

Endunamoo BCTA

Auditing

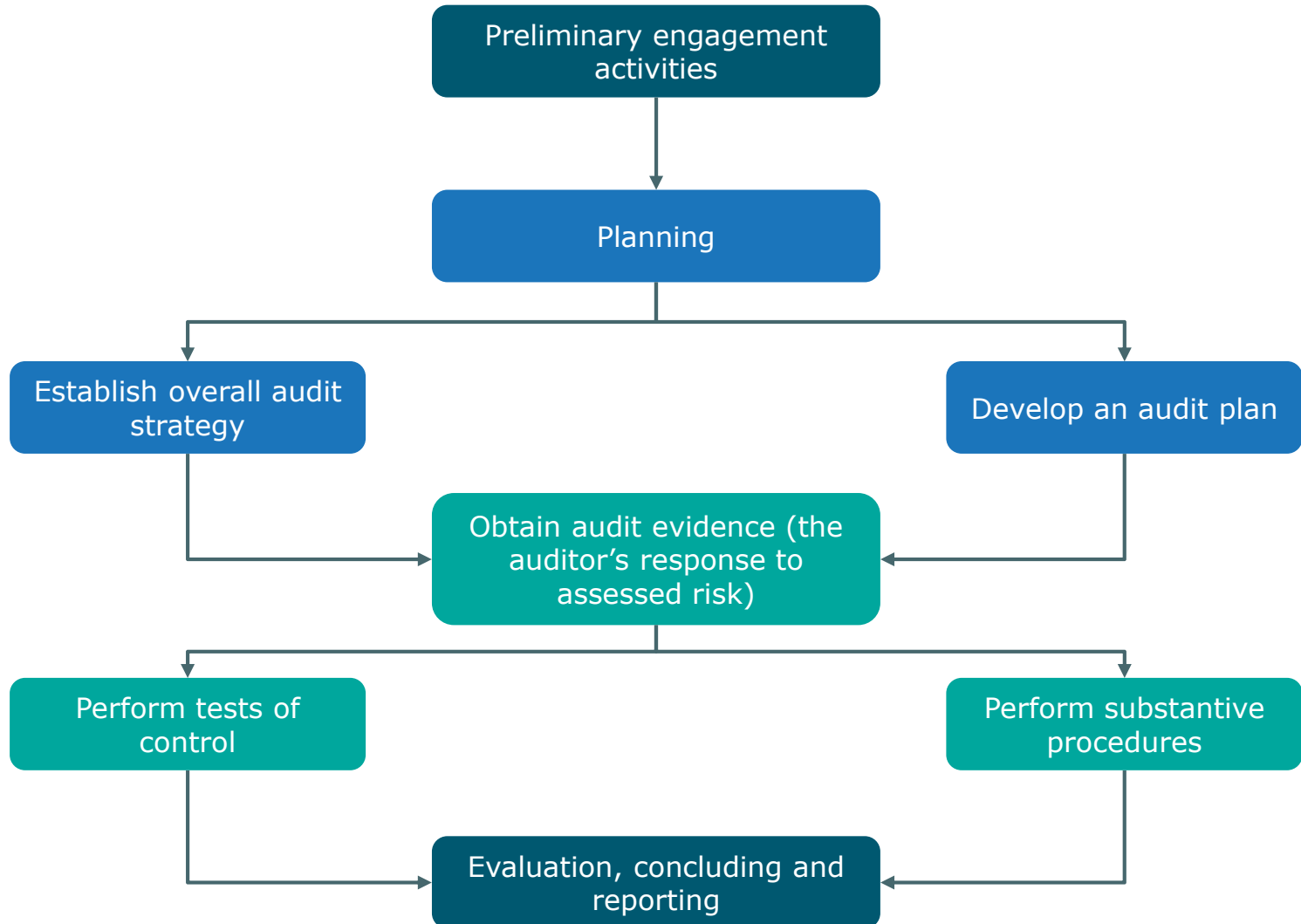
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The Audit Process

The Companies Act (2008)
The Auditing Profession Act (IRBA)
King IV
The Code of Professional Conduct, By-Laws and rules regarding improper conduct



Obtaining audit evidence

Learning objectives:

- Be able to identify risks at the financial statements level;
- Be able to identify risks of material misstatement at the assertion level (this includes an in depth understanding of assertions)
- Be able to formulate substantive audit procedures to address risks identified



Identifying ROMM at the FS level

- Risks that are pervasive to the financial statements as a whole;
- Risks that cannot necessarily be attributed to a specific FSLI because of their pervasive effect
- Ask yourself:
 - Can I identify exactly which FSLI this risk affects?
 - If yes – assertion level risk
 - If no – financial statement level risk





Example 1

Salvatore Ltd is a company listed on the JSE, operating in the construction industry. The company has subsidiaries in 9 African countries, and has recently changed their accounting system from Oracle to SAP.

