor considers it necessary to express an adverse opinion or disclaim an opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement. To include such an unmodified opinion in the same report in these circumstances would contradict the auditor's adverse opinion or disclaimer of opinion on the financial statements as a whole.

Form and Content of the Auditor's Report When the Opinion Is Modified

Basis for Modification Paragraph

When the auditor modifies the opinion on the financial statements, the auditor shall include a paragraph in the auditor's report that provides a description of the matter giving rise to the modification. The auditor shall place this paragraph immediately before the opinion paragraph in the auditor's report and use the heading "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion,"[58] as appropriate.

If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures), the auditor shall include in the basis for modification paragraph a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in the basis for modification paragraph.

If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the basis for modification paragraph an explanation of how the disclosures are misstated.

If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:

- Discuss the non-disclosure with those charged with governance;
- Describe in the basis for modification paragraph the nature of the omitted information;
- Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the basis for modification paragraph the reasons for that inability. Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the basis for modification paragraph the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof.

Opinion Paragraph

When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion," "Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the opinion paragraph. When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state in the opinion paragraph that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph:

[58] The standard encourages the auditor to name the modification type of the report, however in practice it is not necessary to follow this indication.

a) The financial statements present fairly, in all material respects (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework; or
b) The financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion.

When the auditor expresses an adverse opinion, the auditor shall state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion paragraph:

- The financial statements do not present fairly (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework;

or

- The financial statements have not been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall state in the opinion paragraph that:

a) Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and, accordingly,
b) The auditor does not express an opinion on the financial statements.

Description of Auditor's Responsibility When the Auditor Expresses a Qualified or Adverse Opinion

When the auditor expresses a qualified or adverse opinion, the auditor shall amend the description of the auditor's responsibility to state that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's modified audit opinion.

Description of Auditor's Responsibility When the Auditor Disclaims an Opinion

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the introductory paragraph of the auditor's report to state that the auditor was engaged to audit the financial statements. The auditor shall also amend the description of the auditor's responsibility and the description of the scope of the audit to state only the following: "Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with International Standards on Auditing. Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion."

Communication with Those Charged with Governance

When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification.

Emphasis

Requirements

Emphasis of Matter Paragraphs in the Auditor's Report

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

a) Include it immediately after the Opinion paragraph in the auditor's report;
b) Use the heading "Emphasis of Matter," or other appropriate heading;
c) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements; and
d) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Other Matter Paragraphs in the Auditor's Report

If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report and this is not prohibited by law or regulation, the auditor shall do so in a paragraph in the auditor's report, with the heading "Other Matter," or other appropriate heading. The auditor shall include this paragraph immediately after the Opinion paragraph and any Emphasis of Matter paragraph, or elsewhere in the auditor's report if the content of the Other Matter paragraph is relevant to the Other Reporting Responsibilities section.

Communication with Those Charged with Governance

If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the proposed wording of this paragraph.

Comparatives

Audit Procedures

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

- The comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, have been restated; and
- The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the prior period financial statements are amended, the auditor shall determine that the comparative information agrees with the amended financial statements.

The auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information.

Audit Reporting

Corresponding Figures

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except:

If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

- Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material

or

- In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, and the corresponding figures have not been properly restated or appropriate disclosures have not been made, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein.

Prior Period Financial Statements Audited by a Predecessor Auditor

If the financial statements of the prior period were audited by a predecessor auditor and the auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an Other Matter paragraph in the auditor's report:

- That the financial statements of the prior period were audited by the predecessor auditor;
- The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore;
- The date of that report.

Prior Period Financial Statements Not Audited

If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

Comparative Financial Statements

When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed. When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph.

Prior Period Financial Statements Audited by a Predecessor Auditor

If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

- that the financial statements of the prior period were audited by a predecessor auditor;
- the type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore;
- the date of that report,

unless the predecessor auditor's report on the prior period's financial statements is reissued with the financial statements.

If the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and, unless all of those charged with governance are involved in managing the entity, those charged with governance shall request that the predecessor auditor be informed. If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period.

Prior Period Financial Statements Not Audited

If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

Other information and extracts

The auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements. The auditor shall make appropriate arrangements with management or those charged with governance to obtain the other information prior to the date of the auditor's report. If it is not possible to obtain all the other information prior to the date of the auditor's report, the auditor shall read such other information as soon as practicable.

Material Inconsistencies

If, on reading the other information, the auditor identifies a material inconsistency, the auditor shall determine whether the audited financial statements or the other information needs to be revised.

Material Inconsistencies Identified in Other Information Obtained Prior to the Date of the Auditor's Report

If revision of the audited financial statements is necessary and management refuses to make the revision, the auditor shall modify the opinion in the auditor's report. If revision of the other information is necessary and management refuses to make the revision, the auditor shall communicate this matter to those charged with governance, unless all of those charged with governance are involved in managing the entity and:

- Include in the auditor's report an Other Matter paragraph describing the material inconsistency Withhold the auditor's report;

or

- Withdraw from the engagement, where withdrawal is possible under applicable law or regulation.

Material Misstatements of Fact

If, on reading the other information for the purpose of identifying material inconsistencies, the auditor becomes aware of an apparent material misstatement of fact, the auditor shall discuss the matter with management. If, following such discussions, the auditor still considers that there is an apparent material misstatement of fact, the auditor shall request management to consult with a qualified third party, such as the entity's legal counsel, and the auditor shall consider the advice received. If the auditor concludes that there is a material misstatement of fact in the other information which management refuses to correct, the auditor shall notify those charged with governance, unless all of those charged with governance are involved in managing the entity, of the auditor's concern regarding the other information and take any further appropriate action.

Revision

Summary

At audit conclusion the auditor should communicate to the client weaknesses of the internal system of controls. The unadjusted differences must be evaluated, but before that the materiality should be reassessed. The audit opinion is the key product of the audit service. The auditor's report includes a paragraph of the auditor's opinion. The reasons for modification of the auditor's opinion can be different, errors, misstatements and limitation on access to evidence. The disagreement and refusal to issue opinion is a relatively rare situation. The auditor might draw the attention of the users of financial statements by including an Emphasis of Matter paragraph (It is not a qualification but it helps understanding the context of financial statements). In some jurisdictions the auditor has to report other matters in front of the audit opinion. Specific procedures need to applied for the comparatives and extracts.

