

Tutorial letter 501/3/2014

**SUBSTANTIVE PROCE-
DURES AND FINALISING
AN AUDIT**

AUE3702

Semesters 1 and 2

Department of Auditing

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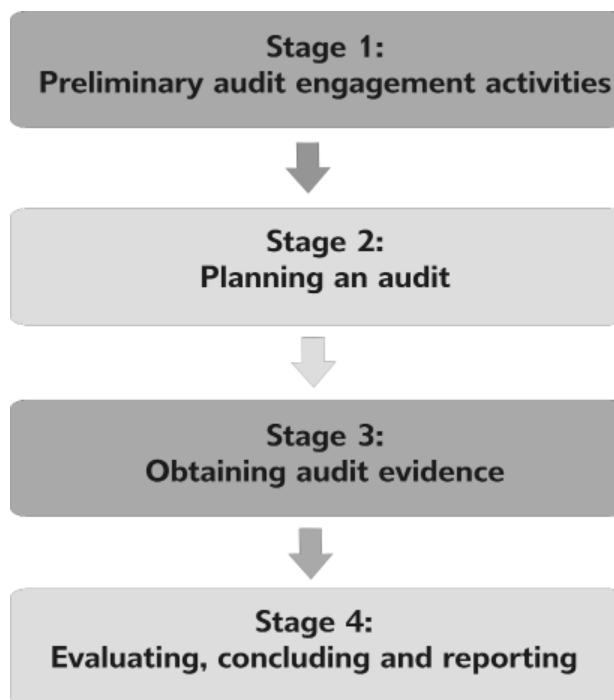
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Orientation and learning approach

Welcome to the module *Substantive procedures and finalising an audit* (AUE3702). We are hoping that you will enjoy this module. By “enjoy” I mean that you approach the module with a positive mindset – not just to pass an examination – but rather to gain insight into and knowledge on the subject of auditing. Besides, the country needs knowledgeable, critical-thinking auditors. In addition you need to compete internationally, because we are part of the global economy. This is your opportunity to achieve just that. However, a prestigious qualification like CA(SA) or Registered Auditor (RA) requires sacrifice, implying commitment and consistent hard work. This module will stretch and challenge you, so remember: “Never, never, never give up” (Winston Churchill).

<http://www.youtube.com/embed/Pwghabw4N80?rel=0>



In this module we are mainly going to focus on the concepts of audit evidence, the gathering of evidence through substantive procedures (**stage 3**) and evaluating, concluding and reporting (**stage 4**). Remember, you covered stage 1 and 2 in previous auditing modules. The topics that we are going to cover are set out as follows:

- Topic 1: Audit evidence
- Topic 2: Substantive procedures: the concepts
- Topic 3: Formulating the substantive procedures for the cycles
- Topic 4: Evaluating, concluding and reporting

LEARNING APPROACH

In this module I am going to approach the teaching and learning process slightly differently to what you were used to in your previous auditing modules. My aim is to focus on **you** as an **active** and **constructive** learner and not as a passive learner who memorises content and forgets it after the examination. Therefore you will be required to do activities **and save them on your computer to submit them online as a single assignment soon as you completed the relevant learning units**. You will benefit from the above approach because it helps you to cover the syllabus appropriately, at the right level of knowledge and consistently throughout the semester. Besides being an active learner, as lecturer I will be able to know whether or not you are working consistently because cramming the learning material before the examination date will be impossible. Knowledge gained through surface learning (cramming) unfortunately does not develop your intellectual ability and you forget it just as fast as you think you learnt it. **You** must engage with the learning material and construct new meaning.

For the assignments I also know very well how easy it is to copy a friend's work and submit the activities as one's own work, but I assume that you are **honest** (ethical) and that you have the **desire** to learn. I cater for honest students and not for criminals. Therefore in your first activity I request you to complete a declaration that all your submissions will be your own work. Only you can make that personal decision and commitment before continuing with this module. Should you wish to be dishonest for whatever reasons (those reasons are somehow always justifiable), the obvious risk that you may expose yourself to disciplinary action.

THE PRESCRIBED BOOKS

The learning units are designed to **guide** you through SAICA's prescribed syllabus. In other words SAICA decides what must be learnt. To this end, in this module we will study many of the International Standards of Auditing (ISAs) and we are going to formulate substantive procedures for all of the business cycles. You will require three prescribed books to cover the syllabus for this module.

- **Prescribed book on the International Standards of Auditing (ISAs)**

The ISAs can be purchased:

SAICA handbook: auditing. 2013/14. Volume 2. Durban: LexisNexis.

Or it may be downloaded (free) from the IRBA website (www.irba.co.za) or from the IFAC link: <http://www.ifac.org/publications-resources/2013-handbook-international-quality-control-auditing-review-other-assurance-a>.

The Independent Regulatory Board of Auditors (IRBA) adapted the ISAs in 2010 (*Government Gazette 33710*). In other words, in South Africa our

audits must be performed in terms of the prescribed international standards (ISAs). Remember, standards are intended to improve quality (thank you to Enron as the reason for these detailed ISAs). At the same time, standards imply that you, as auditor, will be measured/judged against those standards. That's why the IRBA performs practice reviews and auditing firms have quality control departments. Bottom line: You don't want to end up being fired, or be called on as witness in a long-drawn-out court case involving negligence, or even end up in jail (they say it's overcrowded in there – not nice). In your career just strive to meet the requirements as prescribed by the International Standards of Auditing. This alone should motivate you to want to know and really understand the ISAs. Only by complying with the ISAs will you be able to decide and judge whether or not an audit was properly performed.

To recap, you cannot attempt this module without the ISAs. At undergraduate level, we do **not** allow open book examinations. However in the CTA you are allowed to take your *SAICA handbook* into the examination centre with you. Therefore I recommend that you consider purchasing the *SAICA handbook* and become familiar with the book itself if you are intending to continue with CTA studies.

This module covers the bulk of the ISAs. At the beginning of each topic and learning unit I will provide you with the list of the particular ISAs involved, but in summary we will focus on ISA 450 to ISA 706. Remember this will require a lot of reading and it entails “difficult” reading, so plan for enough reading and thinking (reflecting) time.

- **Prescribed book for substantive procedures**

For this important part of the module, I will be referring you to the prescribed book:

Jackson, R & Stent, W. 2012. *Auditing notes for South African students*. 8th edition. Durban: LexisNexis.

This book sets out the substantive procedures in understandable English.

- **Prescribed book with practice questions: additional resources**

For additional practice questions, I will refer you to case study questions as collected and compiled by

Gowar, H & Jackson, R. 2014. *Graded questions on auditing*. Durban: LexisNexis.

In the “additional resources” on your menu, I will refer you to handpicked questions selected from this prescribed book that fit nicely into what you learn in all of the topics.

You must attempt these questions under examination conditions and mark yourself against the suggested solution that we will provide. Part of the

learning process is to **reflect** and ask yourself “**Why** did I not get good marks?” and “**How** can I remedy the problem so that I do not fall into the same trap again?”, for example. Reflection means that **you** may need to **go back** to the prescribed books or redo the question. Figure it out – auditors are active problem solvers and not passive passengers!

The case study questions assess the **application** of the theory that you learn while working through the learning material. This is where we really stretch you and take you to higher thinking levels. I also know that this is the difficult part of learning. The examination format is based on a case study with a scenario, just like in these questions in the additional resources. In addition, you will also be provided with a previous examination paper to familiarise you with the assessment style. This examination paper will also be found in the additional resources. Now, for the schemers – you cannot pass the examination if you only practise the case study questions or work through old examination papers. **You must first master the underlying theory.** The purpose of the case study questions is to facilitate learning and to prepare you for the examination to intellectually deal with the curve balls that come your way.

ASSIGNMENTS

Very important – the purpose of the assignments in this module is to build your own learning portfolio. The assignments will take you systematically through the **whole** syllabus. The activities that you are expected to submit **online** are indicated at the **end of each learning unit**. As soon as you complete a learning unit, you must save it on your computer before moving on to the next learning unit. In so doing, you will work consistently and submit your work continuously. You will feel good about yourself because you can see that you have progressed.

This will require planning and work on your part (ownership and time management skills). This is an open learning environment where you manage your own progress. I do not know your personal circumstances, so I cannot prescribe when to do what. **You** are therefore required to schedule **your** own dates (targets) and discipline yourself to meet those dates. Therefore take **ownership** of your own studies and your progress – it is in your hands. In achieving your targets, you will become positive, focused and driven – the stuff auditors are made of.

For this module you will be required to submit **three** assignments:

Assignment 01 provides you with **admission** to the examination and consists of a self-reflection multiple choice assignment. The due date for this assignment is **10 February 2014** and its unique code is **540438**. You can start by submitting it now.

Assignments 02 and 03 together contribute towards a year mark of 10% (5% per assignment). **Assignment 02** comprises of **all** the activities indicated at the end of each learning unit constituting topic 1. In other words, for Assignment 01 you must have submitted **all** the activities for topic 1: learning units 1.1 to 1.9 **online** on or before **28 March 2014**. All the

activities must be submitted as a single assignment (pdf) and its unique code is **540452**. Therefore I suggest that you open a file on your computer and save the activities as you go along and on the due date submit one document.

Assignment 03 will take you through the remaining topics (topics 2 to 4). You must submit the activities for the remaining topics on or before **24 April 2014**. All the activities must be submitted as a single assignment (pdf) and its unique code is **540458**. The due dates for all the assignments are nonnegotiable therefore plan for the unforeseen and do not leave it for last.

The tutors will open your assignment after the cut-off date and check that you have attempted all the activities and then select a sample to determine the quality of your work. If you did not attempt all the questions, or copied or submitted poor quality responses you will be awarded 0%. If you worked hard the chances of obtaining 100% may easily be achieved.

The portfolio that you will be building through the two assignments becomes part of your study notes. You will **not** receive solutions to these activities because you are given the specific references to find the answer yourself. So nothing is difficult – it only takes time and commitment.

WHY ALL THESE TYPING AND SUBMISSION ACTIVITIES?

Many students lack reading, writing and critical reasoning skills. I want you to nurture communication and critical reasoning skills while you engage with the learning material. **Communication** skills are becoming increasingly important for SAICA: therefore marks are allocated for these skills. Marks are awarded in the examination for these skills (5% to 10%). Refer to the following link to determine what we will look for and how we will assess these skills: <https://www.saica.co.za/LearnersStudents/Examinations/ExamInformation/TheInitialTestofCompetenceITCJanuary2013/tabid/2904/language/en-ZA/Default.aspx>). Look for the document “Guidelines for candidates relating to the assessment of communication skills”.

You must get into the habit of expressing yourself clearly in your sentences; present your information in the manner required by the examiner; use appropriate professional language style (no slang or SMS style allowed); set out your argument logically and the layout must make sense and be structured (Google “mind mapping” as a possible tool to structure your arguments and learning content).

I therefore urge you, whenever you are referred to an ISA, to read the standard critically (underline/make summaries, etc) and learn the definitions used by the profession. You **develop** communication skills through reading and writing (activities that **you** have to do). Remember that these skills may determine whether or not you pass or fail an examination because 5% to 10% can be crucial if you are a borderline case! Therefore, once you have worked through each learning unit, you are required to submit

your answers to the activities online. This module therefore requires a lot of reading and writing (typing) work of you.

I also want you to become a **critical thinker**. This requires you to question the purpose of the content, the underlying theory, the assumptions made, even challenge the standard setters, **but to base your arguments on researched and informed findings**. I am not interested in your **personal** opinions but in your **informed** opinions. This may require you to do some further research on the internet if need be. You must also make sense of what you have learnt and reflect critically on what you have learnt and how you can modify your actions to make the necessary improvements. Start thinking about thinking! To this end, do yourself a favour and open and read the following link on the elements of critical thinking: <http://think.hanover.edu/Resources/MiniGuidetoCT.pdf>. Remember: critical thinking in this module is developed through the case studies in the additional resources, the discussion forums that we will hold on myUnisa and your self-reflections! Therefore participate, reflect, adjust and learn!



ACTIVITY 0.1

With all the above said and explained, let's start off with your **first** activity, namely **Activity 0.1** that you complete and save on a file to be submitted as part of assignment 01, so that you can see how the process works and simultaneously take ownership of your studies. You are required to formulate in your own words a declaration (like a management representation) that all the work that you will be submitting online in this module will be your **own** attempt and that you will not copy and paste it from someone else. I am looking forward to your first online submission!

TOPIC 1

Audit evidence

L Ferreira

Topic overview

An audit opinion must be substantiated by sufficient appropriate audit evidence. In this topic we are going to look at what is meant by the term “sufficient appropriate audit evidence”. In addition we will look at the different forms of audit evidence and special considerations: for example evidence produced by experts, the internal auditors, opening balances and the accounting estimate. We will look at how audit evidence can be selected (sampling) and how it can be requested or confirmed. In the next topic we will examine how analytical procedures (part of substantive procedures) also form part of audit evidence.

This topic is divided into the following learning units.

Learning unit	Title
1.1	The theory of audit evidence (ISA 500)
1.2	Relying on information produced by the work of a management’s expert (ISA 500)
1.3	Using the work of an auditor’s expert (ISA 620)
1.4	Using the work of internal auditors (ISA 610)
1.5	Initial engagements: opening balances (ISA 510)
1.6	Accounting estimates (ISA 540)
1.7	Audit sampling (ISA 530)
1.8	External confirmations (ISA 505)
1.9	Written representations (ISA 580)

LEARNING OUTCOMES

The learning outcomes of each of the learning units are set out in the separate learning units.

LEARNING UNIT 1.1

The theory of audit evidence (ISA 500)

L Ferreira

After having worked through this learning unit you must be able to

- | |
|--|
| <ul style="list-style-type: none">• identify where to search for audit evidence |
| <ul style="list-style-type: none">• list the methods of how to collect evidence |
| <ul style="list-style-type: none">• describe the concept of “sufficient, appropriate audit evidence” |
| <ul style="list-style-type: none">• list the methods of selecting audit evidence |

1.1.1 INTRODUCTION

When reading a set of published unmodified (unqualified) audited financial statements in the newspaper or on the internet, you as the analyst or investor have certain expectations, namely that the figures are a fair representation of the financial position and results. For an auditor to express an opinion in an audit report (signing it off) requires the collecting and reviewing of sufficient, appropriate audit evidence. Therefore your world (as an auditor) revolves around audit evidence. If your friend who is studying engineering or art asks you to describe what auditors do, you would answer something like “It’s about collecting and examining evidence to form conclusions and eventually express an opinion through an audit report.” The auditor, in terms of ISA 500, has the duty to design and perform audit procedures in such a way as to enable the auditor to obtain **sufficient, appropriate audit evidence** to be able to draw reasonable conclusions on which to base the auditor’s opinion. In this learning unit I will be taking you through some relevant concepts regarding audit evidence, as set out in ISA 500.

For this learning unit, make sure you have ISA 500 in front of you and if you like, make something strong to drink ... coffee. In the meantime you may listen to the following podcast: <http://opentuition.com/acca/p7/chapter-6-evidence/>

1.1.2 WHERE TO LOOK FOR AUDIT EVIDENCE

Let's kick off with a basic, but important, activity.



ACTIVITY 1.1.1

During the process of gathering audit evidence the auditor first performs a risk assessment and then performs a combination of tests of controls and substantive procedures. Let's assume you are an audit manager of an audit firm, where do you think you will be searching for evidence in a client's business?

- (1) Bank reconciliations
- (2) -----
- (3) -----
- (4) ----- etc

Come on, jot down some answers! If you don't know where to look for evidence how will you be able to collect it?