REQUIRED:

Identify the audit risks at the financial statement level



Example 1 (cont.)

Suggested solution:

1. There is a risk that financial statements may be misstated in order to meet the JSE listing requirements and also to affect the share price as Salvatore is a listed entity;
2. There is a risk that the consolidated financial statements may be misstated due to:
 - The complexity of consolidating many subsidiaries
 - Consolidating subsidiaries with different functional currencies
 - Intercompany transactions and balances not being appropriately eliminated during the consolidation process
3. There is a risk that the financial statements may be misstated due to financial information being lost during migration from oracle to SAP

What is common in all these risks?

- “Risk that financial statements may be misstated” because we can’t pinpoint exactly which FSLI
- As opposed to “there is a risk that inventory may be overvalued” – assertion level risk

Identifying ROMM at the assertion level

- Risks that very specific to financial statement line items (FSLIs)
- Ask yourself:
 - Can I identify exactly which FSLI this risk affects?
 - If yes – assertion level risk
 - If no – financial statement level risk (previous slides)
- This requires an in-depth understanding of the assertions





Example 2

Kite Flyers Ltd makes and sells kites to various retail chains and toy stores. The company imports some of the components from India, which are invoiced to Kite in US Dollars. A standard costing method is used to cost the kites.

REQUIRED:

Identify the audit risks at the assertion level for the inventory account



Example 2 (Cont.)

What to note from the question (before you start answering):

1. The question asked for risks at the assertion level – did not ask for specific assertions, therefore all assertions should be addressed;
2. Inventory is a balance – therefore address assertions relating to balances (existence; valuation; rights & obligations, completeness)



Example 2 (Cont.)

- There is a risk that the inventory recorded does not exist (items may have been lost/stolen, fictitious units may have been recorded, sales might not have been recorded)
- There is a significant risk that inventory is not valued correctly for the following reasons:
 - Components are imported and the incorrect exchange rate may be used (especially since the USD rate is fluctuating a lot recently)
 - Standard costing is used which can be very complex; the standards used may be inappropriate or variances may be calculated or treated incorrectly



Example 2 (Cont.)

- There is a risk that the rights and obligations are accounted for inappropriately, depending on whether the inventory has been ceded to anybody and on what the import terms of components (CIF, FOB etc.) which affects when risks and rewards of ownership pass
- There is a risk that inventory is not complete due to items purchased but still in transit where risks & rewards have already passed to the company
- Risk that inventory may not be valued at lower of cost or net realisable value

Obtain audit evidence

- Formulate substantive audit procedures to address the identified risks;
- Exam technique:
 - ❑ Always link substantive procedures to the risks
 - ❑ Audit procedures mean – what procedure can you put in place to address the identified risk?
 - ❑ Include use of appropriate action words like inspect, recalculate, compare, enquire, etc.





Introduction to ISA 500

The auditor needs to obtain **sufficient appropriate audit evidence** to be able to draw reasonable conclusions on which to base the audit opinion

Three questions are important and relevant:

- The first question would be what is an **audit evidence**?
- Secondly we need to consider how much audit evidence is **sufficient**, and what type of evidence is **appropriate**?
- Then the last relevant question would be **what procedures need** to be performed in order to obtain that evidence?



Audit evidence

- **Audit evidence** is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based
- It includes information contained in the **accounting records** underlying **the financials** and other information
- Audit evidence is **cumulative in nature** and therefore includes evidence obtained from the audit procedures performed in current and prior audits, and from quality control procedures for client acceptance and continuance



Sufficient and appropriate...

Sufficient

- refers to the quantity / sufficiency of evidence required
- depends on the risk of misstatement (greater risk means more evidence required)

Appropriate

- refers to the quality, i.e. its relevance and reliability
- Which documents can give us more comfort
- Internal vs external documents



Reliability of audit evidence...