Key words

Written Representation, Deficiency In Internal Control, Significant Deficiency In Internal Control, Auditor's Expert , Expertise, Management's Expert, Persuasive, Modified Opinion, Emphasis Of Matter Paragraph, Other Matter Paragraph, Comparative Information, Corresponding Figures, Comparative Financial Statements, Other Information, Inconsistency, Misstatement Of Fact

Y/N Questions

No	Issue	Y/N
1	The written representations provide sufficient appropriate audit evidence about any of the matters with which they deal.	Y/N
2	The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.	Y/N
3	Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality.	Y/N
4	The auditor shares the responsibility for the audit opinion expressed with other experts.	Y/N
5	When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall use the heading "Emphasis of Matter."	Y/N
6	If material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, and the corresponding figures have not been properly restated, the auditor should express a qualified opinion.	Y/N
7	If the auditor concludes that there is a material misstatement of fact in the other information which management refuses to correct, the auditor shall qualify opinion.	Y/N
8	When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures.	Y/N
9	If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance.	Y/N
10	If the financial statements of the prior period were audited by a predecessor auditor the auditor shall state in an Other Matter paragraph in the auditor's report that the financial statements of the prior period were audited by the predecessor auditor.	Y/N

Issues to consider

1. Recall definitions of the key words.
2. Describe the impact to the standards involved on the context of the chapter.
3. Suppose the auditor issued unqualified opinion and following quality control it turns out that the control test on debtors was wrongly assessed to be effective. What would you do in such a situation as the engagement partner in charge?
4. The proceeding auditor modified his opinion, during the year the company booked the restatements to the accounts, what would be the impact of this situation for current year audit opinion?
5. The auditor issued a clean audit opinion using the template from the past year and omitted to change the date of the opinion. What he should do?

Case study Maciej K.

Maciej K. is an outstanding clerk involved in the protection of clients' rights. In his spare time his hobby is accounting and finance. Maciej has a good friend, and this is YOU. Maciej approaches you with the following issues.

Maciej recently analyzed the financial statements of NIBC, but a friend also gave Maciej the audit opinion. Unfortunately, Maciej got lost. He did not understand what the opinion was for.

Maciej is deliberating the following issue: why is there opinion for some financial statements while for others there is not. Maciej has brought the opinion to you in its original language.

This is the opinion:

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers Accountants N.V.
Fascinatio Boulevard 350
3065 WB Rotterdam
P.O. Box 8800
3009 AV Rotterdam
The Netherlands
Telephone +31 (10) 407 55 00
Facsimile +31 (10) 456 43 33
www.pwc.com/nl

To the General Meeting of Shareholders of
NIBC Bank N.V.

Auditor's report

Report on the financial statements

We have audited the accompanying 2008 financial statements of NIBC Bank N.V. (the 'Company'), The Hague as set out on pages 85 to 268. The financial statements consist of the consolidated financial statements and the company financial statements. The consolidated financial statements comprise the consolidated balance sheet as at 31 December 2008, the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes. The company financial statements comprise the company balance sheet as at 31 December 2008, the company income statement for the year then ended and the notes.

The managing board's responsibility

The managing board of the Company is responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards as adopted by the European Union and with Part 9 of Book 2 of the Netherlands Civil Code, and for the preparation of the Report of the Managing Board in accordance with Part 9 of Book 2 of the Netherlands Civil Code. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

Our responsibility is to express an opinion on the financial statements based on our audit. We conducted our audit in accordance with Dutch law. This law requires that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

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PRICEWATERHOUSECOOPERS

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the managing board, as well as evaluating the overall presentation of the financial statements.

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

Opinion with respect to the consolidated financial statements

In our opinion, the consolidated financial statements give a true and fair view of the financial position of the Company as at 31 December 2008, and of its result and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union and with Part 9 of Book 2 of the Netherlands Civil Code.

Opinion with respect to the company financial statements

In our opinion, the company financial statements give a true and fair view of the financial position of the Company as at 31 December 2008, and of its result for the year then ended in accordance with Part 9 of Book 2 of the Netherlands Civil Code.

Report on other legal and regulatory requirements

Pursuant to the legal requirement under 2:393 sub 5f of the Netherlands Civil Code, we report, to the extent of our competence, that the Report of the Managing Board is consistent with the financial statements as required by 2:391 sub 4 of the Netherlands Civil Code.

Rotterdam, 8 April 2009

PricewaterhouseCoopers Accountants N.V.

Originally signed by J.A.M. Stael RA

You are required to:

(a) Explain the basic need for the audit.

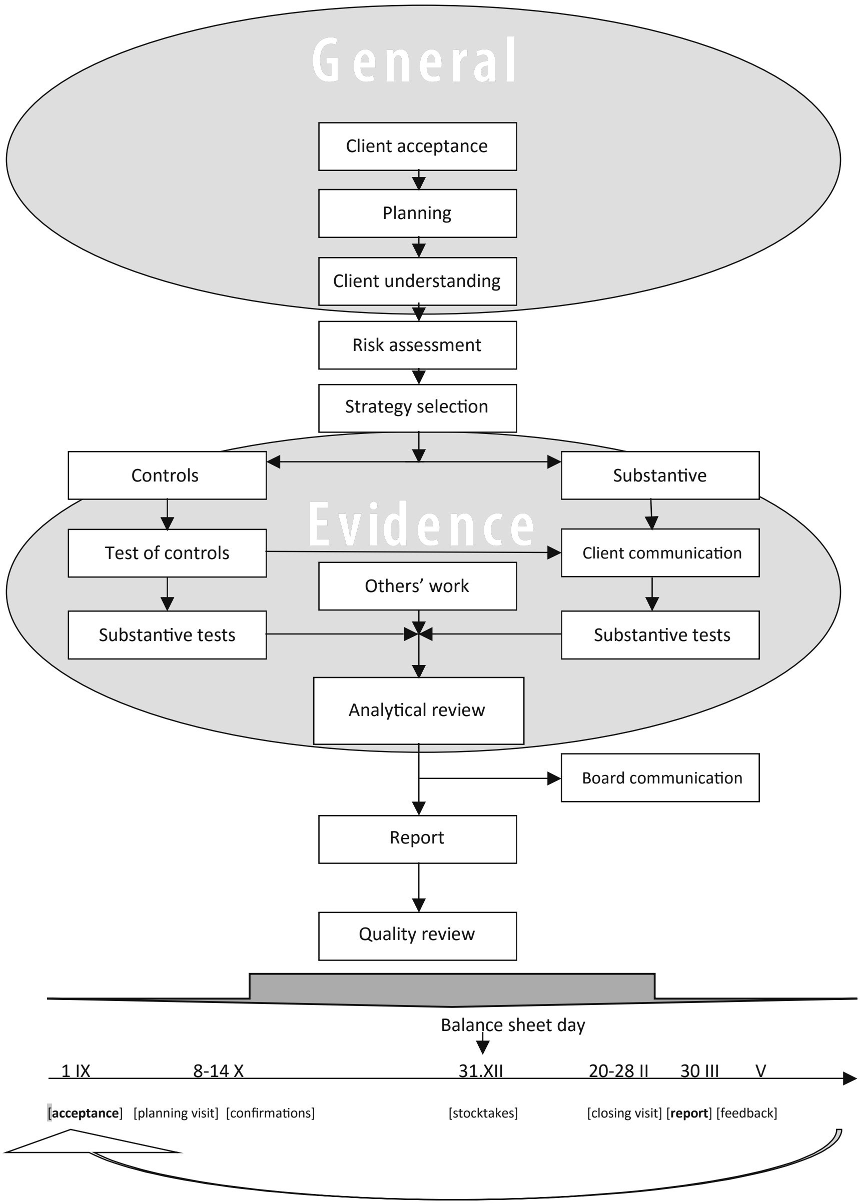
(b) Show Maciej the addressee of the opinion, the producer of the opinion, the name of the auditor and the name of the audit company, which standard was selected to compose the financial statements and what strand was selected to perform the audit.