Study

Now refer to ISA 500, paragraph 5(a), to identify some examples of where you could look for evidence. As I have said, these examples are important to give you some idea about where to start when looking for evidence. Remember that people, accounting systems, source documents and external sources and information all form part of possible sources of evidence. These sources must therefore be included in the formulation of audit procedures.

1.1.3 COLLECTING AUDIT EVIDENCE

Your collection of audit evidence is recorded in your audit working papers. Working papers are a record of the work you have done and the evidence you obtained that is cross-referenced to the financial statements. Therefore you must compile audit working papers that the partner can review and understand without asking additional questions. So do you see why we are so strict about marking auditing procedures? They must be relevant, concise and understandable.

How does the auditor go about collecting evidence (i.e. what methods does the auditor use)? The answer is through inspection, observation, confirmation, recalculation, re-performance, analytical procedures and enquiry. Remember audit procedures should be formulated as **instructions** to junior audit team members to collect the evidence that will be sufficient, appropriate and reliable. When you fill up your car at a garage, what instruction do you give to the attendant? "Fill up, please." See it as a clear instruction. Therefore, when formulating an audit procedure, the tone is almost the same (except for the "please" part). For example "Recalculate the inventory sheets ...". The secret of a well-formulated procedure is to ensure that the reader knows exactly **what** to do and **where** to go to look for the evidence. Remember, an audit procedure is not an objective

(an objective starts with “to ensure that ...”). For example, “to ensure that the values on the inventory sheets are correct; but an auditing procedure is an instruction **to meet the objective** (assertion). Bear this in mind when you formulate audit procedures and when you mark yourself during self-assessments throughout this module.



Study

Refer to ISA 500, paragraphs A14 to A25, and make sure you know what each method for collecting evidence involves. As I have explained, knowing the different methods available to the auditor is extremely important when you formulate auditing procedures. Memorise these words and say them out loud so that you get used to them!



ACTIVITY 1.1.2

List each method of evidence collection.

1.1.4 SUFFICIENT, APPROPRIATE AUDIT EVIDENCE

Think about it, when collecting audit evidence you should neither be collecting too much (it would be too expensive for the client) nor too little (you don't want to end up in court for negligence for not collecting enough evidence to support your opinion). The ISA says: “The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining **sufficient, appropriate audit evidence**” (ISA 500, par 6). So, what does the term “sufficient, appropriate audit evidence” really mean?

Sufficient



Study

Refer to ISA 500 and highlight or underline paragraph A4 (sufficiency) and reflect on what you highlighted. Sufficiency = quantity (enough). Do you notice and understand how risk affects quantity? Now that we know that audit evidence must be sufficient, what about its “quality”? Notice the last sentence in that particular paragraph A4. Often students write numerous audit procedures in the examination and earn no marks for them – that is why – they were not relevant or appropriate! Refer to page 20 of chapter 5 in your prescribed book *Auditing notes for SA students* (Jackson & Stent) to understand the practical application of the term “sufficient”.

Appropriate

Appropriateness is affected by relevance and reliability.



Study

Refer to ISA 500, highlight/underline paragraph A5 and reflect on what is written (appropriateness = relevant and reliable) – Do you notice the word “relevance”? Referring back to the examinations again, your audit procedures must be **relevant** to the question asked to earn marks! Assertions guide the auditor to formulate and **focus** on relevant points or issues. The auditor must be efficient and effective to be competitive, so within the limited time and budgets available the auditing procedures must be “spot on”. Therefore the auditor must know the **purpose** of the audit procedure beforehand. When considering appropriateness of your auditing procedure you need to ask yourself “Am I targeting overstatements or understatements and which assertion(s) am I going to examine?” I will explain the principles of direction of testing in topic 2.



ACTIVITY 1.1.3

You are required to define the term **relevance** (ISA 500, par A27)

Refer to page 21 of chapter 5 in your prescribed book *Auditing notes for SA students* (Jackson & Stent) for a practical explanation of the term **relevance**.

Now let’s consider the concept of **reliability** (a dependable source and the nature of the source). Which is a more reliable source of information? – reading up on health matters, say on cholesterol, in a commercial magazine like *You* or reading about this in a scientific journal that has been peer reviewed by scientists? As a doctor will you treat cholesterol based on blood tests or on the symptoms? Which source of information is more reliable? Now the same applies to the auditor when collecting audit evidence.

Refer to page 21 in chapter 5 of your prescribed book *Auditing notes for SA students* (Jackson & Stent) to understand the hierarchy of reliability for audit evidence.



Study

Read ISA 500, paragraph A31, especially the bulleted paragraphs – reflect on these statements and relate them to some of your own examples. Do you see that the source and nature of evidence determine its reliability?

If you think about it, the client is continuously producing its own evidence (e.g. the cost accountant produces inventory costing values). How will you, the auditor, evaluate evidence produced by the client? You simply ask yourself if the evidence gathered was sufficient and reliable – both of these are concepts you should have mastered above. In a following learning unit we will look at how to evaluate the evidence generated by an expert employed by the client (e.g. a geologist or engineer).



ACTIVITY 1.1.4

What are the implications for the auditor if the auditor is unable to collect sufficient, appropriate audit evidence (ISA 705, par 6)? So the implications are serious!

We have learnt that the auditor must collect sufficient, appropriate evidence, where to look for it, how to collect it and we have some idea how to rank the reliability of evidence. The next aspect we need to consider is how the auditor selects items for testing to obtain audit evidence.

1.1.5 HOW TO SELECT AUDIT EVIDENCE



Study

Refer to ISA 500, paragraphs A52 to A57, and highlight/underline the three means available to the auditor for selecting items for testing.



ACTIVITY 1.1.5

Did you highlight the critical meaning of the text – an honest yes/no?

Now consider (reflect from the text): When will it be most appropriate to use a particular method of selection? Later on in the study guide we will look at the topic of audit sampling.

1.1.6 CONCLUSION

In this learning unit I have introduced you to the concepts of audit evidence and the auditor's responsibility to design and perform audit procedures to obtain **sufficient appropriate audit evidence**. This is necessary for auditors to be able to draw reasonable conclusions on which to base their opinions.

Reflect on the notes that you made and go back to the assessment criteria at the beginning of this learning unit. Make sure that you are able to achieve those outcomes before moving onto the next learning unit.

As soon as you have completed this learning unit you are required to save Activities 1.1.1 to 1.1.5 on your computer to be submitted later as part of assignment 02 on myUnisa.

LEARNING UNIT 1.2

Relying on information produced by a management's expert (ISA 500)

L Ferreira

<p>After having worked through this learning unit you must be able to</p>
<ul style="list-style-type: none"> • identify when management is using its own expert (management's expert)
<ul style="list-style-type: none"> • describe the considerations affecting the nature, timing and extent of the auditor's procedures when relying on the work of an expert
<ul style="list-style-type: none"> • describe the auditor's procedures in order to rely on the work of a management's expert

1.2.1 INTRODUCTION

In the previous learning unit I introduced you to ISA 500 (**Audit evidence**). In this learning unit we are going to look at a section of ISA 500 dedicated to the problem of how and when to rely on information (audit evidence) produced by a management's expert. In a scenario of a case study, you must be able to identify or recognise when management has employed/ appointed an expert and what the auditor (you) must first do before you can rely on such work. That is why it is so important to read between the lines of a scenario given in the examinations. Therefore read your scenarios very critically because valuable clues (alert signals) are provided in the text.

A management's expert simply means someone employed or appointed **by the client** (and not by the auditor) who possesses certain expertise/ skills in a field other than accounting and auditing whose work in that field is used by the client in the preparation of the financial statements. In the next learning unit we will learn about the requirements when the auditor uses his or her **own** expert. Note the difference between a "management's expert" and an "auditor's expert".

Remember, save your answers to the questions and activities as soon as you have completed the learning unit.

1.2.2 RELIABILITY OF INFORMATION PRODUCED BY MANAGEMENT'S EXPERT

Clients pay for the services rendered by their experts and often they are on their payroll. Sometimes their services are required on a contractual basis. You, the auditor, may want to use or rely on the work performed by a management's expert to serve as part of your collection of audit evidence. Although these individuals or firms may be regarded as experts in their fields, the auditor cannot simply accept the expert's work at face value. You, the auditor, must still answer the basic question: Can I **rely** on the evidence produced by this expert of the client? Before placing reliance on the work of a management's expert (to use the information as part of your audit evidence) you have certain responsibilities to perform in terms of ISA 500. In this learning unit we are going to learn about these responsibilities and considerations. Read ISA 500, paragraph 8, to orient yourself for the next activity.



ACTIVITY 1.2.1

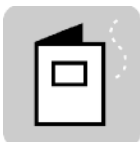
Let's assume that your client is a mining company and you want to place a value on a heap of coal (inventory). You do not have the skills to tell the difference between poor and good quality coal which directly affects value. To assist you in this task, you need the expertise of a geologist who knows all there is to know about coal. The client employs such a geologist.

1. May you use the work produced by the geologist as evidence?

(Study ISA 500, par 8, to answer the question.)



2. Compile a list of things that you must first consider before you can rely on the information generated by the geologist. Structure your answer as follows:
 - competence and objectivity of management's expert
 - understanding of the work of management's expert
 - appropriateness of the work produced by management's expert



(Study ISA 500, pars A34 to A49, to answer the question.)

3. Assume that you intend to rely on the work performed by the geologist employed by your client. Describe the considerations affecting the nature, timing and extent of your procedures when relying on the work of the geologist (management's expert).



(Study ISA 500, par A36, to answer the question.)

Would you be able to answer all of the above questions if I were to ask them in the examination? Reflect on these questions and answers. Do you understand the logic and see the bigger picture why the auditor has to consider all of these things before relying on the work of a management's expert, before using it as part of your audit evidence?

1.2.3 CONCLUSION

In this learning unit the concept of a management's expert was explained and you were made aware of the things that you (the auditor) must consider in terms of ISA 500 before reliance can be placed on the work of a management's (the client's) expert.

Reflect on all the notes that you made and refer to the learning outcomes as listed at the beginning of this learning unit and make sure that you can achieve these before moving on to the next learning unit.

As soon as you have completed this learning unit you are required to save Activity 1.2.1 on your computer as part of your assignment to be submitted later on myUnisa.

LEARNING UNIT 1.3

Using the work of an auditor's expert (ISA 620)

L Ferreira

After having worked through this learning unit you must be able to
<ul style="list-style-type: none"> • describe the factors justifying the need for an auditor's expert
<ul style="list-style-type: none"> • describe the factors to determine the extent of reliance that can be placed on an auditor's expert
<ul style="list-style-type: none"> • list things to consider when reaching an agreement with the auditor's expert
<ul style="list-style-type: none"> • evaluate the adequacy of the work performed by the auditor's expert
<ul style="list-style-type: none"> • consider implications of using an auditor's expert on the audit report

1.3.1 INTRODUCTION

In learning unit 1.2 we learnt about the requirements in terms of ISA 500 when the auditor intends to rely on the work of a **management's expert**. In this learning unit we will examine what ISA 620, on **using the work of an auditor's expert**, has to say (requirements) if and when you, the auditor, wish to make use of an expert that **you** appoint. The auditor is not expected to be an expert in other professions and sometimes the nature of a client's business requires the opinion of an expert. However, auditors cannot just appoint experts left, right and centre because they don't feel like applying their minds! That practice will simply raise the audit fee (someone must pay for the expert) and unnecessary costs will make your audit firm uncompetitive, meaning no business. Therefore such an appointment must be justified. Also remember that the auditor is ultimately responsible for the audit opinion and therefore the auditor is still responsible for the work performed by the expert. So you cannot just "pass the buck" and think you are "done"!

After studying this learning unit you (the auditor) must be able to determine whether or not it is necessary to make use of an expert (auditor's

expert) and be able to determine whether or not the work performed by the expert is adequate for your purposes (i.e. to obtain sufficient, relevant and reliable audit evidence).

You may also use the material made available on IFACs website:

<http://www.ifac.org/publications-resources/isa-module-isa-620-using-work-auditors-expert>

Remember, save your answers to the questions and activities as soon as you have completed the learning unit.

1.3.2 RELYING ON THE WORK OF AN AUDITOR'S EXPERT (ISA 620)

It is important that you recognise the difference between a **management's expert**, which we dealt with in learning unit 1.2 and an **auditor's expert**, which we are going learn about now.



ACTIVITY 1.3.1

Define the term **auditor's expert**.

(Study ISA 620, par 6[a], to determine the definition.)



ACTIVITY 1.3.2

Let's assume that you are the audit manager at an audit firm. Your client has been sued by one of its major customers for a substantial amount for damages caused by one of your client's products. Your client brushes it off as nothing serious, but your professional judgement makes you think otherwise. You are therefore convinced that you need the input of a senior advocate or senior council (SC) to help you to put a value on a possible adjusting event.

Required: 1. Describe the factors to consider to determine whether or not to use an expert. (Do you think you should make use of an expert in this case?)



Study

(Study ISA 620, par 7, and ISA 620, pars A4 to A9, to answer the question.)

2. Describe all the factors that you will consider to determine to what extent reliance can be placed on an expert's work. (ISA 620, par A14, explains the concepts of competence, capability and objectivity.)



Study

(Study ISA 620, pars A15 to A20 to answer the question.) As part of a question in the examination, you may be asked to consider this, so always be aware of how to apply and integrate your knowledge.

- ISA 620, paragraph 10, states: "The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert ..." This may

be done through discussions with the expert. Formulate questions that you would ask the expert to enhance your understanding of the expert's field of expertise.



Study

(Study ISA 620, pars A7 & A22, to answer the question.)

3. ISA 620, paragraph 11, requires the auditor to agree on the terms and conditions relating to the work of the auditor. List the matters that may be agreed upon.



Study

(Study ISA 620, par 11, ISA 620, pars A23 to A26, and the appendix to answer the question.)

4. In the end you have to evaluate the adequacy of the expert's work. Describe how you will assess the appropriateness of the expert's work.



Study

(Study ISA 620, pars A32 to A40.)

5. Are you required in terms of the ISA to make reference to the auditor's expert in the audit report? Substantiate your answer.



Study

(Study ISA 620, pars A41 & A42.)

1.3.3 CONCLUSION

Sometimes the auditor may need to appoint an expert to assist him or her with a specific assignment. The auditor is still ultimately responsible for the audit and therefore for determining whether or not the work of the expert is reliable and makes sense. In this learning unit you learnt about what to consider and how to evaluate the work of the expert in terms of ISA 620.

Reflect on all the notes that you made and refer to the learning outcomes at the beginning of this learning unit and make sure that you can achieve them before moving on to the next learning unit.

As soon as you have completed this learning unit you are required to save Activities 1.3.1 and 1.3.2 on your computer as part of your assignment to be submitted later on myUnisa.

LEARNING UNIT 1.4

Using the work of internal auditors (ISA 610)

L Ferreira

After having worked through this learning unit you must be able to

- | |
|---|
| <ul style="list-style-type: none"> • identify the functions performed by the internal auditors |
| <ul style="list-style-type: none"> • assess when to make use of the work of internal auditors |
| <ul style="list-style-type: none"> • determine the adequacy of the work performed by internal auditors |

1.4.1 INTRODUCTION

In AUE2602, *Auditing: corporate governance in accountancy*, you learnt what the King III Report (2009) has to say on the internal audit function within an organisation. In this learning unit we will briefly refer to that report (it was prescribed material in AUE2602), so look for it and dust it off.