The **reliability of audit evidence** depends on **the source, the nature of the evidence** and **the individual circumstances** under which it was obtained

Generally (note there may be exceptions), audit evidence:

- is more reliable when it is obtained from independent sources outside the entity; *(e.g. JSE listed prices vs internal prices)*
- that is generated internally is more reliable when the related controls are effective; *(e.g. proper controls and reviews in place)*
- is more reliable when it is obtained directly by the auditor rather than indirectly or by inference; *(e.g. Bank confirmations vs Bank statements)*
- is more reliable when it exists in documentary form; and
- is more reliable when it is the original version, rather than copied



Reliability of audit evidence

- All internal information (e.g. schedule/listing/ageing/calculation received that is client prepared) must be verified for **accuracy and completeness**
- Evidence obtained from different sources or of a different nature is **considered more reliable if it is found to be consistent** with other evidence
- It may conflict to evidence already obtained or from representations made by the client, in which case the inconsistency needs to be investigated (additional procedures may need to be performed) and one piece of evidence may be found to be unreliable
- Consider the **greater impact of an inconsistency** if the management representation is found to be unreliable? How does that impact conclusions made regarding client/management integrity?



Audit procedures: Risk assessment procedures

Audit evidence is obtained by performing audit procedures to **obtain an understanding** of the entity and its environment, including its internal control, to assess risks of material misstatement (at the assertion and FS level)

These are referred to as **risk assessment procedures**, which can never by themselves provide sufficient appropriate evidence on which to base an audit opinion



Audit procedures: Tests of controls

When applicable, audit evidence is also obtained by performing audit procedures to test the operating effectiveness of **controls in preventing, detecting and correcting material misstatements at the assertion level**

These are referred to as **tests of controls**, and are necessary when the auditor's risk assessment includes an expectation of the operating effectiveness of controls OR when substantive procedures alone do not provide sufficient appropriate evidence



Audit procedures: Substantive procedures

Audit evidence is also obtained by performing audit procedures to detect material misstatements at the assertion level by performing **substantive procedures** (tests of detail and substantive analytics)

There are always inherent limitations to internal controls, including the **risk of management override, possibility of human error** and the **effect of system changes**

Therefore even if tests of controls are performed and controls are found to be operating effectively, substantive procedures are **ALWAYS** required to obtain sufficient appropriate evidence for material classes of transactions, account balances and presentation and disclosure



Response to risks at the assertion level

Audit procedures to respond to risks at the assertion level (ISA 330)

The procedures designed and performed by the auditor should respond (in **nature**, **timing** and **extent**) to the **assessed risk** of material misstatement. The auditor considers:

- the significance of the risk;
- the likelihood that a material misstatement will occur;
- the characteristics of the class of transactions or account balance or presentation and disclosure;
- the nature of the specific controls used by the entity (manual or automated); and
- whether the auditor expects to obtain audit evidence to determine if the entity's controls are operating effectively



Audit response: Nature

The **nature of audit procedures** refers to their purpose (tests of controls or substantive) and their type (inspection, inquiry, observation etc.)

Certain procedures are more effective to address specific assertions, and the type of procedure should be selected considering the risk (the higher the risk the more reliable and relevant the evidence needs to be)

In deciding on the approach to follow between whether to use a **combined approach** (tests of control and substantive procedures) or a **substantive approach**, the following should be considered:

- the necessity of test of controls / perform substantive procedures;
- the possibility of placing reliance on controls; and
- the desirability of relying on controls



Audit response: Timing

- The **timing of audit procedures** refers to **when** the audit procedures are performed or the **period** or date to which the audit evidence applies
- Tests of controls or substantive procedures may be performed at an **interim date** and/or at **period end**
- The higher the risk, the more likely it is that the procedure would be performed at or near period end, and the better it is to perform procedures unannounced or at unpredictable times
- Performing procedures earlier may give the auditor sufficient time to identify **significant matters** and to plan additional procedures to address these matters appropriately
- If procedures are performed at an interim period, roll forward procedures will be necessary for the remaining period



Audit response: Extent

- The **extent** refers to the **quantity** of a specific procedure to be performed, e.g. a sample size or the number of observations of a control activity
- The auditor uses **professional judgement** to determine the extent, after considering the **materiality**, the **assessed risk**, and the **degree of assurance** the auditor plans to obtain
- The higher risk, the higher the quantity (materiality plays a big role here)
- CAATs can be useful in extending the extent of procedures performed on electronic data and may even allow the auditor to perform the procedure on the entire population



Audit procedures

- The **nature and timing of audit procedures** will be affected by what format the accounting data and other information is available in e.g. electronic format and e-commerce transactions, and when this information becomes available
- An entity's data retention policies may require the auditor to request retention of some information for the auditor's review or to perform audit procedures at the time when the information is available
- For example, some IT systems may not allow reports to be **backdated** in which case the auditor should request the client to generate the reports on the date the report is required for
- When information comes in electronic form, CAATs may be useful to perform some of the procedures
- **Don't overcomplicate CAATs:** They include simple functions used in excel to cast, re-perform a calculation, recalculate something which might take hours to do manually



Audit procedures...