(c) Asses the type of opinion upon which the statement is issued and based.

(d) Explain what is meant by universal audit requirements.
(e) Write a letter to Maciej explaining what data are shown in the auditor register and audit company's register. Show what kind of data are disclosed for the auditor who signs the opinion and for the audit company. Explain to Maciej where this information can be obtained and what the cost of it is.

Chapter 9

Special issues



Learning goal

To understand the risk and procedures relating to extract and special purposes reporting.

Standards involved

ISA 800 Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
ISA 805 Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
ISA 810 Engagements to Report on Summary Financial Statements

Link to previous chapters

This chapter discusses isolated issues such as producing the abbreviated accounts, e.g. for the annual report, extracts and reports based on the special purposes frameworks (e.g. assets in custody confirmations). All the standards in range 100–700 are applicable, however an extension of this application is outlined with the standards of the 800 group.

Overview

Special Purpose Frameworks

Special purpose financial statements are financial statements prepared in accordance with a special purpose framework. A special purpose framework is a financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework. Reference to "financial statements" means "a complete set of special purpose financial statements, including the related notes." The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The requirements of the applicable financial reporting framework determine the form and content of the financial statements, and what constitutes a complete set of financial statements.

The ISA 800 standard deals with special considerations in the application of those ISAs to an audit of financial statements prepared in accordance with a special purpose framework. It is written in the context of a complete set of financial statements prepared in accordance with a special purpose framework. ISA 805 deals with special considerations relevant to an audit of a single financial statement or of a specific element, account or item of a financial statement. Neither ISA overrides the requirements of the other ISAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement.

The objective of the auditor, when applying ISAs in an audit of financial statements prepared in accordance with a special purpose framework, is to address:

a) The acceptance of the engagement;
b) The planning and performance of that engagement; and
c) Forming an opinion and reporting on the financial statements.

Single financial statement

"Element of a financial statement" or "element" means an "element, account or item of a financial statement." A single financial statement or to a specific element of a financial statement includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.

ISAs 100–700 apply to an audit of financial statements and are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. ISA 805 deals with special considerations in the application of those ISAs to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework.

The objective of the auditor should address the following matters:
a) The acceptance of the engagement;
b) The planning and performance of that engagement; and
c) Forming an opinion and reporting on the single financial statement or on the specific element, account or item of a financial statement.

Summary financial statements

Summary financial statements comprise the historical financial information derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time. Different jurisdictions may use different terminology to describe such historical financial information.

By audited financial statements is meant the financial statements audited by the auditor in accordance with ISAs, and from which the summary financial statements are derived.

ISA 810 deals with the auditor's responsibilities relating to an engagement to report on summary financial statements derived from financial statements audited in accordance with ISAs by that same auditor.

Basically, the auditor should ensure that:
a) It is appropriate to accept the engagement to report on summary financial statements;
b) If engaged to report on summary financial statements, they:
    - Form an opinion on the summary financial statements based on an evaluation of the conclusions drawn from the evidence obtained; and
    - Express clearly that opinion through a written report that also describes the basis for that opinion.

Example

How would you formulate the report on the summary financial statements if:

i) the audited financial statements were qualified

and

ii) the criteria are developed by management are adequately disclosed in Note X.

You believe that the criteria applied[59] are acceptable in the circumstances.

Solution

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

[Appropriate Addressee]

The accompanying summary financial statements, which comprise the summary statement of financial position as at December 31, 20X1, the summary statement of comprehensive income, summary statement of changes in equity and summary statement of cash flows for the year then ended, and related notes, are derived from the audited financial statements of ABC Company for the year ended December 31, 20X1. We expressed a qualified audit opinion on those financial statements in our report dated February 15, 20X2 (see below).

The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparation of the audited financial statements of ABC Company]. Reading the summary financial statements, therefore, is not a substitute for reading the audited financial statements of ABC Company.

Management's Responsibility for the Summary Financial Statements

Management is responsible for the preparation of a summary of the audited financial statements on the basis described in Note X.

Auditor's Responsibility

Our responsibility is to express an opinion on the summary financial statements based on our procedures, which were conducted in accordance with International Standard on Auditing (ISA) 810, Engagements to Report on Summary Financial Statements.

When the auditor's report on the summary financial statements is dated later than the date of the auditor's report on the audited financial statements from which it is derived, the following sentence is added to this paragraph: "Those financial statements, and the summary financial statements, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements."

Opinion

In our opinion, the summary financial statements derived from the audited financial statements of ABC Company for the year ended December 31, 20X1 are consistent, in all material respects, with (or a fair summary of) those financial statements, on the basis described

[59] Applied criteria - The criteria applied by management in the preparation of the summary financial statements

in Note X. However, the summary financial statements are misstated to the equivalent extent as the audited financial statements of ABC Company for the year ended December 31, 20X1.

The misstatement of the audited financial statements is described in our qualified audit opinion in our report dated February 15, 20X2. Our qualified audit opinion is based on the fact that the company's inventories are carried in the statement of financial position in those financial statements at xxx. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from International Financial Reporting Standards. The company's records indicate that had management stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively. Our qualified audit opinion states that, except for the effects of the described matter, those financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of ABC Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

[Auditor's signature]
[Date of the auditor's report]
[Auditor's address]

Requirements

Special Purpose Frameworks

When accepting the engagement on special purposes framework, the following areas should be taken into account:

- Acceptability of the financial reporting framework
- Considerations when planning and performing the audit
- Forming an opinion and reporting considerations
- Description of the applicable financial reporting framework
- Readers' communication

Acceptability of the Financial Reporting Framework

The auditor should determine the acceptability of the financial reporting framework applied in the preparation of the financial statements. In an audit of special purpose financial statements, the auditor shall obtain an understanding of:

- The purpose for which the financial statements are prepared;
- The intended users; and
- The steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances.

Considerations When Planning and Performing the Audit

The auditor should comply with all ISAs relevant to the audit. In planning and performing an audit of special purpose financial statements, the auditor shall determine whether application of the ISAs requires special consideration in the circumstances of the engagement. The auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements. An interpretation is significant when adoption of another reasonable interpretation would have produced a material difference in the information presented in the financial statements.

Forming an Opinion and Reporting Considerations

When forming an opinion and reporting on special purpose financial statements, the auditor shall apply the requirements in ISA 700.

Description of the Applicable Financial Reporting Framework

The audit ensures that the financial statements adequately refer to or describe the applicable financial reporting framework. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.

In the case of an auditor's report on special purpose financial statements:

a) The auditor's report shall also describe the purpose for which the financial statements are prepared and, if necessary, the intended users, or refer to a note in the special purpose financial statements that contains that information;
b) If management has a choice of financial reporting frameworks in the preparation of such financial statements, the explanation of management's responsibility for the financial statements shall also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

Alerting Readers that the Financial Statements Are Prepared in Accordance with a Special Purpose Framework

The auditor's report on special purpose financial statements shall include an Emphasis of Matter paragraph alerting users of the auditor's report that the financial statements are prepared in accordance with a special purpose framework and that, as a result, the financial statements may not be suitable for another purpose. The auditor shall include this paragraph under an appropriate heading.