The internal auditor's role has evolved into a more important and strategic function in business than ever before. The internal auditors also know very well how the client operates and how the client's systems operate. The big question you should be asking yourself is "What value do the internal auditors hold for me, the external auditor, and how can I use their expertise while performing the audit?". In this learning unit we will look at what the internal auditor does in practice and decide if you (the external auditor) can rely on the work produced by the internal auditors. We also determine the ISA requirements that must be satisfied before reliance can be placed on the work of the internal auditor.

Remember, save your answers to the questions and activities as soon as you have completed the learning unit.

If you like, you may begin this learning unit by listening to the following podcast for some background information: <http://opentuition.com/acca/p7/chapter-14-internal-audit/>

1.4.2 WHAT DOES THE INTERNAL AUDITOR DO?

The obvious start would be to first understand someone's expertise to utilise it properly. It's no use going to the gynaecologist if you broke your arm – you must know what a gynaecologist specialises in and what an orthopaedic specialist does and then use the right one! So let's first find out what internal auditors do and how we can use them when performing the audit. (Some of you may even consider a career as an internal auditor or even become the Chief Audit Executive in an organisation.) Visit www.theiia.org and just browse around on their website to get an idea of the internal auditing profession.



ACTIVITY 1.4.1

What are the objectives of the internal audit function in terms of ISA 610. A1?

What type of approach must the internal auditor follow in terms of the King III Report (2009:94)?

What role must the internal auditor play in terms of the King III Report (2009:95)?

(The answers to all of the above questions may be found in the references provided.)



Reflect and discuss (Activity 1.4.2)

- To what extent does the internal audit function correspond to the work performed by the external auditor?
- Why do you think that the internal auditor is a valuable source of information for the external auditor?
- How can working with the internal auditors benefit the external auditor?

1.4.3 CAN WE USE THE WORK OF THE INTERNAL AUDITORS?

The answer to this question is simply: It depends. The external auditor must consider whether the work of the internal auditor is **adequate** for purposes of the audit and consider the planned effect of the internal auditor's work on the nature, timing and extent of the external auditor's procedures.



Study

Study ISA 610, paragraphs 9 and 13 to 24, and then ISA 610, paragraphs A5 to A11. (Evaluating the internal audit function); A15 to A23 (Nature and extent); A24–A26 (Using the work) and A27 to A29 (Adequacy).



Reflect and discuss (Activity 1.4.3)

- In practice do you think the internal function can be objective and can this be managed? (Substantiate your answer with an argument.)



ACTIVITY 1.4.4

As audit manager of a large manufacturing company you appreciate the value and expertise of the internal audit function at the client company and you are investigating ways to remain within the budgeted audit fee but without compromising standards. You think that using the work of the internal auditors may be a possible option.

Required

- (1) Compile a check list that you will address to the Chief Audit Executive (CAE) to help you assess the work of the internal auditors will be adequate for purposes of the audit (a check list consists of a list of short questions each requiring a yes/no or n/a tick response) (reference ISA 610, par A5 to A14).
- (2) Assume that the majority of the questions to your check list were answered favourably by the CAE, suggesting that you could seriously consider using the work of the internal auditors. You therefore had the internal auditors compile some work for you that you intend to use as part of your audit evidence.
- (3) List five things that you will consider when evaluating the work of The internal auditors.
(reference ISA 610, par 21, 22, 23 and A27–A30)

1.4.4 CONCLUSION

In this learning unit we opened our minds to the value that internal auditors hold for the external auditor. Knowing and appreciating the role that they play in an organisation it seems desirable to make use of their work. ISA 610 informs us when we can rely on their work and what the auditor's duties are before he or she can place reliance on the internal auditor's work.

Reflect on all the notes that you made and refer to the learning outcomes at the beginning of this learning unit and make sure that you can achieve these before moving on to the next learning unit.

As soon as you have completed this learning unit you are required to save Activities 1.4.1 to 1.4.4 on your computer as part of your assignment to be submitted later on myUnisa.

LEARNING UNIT 1.5

Initial engagements: opening balances (ISA 510)

M La Grange

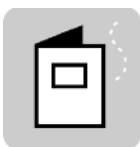
After having worked through this learning unit you must be able to

- describe the audit procedures followed by the auditor to audit opening balances of initial audit engagements
- determine the influence of various scenarios, which includes the inability to obtain sufficient and appropriate audit evidence, material misstatements, accounting policies not consistently applied, changes in accounting policies not appropriately accounted for, and modification of the previous auditor's report, on the opening balances of initial engagements and express all this in an audit report

1.5.1 INTRODUCTION

When auditing financial statements for the first time, the auditor has to obtain evidence to support the opening balances, which make up an integral part of the financial statements. Since the audit opinion includes the opening balances, it is specifically necessary to examine the question of verifying opening balances.

You must concentrate on two things when studying this learning unit, namely the **audit procedures** to be performed by an auditor with regard to opening balances, and secondly the formulation of an appropriate **audit report** based on various scenarios concerning the opening balances.



Study

Study ISA 510, and the relevant sections dealing with initial audit engagements (opening balances) in chapter 17 of Jackson and Stent.

Note the following in the above study sources:

- The definitions of “initial audit engagement”, “opening balances”, and “predecessor auditor” (ISA 510, par 04). These definitions are important to enable you to understand the ISA.

- The audit procedures to be followed when auditing the opening balances of initial engagements (ISA 510, pars .05, .06, .07, .08 and .09, A3 to A7).
- The effect of various scenarios (e.g. misstatements in the opening balances) concerning the opening balances on the auditor's report (ISA 510, pars .10, .11, .12, .13, A8 to A9, and the appendix which illustrates the effect of opening balances on the audit report). Also refer to ISA 700, 705 and 710 as discussed in learning unit 4.6 where the various auditor reports are discussed in detail.

Self-reflection Activity 1.5.1, to be submitted:

After studying the theoretical concepts above I want you to attempt question (1) of Activity 1.5.1 below as if under examination conditions. But you mark it yourself by awarding 1½ marks for a properly formulated procedure. (Don't look at the comments or solution yet.) Part 1 for this exercise counts a maximum of 14 marks. Your attempt must cover all the accounts in the scenario. You are then required to submit the **percentage** you obtained **and** a **self-reflection**. Your self-reflection may include questions you ask yourself: Did I understand the purpose of the question? Did I understand the theoretical principles? Must I read up more (research) the topic? Must I practise more, by repeating the question? What did I learn from doing the activity? What made the question difficult? Doing the self-reflection exercise is more important than the marks. Self-reflection nurtures critical thinking and at the same time improves your communication skills. These are the soft skills that the accounting and auditing professions require and give recognition for.



ACTIVITY 1.5.1

You have recently been appointed as the auditor of Whiskey (Pty) Ltd for the year ended 31 March 2013. This is the first year in which the financial statements are being audited, although the organisation has been in existence for 15 years. The organisation was previously run as a one-person concern and was converted into a private company during the past year.

You made provision in your planning of the audit for the auditing of the initial balances.

The following is an extract from the statement of financial position of Whiskey (Pty) Ltd (before a company had been established) at 31 March 2013:

Long-term loan payable: ABC Bank	R250 000
Property, plant and equipment	R140 000
Trade receivables	R360 000
Bank	R25 000
Inventory (perpetual system)	R321 000

You were able to obtain sufficient, appropriate audit evidence regarding all of the account balances, except for the opening balance of inventory. The opening balance of inventory is deemed to be material but not pervasive

to the entity's financial position. Except for this matter, the financial statements are fairly presented.

The financial position at year end is fairly presented.

Required

- (1) Describe the audit procedures you would apply in order to verify each of the opening balances mentioned above.
- (2) Describe the type of audit report that will issued by the auditor.



FEEDBACK ON ACTIVITY 1.5.1

(1) Audit procedures

Long-term loan payable: ABC Bank

- Send a letter to the creditor requesting the bank to confirm the balance as at 31 March 2013.
- If the above is impossible, the repayments as laid down in the contract should be determined and the transactions that have taken place during the year should be examined.
- The balance at 31 March 2013 plus or less the transactions of the past year should give the opening balance.

Property, plant and equipment

- All transactions according to the ledger must be vouched for by supporting documentation to ensure that the transactions were authorised and occurred.
- Work through the minutes, cash book and other relevant documentation to trace any unrecorded transactions pertaining to property, plant and equipment.
- Calculate the opening balance for fixed assets by adjusting the closing balance by the transactions for the year.

Trade receivables

- Verify the opening balances according to the trade receivables' ledger by vouching the payment of debtors as at 31 March 2013 against receipts issued.
- The trade receivables can be circularised, that is letters of confirmation can be sent to them in which they are requested to confirm the balance at 31 March 2013.
- If necessary, the balances can be further verified by examining the source documents that make up the balances.

Bank

- Obtain the bank statement, cash book and bank reconciliation of the organisation as at 31 March 2013.

- Send a letter to the bank in which you request them to confirm the balance as at 31 March 2013.
- Compare the balances on the reconciliation with the ledger and the bank statement respectively.
- Vouch every reconciling item and ensure that it is valid.
- If the reconciliation is correct, the opening balance can be accepted as correct.

Inventory

- Select documents that represent the inflow and outflow of inventory, possibly goods receipts vouchers and consignment notes, and make certain that the inventory records have been correctly kept.
- Select entries from the inventory records for both the inflow and the outflow of inventory and follow them through to the source documents to ensure that all entries in the inventory records are valid.
- If you are satisfied that the system of internal control over inventory works, you can rely on the system and the quantities of items given in the inventory records can be accepted.
- Analytical procedures such as gross profit percentage and inventory revenue rate can also contribute to the verification of the opening balance.
- Verify the cost price of inventory as at 31 March 2013 by comparing it with the purchase invoices.
- Apply cut-off procedures to the opening inventory.
- Reconcile the opening balance of inventory with the closing balance.

Comments on question (1) in Activity 1.5.1

- Pay attention to the manner in which the answer was presented. The use of headings (in this question representing the different account names) enables you to write the applicable audit procedures relating to the specific account underneath each heading. The use of headings will also assist you to deal with all the accounts (i.e. not leaving out one account by mistake) to enable you to earn the maximum marks.
- Also, the use of bullets for each audit procedure will allow you to present your answer in a neat manner.

(2) Audit report

An opinion that is qualified by the auditor's ability to obtain sufficient appropriate evidence will be included in the audit report.

Comments on question (2) in Activity 1.5.1

Please note that in the examination you could also be required to draft certain parts of the audit report. For example, you could be required to draft paragraphs under the following headings: “Basis for qualified opinion” and “Qualified opinion”:

Basis for qualified opinion

We were unable to obtain sufficient appropriate evidence about the opening balance of inventory included in the entity’s statement of financial position as at 31 March 2013. 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 paragraph on basis for qualified opinion, the financial statements present fairly, in all material respects, the financial position of Whiskey (Pty) Ltd as at 31 March 2013, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Also refer to ISA 700, 705 and 710 as discussed in learning unit 4.2 where the various auditor reports are discussed in detail. Pay attention to the decision tree which illustrates the different kinds of audit opinions that can be issued.



ACTIVITY 1.5.2

You have recently been appointed as the auditor of Whiskey (Pty) Ltd for the year ended 31 March 2013. Whiskey (Pty) Ltd has always been a company and as the newly appointed auditor you have simply taken over the audit from the previous auditor.

Required

- Describe the audit procedures you would apply in order to verify the opening balances mentioned previously.



FEEDBACK ON ACTIVITY 1.5.2

- The newly appointed auditor can obtain sufficient relevant audit evidence in respect of the opening balances by examining the previous auditor’s working papers.
- The present auditor should, however, consider the previous auditor’s professional competence and independence and also study any qualifications to the previous year’s audit report.
- Before the present auditor may contact the previous auditor, she must study and comply with the ethical principles as contained in the Profes-

sional Code of Ethics: that is, consent must first be obtained from the management of Whiskey (Pty) Ltd before contacting the previous auditors.

Comments on Activity 1.5.2

- Please note that in the answer to Activity 1.5.2 the different headings of the accounts are not displayed. The reason is that the procedures that the newly appointed auditor would apply are the same for all of the account balances.
- Therefore these general procedures should **not** be repeated for every account balance. Marks will only be awarded once in a question.
- Please note the following: if access to the previous auditors' working papers is denied, the auditor should consider whether the audit engagement should still be accepted. This pre-engagement activity was dealt with in AUE3701.
- Also, if there is insufficient evidence in the previous auditor's working papers, this may lead to the newly appointed auditor being unable to obtain sufficient, appropriate audit evidence regarding the opening balances. In such a case, the auditor should express a qualified opinion or disclaim an opinion on the financial statements as appropriate, in accordance with ISA 705.

1.5.4 CONCLUSION

In this learning unit we dealt with guidelines for the auditor in respect of opening balances in initial audit engagements.



Self-assessment

After having worked through the learning unit and the references to the prescribed study material, decide whether you feel comfortable about doing the following:

- (1) Describe the audit procedures followed by the auditor to audit opening balances of initial audit engagements.
- (2) Determine the influence of various scenarios on the opening balances of initial engagements and express this in an audit report.

As soon as you have completed this learning unit you are required to save Activity 1.5.1 (consists of a percentage and a self-reflection) as part of your assignment to be submitted later on myUnisa. The self-reflection must not be skimpy.

LEARNING UNIT 1.6

Accounting estimates, including fair value accounting estimates, and related disclosures (ISA 540)

L Ferreira

After having worked through this learning unit you must be able to
<ul style="list-style-type: none"> • explain the nature of accounting estimates
<ul style="list-style-type: none"> • define certain terms relating to accounting estimates
<ul style="list-style-type: none"> • explain the risk that accounting estimates holds for the auditor
<ul style="list-style-type: none"> • formulate the audit procedures for accounting estimates

1.6.1 INTRODUCTION

In business, the accountant often has to make a prediction and pass an entry in the accounting records, presenting and disclosing what cannot be measured/determined accurately (estimate). These entries and disclosures are nevertheless essential to provide the reader of the annual financial statements with a fair or reasonable representation of the financial results and financial position. In our daily lives we estimate many things (e.g. when you plan a weekend away to the coast you will **estimate** how much it will cost and then decide if you can afford to go or whether you should postpone it until you have saved sufficient funds).

In this learning unit we are going to learn how the auditor collects sufficient appropriate evidence regarding accounting estimates made by management and the disclosure thereof. These requirements are set out in ISA 540 on **auditing accounting estimates**.

Remember, save your answers to the questions and activities as soon as you have completed the learning unit.

You may also use the material made available on IFAC's website for an overview of the topic: <http://www.ifac.org/publications-resources/isa-module-isa-540-auditing-accounting-estimates-including-fair-value-account>

1.6.2 DESCRIBE THE NATURE OF ACCOUNTING ESTIMATES AND DEFINE TERMS

Before you can audit something, you need to understand what it entails. Let's start off by examining the nature of accounting estimates.



Study

Study ISA 540, paragraphs 2 to 4.



ACTIVITY 1.6.1

Explain the nature of accounting estimates and describe what influences the measurement thereof.



Reflect

Do you see that the applicable financial reporting framework plays a very important role in accounting estimates (substantiate)? Therefore you must know the disclosure requirements in terms of IAS 37. In addition you must enquire from management what their accounting policies are in terms of the relevant accounting framework. In other words the auditor is concerned with **auditing the fair value principle**.



Study

Study ISA 540, paragraphs A6 and A7.



ACTIVITY 1.6.2

List 13 examples of accounting estimates. This exercise is important because from the information given you must be able to identify a scenario that an accounting estimate is involved. When I call out “allowance for doubtful debts” while you are in a deep sleep you must instinctively respond “ISA 540”!