Audit procedures include (ISA500 par A14 to A25)

- **Inspection of records and documents** provides evidence of varying degrees of reliability depending on the nature and whether record/ document is from an external or internal source (then it also depends on the effectiveness of the controls over their production & maintenance)
- **Inspection of tangible assets** usually provides reliable audit evidence regarding the existence assertion, not rights and obligations or valuation
- **Confirmation**; specific type of inquiry where auditor obtains a representation of information or of an existing condition directly from a third party. They are frequently used for account balances, but may also be used to verify other items, e.g. the terms of an agreement, transactions an entity has with third parties or the absence of certain conditions



Audit procedures...

Inquiry involves seeking information through formal written inquiries or informal oral inquiries

- It is used extensively and is often complementary to another procedure
- All responses need to be evaluated, especially where the responses are contrary to other audit evidence obtained
- Inquiry alone does not usually provide sufficient appropriate evidence to detect a misstatement or test the operating effectiveness of controls so it would be performed in conjunction with another procedure
- Inquiries about management intent are sometimes difficult to corroborate so management's past practice, reasons for their intended action, and their ability to take that action are factored in
- Management representations are used as evidence to confirm results of oral inquiries for certain matters



Audit procedures...

- **Observation** involves looking at a process or procedure being performed by others, which provides evidence about the performance of a process or procedure. The limitations are that observation can usually only take place at a certain point in time and does not provide comfort of the consistent performance of it, and the observation may in itself impact how the process or procedure is performed at that moment compared to normally
- **Recalculation** involves checking the mathematical accuracy of documents or records, which will often be done using CAATs on the electronic format
- **Re-performance** involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, either manually or using CAATs



Audit procedures

- **Analytical procedures** (DO NOT FORGET) is the evaluation of financial information by comparing both financial and non-financial data and determining if the relationships are plausible among them, and the investigation of identified fluctuations and relationships that are inconsistent with other information or deviate significantly from expectations. Preliminary analytical procedures are often used in the risk assessment process and concluding analytical procedures in the audit finalisation process



Specific audit procedures

- Specific audit procedures may provide evidence that relates to more than one assertion, and to some assertions but not to others (e.g. a stock count may provide evidence regarding more than one assertion, the existence and completeness of inventory, but not the rights and obligations)
- Sometimes a number of procedures are designed to address one assertion (e.g. for existence of receivables obtain debtors' confirmations plus inspect bank statements for subsequent receipts) especially where the risk of material misstatement is high



Specific items (ISA 501)

ISA 501 deals with specific procedures designed to obtain sufficient appropriate evidence relating to specific items, namely:

1) Inventory counts

- Attendance of stock counts, when inventory is material to the financial statements, so that the auditor can obtain sufficient and appropriate evidence regarding existence and completeness
- If the auditor cannot attend on the client's planned count date an alternative date should be arranged
- If the count is not at period end, then roll forward or roll back procedures will be used to reconcile the balance to period end as the balance is being tested as at that date



Specific items (ISA 501)

2) Litigations and claims

- Procedures regarding litigation and claims, since these may have a material impact on the financials
- The auditor should design procedures to become aware of any litigation and claims involving the client, including confirmations with lawyers, review of meeting minutes of management or those charged with governance, examining legal expense accounts etc.

3) Long-term investments

- Valuation and disclosure of long-term investments when these are material to the financial statements, including determining whether the entity has the ability and intention to hold the assets for long

- 4) The presentation and disclosure of segment information when this is material to the financials.