Single Items

When accepting the engagement for single financial statement, the following should be taken into account:

- Application of ISAs
- Acceptability of the Financial Reporting Framework

- Form of Opinion
- Planning and Performing the Audit
- Forming an Opinion and Reporting
- Financial Statement or on a Specific Element of Those Financial Statements
- Modified Opinion, Emphasis of Matter Paragraph or Other Matter Paragraph in the Auditor's Report on the Entity's Complete Set of Financial Statements

Application of ISAs

In the case of an audit of a single financial statement or of a specific element of a financial statement, audit should apply all ISAs as relevant. This requirement applies irrespective of whether the auditor is also engaged to audit the entity's complete set of financial statements. If the auditor is not also engaged to audit the entity's complete set of financial statements, the auditor shall determine whether the audit of a single financial statement or of a specific element of those financial statements in accordance with ISAs is practicable.

Acceptability of the Financial Reporting Framework

For a single financial statement or of a specific element of a financial statement, this shall include whether application of the financial reporting framework will result in a presentation that provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the element.

Form of Opinion

For an audit of a single financial statement or of a specific element of a financial statement, the auditor shall consider whether the expected form of opinion is appropriate in the circumstances.

Considerations When Planning and Performing the Audit

During planning and performing the audit of a single financial statement or of a specific element of a financial statement, the auditor shall adapt all ISAs relevant to the audit as necessary in the circumstances of the engagement.

Forming an Opinion and Reporting Considerations

When forming an opinion and reporting on a single financial statement or on a specific element of a financial statement, the auditor shall apply the requirements in ISAs adapted as necessary in the circumstances of the engagement.

Financial Statement or on a Specific Element of Those Financial Statements

If the auditor undertakes an engagement to report on a single financial statement or on a specific element of a financial statement in conjunction with an engagement to audit the entity's complete set of financial statements, the auditor shall express a separate opinion for each engagement. An audited single financial statement or an audited specific element of a financial statement may be published together with the entity's audited complete set of financial statements. If the auditor concludes that the presentation of the single financial statement or of the specific element of a financial statement does not differentiate it sufficiently from the complete set of financial statements, the auditor shall ask management to rectify the situation. The auditor shall also differentiate the opinion on the single financial statement or on the specific element of a financial statement from the opinion on the complete set of financial statements. The auditor shall not issue the auditor's report containing the opinion on the single financial statement or on the specific element of a financial statement until satisfied with the differentiation.

Modified Opinion, Emphasis of Matter Paragraph or Other Matter Paragraph in the Auditor's Report on the Entity's Complete Set of Financial Statements

If the opinion in the auditor's report on an entity's complete set of financial statements is modified, or that report includes an Emphasis of Matter paragraph or an Other Matter paragraph, the auditor shall determine the effect that this may have on the auditor's report on a single financial statement or on a specific element of those financial statements. When deemed appropriate, the auditor shall modify the opinion on the single financial statement or on the specific element of a financial statement, or include an Emphasis of Matter paragraph or an Other Matter paragraph in the auditor's report, accordingly. If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole it is not permitted for the auditor to include in the same auditor's report an unmodified opinion on a single financial statement that forms part of those financial statements or on a specific element that forms part of those financial statements. This is because such an unmodified opinion would contradict the adverse opinion or disclaimer of opinion on the entity's complete set of financial statements as a whole.

If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole but, in the context of a separate audit of a specific element that is included in those financial statements, the auditor nevertheless considers it appropriate to express an unmodified opinion on that element, the auditor shall only do so if:

a) The auditor is not prohibited by law or regulation from doing so;
b) That opinion is expressed in an auditor's report that is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion; and
c) The specific element does not constitute a major portion of the entity's complete set of financial statements.

The auditor shall not express an unmodified opinion on a single financial statement of a complete set of financial statements if the auditor has expressed an adverse opinion or disclaimed an opinion on the complete set of financial statements as a whole. This is the case even if the auditor's report on the single financial statement is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion. This is because a single financial statement is deemed to constitute a major portion of those financial statements.

Summaries

Engagement Acceptance

The auditor shall accept an engagement to report on summary financial statements in accordance with this ISA only when the auditor has been engaged to conduct an audit in accordance with ISAs of the financial statements from which the summary financial statements are derived.

Before accepting an engagement to report on summary financial statements the auditor shall determine whether the applied criteria are acceptable and obtain the agreement of management that it acknowledges and understands its responsibility:

i) For the preparation of the summary financial statements in accordance with the applied criteria;
ii) To make the audited financial statements available to the intended users of the summary financial statements without undue difficulty (or, if law or regulation provides that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements, to describe that law or regulation in the summary financial statements);
iii) To include the auditor's report on the summary financial statements in any document that contains the summary financial statements and that indicates that the auditor has reported on them.

In addition, the auditor should agree with management the form of opinion to be expressed on the summary financial statements.

Nature of Procedures

The auditor shall perform at least the following procedures, as the basis for the auditor's opinion on the summary financial statements:

- Evaluate whether the summary financial statements
  - i) adequately disclose their summarized nature and identify the audited financial statements.
  - ii) adequately disclose the applied criteria.
  - iii) are prepared in accordance with the applied criteria.
  - iv) contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.
  - v) establish the criteria for the preparation of the summary financial statements without undue difficulty.[60]
  - vi) are accompanied by the audited financial statements for the intended users of the summary financial statements
- When summary financial statements are not accompanied by the audited financial statements, evaluate whether they describe clearly:
  - i) From whom or where the audited financial statements are available;

  or
  - ii) The law or regulation that specifies that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements.
- Compare the summary financial statements with the related information in the audited financial statements to determine whether the summary financial statements agree with or can be recalculated from the related information in the audited financial statements.

Form of Opinion

When the auditor has concluded that an unmodified opinion on the summary financial statements is appropriate, the auditor's opinion shall[61] use one of the following phrases:

- The summary financial statements are consistent, in all material respects, with the audited financial statements, in accordance with [the applied criteria];

or

- The summary financial statements are a fair summary of the audited financial statements, in accordance with [the applied criteria].

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[60] Unless law or regulation provides that they need not be made available.

[61] Unless otherwise required by law or regulation.

If law or regulation prescribes the wording of the opinion on summary financial statements in terms that are different from those described above the auditor shall:

- Apply the procedures described above and any further procedures necessary to enable the auditor to express the prescribed opinion;

and

- Evaluate whether users of the summary financial statements might misunderstand the auditor's opinion on the summary financial statements and, if so, whether additional explanation in the auditor's report on the summary financial statements can mitigate possible misunderstanding.

If the auditor concludes that additional explanation in the auditor's report on the summary financial statements cannot mitigate possible misunderstanding, the auditor *shall not accept* the engagement, unless required by law or regulation to do so. An engagement conducted in accordance with such law or regulation *does not comply with ISA*. Accordingly, the auditor's report on the summary financial statements shall not <u>indicate that the engagement was conducted in accordance with</u> International Standards on Auditing.