I want you to study a couple of definitions. You will never be examined on definitions, but they are nevertheless very important to be able to understand the ISA – see them as the terms of reference.



Study

Study ISA 540, paragraph 7, highlight/underline the definitions and reflect on their meanings.

1.6.3 RISKS THAT ACCOUNTING ESTIMATES HOLD FOR THE AUDITOR

The one thing that an auditor dislikes is a surprise. Auditors like accounts that balance and that can be verified against a reliable source of evidence. They hate risk and are always a little bit conservative. Accounting estimates have all the attributes of a potential surprise: they involve conditions of uncertainty; they require judgement, and management bias plays a big role.

Therefore the nature of accounting estimates immediately takes the auditor out of his or her comfort zone. However, these fears can be overcome (managed) through collecting sufficient appropriate evidence that will ensure that the accounting estimates are correctly recognised and disclosed in the AFSs at the correct amounts.

So how does the auditor manage this risk? The first step in auditing accounting estimates is to **assess** the risks involved in the particular estimate that has to be audited. Let's zoom into the risk assessment procedures to help ease the auditor's nerves.



Study

Study ISA 540, paragraphs 8 and A12 to A44. The crux of these paragraphs is that the auditor must identify the applicable accounting framework, understand how management identifies accounting estimate transactions and how management calculates the estimate. In the end if everything makes sense to the auditor he or she will be at ease. Study ISA540 paragraphs 12 to 14, on how the auditor is expected to respond to assessed risks.

I also want you to refer to your financial accounting study material and revise IAS 37. You must be able to integrate the accounting and disclosure requirements into this learning unit. Do you see the integrated bigger picture?



ACTIVITY 1.6.3

The following activity will take some time to do, but it is very important that you do it right. Study ISA 540, paragraphs A12 to A44, and formulate the steps and procedures to be performed by the auditor to assess the risk of accounting estimates. I will start with a couple, but you must complete the activity.

- (1) Obtain an understanding of the requirements of the applicable accounting framework.
- (2) Hold discussions with management about how management has applied these requirements relevant to the accounting estimate.
- (3) Obtain an understanding of how management identifies the need for accounting estimates.
- (4) Consider management's knowledge of the entity's business.
- (5) Etc.

1.6.4 THE AUDITOR'S RESPONSE TO THE RISK ASSESSMENT

ISA 330 requires the auditor to design and perform audit procedures with the nature, timing and extent responsive to the assessed risks of material misstatement in relation to accounting estimates at both the financial statement and assertion levels. That is why the previous activity is so important. Our next step is to formulate the audit procedures to audit accounting estimates.

Auditing accounting estimates focuses on the correct accounting (fair value) as well as presentation and disclosure.



ACTIVITY 1.6.4

Let's assume your client accounts for a warranty provision on the products that it manufactures and sells. The client provides you with the policies and calculations.

Required

- (1) Formulate the audit procedures to audit the **value** of the provision.
(Refer to Jackson & Stent, ch 14, p 7.)
- (2) Formulate the audit procedures pertaining to the **presentation and disclosure** of the warranty obligation.
(Refer to Jackson & Stent, ch 14, pp 18–19.)

1.6.5 CONCLUSION

In this learning unit we learnt about the nature of accounting estimates and how these are woven into IAS 37. We formulated the risk assessment procedures and other audit procedures to audit accounting estimates. Reflect on all the notes that you made and refer to the learning outcomes at the beginning of this learning unit and make sure that you can achieve these before moving on to the next learning unit.

As soon as you have completed this learning unit you are required to save Activities 1.6.1 and 1.6.4 on your computer as part of your assignment to be submitted later on myUnisa.

LEARNING UNIT 1.7

Audit sampling (ISA 530)

L Ferreira

After having worked through this learning unit you must be able to
• demonstrate your familiarity with audit sampling definitions
• describe the steps in the sampling process
• describe the sampling selection methods
• evaluate errors of the sampling results
• evaluate the factors influencing sample size

1.7.1 INTRODUCTION

When you are ill or visiting the doctor for an annual check up, the doctor often completes a list of blood tests that you must undergo. At the pathologist's rooms, some of your blood is drawn for the laboratory to analyse. In the end, from the small amount of blood, the pathologists can determine exactly what is wrong in your body. Incredible if you think about it. Read ISA530 paragraph 4.

The same principle applies to the auditor. By selecting and examining a sample of documentation (e.g. invoices, payments) the auditor can determine whether or not the client is "well" or "ill". It will be too expensive for the auditor to test 100% of the documents, although in very small populations you will possibly examine everything. The auditor therefore makes use of sampling and ISA 530 – *Audit sampling* prescribes the requirements with which the auditor must comply when using sampling. If you can recall, when you studied the learning unit on audit evidence, I said that audit sampling was one of the selecting and testing methods to obtain audit evidence (ISA 500, par A56). In this learning unit we are going to study ISA 530 on audit sampling, which provides the auditor with a reasonable basis to draw conclusions about the population from which the sample is selected.

Remember, save your answers to the questions and activities as soon as you have completed the learning unit.

1.7.2 DEFINITIONS



Study

ISA 530, paragraph 5, kicks off with a couple of definitions. I do not require you to memorise the definitions, but you must understand them and be able to link concepts to the terms. Just like the doctor must know the anatomy of a human, you the auditor must know auditing concepts. This is necessary firstly to fully understand the rest of this ISA (avoid misunderstandings) and secondly to be able to talk to other auditors using the correct jargon.



ACTIVITY 1.7.1

Highlight/underline the main concepts of the definitions in ISA 530, paragraph 5, and spend some time getting to grips with the terms. Now read the definition description and see if you can label it with the correct term. Are you fine so far?

1.7.2.1 When will the auditor use sampling?

Where there are many transactions (large population) the auditor will make use of sampling. Therefore sampling will mainly be used for performing tests of controls and substantive procedures. For tests of controls the auditor will want to determine whether or not the internal controls are functioning – in other words the auditor will test a certain attribute. Tests of controls are performed if the auditor plans to assess control risk at less than high for a particular assertion.

For substantive procedures, the auditor uses sampling to test the amounts in the financial statements (balances and totals) and tests of detail. This allows the auditor to make an estimate or projection of an amount. Now refer to ISA 530, read paragraphs 5 (i) & A3 and then read paragraph and link the terms **tolerable misstatement** and **tolerable rate of deviation** with the types of tests described above.

1.7.2.2 How large must the sample size be?



Study

Refer to ISA 530, paragraphs A10 and A11. To test your understanding on how sample size may be affected read appendix 2 and appendix 3 in ISA 530. Make sure you understand the logic (why) behind the examples given in the appendix.

1.7.2.3 The sampling process

Let's look at the sampling process in the same way you would look at a photograph – first you see the beautiful bigger picture and then you look at the finer details.



Study

Refer to Jackson and Stent, chapter 5, pages 30–32. That's the bigger picture. This gives you a good idea of the factors that must be considered when using audit sampling but also puts in context how it is used. Do you also appreciate why it was so important to learn those definitions at the beginning of this learning unit?



ACTIVITY 1.7.2

In the examination I may ask you **to formulate the steps followed by the auditor when applying audit sampling**. Your activity now is to jot down those steps. Remember you must always aim for full marks in these theoretical giveaway questions.

1.7.2.4 How to select the sample

Now that we have looked at the bigger picture let's look at some details on our audit sampling photograph, namely how to select the sample.



Study

Study the relevant section in Jackson and Stent, pages 30–31. Also pay particular attention to ISA 530, appendix 4.



Reflect

Let's assume you are intending to audit credit sales (revenue) at a client. Reflect on which sample selection method you will use and why you think it is the best method.

1.7.3 EVALUATING ERRORS IN THE SAMPLING RESULTS

Right, you are at the client, you selected a sample, and performed the audit procedures. What happens if there are “errors” in the sampling results?

One will want to know **why** the error occurred (perhaps fraud) and what the **effect** will be on the rest of the population. The auditor is obliged to go and find out the root cause of the deviations and misstatements.



Study

Refer to ISA 530, paragraphs 12 and 13. Notice the term “anomaly” that was learnt in the definitions.

The beauty of audit sampling is that for tests of details you, as auditor, can project misstatements – amounts – found in the sample to the population. (Remember the pathologist in the introduction.) Remember, for test of controls you do not project amounts but deviation rates (i.e. controls are or are not working).



Study

Refer to ISA 530, paragraphs A18 to A23. It is very important that you know that section well because we are going to integrate it later with ISA 450 (Evaluation of misstatements identified during the audit) in the study guide.



ACTIVITY 1.7.3

Describe the steps to project misstatements in the population and evaluate the results of audit sampling.

1.7.4 CONCLUSION

In this learning unit we increased our vocabulary with some new words. We learnt the reasoning behind why the auditor uses audit sampling and the steps that the auditor follows when using audit sampling. We also know what to do if we find errors in our sample and how to project the value of the errors to the population. Reflect on all the notes that you made and refer to the learning outcomes at the beginning of this learning unit. Make sure that you are able to achieve these before moving on to the next learning unit.

As soon as you have completed this learning unit you are required to save Activities 1.7.2 and 1.7.3 on your computer as part of your assignment to be submitted later on myUnisa.

LEARNING UNIT 1.8

External confirmations (ISA 505)

L Ferreira

After having worked through this learning unit you must be able to
<ul style="list-style-type: none"> • identify the accounts for which the auditor will most likely make use of external confirmations
<ul style="list-style-type: none"> • describe the actions to be taken by the auditor when the client refuses permission to send out a confirmation request
<ul style="list-style-type: none"> • describe the actions to be taken by the auditor when the client refuses the auditor to send out a confirmation request
<ul style="list-style-type: none"> • describe the actions to be taken by the auditor when no response to an external confirmation is obtained
<ul style="list-style-type: none"> • describe and apply the external confirmation process
<ul style="list-style-type: none"> • formulate substantive procedures for external confirmations

1.8.1 INTRODUCTION

In learning unit 1.1 (The theory of audit evidence), we looked at the various methods to obtain audit evidence (e.g. inspection, observation). One of those methods was obtaining **external confirmations** of information as a written response to the auditor from a third party. We also learnt that external confirmations are more reliable than evidence obtained directly from the client or oral confirmations. Because external confirmations sometimes render a more effective source of evidence, we are going to learn how and when to use these.

Remember, save your answers to the questions and activities as soon as you have completed the learning unit.

1.8.2 EXAMPLES OF EXTERNAL CONFIRMATIONS

To use external confirmations effectively, we must first have some idea of when external confirmations are most likely to be used. Now remember you cannot request external confirmations for everything (remember relevance!) – our aim is to use external confirmations effectively during the audit. For example you will not use an external confirmation to examine the occurrence of the loan when you have the loan agreement, which is

a more reliable source of evidence. When I use the term “effectively”, I mean that the auditor must use external confirmations that will provide **relevant** and **reliable** audit evidence.

This is all theoretical, but what does an external confirmation look like? Refer to SAAPS 1100 in the *SAICA handbook* – **appendix example of a bank confirmation letter**. Notice the types of questions asked in this example.



Reflect and discuss

Refer to any set of annual financial statements. You can Google a company like Shoprite, Pick n Pay or Woolworths if you like (we all buy groceries). Now, from the AFSs, identify the accounts that you think it would be effective to audit by using external confirmations and then list examples of balances or transactions that would be suitable for external confirmation.

I hope you applied your mind and came up with examples – please add to the examples given below.

Some examples would be bank balances, accounts receivables balances, loan balances, inventory held by third parties, and related party transactions. Did you notice from your reflection that external confirmations are mainly used to verify account balances? (Study ISA 505, par A1.) They can also be used to confirm terms of agreements, contracts or transactions.

1.8.3 EVALUATING MANAGEMENT’S RESPONSE WHEN REQUESTING AN EXTERNAL CONFIRMATION AND EVALUATING RESPONSES TO CONFIRMATIONS



Study

Study ISA 505, paragraph 6. Notice the type of categories of external confirmations. This background knowledge is important to know because when I ask you for example to verify accounts receivable, the terms positive and negative confirmations must immediately come to mind. We will look at this in more detail in this learning unit.

Study ISA 505, paragraph 7. This paragraph tells us how the auditor should go about using external confirmations. This is important and we are going to study it in more detail in a moment, but study this section in the meantime so that you understand the overall process.

Study ISA 505, paragraphs 8 and A8 to A10. What on earth will you, the auditor, do when the client refuses to allow you to send out a confirmation request? Tough one – you must know what to do when this happens. Don’t jump to conclusions and just say “qualify the audit report”. We want to avoid a qualification.

Study ISA 505, paragraphs 10 to 16 and A11 to A25. Remember the auditor (you) cannot accept audit responses at face value – you must still apply

professional judgement to evaluate their reliability. When evaluating responses which just don't seem right to you, you must think further – think of risk and possible fraud. The term professional judgement is often used in auditing literature and is a complex phenomenon to study if you are a researcher. But in a nutshell it means wisdom – what humankind seems to lack. Think of grandparents – they have wisdom that they gained through years of living experience. The auditor as a professional is expected by the public to apply wisdom too. Professional judgement is gained through technical knowledge (all your studies) and groomed during workplace experience. Therefore while learning auditing, your aim must be to accumulate wisdom and not merely pass an examination by spotting questions. Without good foundations you will fall short in the workplace – and gone are all the promotions.

- What do you do if the response to the external confirmation raises doubt about its reliability?
- What do you do when you receive no response to your request?
- What happens when the response to the external confirmation provides you with an exception? This is very important.

You must be able to answer all of these questions and you will find the answers in the above study references.

1.8.4 THE EXTERNAL CONFIRMATION PROCESS

In practice you will be required to plan the external confirmation process and you must be able to explain this process, say to a trainee accountant at your auditing firm.



Study

Study ISA 550, paragraphs A1 to A7, and jot down or highlight the main steps to consider when planning to use external confirmations.



ACTIVITY 1.8.1

Formulate the steps to be followed by the auditor when planning to use external confirmations (when to use confirmations, selecting the appropriate confirming party, designing the requests and follow up).

You will find the solution to the above activity in the above study reference. One thing that I want to highlight is about considering the assertion being tested. Which assertions do you think an external confirmation can test? To answer this question think of what you are asking to be confirmed!

1.8.5 APPLYING THE PRINCIPLES TO THE CYCLES

You have learnt the theoretical underpinnings for using external confirmations. Let's now examine how this knowledge is translated into the audit procedures.



Study

Refer to Jackson and Stent and study the following sections:

- Trade receivables: assertion – existence (ch 10, par 9.21).
- Bank and cash: assertion – rights, existence and completeness (ch 10, par 12.4).
- Trade payables: assertion – completeness (ch 11/51). Notice how the external confirmation is used **selectively** when auditing trade payables – it is different to trade receivables because you have trade payable statements, which are externally generated.
- Long-term-loans: assertion – completeness and sometimes presentation and disclosure (ch 14/12). (Remember, you have access to the loan agreement.)

1.8.6 CONCLUSION

In this learning unit we learnt what ISA 505 has to say about when to use and how to plan when you intend to use external confirmations. In addition we learnt what to do if management does not give you permission to request an external confirmation and what to do if there is an exception or difference on the external confirmations. Finally we looked at how external confirmations are used when formulating substantive audit procedures. Reflect on the notes that you made. Go back to the learning outcomes formulated at the beginning of this learning unit and make sure that you are able to meet those outcomes before moving on to the next learning unit.