Tests of controls

- **Tests of controls** will be performed when the auditor's risk assessment included an expectation that controls are operating effectively (the design of the control, and its operating effectiveness are considered), and when the auditor has determined that evidence obtained from substantive procedures alone will not reduce audit risk to an acceptably low level
- Inquiry alone will not be appropriate, so combined procedures should be performed, which commonly includes inspection, observation or re-performance of the control



Substantive procedures

- **Substantive procedures** include tests of detail and substantive analytical procedures
- Irrespective of the assessed risk, the auditor should design and perform substantive procedures for each material class of transaction, account balance and presentation and disclosure
- Closing procedures should include agreeing or reconciling the financial statements to the underlying accounting records that were tested, and examining material journal entries and other adjustments made during the course of preparing the financial statements
- If there is a significant risk at the assertion level, perform substantive procedures specifically responsive to that risk



Substantive procedures

Nature

- Substantive analytical procedures are more applicable to large volumes of transactions that tend to be predictable over time (e.g. sales of products might have a consistent GP margin, so cost of sales can be assessed for a large volume of sales)
- Tests of detail are ordinarily more appropriate to audit specific assertions (e.g. existence and valuation of account balances)
- A combination of both types may be necessary

Timing

- Interim testing increases the risk that material misstatements at period end will not be detected, thus should be supplemented by additional procedures for the roll forward period
- Items with significant risks may rather be tested at year end due to the increased risks of interim testing



Substantive procedures

Extent

- The greater the risk, the greater should be the extent of substantive procedures
- The extent may also increase if tests of controls found that operating effectiveness of controls was worse than expected
- For tests of detail, the extent of testing will often refer to the sample size

The adequacy of presentation and disclosure should be audited to evaluate if the overall financials adhere to the financial reporting framework



Substantive procedures

Direction of testing

- Understand whether the risks under consideration relate to an overstatement or understatement
- If there is a risk of overstatement, the assertions to be tested are occurrence and existence, e.g. there could be a risk that debtors have been overstated because fictitious invoices were processed (i.e. occurrence of sales and existence of debtors will be under consideration). In such a case, the direction would be from accounting records to source documents
- If there is a risk of understatement, the assertions to be tested is completeness, e.g. the risk that invoices received were not processed in the accounting records. In such a case, the direction would be from the source documents through to the accounting records



Examination technique

It is important to formulate the procedure in a clear and concise manner. The following guide is recommended in formulating audit procedures:

- Address the **HOW**:
 - Use an appropriate and descriptive verb (inspect, recalculate, etc)
 - Verbs such as 'confirm / ensure' and 'check' will result in no mark
 - Consider the meaning and appropriateness of the verb, e.g. it would be inappropriate to state that you will "observe" a signature on a document (correct verb would "inspect")
- Address the **WHAT**:
 - Identify the appropriate source document and/or action to be performed, e.g. inspect the contract for signature
 - Consider the starting point of the transaction
- Address the **WHY**:
 - State the rationale of the specific procedure
 - If you cannot understand why it should be done, perhaps it shouldn't be done



Exam technique: Substantive procedures

- For substantive procedures, an understanding of financial accounting principles is quite helpful in generating the applicable audit procedures (think about the debits or credits)
- Pay careful attention to the assertions and class of transactions or balances to be tested as per the required
- Determine point at which the audit is taking place, interim vs year end
- When more than a single assertion is to be addressed, it might be useful to deal with each assertion at a time using headings where appropriate
- Never forget about analytical procedures
- Consider the appropriateness of the general audit procedures
- Consider all the legal documents involved
- Procedures performed: Inspection, confirmations, recalculations and substantive test of details



Example 3

Kite Flyers Ltd *continued...*

REQUIRED:

Identify the audit procedures that should be performed to address the risks identified for the valuation of inventory in Lecture example 1



Example 3

The following procedures can be performed to address the risk regarding valuation:

- **Inquire** regarding the client's choice between FIFO or weighted average and confirm this by inspecting the policy disclosed in the most recent or draft financial statements
- **Inquire** regarding the client's policy of treating standard cost variances and ensure this is consistent with IFRS
- **Obtain** the inventory valuation including raw materials, WIP and finished goods
- **Select** a sample of items from the valuation and obtain the costings, invoices, job cards (if applicable), supplier contracts and other supporting documentation for the selected items
- **Obtain** a list of standards from the inventory controller or financial manager, as well as supporting calculations
- **Perform** an analysis on the reasonability of standards by comparing these to industry norms, historic rates, best practices and assessing the size and frequency of variances



Example 3

Inspect the costing and inspect the supporting documentation for each item selected:

- **Agree** the standards used in the standard costing to the standards per the list received in earlier steps
- **Agree** the recognition date of raw materials to import/ other documentation and confirm that the risks and rewards of ownership passed as per contractual terms with suppliers
- **Agree** the actual quantities, hours, prices etc. used in variance calculations to actual invoices, job cards etc.
- **Re-perform** the costing and the variance analysis or recalculate these
- **Attend** the stock count and in the process of performing test counts inspect the inventory to identify damaged, impaired or unsaleable goods