Timing of Work and Events Subsequent to the Date of the Auditor's Report on the Audited Financial Statements

The auditor's report on the summary financial statements may be dated later than the date of the auditor's report on the audited financial statements. In such cases, the auditor's report on the summary financial statements shall state that the summary financial statements and audited financial statements do not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements that may require adjustment of, or disclosure in, the audited financial statements.

However:

The auditor may become aware of facts that existed at the date of the auditor's report on the audited financial statements, but of which the auditor was previously unaware. In such cases, the auditor shall not issue the auditor's report on the summary financial statements until the auditor's consideration of such facts in relation to the audited financial statements in accordance with the ISA on subsequent event is satisfied.

Auditor's Report on Summary Financial Statements

Elements of the Auditor's Report

The auditor's report on summary financial statements shall include the following elements:

a) A title clearly identifying it as the report of an independent auditor.
b) An addressee.
c) An introductory paragraph that:
    i) Identifies the summary financial statements on which the auditor is reporting, including the title of each statement included in the summary financial statements;

ii) Identifies the audited financial statements;
iii) Refers to the auditor's report on the audited financial statements, the date of that report;
iv) If the date of the auditor's report on the summary financial statements is later than the date of the auditor's report on the audited financial statements, states that the summary financial statements and the audited financial statements do not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements; and
v) A statement indicating that the summary financial statements do not contain all the disclosures required by the financial reporting framework applied in the preparation of the audited financial statements, and that reading the summary financial statements is not a substitute for reading the audited financial statements.

d) A description of management's responsibility for the summary financial statements, explaining that management is responsible for the preparation of the summary financial statements in accordance with the applied criteria.
e) A statement that the auditor is responsible for expressing an opinion on the summary financial statements based on the procedures required by this ISA.
Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.
f) A paragraph clearly expressing an opinion.
g) The auditor's signature.
h) The date of the auditor's report.
i) The auditor's address.

If the addressee of the summary financial statements is not the same as the addressee of the auditor's report on the audited financial statements, the auditor shall evaluate the appropriateness of using a different addressee.

The auditor shall date the auditor's report on the summary financial statements no earlier than:

- The date on which the auditor has obtained sufficient appropriate evidence on which to base the opinion, including evidence that the summary financial statements have been prepared and those with the recognized authority have asserted that they have taken responsibility for them;

and

- The date of the auditor's report on the audited financial statements.

Modifications to the Opinion, Emphasis of Matter Paragraph or Other Matter Paragraph in the Auditor's Report on the Audited Financial Statements

When the auditor's report on the audited financial statements contains a qualified opinion, an Emphasis of Matter paragraph, or an Other Matter paragraph, but the auditor is satisfied that the summary financial statements are consistent in all material respects with, or are a fair summary of, the audited financial statements, in accordance with the applied criteria, the auditor's report on the summary financial statements shall:

- State that the auditor's report on the audited financial statements contains a qualified opinion, an Emphasis of Matter paragraph, or an Other Matter paragraph;

and

- Describe:
    i) The basis for the qualified opinion on the audited financial statements, and that qualified opinion; or the Emphasis of Matter or the Other Matter paragraph in the auditor's report on the audited financial statements;

    and

    ii) The effect thereof on the summary financial statements, if any.

When the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion, the auditor's report on the summary financial statements shall:

- State that the auditor's report on the audited financial statements contains an adverse opinion or disclaimer of opinion;
- Describe the basis for that adverse opinion or disclaimer of opinion;
- State that, as a result of the adverse opinion or disclaimer of opinion, it is inappropriate to express an opinion on the summary financial statements.

Modified Opinion on the Summary Financial Statements

If the summary financial statements are not consistent in all material respects with, or are not a fair summary of, the audited financial statements, in accordance with the applied criteria, and management does not agree to make the necessary changes, the auditor shall express an adverse opinion on the summary financial statements.

Restriction on Distribution or Use or Alerting Readers to the Basis of Accounting

When distribution or use of the auditor's report on the audited financial statements is restricted, or the auditor's report on the audited financial statements alerts readers that the audited financial statements are prepared in accordance with a special purpose framework, the auditor shall include a similar restriction or alert in the auditor's report on the summary financial statements.

Comparatives

If the audited financial statements contain comparatives, but the summary financial statements do not, the auditor shall determine whether such omission is reasonable in the circumstances of the engagement. The auditor shall determine the effect of an unreasonable omission on the auditor's report on the summary financial statements.

Unaudited Supplementary Information Presented with Summary Financial Statements

The auditor shall evaluate whether any unaudited supplementary information presented with the summary financial statements is clearly differentiated from the summary financial statements. If the auditor concludes that the entity's presentation of the unaudited supplementary information is not clearly differentiated from the summary financial statements, the auditor shall ask management to change the presentation of the unaudited supplementary information. If management refuses to do so, the auditor shall explain in the auditor's report on the summary financial statements that such information is not covered by that report.

Other Information in Documents Containing Summary Financial Statements

The auditor shall read other information included in a document containing the summary financial statements and related auditor's report to identify material inconsistencies, if any, with the summary financial statements. If, on reading the other information, the auditor identifies a material inconsistency, the auditor shall determine whether the summary financial statements or the other information needs to be revised. If, on reading the other information, the auditor becomes aware of an apparent material misstatement of fact, the auditor shall discuss the matter with management.

Auditor Association

If the auditor becomes aware that the entity plans to state that the auditor has reported on summary financial statements in a document containing the summary financial statements, but does not plan to include the related auditor's report, the auditor shall request management to include the auditor's report in the document. If management does not do so, the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the summary financial statements in that document.

The auditor may be engaged to report on the financial statements of an entity, while not engaged to report on the summary financial statements. If, in this case, the auditor becomes aware that the entity plans to make a statement in a document that refers to the auditor and the fact that summary financial statements are derived from the financial statements audited by the auditor, the auditor shall be satisfied that:

a) The reference to the auditor is made in the context of the auditor's report on the audited financial statements;

and

b) The statement does not give the impression that the auditor has reported on the summary financial statements.

If (a) or (b) are not met, the auditor shall request management to change the statement to meet them, or not to refer to the auditor in the document. Alternatively, the entity may engage the auditor to report on the summary financial statements and include the related auditor's report in the document. If management does not change the statement, delete the reference to the auditor, or include an auditor's report on the summary financial statements in the document containing the summary financial statements, the auditor shall advise management that the auditor disagrees with the reference to the auditor, and the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately referring to the auditor.

Revision

Summary

Beside typical audit engagements the auditor might be asked to perform audit procedures on reporting done based on special purpose frameworks, to perform reporting on an isolated item of the financial statements or on the summaries thereon. None of these engagements constitute classical audit, however the auditor shall apply other standards accordingly. As a rule, communication for the underlying financial statements and the summaries or element thereof should be consistent.

Keywords

Special Purpose Financial Statements, The Financial Reporting Framework, Element Of A Financial Statement, Element, Summary Financial Statements.