As soon as you have completed this learning unit you are required to save Activity 1.8.1 on your computer as part of your assignment to be submitted later on myUnisa.

LEARNING UNIT 1.9

Written representations (ISA 580)

M La Grange

After having worked through this learning unit you must be able to

- | |
|--|
| <ul style="list-style-type: none"> • explain how written representations are used as audit evidence |
| <ul style="list-style-type: none"> • formulate substantive audit procedures, including obtaining written representations |
| <ul style="list-style-type: none"> • describe the action that should be taken if management refuses to provide a written representation |

1.9.1 Introduction

Management is responsible for the fair presentation of financial statements. Written representations remind management of this responsibility and also serve as useful audit evidence to complement other evidence gathered during the course of the audit.

**Study**

Study ISA 580 and the relevant sections dealing with written representations in chapter 17 of Jackson and Stent.

Note the following:

- The **objectives of the auditor with regard to written representations** (ISA 580, par .06).
- The definition of “Written representation” (ISA 580, par .07).
- The written representations to be obtained from **management regarding their responsibilities** (ISA 580, pars .10–.12).
- The **date** and **form** of written representations (ISA 580, pars .14–.15).
- The auditor’s response regarding **doubt as to the reliability of written representations and requested written representations not provided** (ISA 580, pars .16–.20).
- Including the obtaining of a written representation from management as part of your substantive procedures in an examination often earns a mark. The following serves as an example of an audit procedure dealing with a written presentation relating to the valuation of the inventory balance which will earn marks in an examination: “Obtain a management representation letter with regard to the inventory value as at year end”.

- I will never ask you to draft a representation letter in the examination, but please read the appendix at the back of ISA 580 so that you can see what it looks like in practice.



ACTIVITY 1.9.1

Your client provides you with a written representation letter referring to trade receivables (debtors) and informs you that there is no need for you to circularise the debtors.

Required

Comment on whether you would accept your client's request.



FEEDBACK ON ACTIVITY 1.9.1

A representation letter is a written statement from a non-independent source and therefore cannot be regarded as reliable evidence. Representations by management cannot serve as a substitute for other audit evidence that the auditor could reasonably expect to be available; therefore I could not accept my client's request. I would definitely still circularise debtors.



ACTIVITY 1.9.2

A written management representation letter referring to revenue is given to you, as the auditor of the enterprise. However, you are unable to obtain sufficient appropriate audit evidence to vouch the revenue figure, which is material in relation to the financial statements.

Required

- (1) Identify the matter that should be considered by the auditor based on the above-mentioned situation.
- (2) What would the auditor's action be if management refuses to provide a written representation letter that is necessary in order to obtain sufficient, appropriate audit evidence?



FEEDBACK ON ACTIVITY 1.9.2

- (1) If the auditor is unable to obtain sufficient appropriate audit evidence regarding a matter that has, or may have a material effect on the financial statements and such evidence is expected to be available, this will constitute a limitation on the scope of the audit, even if a representation from management has been received on the matter.
- (2) If management refuses to provide the representations needed, this constitutes a scope limitation and the auditor should express a qualified opinion or a disclaimer of opinion. (ISA 700, 705 and 706 deal with audit reports and will be dealt with in learning unit 4.2)

1.9.2 CONCLUSION

In this learning unit we discussed and explained written representations. When studying the next topic (substantive procedures) notice the importance of requesting management for a representation letter.



Self-assessment

After having worked through the learning unit and the references to the prescribed study material, decide whether you feel comfortable about doing the following:

- Describe the use of management representations as audit evidence.
- Formulate substantive audit procedures which include obtaining written representations (refer to topic 3, where this will be clearly demonstrated).
- Describe the action to be taken if management refuses to provide a written representation.

As soon as you have completed this learning unit you are required to save the answer to the following activity (Reference it 1.9.2.1) on your computer to be submitted as part of your assignment later on myUnisa: Read the illustrative representation letter in Appendix 1 of ISA 580 and identify the ISAs that occur in the example.

You are now ready to submit assignment 02:

You have covered all the learning material required for assignment 02. Make sure that you have numbered the questions and activities correctly, copy all the activities that you have saved thus far on one document. Save the document as assignment 02 in a pdf format and submit it online before the due date. The unique code for this assignment is provided in learning unit 0.

TOPIC 2

Substantive procedures: the concepts

L Ferreira

Topic overview

This is a very important topic and if you master the principles in this topic you will be able to formulate audit procedures. In this topic we are going to learn about the principles and concepts involved in formulating substantive procedures, including those performed with CAATs. Substantive procedures are audit procedures designed to detect material misstatements at the assertion level. Substantive procedures branch out into two components, namely **tests of detail** (classes of transactions, account balances and presentation and disclosures) and **analytical procedures**. With this knowledge we will be able to apply these principles in formulating the substantive procedures for all the cycles as dealt with in topic 3.

This topic is divided into the following study units.

Learning unit	Title
2.1	Principles in formulating substantive procedures
2.2	Substantive procedures with assistance of CAATs
2.3	Analytical review procedures

Learning outcomes

The learning outcomes of each of the learning units are set out in the separate learning units.

LEARNING UNIT 2.1

Principles in formulating substantive procedures

L Ferreira

After having worked through this learning unit you must be able to
<ul style="list-style-type: none"> • describe the reasons for formulating substantive procedures
<ul style="list-style-type: none"> • explain the nature, timing and extent of substantive procedures
<ul style="list-style-type: none"> • show that you understand the difference between assertions for classes of transactions and account balances and be able to list the assertions for each classification
<ul style="list-style-type: none"> • associate understatements and overstatements with direction of testing
<ul style="list-style-type: none"> • use verbs, evidence and methods of evidence collection correctly
<ul style="list-style-type: none"> • recognise common mistakes when formulating substantive procedures and remedy them

2.1.1 INTRODUCTION

In AUE3701 you learnt to formulate tests of controls. In this learning unit we are going to learn the **principles** needed to formulate sound substantive procedures. In topic 3 of the study guide you will learn how to **apply** these principles to each cycle. You must see this learning unit similarly to building a house – your house. If the foundation is nice and strong then we won't sit with cracks and unnecessary repairs at a later stage – or walls collapsing on you while you think you're protected from the elements! This learning unit comprises a lot of theory and principles that you need to master.

2.1.2 REASONS FOR FORMULATING SUBSTANTIVE PROCEDURES

In topic 1 of this module we spent a great deal of time on audit evidence. Remember that the aim of the auditor is to express an audit opinion on

the annual financial statements – but to do that, the auditor must be able to support or substantiate his or her findings with audit evidence.

Remember from the audit risk model that detection risk is that part of the equation that the auditor can control to balance the equation? The objective of substantive procedures is to reduce detection risk to an acceptable level. To this end, substantive procedures are performed to obtain evidence to determine whether the amounts, and presentation and disclosures in the financial statements are free from material misstatements. Substantive procedures comprise **tests of detail of classes of transactions, account balances, disclosures and presentation** and **analytical procedures**. In topic 1 I often referred to the fact that our audit procedures must be on target (bull's eye). To align our aim, so that we are spot on the target, the auditor will first perform risk assessment procedures and then relate these risks to what can go wrong at assertion level. If the internal controls at the client are designed to reduce errors that affect the identified risk areas and furthermore, through tests of controls, the auditor is able to obtain evidence that the controls are indeed working, then one can argue that it is acceptable to perform less intensive substantive procedures (because the control risk is low and a higher detection risk will be acceptable). However, if the tests of control indicate that the internal controls are not working as intended by management, then the auditor must gather more persuasive audit evidence (to balance the equation) through intensive substantive procedures to support his or her audit opinion (because the control risk is high).

2.1.3 PLANNING SUBSTANTIVE PROCEDURES

During the planning stage of the audit the auditor will consider the nature, timing and extent of the substantive procedures. The auditor shall design and perform further audit procedures with nature, timing and extent based on and responsive to the assessed risks of material misstatement at the assertion level. In AUE3701 you studied ISA 330 (The auditor's responsibility to assessed risks). At the end of this learning unit I will illustrate to you how the bigger picture looks. Let's begin with some revision on the nature, timing and extent of substantive procedures.



Study

- **Nature (test of detail or analytical)** (ISA 330, pars A9 to A10): Substantive procedures for detecting material misstatement at assertion level may include
 1. tests of details – of all assertions for material classes of transactions, account balances and disclosure (ISA 339, par 18)
 2. analytical procedures – for amounts/quantities that tend to be predictable over time

- **Timing (when)** (ISA 330, pars A11 to A14)
refers to **when** audit procedures are performed or the period or date to which audit evidence applies.

When substantive procedures are performed at an interim date, the auditor should perform further substantive procedures or substantive procedures combined with tests of controls to cover the remaining period that provide a reasonable basis for extending the audit conclusions from the interim date to the date at the end of the period under review (ISA 330, pars 22 and 23 and A54 to A58).

- **Extent (quantity)** (ISA 330, pars A15 to A16)
refers to how **much** of a specific audit procedure must be performed, for example a sample size for substantive procedures or the number of observations of a control activity.

The greater the risk of material misstatement, the greater the extent of the substantive procedures. It is necessary to increase the extent of substantive procedures if the tests on internal controls show unsatisfactory results.

2.1.4 WHAT ARE THE FINANCIAL STATEMENT ASSERTIONS?

If you know the answer to this question you can skip this section. If not, study the following section since the concepts are crucial to understanding the concepts of substantive procedures.



Study

Study ISA 315, paragraph A124, and Jackson and Stent, pages 5/22–5/24.



Reflect and discuss

- Are you able to differentiate between transactions and balances?
- Do you know the assertions for transactions and events off by heart?
- Do you know the assertions for account balances off by heart?
- Do you know the assertions for presentation and disclosure off by heart?
- Explain why the assertions for transactions and balances differ from each other.
- Could the assertions for classes of transactions ever be relevant to account balances?



ACTIVITY 2.1.1

You are the senior on the audit of Prizm (Pty) Ltd, a retailer of glassware. You asked a junior trainee about the assertions pertaining to the following account headings:

Accounts receivable	R1 297 141
Sales	R4 863 219

Her response was as follows:

Accounts receivable. The assertions are

- Existence: All debtors making up the balance of R1 297 141 actually exist; they are not fictitious.
- Accuracy: The amount of R1 297 141 is accurate; i.e. no mistakes are included in the balance.
- Completeness: Only debtors who can pay the complete amount owed by them are included in the balance.
- Obligation: Debtors included in the amount are obliged to pay within the company's credit period.

Sales. The assertions are

- Materiality: The sales figure of R4 863 219 is material in relation to the other figures in the balance sheet.
- Cut-off: The figure of R4 863 219 includes only sales made in the financial year being audited.
- Validity: All sales included are valid sales; e.g. they are not fictitious.

Required

- (1) Comment on your junior trainee's understanding of the assertions. Explain your answer.
- (2) List the correct assertions for each of the two account headings given. You are not required to describe the assertions.

(Adapted from *Graded questions on Auditing*)

Suggested solution**(1) Comments**

1. My trainee shows very little understanding of the assertions.
2. Account: Accounts receivable
 - 2.1 **Existence:** she has got this one correct (but could have added that they "exist at balance sheet date").
 - 2.2 **Accuracy:** not an assertion which applies to accounts receivable (balances); it applies to transactions (e.g. sales) and asserts that the transaction has been recorded appropriately.
 - 2.3 **Completeness:** the trainee isn't too far off! The assertion actually has nothing to do with whether the debtor can pay, but rather that **all** accounts receivable are included.
 - 2.4 **Obligation:** not an assertion which applies to asset balances and has nothing to do with the credit terms set for the debtor. It applies to credit balances such as liabilities and asserts that the liabilities are obligations of Prizm (Pty) Ltd.

3. Account: Sales

- 3.1 **Materiality.** This is not an assertion; it is an auditing concept.
- 3.2 **Cut-off.** This is virtually correct. More accurately it means that the sales transactions included in the total of R4 863 219 have been recorded in the correct accounting period; e.g. sales which took place after the year end are not included.
- 3.3 **Validity.** This is not an assertion; it is an internal control objective. She seems to be muddling it with occurrence.

(2) Correct assertions

Accounts receivable	Sales
Rights	Occurrence
Existence	Cut-off
Completeness	Accuracy
Valuation	Classification
	Completeness

2.1.5 UNDERSTATEMENT VERSUS OVERSTATEMENT

Consider another aspect that affects our audit approach: in our risk assessment, we are concerned with overstatements or understatements because both will affect the direction of our testing. For example, auditors usually test accounts like debtors for overstatement and creditors for understatement as management could manipulate these accounts in this way to improve liquidity ratios.

Reflect on the following statements:

- Existence/occurrence ensures that the client is not recording things that they should not be (if wrong, the result is overstatement).
- Completeness ensures that the client is not leaving anything out (if wrong, it results in understatement).
- Identifying the direction of the misstatement becomes critical when designing procedures to try and pick up the misstatement.
- Overstatement – must select from **what has been recorded** to be able to see if it does in fact belong in the records (existence/occurrence tests).
- Understatement – must select from outside the records (initiating event/**what should have been recorded**) to see if it was actually recorded (completeness tests).

2.1.6 ORIENTATION

When planning to write your substantive procedures from a case study scenario you bear the following in mind:

- the cycle that you are dealing with
- the category of financial information that should be dealt with (i.e. classes of transactions or account balance or presentation and disclosure)
- the assertion(s) to be focused on.
- the direction of testing
- use of analytical procedures if appropriate
- audit procedures already performed (given in the scenario of the exam) and auditor's findings based on these
- the documents involved and books of entry
- wording the procedure as an instruction
- Companies Act requirements that may be applicable
- financial accounting standards that might be applicable
- awareness of the need for integration of taxation and/or management accounting principles when designing the substantive procedures

2.1.7 COMMON MISTAKES

Watch this video for an introduction to formulating the procedure:

<http://www.youtube.com/watch?v=RH0-O7JO-0c>

Let's look at some of the common mistakes that students make in the examination so that we can train ourselves to avoid them. It boils down to not formulating the procedures properly and not being relevant:

- Students often formulate generic audit procedures and do not make them applicable to the scenario (memory dump).
- Students do not make the procedures applicable to the scenario – no marks can be awarded for these types of procedures.
- Students often elaborate too much on one issue and forget to cover all the relevant issues.
- Students often don't manage their time properly and are therefore unable to cover all the relevant issues.
- Students' knowledge of the cycles is often not up to standard and they then find it difficult to identify and deal with all the issues.
- Students often battle to link the audit procedures to the relevant assertions.
- Students often find it difficult or are scared to answer integrated questions and therefore struggle to incorporate their knowledge of the other subjects into their solutions.
- Students often find it difficult to determine whether they need to discuss the class of transaction or account balance assertions or both.

2.1.8 RECTIFYING THE COMMON MISTAKES

Now that we know what the common mistakes are, let's take some of the medicine available to heal the ailments.

2.1.8.1 How, what and why

An audit procedure should include **how**, **what** and **why** questions:

- **how:** requires the use of an **applicable verb** which should describe the action
- **what:** a reference to a relevant and reliable **source of evidence** required here
- **why:** setting out the **reason** for the audit procedure with regard to the assertion being tested and the risk that is responded to

- **Example of a badly worded procedure:**

Check minutes to see if transactions were approved by management.