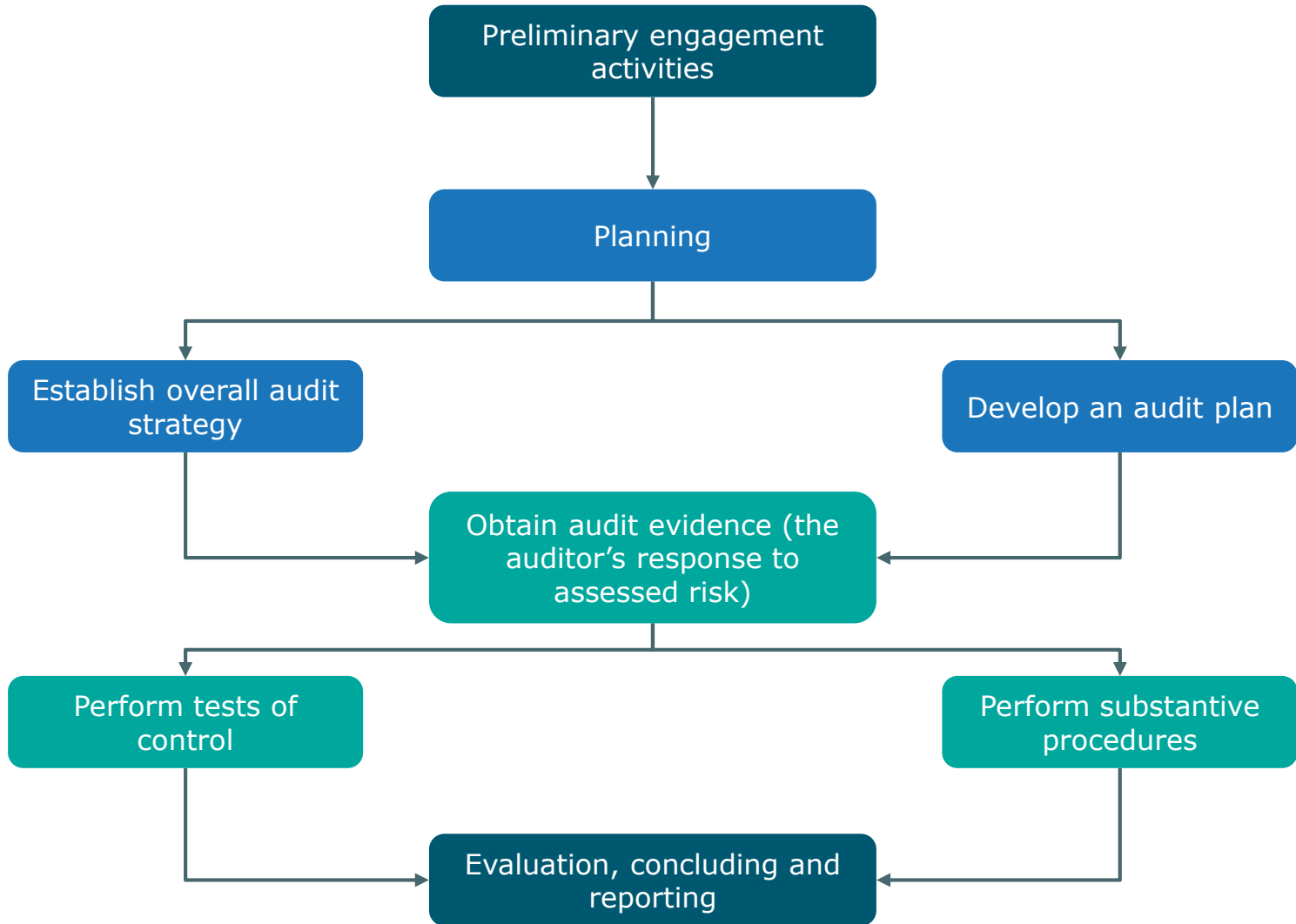
Example 3

- **Follow up** with the relevant client employee regarding write-offs or impairments of inventory identified above
- **Obtain** the client's inventory age analysis and provision for inventory calculation
- **Discuss** the write-off/provision policy with the financial manager/inventory controller
- **Re-perform** the ageing of the inventory
- **Perform** net realisable value testing by obtaining recent invoices and comparing the selling price achieved to the cost price, especially on slow moving lines



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Thank you

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