Y/N Questions

No	Issue	Y/N
1	The auditor does not have the obligation to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements.	Y/N
2	When forming an opinion and reporting on special purpose financial statements, the auditor shall apply the requirements in ISA 700.	Y/N
3	The auditor might express an unmodified opinion on a single financial statement of a complete set of financial statements if the auditor has expressed an adverse opinion on the complete set of financial statements as a whole.	Y/N
4	The auditor does not have an obligation to read other information included in a document containing the summary financial statements.	Y/N
5	In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract.	Y/N
6	The auditor's report on summary financial statements shall include the auditor's address.	Y/N
7	The auditor's report on summary financial statements shall include the auditor's reference number.	Y/N
8	When the auditor has concluded that an unmodified opinion on the summary financial statements is appropriate, the auditor's opinion shall be the same as in the whole financial statements.	Y/N
9	The statements "the summary financial statements are a fair summary of the audited financial statements" indicate a clean opinion.	Y/N
10	If the audited financial statements contain comparatives, but the summary financial statements do not, the auditor should qualify.	Y/N

Issues to consider

1. Recall definitions of the keywords.
2. Describe the impact of the standards involved on the context of the chapter.
3. What the auditor should do if he becomes aware that the entity plans to state that the auditor has reported on summary financial statements in a document containing the summary financial statements, but does not plan to include the related auditor's report?
4. Suppose the auditor announces bankruptcy during the audit of the summaries, what should the client do?
5. Suppose the audited financial statements were done in accordance with one financial framework, and the summaries on them were done in accordance with another financial framework. Can the audit opinions be different?

Case study Tabaco S.A

Tabaco S.A. produces electronic cigarates. Frank, its CFO, has met Zenek, an audit partner of Krytex s.c., a Polish registered audit company. Both gentelmen are negotiating the terms of the abbreviated account audit engamement for an EU grants settlements . Because Frank is a registered auditor and Zenel is a well-recognized investor with a long-standing professional with ballroom dancing experience, both parties have hard negotiations. Due to some obstacles during their negotiation both have agreed to ask you for advice in some matters.

Required:

(a) Show the main points which should be inclued in the contract for engagement.
(b) Explain to Zenek, while Frank does not agree that Zenek make the audit by himself.
(c) Zenek offered 30 thousands of PLN as the fee, Frank wants 50 thousand PLN, indicate the non-financial aspect which might be taken by both parties to agree on a contract fee.
(d) Explain the difference between the audit opinon on financial statements and opinon of statements prepared for EU settlements purposes.

Exam: Auditing

MQT

1. What is the first element of the audit process?
   a) Quality review
   b) Understanding of client
   c) Client acceptance
   d) Risk assessment

2. Audit report is:
   a) Public document
   b) Private document
   c) Electronic document
   d) Advisory product

3. Who does appoint the auditor?
   a) Shareholders
   b) Board of Directors
   c) President of the company
   d) Regulated body

4. What is a modification of audit opinion?
   a) Qualification
   b) Adverse
   c) With explanation
   d) With limitation of scope

5. The typical tool for the risk area identification is:
   a) Risk model
   b) Analytical review
   c) Substantive review
   d) One off test

6. The sample size used by auditor impact:
   a) Inherent risk
   b) Control risk
   c) Detection risk
   d) Walk-though

7. The materiality is defined as:
   a) The level of error or omission which alert the decision of auditor
   b) The level of error or omission which alert the decision of auditee
   c) The level of error or omission which alert the decision of financial statement user
   d) The level of error or omission which alert the decision of KIBR

8. The report issues after the statutory audit is issued to:
   a) Supervisory Board
   b) Board of Directors
   c) Shareholders
   d) Audit Committee

9. A broker-dealer subsidiary of the auditing network impact:
   a) Credit risk
   b) Detection risk
   c) Inherent risk
   d) Control risk

10. Assets are tested for:
   a) Overvaluation
   b) Undervaluation
   c) Fun
   d) Relation

11. Total errors net 100, planning materiality 110 you audit opinion will be:
   a) Clean
   b) Qualified
   c) Limited with scope
   d) Adverse

12. Statement in opinion saying: in our opinion the attached financial statements give true and fair picture of...Is example of:
   a) Unqualified opinion
   b) Qualified opinion
   c) Expression of interests
   d) Fairness note

13. Reasonable assurance is reported in terms of:
   a) Positive expression
   b) Limited assurance
   c) Negative expression
   d) Confidence level

14. In auditing we test all items:
    a) Yes
    b) No

15. Usually the most risky asset is:
    a) Cash
    b) T-bills
    c) Stock
    d) Long term contract

16. The ultimate level of true and fairness is decided by:
    a) Auditor
    b) Audit Chamber
    c) Audit Supervision Authority
    d) Court

17. The fees for statutory audits:
    a) Cannot be based on any form of contingency
    b) Can be based on contingency

18. A failure to reconcile the general lager by auditee is example of:
    a) Inherent risk
    b) Credit risk
    c) Detection risk
    d) Control risk

19. A typical test for the inventories is:
    a) Stock take
    b) Debtors confirmation
    c) Legal letter
    d) Comfort letter

20. The audit risk model is:
    a) IRxCRxWR
    b) IRxDrxCR
    c) IR+DR+CR
    d) IR+WR+CR

21. The typical tool for identification of the risk areas is:
    a) Variance-covariance method
    b) Analytical review

c) Trail balance reconciliation
d) Stock take

22. The statutory audit requires adequate knowledge of:
a) Company law, fiscal law and social law
b) Company law,
c) Company law, fiscal law
d) Company law, fiscal law and leisure law

23. The to total assets 100, profit (10), total revenue 1, the basis for materiality calculation would be:
a) Revenue
b) Profit
c) Profit after tax
d) Total assets

24. The less risky position is:
a) Financial instruments
b) Contingent liability
c) Contingent asset
d) Equity

25. The primary motivation for written audit contracts is:
a) Court proof
b) Limitation of expectation gap
c) VAT settlements
d) Financial statements disclosure

Case study

Okuru Public Hall Board

Financial statements period ended: 12 June 2003

The Board did not prepare its annual financial statements in accordance with the Public Finance Act 1989, and the financial statements did not comply with generally accepted accounting practice in New Zealand. In addition, the Board did not maintain appropriate accounting records, and the limited financial information presented did not fairly reflect the Board's assets, liabilities, receipts, and payments. We highlighted that the going concern assumption appropriately had not been used in the preparation of the financial statements because the Hall Board was disestablished and its assets and liabilities were vested in Westland District Council on 12 June 2003.

Source: http://www.oag.govt.nz/2006/2004-05/appendix.htm

You are required:

(a) Discuss the difference between the National Court of Auditors and the Auditing Company. (5 points)
(b) Taking account the facts presented for Okuru, what kind of the audit opinion would be issued. (10 points)
(c) Discuss the difference between the financial and performance audit. (5 points)
(d) Explain if ISA are applied to the performance audit. (5 points)

Solution

(a) National Court of Auditor or Supreme Court of Auditor is the public body responsible for the auditing of the state finance project and organization including the government, while the public auditing company audits privately holds assets for owners. Those two builds up the overseeing system however are independent and differently organized.
(b) Irrespectively of the standard those facts indicates on the adverse opinion. The magnitude of the findings is fundamental.
(c) Financial audit focus on the fairness of the historic financial data prepared in accordance of given accounting framework, the performance audit exempt from the financial focuses takes into account the future effects of the action taken, and assess as well cost benefit approach and adherence to the long term key performance indicators.
(d) ISA are dedicated for the historical information, and from this perspective can be applicable to this part of the performance audit which deals with historical data, however the accounting framework must be assesses as fair value than the compliance one. In practice majority of the National Court of Auditors follows the framework of IAS but they usually do not comply in all aspects.