- **Example of a well-worded procedure:**

Inspect⁽¹⁾ minutes of directors' meetings⁽²⁾ to confirm that the purchase of motor vehicles was authorised.⁽³⁾

- (1) verb (**how**)
- (2) source (**what**)
- (3) reason with regard to the assertion (**why**)

2.1.8.2 Verbs and relevant and reliable sources of audit evidence

To formulate the substantive procedures for all the cycles you must understand (visualise) how the cycles operate and all the documents pertaining to them. In topics 3 to 8 of the auditing module AUE2602, you mastered the business cycles, the accounts for the Statement of Financial Position and the classes of transactions for the Statement of Comprehensive Income. This knowledge is fundamental to being able to formulate a proper substantive procedure because this is **where** you are going to look for the evidence. If you are unsure, please quickly revise those sections.

In order to write a good audit procedure you have to know which verbs to use, to begin your sentence. The source of evidence will also help you when you write a procedure. Study the following summary of verbs and examples of sources of evidence:

Verbs	Sources of evidence	
<p>Inspection (ISA 500, pars A14 to A16):</p> <ul style="list-style-type: none"> • Inspect • Examine • Trace • Scrutinise • Compare • Review 	<p>Documented evidence:</p> <ul style="list-style-type: none"> - Cash receipts/ payment journals - Journals - Ledgers - Financial statements - Management reports - Management representations - Previous audit working papers - Budgets - Client working papers - Reconciliations - Tax computations - Orders - Paid cheques - Deposit books 	<ul style="list-style-type: none"> - Invoices - Goods received vouchers (GRVs) - Registers - Stock sheets - Minutes of meetings - Correspondence - Third party certificates - Monthly statements - Agreements/ contracts - Scripts - Licences - Insurance policies - Bank statements
<p>Observation (ISA 500, par A17):</p> <ul style="list-style-type: none"> • Observe 	<p>Procedures:</p> <ul style="list-style-type: none"> - Inventory count - Wages payout 	

Verbs	Sources of evidence
<p>Enquiry and external confirmation (ISA 500, pars A18 and A22):</p> <ul style="list-style-type: none"> • Enquire and confirm • Discuss with ... and confirm • Request • Obtain through discussion/ confirmation <p>(Remember that enquiries of management may not be used on its own as audit evidence. These must be followed up and substantiated.)</p>	<ul style="list-style-type: none"> - <i>Formal, written:</i> <ul style="list-style-type: none"> Bank confirmation letters Enquiries from attorneys Debtors and creditors confirmations Enquiries from third parties (who are involved, e.g. government institutions, trade unions, SARS) - <i>Informal, oral:</i> <ul style="list-style-type: none"> Documenting of enquiries from board of directors
<p>Re-calculation (ISA 500, par A19):</p>	<ul style="list-style-type: none"> - Calculations on any of the abovementioned source documents and accounting records
<p>Analytical procedures (ISA 500, par A21):</p> <ul style="list-style-type: none"> • Calculate ratios • Compare • Analyse • Predict (trends) <p>(Remember that analytical procedures can only be applied to recurring, routine transactions, balances, where a trend is expected.)</p>	<ul style="list-style-type: none"> - <i>Past:</i> <ul style="list-style-type: none"> Compare previous years' financial statements, budgets, projections, management reports, etc, with present years. - <i>Present:</i> <ul style="list-style-type: none"> Current year's management's reports Financial statements of other enterprises in the same operating sector - <i>Future:</i> <ul style="list-style-type: none"> Budgets Cash flow projections Profit forecasts Other operating projections
<p>Re-performance (ISA 500, par A20):</p> <ul style="list-style-type: none"> • Re-perform 	<ul style="list-style-type: none"> - Calculations composed by the client/ third parties/experts - Client's debtors age analysis

2.1.8.3 Examples of audit procedures for obtaining audit evidence

The following table sets out some assertions and examples of audit procedures to test whether these assertions are met.

Audit assertion	Examples of audit procedures to test assertions (not complete procedures in all instances)
Account balances <ul style="list-style-type: none"> ● Existence 	<ul style="list-style-type: none"> ● Attend stock count to confirm existence of stock. ● Physically inspect fixed assets selected from the fixed asset register to confirm existence. ● If physical inspection of assets is not possible, inspect, for instance ... <ul style="list-style-type: none"> – insurance portfolio – income generated by the asset – valuation by a third party
<ul style="list-style-type: none"> ● Rights/ obligations 	<ul style="list-style-type: none"> ● Inspect title deeds. ● Inspect licences and registration documents. ● Inspect insurance portfolio. ● Inspect bank confirmations.
<ul style="list-style-type: none"> ● Completeness 	<ul style="list-style-type: none"> ● Creditors – select goods received notes issued close to year end and trace to creditors listing to ensure all creditors are recorded.
<ul style="list-style-type: none"> ● Valuation/ allocation 	<ul style="list-style-type: none"> ● Inspect valuer's report. ● Compare unit cost prices on stock sheets with prices on recent suppliers' invoices/authorised standard selling prices.
Classes of transaction/ events <ul style="list-style-type: none"> ● Accuracy 	<ul style="list-style-type: none"> ● Recalculate suppliers' invoices and follow amount through to purchases journal. ● Compare the cost of the property with the purchase agreement and the statement from the attorney to verify the cost of acquisition and transfer of the property.
<ul style="list-style-type: none"> ● Classification 	<ul style="list-style-type: none"> ● Scrutinise the repairs and maintenance account to confirm that no capital items were included.

Audit assertion	Examples of audit procedures to test assertions (not complete procedures in all instances)
<ul style="list-style-type: none"> • Cut-off 	<ul style="list-style-type: none"> • Note the last delivery note number for the year. • Confirm by means of inspection that the 10 delivery notes before year end are included in the current year's debtors journal. • Confirm by means of inspection that the 10 delivery notes after year end are excluded from the current year's debtors journal.
<ul style="list-style-type: none"> • Completeness 	<ul style="list-style-type: none"> • Trace sales transactions from the goods delivery notes to the sales invoices/sales journal to establish that all sales transactions have been included. (Note: direction of testing.)
<p>Presentation and disclosure</p> <ul style="list-style-type: none"> • Occurrence/ rights and obligations • Completeness • Classification/ understand-ability • Accuracy/ valuation 	<ul style="list-style-type: none"> • When the question specifically requires you to deal with disclosure requirements, you should provide all the details as per the IAS/IFRS statements and the Companies Act. • Otherwise a general statement such as the following will be sufficient: <ul style="list-style-type: none"> – Inspect the financial statements and accounting policies and confirm that they are in agreement with IAS/IFRS statements and the Companies Act.

By simply knowing the assertions, the verbs, sources of evidence and the types of procedures to obtain the evidence you are so close to formulating a good substantive procedure! Let's just refine this knowledge so that you can formulate these procedures correctly in the examination.

2.1.8.4 Suggestions about answering substantive testing questions

- (1) Substantive testing questions could require candidates to describe audit procedures to audit **all** or **specified** assertions related to
 - a class of transactions or a particular transaction
 - balances or a balance at a certain date
 - presentations and disclosures of particular transactions, balances and accounting policies in financial statements
- (2) Make use of assertions to serve as subheadings, for the following reasons:

- It is a framework from which you can do a mind map.
 - It helps you to structure your answer.
 - It enhances the presentation of the suggested solution and therefore earns presentation marks.
 - It ensures that your thoughts remain focused.
 - It ensures that all appropriate assertions are dealt with.
- (3) You will often be required to describe substantive procedures to test a specific assertion only, in which case you should take care to relate your answer to the required assertion only. When a question is silent on this, your answer should deal with all the relevant assertions.
- (4) When detailed procedures are required it is not sufficient to state “Perform cut-off tests” as a procedure. You have to describe in detail the cut-off procedures which you will perform. Look at the detail that will be required.

For purchases	For sales
<ul style="list-style-type: none"> • Note number of last goods received voucher (GRV) for year during your attendance at the inventory count 	<ul style="list-style-type: none"> • Note the last delivery note number for the year during your attendance at the inventory count
<ul style="list-style-type: none"> • Confirm by means of inspection that the 10 GRVs before the last number for the year are included in the current year’s creditors journal 	<ul style="list-style-type: none"> • Confirm by means of inspection that the 10 delivery notes before the last number for the year are included in the current year’s sales journal
<ul style="list-style-type: none"> • Confirm by means of inspection that the 10 GRVs after the last number for the year are not included in the current year’s creditors journal 	<ul style="list-style-type: none"> • Confirm by means of inspection that the 10 delivery notes after the last number for the year are not included in the current year’s debtors journal.

- (5) If a question specifically requires you to deal with disclosure requirements you should provide all the details as per IAS statements. When not specifically required, a general statement such as “Inspect the financial statements and accounting policies and confirm that these are in agreement with IFRS” will be sufficient.
- (6) Analytical review procedures form part of substantive procedures, so do not forget about them (ISA 520, pars 5 and A4 to A5). Also state that **unexpected** fluctuations/ratios should be followed up. Name at least two examples of specific relevant ratios that the auditor should calculate in the circumstances.

- (7) Although this rule applies more to postgraduate auditing (you will earn bonus marks in this module), it is important that you develop the ability to apply lateral thinking while studying Financial Accounting, Management Accounting, Taxation and the Companies Act. Therefore, when studying those subjects,
- visualise and note the accounting entries relevant to the transactions/ constituting the balance(s) given in the question
 - note how the amounts of the accounting entries are calculated
 - identify sources of evidence underlying the given transactions/balances
 - develop appropriate audit procedures by taking into account the accounting entries and the appropriate sources of audit evidence
- (8) Refrain from using statements such as “ensure”, “check”, “verify”, “see” “look”, “confirm”, “consider”, “determine” and “assess” in your answers because they usually don’t lead to a description of audit procedures, but rather result in the description of an assertion to be tested.
- (9) If you are required to describe audit procedures you should describe them as you would to a first-year trainee accountant. For example, if you tell him to “Check the ownership of vehicles” he won’t know what procedures to perform. So you have to explain in detail: “Inspect the registration documents and licences and confirm that the vehicle is registered in the client’s name.”
- (10) Always identify source documents: “Reconcile creditor’s balance with creditor’s monthly statement and goods received notes.”
- (11) Where relevant, never forget these general audit procedures that students tend to forget:
- Recalculate castings and calculations of general ledger accounts, annual financial statements, documentary evidence, reconciliations, etc.
 - Agree opening balances with closing balances on previous year’s working papers and audited financial statements.
 - Follow applicable procedures when using the work of an expert.
 - Test postings from the subsidiary ledgers to the general ledger.
 - Agree the totals of lists (e.g. debtors age analysis or list of creditors) with the general ledger account.
 - Agree the balance of the general ledger account with the trial balance and annual financial statements.
 - Inspect minutes of meetings (management, board of directors, and shareholders) for decisions taken, authorisation, etc.
 - Perform analytical procedures: give examples of ratios to be used.
 - Refer to IAS statements regarding the accounting treatment, where possible.
 - Obtain/request from management:
 - a signed management representation letter on the matter being audited
 - attorney’s letter
 - bank confirmation letter

- For a first audit request access the previous auditor's working papers (with the client's permission) in respect of opening balances.
 - Do overall review for abnormal items/exceptions in
 - general ledger accounts, subsidiary ledgers, etc
 - Presentation and disclosure – inspect for compliance with the following:
 - IASs, IFRSs and accounting policies
- (12) There's usually uncertainty about how much **detail** an audit procedure should be discussed in. Use the following as guidelines:
- Examine the question properly, especially the “required” part, and determine whether specific instructions are given.
 - When instructions are not given – note the mark allocation of the question to determine the extent of the answer required.
 - Always start with general procedures.
 - Determine whether the extent of your planned answer is comparable with the marks allocated to the question.
 - When your planned answer seems limited – expand it by including more detailed procedures.
 - When instructions are given – follow them.
- (13) **Make use of the information** contained **in the question**. For example:
- People mentioned, for example the “production manager”, should agree quantities produced to budgeted production quantities. Do not refer to the financial manager only.
 - Documents mentioned should be included in your answer.
 - Amounts provided should be used.
 - Do not make unfounded assumptions.
 - If assumptions are made, substantiate them on the grounds of information which is given in the question and describe the relevant assumption in the suggested solution.
 - Give journal entries where applicable (e.g. as part of an audit procedure to test allocation of a transaction).
- (14) **Double check** your reasoning.
- Identify the general ledger accounts affected by a transaction in the given scenario.
 - Write out the journal entries – to ensure that you understand the accounting treatment.
 - Audit those entries from where they originated (measurement and recognition) up to the point where they are presented in the financial statements.
- (15) Audit **work already performed – outstanding** procedures.

When a question requires you to describe **further** procedures, you should base your answer on procedures that should normally be performed during the particular stage of the audit, on the specified item, taking into account the appropriate audit approach **and** the procedures already performed according to the question.

(16) Describe **additional procedures**.

When a question requires you to describe **additional** procedures, your answer should be responsive to significant risks described in the question: describe procedures that should be performed in addition to the normal audit procedures. Your answer should thus not merely include general audit procedures.

Your answer may include normal audit procedures which should be extended and which should focus on specific shortcomings.

2.1.9 CONCLUSION

In this learning unit you mastered the principles to formulate substantive procedures and all the caveats that you must avoid when formulating substantive procedures. You will **apply** this knowledge in the next topic of this module where we are going to formulate the substantive procedures for each cycle, based on these principles. The assumption that I, as lecturer, make is that if you have mastered the content of this learning unit then you will not battle with topic 3. Therefore, before moving on to the next learning unit, check yourself against the learning outcomes formulated at the beginning of this learning unit and make sure that you are able to meet them.

There are no activities to be submitted for this learning unit, but reflect on what you have learnt and re-read until you have mastered the principles.

LEARNING UNIT 2.2

Substantive procedures with assistance of CAATs

A Botha

After having worked through this learning unit you must be able to

- formulate substantive procedures with the assistance of CAATs

2.2.1 INTRODUCTION

The previous learning unit explained how substantive procedures are formulated without the use of computer-assisted audit techniques (CAATs). The aim of this learning unit is to explain how substantive procedures are formulated with the assistance of CAATs. Even though the use of CAATs sounds very complicated, it is not. The only change when you formulate substantive procedures using CAATs is that you should **use the computer** to perform substantive procedures. This is easy! We will explain later in this learning unit.

Before we continue with further explanations about formulating substantive procedures using CAATs, study a few theoretical concepts which will assist help you to apply your knowledge.



Study

Study the relevant sections under the heading “Computer assisted audit techniques (CAATs)”, namely “Data orientated CAATs” and “Audit functions which can be performed using data orientated CAATs” in chapter 8 of Jackson and Stent. (The other sections under this heading were referred to in study unit 4.3 of AUE3701. Please revise those sections to refresh your memory.)



ACTIVITY 2.2.1

- (1) List the audit functions which can be performed using data CAATs.
- (2) For each audit function, provide a practical **example** of using CAATs in relation to the payroll and personnel cycle (refer to chapter 13 in Jackson and Stent for examples).

Give your answer in tabular format.



FEEDBACK ON ACTIVITY 2.2.1

(1) Audit functions using data CAATs	(2) Example of using CAATs
<ul style="list-style-type: none"> • Re-perform casts and calculations. 	<ul style="list-style-type: none"> • Use CAATs to recalculate wages.
<ul style="list-style-type: none"> • Determine sample size and select certain items. 	<ul style="list-style-type: none"> • Use CAATs to select a sample of employees.
<ul style="list-style-type: none"> • Compare data on separate files. 	<ul style="list-style-type: none"> • Use CAATs to compare total wage balances between files.
<ul style="list-style-type: none"> • Perform analytical procedures. 	<ul style="list-style-type: none"> • Use CAATs to perform analytical procedures on wages.
<ul style="list-style-type: none"> • Discover missing data on file (examining inconsistencies and exception reporting). 	<ul style="list-style-type: none"> • Use CAATs to scan the employee master file for “error” conditions, for example missing data.
<ul style="list-style-type: none"> • Discover duplication (examining inconsistencies and exception reporting). 	<ul style="list-style-type: none"> • Use CAATs to scan the employee master file for “error” conditions, for example duplication.
<ul style="list-style-type: none"> • Extract summaries. 	<ul style="list-style-type: none"> • Use CAATs to extract the PAYE/ UIF totals.
<ul style="list-style-type: none"> • Sort. 	<ul style="list-style-type: none"> • Use CAATs to sort employees according to their job grades.