Lexicon

Conceptual framework defined within the standards

Term	Definition	Reference
Accounting estimate	An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this ISA addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.	ISA.540.7.a
Accounting records	The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.	ISA.500.5.a
Analytical procedures	Means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.	ISA.520.4
Anomaly	A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.	ISA.530.5.e
Applicable financial reporting framework	The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.	ISA.200.13.a
Applied criteria	The criteria applied by management in the preparation of the summary financial statements.	ISA.810.4.a
Appropriateness (of audit evidence)	The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.	ISA.500.5.b
Arm's length transaction	A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.	ISA.550.10.a
Assertions	Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.	IAS.315.4.a

Audit documentation	The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used).	ISA.230.6.a
Audit evidence	Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.	ISA.200.13.b ISA.500.5.c
Audit file	One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.	ISA.230.6.b
Audit risk	The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.	ISA.200.13.c
Audit sampling (sampling)	The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.	ISA.530.5.a
Audited financial statements	Financial statements1 audited by the auditor in accordance with ISAs, and from which the summary financial statements are derived.	ISA.810.4.b
Auditor	The person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an ISA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used. "Engagement partner" and "firm" are to be read as referring to their public sector equivalents where relevant.	ISA.200.13.d
Auditor's expert	An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner3 or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.	ISA.620.6.a ISA.700.6.a
Auditor's point estimate or auditor's range	The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.	ISA.540.7.b
Business risk	A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.	IAS.315.4.b

Comparative financial statements	Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.	ISA.710.c
Comparative information	The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.	ISA.710.a
Complementary user entity controls	Controls that the service organization assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives, are identified in the description of its system.	ISA.402.8.a
Compliance framework	To refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in: (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.	ISA.200.13.a
Component	An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.	ISA.600.9.a
Component auditor	An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.	ISA.600.9.b
Component management	Management responsible for the preparation of the financial information of a component.	ISA.600.9.c
Component materiality	The materiality for a component determined by the group engagement team.	ISA.600.9.d
Control risk	The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.	ISA.200.13.n.ii

Corresponding figures	Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures"). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.	ISA.710.b
Date of approval of the financial statements	The date on which all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognized authority have asserted that they have taken responsibility for those financial statements.	ISA.560.5.b
Date of the auditor's report	The date the auditor dates the report on the financial statements in accordance with ISA 700.	ISA.560.5.c
Date of the financial statements	The date of the end of the latest period covered by the financial statements.	ISA.560.5.a
Date the financial statements are issued	The date that the auditor's report and audited financial statements are made available to third parties.	ISA.560.5.d
Deficiency in internal control	This exists when: (i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.	ISA.265.6.a
Detection risk	The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.	ISA.200.13.e
Direct assistance	The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.	ISA.610.14.b
Element of a financial statement or element	Means an "element, account or item of a financial statement;"	ISA.805.6.a
Emphasis of Matter paragraph	A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.	ISA.706.a
Engagement partner	The partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.	ISA.220.7.a

Engagement quality control review	A process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report. The engagement quality control review process is for audits of financial statements of listed entities and those other audit engagements, if any, for which the firm has determined an engagement quality control review is required.	ISA.220.7.b
Engagement quality control reviewer	A partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report.	ISA.220.7.c
Engagement team	All partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform audit procedures on the engagement. This excludes an auditor's external expert engaged by the firm or a network firm. The term "engagement team" also excludes individuals within the client's internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of ISA 610 (Revised 2013).	ISA.220.7.d
Estimation uncertainty	The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.	ISA.540.7.c
Exception	A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.	ISA.505.6.e
Experienced auditor	An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of: (i) Audit processes; (ii) ISAs and applicable legal and regulatory requirements; (iii) The business environment in which the entity operates; and (iv) Auditing and financial reporting issues relevant to the entity's industry.	ISA.230.6.c
Expertise	Skills, knowledge and experience in a particular field.	ISA.620.6.b ISA.700.6.b
External confirmation	Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.	ISA.505.6.a

fair presentation framework	To refer to a financial reporting framework that requires compliance with the requirements of the framework and: (i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or (ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.	ISA.200.13.a
Financial statements	A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.	ISA.200.13.f
Firm	A sole practitioner, partnership or corporation or other entity of professional accountants.	ISA.220.7.e
Fraud	An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.	IAS.240.11.a
Fraud risk factors	Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud	IAS.240.11.b
Group	All the components whose financial information is included in the group financial statements. A group always has more than one component.	ISA.600.9.e
Group audit	The audit of group financial statements.	ISA.600.9.f
Group audit opinion	The audit opinion on the group financial statements.	ISA.600.9.g
Group engagement partner	The partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor's report on the group financial statements that is issued on behalf of the firm. Where joint auditors conduct the group audit, the joint engagement partners and their engagement teams collectively constitute the group engagement partner and the group engagement team. This ISA does not, however, deal with the relationship between joint auditors or the work that one joint auditor performs in relation to the work of the other joint auditor.	ISA.600.9.h

Group engagement team	Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.	ISA.600.9.i
Group financial statements	Financial statements that include the financial information of more than one component. The term "group financial statements" also refers to combined financial statements aggregating the financial information prepared by components that have no parent but are under common control.	ISA.600.9.j
Group management	Management responsible for the preparation of the group financial statements.	ISA.600.9.k
Group-wide controls	Controls designed, implemented and maintained by group management over group financial reporting.	ISA.600.9.l
Historical financial information	Information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.	ISA.200.13.g
Inconsistency	Other information that contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence	ISA.720.5.b
Inherent risk	The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.	ISA.200.13.n.i
Initial audit engagement	An engagement in which either: (i) The financial statements for the prior period were not audited; or (ii) The financial statements for the prior period were audited by a predecessor auditor.	ISA.510.4.a
Inspection	In relation to completed audit engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.	ISA.220.7.f
Internal audit function	A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.	ISA.610.14.a

Internal control	The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.	IAS.315.4.c
International Financial Reporting Standards	Means the International Financial Reporting Standards issued by the International Accounting Standards Board;	ISA.805.6.b
Listed entity	An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.	ISA.220.7.g
Management	Management and, where appropriate, those charged with governance	IAS.210.5
Management	The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.	ISA.200.13.h
Management	Should be read as "management and, where appropriate, those charged with governance." Furthermore, in the case of a fair presentation framework, management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; or the preparation of financial statements that give a true and fair view in accordance with the applicable financial reporting framework.	ISA.580.8
Management bias	A lack of neutrality by management in the preparation of information.	ISA.540.7.d
Management's expert	An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.	ISA.500.5.d ISA.500.5d ISA.6020.6.c ISA.700.6.c
Management's point estimate	The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.	ISA.540.7.e

Misstatement	A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. Where the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.	ISA.200.13.i ISA.450.4.a
Misstatement of fact	Other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.	ISA.720.5.c
Modified opinion	A qualified opinion, an adverse opinion or a disclaimer of opinion.	ISA.705.b
Monitoring	A process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to provide the firm with reasonable assurance that its system of quality control is operating effectively.	ISA.220.7.h
Negative confirmation request	A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request	ISA.505.6.c
Network	A larger structure: (i) That is aimed at cooperation, and (ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.	ISA.220.7.j
Network firm	A firm or entity that belongs to a network.	ISA.220.7.i
Non-compliance	Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.	ISA.250.11
Non-response	A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.	ISA.505.6.d

Non-sampling risk	The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.	ISA.530.5.d
Opening balances	Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments	ISA.510.4.b
Other information	Financial and non-financial information (other than the financial statements and the auditor's report thereon) which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor's report thereon.	ISA.720.5.a
Other Matter paragraph	A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.	ISA.706.b
Outcome of an accounting estimate	The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.	ISA.540.7.f
Partner	Any individual with authority to bind the firm with respect to the performance of a professional services engagement.	ISA.220.7.k
Performance materiality	Means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.	IAS.320.9
Personnel	Partners and staff.	ISA.220.7.l
Pervasive	A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment: (i) Are not confined to specific elements, accounts or items of the financial statements; (ii) If so confined, represent or could represent a substantial proportion of the financial statements; or (iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.	ISA.705.a

Population	The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.	ISA.530.5.b
Positive confirmation request	A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.	ISA.505.6.b
Preconditions for an audit	The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted	IAS.210.4
Predecessor auditor	The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.	ISA.510.4.c
Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted	That management and, where appropriate, those charged with governance have acknowledged and understand that they have the following responsibilities that are fundamental to the conduct of an audit in accordance with ISAs. That is, responsibility: (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation; (ii) For such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and (iii) To provide the auditor with: a. Access to all information of which management and, where appropriate, those charged with governance are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters; b. Additional information that the auditor may request from management and, where appropriate, those charged with governance for the purpose of the audit; and c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence. In the case of a fair presentation framework, (i) above may be restated as "for the preparation and fair presentation of the financial statements in accordance with the financial reporting framework," or "for the preparation of financial statements that give a true and fair view in accordance with the financial reporting framework." The "premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted" may also be referred to as the "premise."	ISA.200.13.j

Professional judgment	The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.	ISA.200.13.k
Professional skepticism	An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.	ISA.200.13.l
Professional standards	International Standards on Auditing (ISAs) and relevant ethical requirements.	ISA.220.7.m
Reasonable assurance	In the context of an audit of financial statements, a high, but not absolute, level of assurance.	ISA.200.13.m
Related party	A party that is either: (i) A related party as defined in the applicable financial reporting framework; or (ii) Where the applicable financial reporting framework establishes minimal or no related party requirements: a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity; b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or c. Another entity that is under common control with the reporting entity through having: i. Common controlling ownership; ii. Owners who are close family members; or iii. Common key management. However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.	ISA.550.10.b
Relevant ethical requirements	Ethical requirements to which the engagement team and engagement quality control reviewer are subject, which ordinarily comprise Parts A and B of the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements together with national requirements that are more restrictive.	ISA.220.7.n
Risk assessment procedures	The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.	IAS.315.4.d
Risk of material misstatement	The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:	ISA.200.13.n

Sampling risk	The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions: (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion. (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.	ISA.530.5.c
Sampling unit	The individual items constituting a population.	ISA.530.5.f
Service auditor	An auditor who, at the request of the service organization, provides an assurance report on the controls of a service organization.	ISA.402.8.d
Service organization	A third-party organization (or segment of a third- party organization) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.	ISA.402.8.e
Service organization's system	The policies and procedures designed, implemented and maintained by the service organization to provide user entities with the services covered by the service auditor's report.	ISA.402.8.f
Significant component	A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.	ISA.600.9.m
Significant deficiency in internal control	A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.	ISA.265.6.b
Significant risk	An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.	IAS.315.4.e
Single financial statement or to a specific element of a financial statement includes the related notes.	The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.	ISA.805.6.c
Special purpose financial statements	Financial statements prepared in accordance with a special purpose framework	ISA.800.6.a

Special purpose framework	A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.	ISA.800.6.b
Staff	Professionals, other than partners, including any experts the firm employs.	ISA.220.7.o
Statistical sampling	An approach to sampling that has the following characteristics: (i) Random selection of the sample items; and (ii) The use of probability theory to evaluate sample results, including measurement of sampling risk. A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling.	ISA.530.5.g
Stratification	The process of dividing a population into sub¬populations, each of which is a group of sampling units which have similar characteristics (often monetary value).	ISA.530.5.h
Subsequent events	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.	ISA.560.5.e
Subservice organization	A service organization used by another service organization to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.	ISA.402.8.g
Substantive procedure	An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise: Tests of details (of classes of transactions, account balances, and disclosures); and Substantive analytical procedures.	IAS.330.4
Sufficiency (of audit evidence)	The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.	ISA.500.5.e
Suitably qualified external person	An individual outside the firm with the competence and capabilities to act as an engagement partner, for example, a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits of historical financial information or of an organization that provides relevant quality control services.	ISA.220.7.p
Summary financial statements	Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time. Different jurisdictions may use different terminology to describe such historical financial information.	ISA.810.4.c

Test of controls	An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level	IAS.330.4
The applicable financial reporting framework	Financial reporting framework that applies to the group financial statements.	ISA.600.10
The consolidation process	Includes: (a) The recognition, measurement, presentation, and disclosure of the financial information of the components in the group financial statements by way of consolidation, proportionate consolidation, or the equity or cost methods of accounting; and (b) The aggregation in combined financial statements of the financial information of components that have no parent but are under common control.	ISA.600.10
Those charged with governance	The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.	ISA.200.13.o
Tolerable misstatement	A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.	ISA.530.5.i
Tolerable rate of deviation	A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.	ISA.530.5.j
Type 1 report	Report on the description and design of controls at a service organization - A report that comprises: (i) A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls that have been designed and implemented as at a specified date; and (ii) A report by the service auditor with the objective of conveying reasonable assurance that includes the service auditor's opinion on the description of the service organization's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.	ISA.402.8.b

Type 2 report	Report on the description, design, and operating effectiveness of controls at a service organization - A report that comprises: (a) A description, prepared by management of the service organization, of the service organization's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and (b) A report by the service auditor with the objective of conveying reasonable assurance that includes: a. The service auditor's opinion on the description of the service organization's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and b. A description of the service auditor's tests of the controls and the results thereof.	ISA.402.8.c
Uncorrected misstatements	Misstatements that the auditor has accumulated during the audit and that have not been corrected.	ISA.450.4.b
User auditor	An auditor who audits and reports on the financial statements of a user entity.	ISA.402.8.h
User entity	An entity that uses a service organization and whose financial statements are being audited.	ISA.402.8.i
Written representation	A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.	ISA.580.7

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