Note: The examples provided above are not properly formulated substantive procedures. If you are required to formulate substantive procedures using CAATs in the examination and you write these examples down, you will not earn any marks.

In the next section we will explain to you how to formulate a proper substantive procedure using CAATs. Remember, substantive procedures should be formulated in terms of how, what and why.



How should you formulate a substantive procedure using CAATs?

How should substantive procedures using CAATs be formulated?

- A substantive procedure using CAATs should deal with the following:
 - **HOW:** This is about the **verb** that describes the action to be performed. The **how** in a substantive procedure using CAATs includes doing the following:
 - Use CAATs to **recalculate** ...
 - Use CAATs to **select a sample** ...
 - Use CAATs to **compare** ...
 - Use CAATs to perform **analytical procedures** ...
 - Use CAATs to **scan a file for “error” conditions** for example ... and to print an **exception report**
 - Use CAATs to **extract a summary** of ...
 - Use CAATs to **sort** ...
 - **WHAT:** Here you should make reference to what relevant source of evidence is required. For example:
 - Use CAATs to recalculate the **net wages** ...
 - Use CAATs to select a sample of **employees** ...
 - Use CAATs to compare **net wage totals** ...
 - **WHY:** This is about the **reason** for the audit procedure with regard to the assertion being tested and the risk that is being responded to. For example:
 - Use CAATs to recalculate the net wages to **confirm the accuracy** of the wages.
 - Use CAATs to select a sample of employees and **perform physical positive identification to confirm that employees are employed** (i.e. no fictitious employees).
 - Use CAATs to compare net wages totals in the master file with net wages totals in the general ledger and trial balance to **confirm accuracy**.

The following are examples of **badly** worded substantive procedures using CAATs in common mistakes made by students:

Example 1:

Use CAATs to physically verify an employee.

Comment: Can CAATs be used to verify an employee? No, they can not. However you can use CAATs to select a sample of employees that you can verify physically.

Example 2:

Use CAATs to print an exception report.

Comment: Why and of **what?** The substantive procedure is not properly formulated in terms of **how, what** and **why**.

Other common mistakes made by students include the following:

- Substantive procedures are often too **generic** and students **do not apply** their substantive procedures to the information provided in the scenario.
- Students **do not know their cycles** and therefore find it difficult to identify all the relevant issues for which they should perform substantive procedures.
- Students struggle to link their substantive procedures with **assertions**.
- Students do not manage their **time** according to the marks allocated and therefore do not formulate all the relevant substantive procedures.

Now that you have a better understanding of how substantive procedures using CAATs should be formulated, do Activity 2.2.2.

**ACTIVITY 2.2.2**

- (1) List the audit functions that can be performed using data CAATs.
- (2) For each audit function, provide an example of a **substantive procedure** that can be performed with the use of data CAATs in the payroll and personnel cycle (refer to chapter 13 in Jackson and Stent for examples).

**FEEDBACK ON ACTIVITY 2.2.2**

(1) Audit functions using data CAATs	(2) Examples of a substantive procedure using data CAATs in the payroll and personnel cycle
<ul style="list-style-type: none"> • Re-perform casts and calculations. 	<ul style="list-style-type: none"> • Use CAATs to recalculate total net wages in the employee master file to confirm accuracy of wages.

(1) Audit functions using data CAATs	(2) Examples of a substantive procedure using data CAATs in the payroll and personnel cycle
<ul style="list-style-type: none"> Determine sample size and select certain items. 	<ul style="list-style-type: none"> Use CAATs to select a sample of employees from the employee master file and perform physical positive identification of the employees to confirm that employees are employed by the company.
<ul style="list-style-type: none"> Compare data on separate files. 	<ul style="list-style-type: none"> Use CAATs to compare the total wage balance in the master file with the total wage balance in the trial balance and general ledger to confirm accuracy.
<ul style="list-style-type: none"> Perform analytical procedures. 	<ul style="list-style-type: none"> Use CAATs to perform analytical procedures on wages by comparing the total wages balance of the current year with the total wages balance in the previous year.
<ul style="list-style-type: none"> Discover missing data on file (examining inconsistencies and exception reporting). 	<ul style="list-style-type: none"> Use CAATs to scan the employee master file for “error” conditions (e.g. no amounts in the net wages field where an employee has been employed) and print an exception report to discuss with management.
<ul style="list-style-type: none"> Discover duplication (examining inconsistencies and exception reporting). 	<ul style="list-style-type: none"> Use CAATs to scan the employee master file for “error” conditions (e.g. duplicated employee numbers) and print an exception report to discuss with management.
<ul style="list-style-type: none"> Extract summaries. 	<ul style="list-style-type: none"> Use CAATs to extract the PAYE/UIF totals in the employee master file and compare with totals on tax returns submitted to SARS.
<ul style="list-style-type: none"> Sort. 	<ul style="list-style-type: none"> Use CAATs to sort employees according to their job grades in the employee master file, compare the job grade and rate with documentation in the personnel file.

2.2.2 Conclusion

This learning unit explained how substantive procedures are formulated with the assistance of CAATs. By using the knowledge that you obtained in this learning unit and in the previous learning unit, we will require you to formulate substantive procedures for each of the different business cycles in the next topic of this module.



Self-assessment

After having worked through the learning unit and the references to the prescribed study material, decide whether you feel comfortable about doing the following:

- Formulate substantive procedures with the assistance of CAATs.

There are no activities to be submitted for this learning unit, but reflect on what you have learnt and re-read until you have mastered the principles.

LEARNING UNIT 2.3

Analytical procedures

A Botha

After having worked through this learning unit you must be able to

- explain the definition of analytical procedures
- explain the use of analytical procedures as substantive procedures
- formulate the analytical procedures that the auditor could perform during an audit

2.3.1 INTRODUCTION

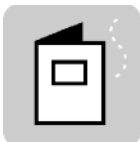
ISA 520 (**Analytical procedures**) deals with the auditor's use of analytical procedures as substantive procedures (ISA 520, par 01).



Study

Study risk assessment procedures, including performing analytical procedures:

- Study ISA 520, paragraph 01.
- Study ISA 315, paragraphs 6(b) and A7 to A9.



Study

Study ISA 330, paragraph 4(a), and ISA 500, paragraphs A10 and A21.

Can you see that analytical procedures are classified as substantive procedures?

Hint for the examination: This means that if we require you to formulate substantive procedures, you should include analytical procedures in your answer. However, the question can sometimes specifically request you to exclude analytical procedures. Therefore, make sure that you read the required part of the question very carefully so that you understand what is required of you.



Study

Study ISA 520 paragraphs 04, A1 to A3.



ACTIVITY 2.3.1

Explain the definition of analytical procedures.



FEEDBACK ON ACTIVITY 2.3.1

Refer to ISA 520 paragraphs 04, A1 to A3.

In summary, analytical procedures can include the following:

- Comparisons of the entity's financial information to, for example
 - prior periods
 - anticipated results of the entity, such as budgets and forecasts or expectations of the auditor
 - similar industry information
- Consideration of relationships, for example
 - in the entity's financial information, such as the gross profit percentage (ratios)
 - between financial information and non-financial information, such as payroll costs to the number of employees



Study

- Study the requirements applicable to designing and performing analytical procedures in ISA 520, paragraphs 05, A1 to A3.
- Study ISA 520, paragraphs 06, A17 to A19, and note that the auditor should design and perform analytical procedures near the end of the audit to assist when forming an overall conclusion.
- Study ISA 520, paragraphs 07, A20 to A21, and note that the auditor should investigate the results of analytical procedures.



ACTIVITY 2.3.2

CompTech Limited's main business involves the sale of computer equipment to various clients all over South Africa. You are the audit senior in charge of the audit of CompTech Limited (CompTech).

CompTech uses an automated sales system. Based on your identification and assessment of risk in the planning stage of the audit of CompTech, you decided to use a combination of tests of details and substantive analytical procedures to obtain audit evidence of CompTech's sales total during the current financial year.

The financial manager of CompTech provided you with the following information:

- financial statements and trial balance for the current and prior financial year end
- budget for the current financial year end
- financial statements of other enterprises in the same operating sector with a similar clientele
- director's minutes of meetings

Required

Describe the **analytical procedures** that you will perform on the sales of CompTech.



FEEDBACK ON ACTIVITY 2.3.2

Analytical procedures on the **sales** value of CompTech:

- Inspect the financial statements and trial balance and compare the sales total of this year with the sales total of the **prior year**. Investigate significant fluctuations.
- Inspect the current financial year end's financial statements and trial balance and compare the sales total with the **budgeted** sales total. Investigate inconsistent fluctuations.
- Inspect the sales total in the financial statements of the current year and compare to the sales total in financial statements of **other enterprises in the same operating sector**. Investigate inconsistent fluctuations.
- Calculate the **gross profit margin** of the current financial year and compare it to the **gross profit margin of the prior** financial year. Follow up on significant differences.
- Calculate the **gross profit margin** of the current financial year and compare it to the **budgeted gross profit margin**. Follow up on inconsistent fluctuations.
- Compare the increase or decrease in **sales** with the increase or decrease in **debtors**. If debtors increase and sales decrease follow up with management.

If you are provided with the general ledger indicating the monthly sales, you may also perform the following analytical procedure:

- Compare the sales on a monthly basis to the monthly budgeted prediction of sales. Identify significant differences and follow up with management.

Comments or additional notes

- Analytical procedures are a form of substantive procedures. Therefore, when you are required to describe substantive procedures, remember to include the analytical procedures that you will perform with your other substantive procedures (ISA 520, pars .05, A4 to A16).

- Analytical procedures can include the following (ISA 520, pars .04, A1 to A3):
 - Comparisons of the entity's financial information to, for example
 - * prior periods
 - * anticipated results of the entity, such as budgets and forecasts or expectations of the auditor
 - * similar industry information
 - Consideration of relationships, for example
 - * in the entity's financial information, such as the gross profit percentage (ratios)
 - * between financial information and non-financial information, such as payroll costs to the number of employees
- An auditor can decide to perform analytical procedures at the beginning of the audit as part of the risk assessment procedures and the auditor can also perform analytical procedures when obtaining audit evidence in each of the different business cycles of an entity. The auditor may also perform analytical procedures near the end of the audit to assist when forming an overall conclusion of the audit (ISA 520, pars .06, A17 to A19).
- Remember that the success of analytical procedures depends on the effective identification of significant fluctuations and inconsistencies and their investigation. The investigation of the results of analytical procedures includes (ISA 520, pars .07, A20 to A21):
 - enquiring of management and following up on management's responses by obtaining the appropriate audit evidence
 - performing other necessary audit procedures
- Analytical procedures do not include, for example
 - comparing the current year's opening balances with the prior year's closing balances or
 - comparing the total sales value in the trial balance with the total sales value in the financial statements

These are examples of substantive procedures and not analytical procedures.

- Analytical procedures can also be performed with the use of computer assisted audit techniques (CAATs). CAATs were covered in learning unit 2.2. Even though you learnt how to formulate substantive procedures using CAATs, we want to refer you to a quick example.

Example of an analytical procedure without using CAATs:

Inspect the financial statements and compare the sales total of this year with the sales total of the **prior year**. Investigate unreasonable fluctuations.

Example of the same analytical procedure with the assistance of CAATs:

Use CAATs to compare the sales total in the trial balance of this year with the sales total in the trial balance of the prior year. Investigate unreasonable fluctuations.

2.3.2 CONCLUSION

In this learning unit we explained the auditor's use of analytical procedures as substantive procedures.

**Self-assessment**

After having worked through this learning unit and the references to the prescribed study material, find out whether you feel comfortable about doing the following:

- Explain the definition of analytical procedures.
- Explain the use of analytical procedures as substantive procedures.
- Formulate the analytical procedures that the auditor could perform during an audit.

There are no activities to be submitted for this learning unit, but reflect on what you have learnt and re-read until you have mastered the principles.

TOPIC 3

Formulating the substantive procedures for the cycles

L Ferreira

Topic overview

In this topic we are going to **apply** the principles of formulating substantive procedures (including analytical review) as set out in topic 2 to **all** the business cycles.

The stance followed in the topic is that you must first understand the business cycles (visualise these as if they are part of your **own** business) and identify the source documents and accounting records and accounting treatment for presentation and disclosure purposes. This knowledge was acquired by you in AUE2602 and in financial accounting modules. The next step is to examine a set of annual financial statements (AFSs). Refer to pages 50 and 51 in your AUE2602 study guide when you start each of the learning units, or to any other example of a set of AFSs. The items on these AFSs are assertions made by management. What you are going to learn in this topic is to formulate the substantive procedures for each cycle so that you are able to collect sufficient appropriate evidence (topic 1) to support the AFS. This requires you to consider the risk of material misstatement and the risk factors you have mastered in AUE3701. Watch this video clip to help you understand where we are heading:

<https://www.youtube.com/watch?v=1ZScXtzafI4>

Once you have mastered the theory you need to apply it. Therefore in the **additional resources** I will refer you to references to questions (case study scenarios) and these questions are found in your prescribed book *Graded questions on auditing*, with the suggested solutions. When attempting these questions, you must do so under examination conditions. You **time** and **mark** yourself. The learning comes in when you **reflect** and **correct** yourself. If you merely read the case study and memorise the suggested solution (the “oh yeah” method) you are missing the whole point. I also do not expect you to do well in your first attempt, because applications are difficult, but rather to learn from your mistakes and grow.

This topic is divided into the following learning units.

Learning unit	Title
3.1	Revenue and receipts cycle
3.2	Acquisition and payments cycle
3.3	Inventory and production cycle
3.4	Payroll and personnel cycle
3.5	Finance and investment cycle

Learning outcomes

The learning outcomes for each of the learning units are set out in the separate learning units.

LEARNING UNIT 3.1

Revenue and receipts cycle

L Ferreira

After having worked through this learning unit you must be able to
<ul style="list-style-type: none"> • identify the source documents for the revenue and receipts cycle (revision)
<ul style="list-style-type: none"> • describe the functioning of the revenue and receipts cycle (revision)
<ul style="list-style-type: none"> • describe the assertions for sales, receipts and trade receivables
<ul style="list-style-type: none"> • formulate the substantive procedures to audit sales, receipts and trade receivables
<ul style="list-style-type: none"> • formulate the substantive procedures for the audit of bank and cash

3.1.1 INTRODUCTION

We have all sold something to someone, be it silkworms during your primary school days or more recently you may have sold something on Gumtree or OLX. The point I wish to make is that you wanted to convert a commodity item into cash, but usually with a profit motive. The profit motive allows you to buy something better in its place (Investment cycle). From the outset I want you to realise that auditing the revenue and receipts cycle is not something abstract because we are exposed to it in our own revenue and receipts cycle in our daily lives. In this learning unit I am going to teach you how to formulate the substantive procedures for the revenue and receipts cycle for a business. In topic 2 you mastered the principles of formulating substantive procedures (with or without CAATs) and analytical review - therefore you need to consider and apply those principles. For an overview of the revenue cycle view these slides: <http://www.slideserve.com/genesis/auditing-the-revenue-cycle>

Remember, save your answers to the questions and activities online as soon as you have completed the learning unit.

3.1.2 IDENTIFY THE SOURCE DOCUMENTS

In your earlier accounting modules you learnt how to account for revenue and receipts and how the balance between those two accounts are actually reflected in the trade receivable account (if sold on credit). You also learnt how to perform a bank reconciliation. This knowledge is very important for auditing because this allows you to visualise the accounting process of transactions and balances. Your degree must be seen as an integrated unit of knowledge and not as separate compartments. You must break any barriers that prevent integration and lateral thinking. To break that mental block that many students have, remember that auditing is not rocket science. If you are able to visualise the cycle (a man made invention) then you, the auditor, must just collect evidence based on this cycle.

Therefore, before you can audit a cycle you must first be able to *name* the source documents and envisage the business environment and the transaction flow from initiation of the transaction through to recording it in the accounting books and general ledger and the presentation and disclosure thereof in the AFS. Besides your accounting knowledge, you have also mastered the business cycles in AUE2602. If you are like me, then you sometimes forget detail. Therefore, I would like you to quickly revise the following topics just to refresh your memory. If you know the answers to the activity, then you may skip it.



ACTIVITY 3.1.1

- Identify the Statement of Financial Position account balances and Statement of Comprehensive Income classes of transaction for the revenue and receipts cycle.
- Describe credit sales transactions by explaining the activities, functions and risks associated with credit sales.
- Describe cash sales transactions by explaining the activities, functions and risks associated with cash sales.
- Explain the accounting processes involved to reflect the balances of the accounts receivable and cash and cash equivalents accounts in the general ledger.

3.1.3 FUNCTIONING OF THE REVENUE AND RECEIPTS CYCLE

The next step is to understand how all of the above documents and accounting records function. In other words, we want to visualise the clients accounting system and transaction flow (many of you may not have practical experience). In practice, such a description will form part of the auditor's working papers to evidence the understanding of the business. Therefore as a trainee accountant at an auditing firm you may be allocated the task of compiling a systems description of a client. An example of such a description is found in the next study activity. You are merely required to read it and form a picture in your mind.



Study

Refer to your prescribed book Jackson and Stent, pages 10/44 to 10/53.

Are you able to visualise ProRide (Pty) Ltd's transaction flow and accounting system?

In the examinations you will be provided with a case study (scenario) that requires quite a lot of reading. Besides understanding the accounting treatment and transaction flow of an acquisition and payment cycle, reading the above study reference will assist you in developing reading and comprehension skills that are so crucial in the examinations.

3.1.4 AUDITING THE REVENUE AND RECEIPTS CYCLE

Remember in topic 1 you learnt that auditing evidence must be relevant. Relevant means the audit procedure must be spot on the target and anything that misses the target will waste time and therefore cost money. You don't want to lose your clients due to an excessive audit fee attributed to trainee accountants that performed irrelevant procedures! To be relevant you must identify the risks embedded in the assertions.



Reflect and discuss

You own a business and through your hard work it has grown (you are making money – you picture how the profits are going to pay for that Mauritius holiday). You were able to sell the product and collect what was due to you, but the business has grown so rapidly that you can no longer do all of these tasks any more. You started appointing people to handle the revenue and receipts cycle on your behalf.

Reflect and discuss what risks (including the possibility of fraud) the revenue and receipts cycle potentially holds you, the business owner, now that others are doing some of the work for you on your behalf.

Example

Despatching the wrong goods; money collected is not banked; certain customers should not have been provided with a credit facility because they will not pay their accounts etc.

Do you see why it is important to identify these risks? As the auditor of a client, you don't want your client to be losing money – you will then not have a client for a long time! See your client through a lens: what if it was *your* business and what would *you* be expecting from your auditors?

Please read the following http://en.wikipedia.org/wiki/Audit_risk just to help you see the bigger picture – it will help you. (But in research projects, never ever use Wikipedia as a source!)

Your primary task as auditor is to provide the shareholders with assurance that the AFS are a fair representation of their business. Financial statements

are management's assertions. Therefore in designing your substantive procedures your aim is to reduce the risk of material misstatements in the AFS knowing that the AFS are management's assertions. The auditor has to consider risks at financial statement level, at account balance level and at transaction level and then design the audit procedures to target risks of material misstatement to be in a position to express an opinion of the AFS in spite of the business risks. Now, do you see why assertions are so important in studying auditing?

Assertions for the revenue and receipts cycle



Study

Refer to Jackson and Stent, pages 10/54 to 10/55 (Assertions, and Revenue and receipts cycle). It is very important that you notice there are assertions for **transactions** (revenue and receipts) and for **balances** (trade receivables) and **presentation and disclosure**. Transactions begin with matching (corresponding) the relevant source documents pertaining to a specific transaction with each other. For example the order, picking slip, delivery note and invoice and then vouching these matched source documents to the recorded amounts in the sales journal and receipts to the receipts journal or vice versa. Assertions for balances refer to the aggregate effect of transactions as reflected in an ending balance (accounts receivable). Therefore when auditing balances one begins with the ending balance reflected in the general ledger (also the balance as reflected in the Statement of Financial Position). Presentation and disclosure refers to the notes and disclosures reflected in the AFS in terms of IAS.



ACTIVITY 3.1.2

Describe the assertions for **sales transactions, receipts transactions, trade receivables** and **presentation and disclosure**. Understanding these concepts is crucial to formulating relevant (on target) substantive procedures.

3.1.5 FORMULATE SUBSTANTIVE PROCEDURES

Now that you have learnt the assertions for this cycle, we are ready to formulate the substantive procedures for transactions, balances and disclosure and presentation. Remember transactions are vouched (throughout the year) but a balance (at year end) is verified. Transactions are like a movie while a balance is like a snapshot.

3.1.5.1 Revenue and receipts (transactions)



Study

Refer to Jackson and Stent, pages 10/61 to 10/63.

Note the following while studying the substantive procedures for sales:

- They are formulated as an instruction.
- The documents to be inspected are named.
- The accounting records to be inspected are named.
- Occurrence – the transaction recorded occurred and relates to the client. This requires selecting entries and examining them against all the relevant **source documents**.
- Accuracy – the transaction has been recorded at the correct amounts (values). Therefore **calculations** (price x quantity) and **additions** (cast) are important when examining accuracy.
- Cut-off – the transaction is accounted for in the correct financial year (**dates** of transactions). By fiddling with cut-off dates management can for example understate (to pay less tax) or overstate profits (bonuses).
- Classification – the transactions have been posted to the correct accounts. Again you need to examine the source documents and trace them to the **sales journal** and then to the **general ledger accounts**.
- Completeness – nothing has been left out. Have the all the invoices; dispatch notes been recorded?
- Analytical review procedures – By comparing monthly and yearly trends and ratios you can highlight errors.

You can apply the above framework to receipts too. As soon as you understand the assertions, envisage the source documents, books of primary entry and the general ledger account you can formulate the substantive procedures for transactions.



ACTIVITY 3.1.3

You are the audit manager and the audit partner has allocated you to the client ExWhy (Pty) Ltd. You intend to formulate the substantive procedures for revenue in such a way that a junior member on your audit team will be able to understand them and therefore execute them correctly.

Required

- Formulate all the substantive procedures to audit revenue (sales transactions) for the year under audit.

Make sure that you can do the activity. I could also have required you to formulate the substantive procedures for a specific assertion e.g. “Formulate the substantive procedures to test (vouch) the **accuracy** of sales for the year under audit”. Therefore read your questions very carefully in the examinations. You must answer what the examiner requested, in other words your procedures must be relevant. If in the scenario reference was made to the fact that the auditor wishes you use CAATs, then just incorporate the principles of learning unit 2.2 into your solution. CAATs help you to **extract** the information quickly and efficiently.

3.1.5.2 Trade receivables (balances at year end)

Remember, when we verify balances at year end we do not go back and vouch the transactions, because we did that when we audited the revenue and receipts. That is why the assertions for balances are different to the assertions for transactions:

- Existence – the balance existed at year end – therefore the procedures will start with trade receivables balance.
- Right – the company has a right to the amount owed by a debtor.
- Completeness – all the debtors are included at year end.
- Valuation – the balances are stated at a correct value (not over- nor understated).



Study

Refer to Jackson and Stent, pages 10/63 to 10/70, and do the next activity.



ACTIVITY 3.1.4

You are the audit manager and the audit partner has allocated you to the client ExWhy (Pty) Ltd. You want to formulate the substantive procedures to audit the trade receivables balance of R18 152 112 at year end.

Required

- Formulate all the substantive procedures to audit (verify) trade receivables at year end.

Make sure that you can do the activity. I could also have required you to formulate the substantive procedures for a specific assertion e.g. Formulate the substantive procedures to verify the **valuation** of trade receivables at year end. Therefore read your questions very carefully in the examinations.

3.1.5.3 Substantive procedures for the audit of bank and cash

You must also be able to audit the bank account. You could be asked to audit the bank reconciliation or be required to formulate the audit procedures to audit the bank balance at year end.



Study

Study Jackson and Stent, pages 10/71 to 10/73. Make sure that you can formulate the substantive procedures to audit the bank balance at year end.

3.1.6 CONCLUSION

In this learning unit we identified the source documents, books of prime entry and accounts that are relevant to the revenue and receipts cycle (including the bank). We also looked at the accounting flow of transactions

and balances for this cycle. We identified the assertions, but also noted that the assertions for transactions and balances are different. Finally we formulated the substantive procedures for revenue and receipt transactions and trade receivables and bank (balances).

As soon as you have completed this learning unit you are required to save Activities 3.1.2 to 3.1.4 on your computer.

(NB: Refer to your “additional resources” for scenario-based activities.)

LEARNING UNIT 3.2

Acquisitions and payments cycle

L Ferreira

After having worked through this learning unit you must be able to
<ul style="list-style-type: none"> • identify the source documents for the acquisitions and payments cycle (revision)
<ul style="list-style-type: none"> • describe the functioning of the acquisitions and payments cycle (revision)
<ul style="list-style-type: none"> • describe the assertions for the acquisitions, payments and trade payables
<ul style="list-style-type: none"> • formulate the substantive procedures for acquisitions, payments and trade payables

3.2.1 INTRODUCTION

We all like to shop and buy things – ladies like beautiful clothes (we have expensive taste), gentlemen you like to buy ... fast cars? When you shop you have a **need** for something and then you will look at the **price** – you want value for your money and then you **pay** for the item. As I said in learning unit 3.1, auditing is neither an abstract nor rocket science. We are exposed to our own acquisition and payment cycles in our daily lives. In this learning unit I am going to teach you how to formulate the substantive procedures for the acquisition and payment cycle of a business. Again, remember to rely on the knowledge that you acquired in topic 2.

Remember, submit your answers to the questions and activities online as soon as you have completed the learning unit.

3.2.2 IDENTIFY THE SOURCE DOCUMENTS

In your earlier accounting modules you learnt how to account for acquisitions (purchases) and payments and how the balance between these two accounts was reflected in the trade payables balance – you even learnt how to do a creditors reconciliation. This knowledge is very important for this learning unit because you are then able to visualise the accounting process

of transactions and balances. Break the “silo thinking” mentality and use and apply what you learnt in other modules!

Before you can audit a cycle you must first be able to **name** the source documents and envisage the business environment and the transaction flow, from initiation of the transaction through to recording it in the accounting books and general ledger and its presentation and disclosure in the AFS. To refresh your memory do the following activity.



ACTIVITY 3.2.1

- Identify the **stages** of the acquisition and payment cycle and list all the **source documents** and the **accounting records**.
- Describe acquisition transactions by explaining the activities, functions and risks associated with acquisitions.

(Refer to topic 5 in your AUE2602 study guide to answer this question.)

3.2.3 FUNCTIONING OF THE ACQUISITIONS AND PAYMENTS CYCLE

The next step is to understand how all of the above documents and accounting records function. In other words, we want to obtain an understanding of the client’s accounting system and transaction flow. If you can see the picture in your mind then you can audit it. I bet you never thought that auditors are supposed to be creative! In practice such a description will form part of the auditor’s working papers to evidence the understanding of the business. Therefore, as a trainee accountant at an auditing firm, you may be allocated the task of compiling a systems description of a client. An example of such a description is found in the next study activity.



Study

Refer to Jackson and Stent, pages 11/32 to 11/40.

Are you able to visualise ProRide (Pty) Ltd’s transaction flow and accounting system?

Remember what I said in the previous learning unit. In the examinations you will be provided with a case study (scenario) that requires quite a lot of reading. Besides understanding the accounting treatment and transaction flow of the acquisition and payments cycle, reading the above study reference will help you develop the reading and comprehension skills that are so crucial in the examinations.

3.2.4 AUDITING THE ACQUISITION AND PAYMENTS CYCLE

Remember the principle of relevance, meaning that the audit procedure must be right on the target and anything that misses the target will waste time and cost money. You don’t want to lose your clients because of an ex-

cessive audit fee caused by trainee accountants' irrelevant audit procedures! To be relevant you must identify the risks embedded in the assertions.



Reflect and discuss

You own a business that has grown through your hard work (you are making money). You were able to order and pay for goods yourself, but the business has grown so rapidly that you can no longer do all of these tasks any more. You started appointing people to handle the acquisition and payments cycle on your behalf.

Reflect and discuss what risks (including the possibility of fraud) the purchases and acquisition cycle potentially holds for you, the business owner.

Example

Buying more than is needed (overstocking), or paying excessive prices for acquisitions.

Do you see why it is important to identify these risks? Just as you will not like your employees wasting money or even stealing your money from your business, so too will your clients not like that happening in their business. Your primary task is to provide the shareholders with assurance that the AFS is a fair representation of their business. Therefore designing substantive procedures to target risks and examining the assertions makes good sense – but the auditor will not always know where all the risks are hidden until some testing is done. The auditor has to consider risks at financial statement level, at account balance level and at transaction level and then design the audit procedures to target those risks to be able to express an opinion of the AFSs in spite of the risks. The AFSs are a collection of management's assertions.

3.2.5 ASSERTIONS FOR THE ACQUISITION AND PAYMENTS CYCLE



Study

Refer to Jackson and Stent, page 11/42 (Assertions and the acquisition and payments cycle). It is very important that you notice there are assertions for **transactions** (acquisitions and payments), for **balances** (trade payables) and for **presentation and disclosure**. Auditing transactions begin with approval or authorisation of the transaction, matching the source documents like the order, goods received note (GRN), supplier delivery note and invoice, focusing on details and vouching these source documents to the recorded amounts in the purchases journal and payments to the payments journal. Auditing balances are aimed at substantiating the ending balances of a general ledger account.



ACTIVITY 3.2.2

Describe the assertions for **aquisitions (purchase) transactions, payment transactions, trade payables and presentation and disclosure**. Understanding these concepts is crucial to being able to formulate relevant (on target) substantive procedures.

3.2.6 FORMULATE SUBSTANTIVE PROCEDURES

Now that you have learnt the assertions for this cycle, we are ready to formulate the substantive procedures for transactions, balances and disclosure and presentation. Remember transactions are vouched (throughout the year) but a balance (at year end) is verified. Transactions are like a movie while a balance is like a snapshot.

3.2.6.1 Purchases and payments (transactions)



Study

Refer to Jackson and Stent, pages 11/47 to 11/48.

Note the following while studying the substantive procedures for purchases:

- They are formulated as an instruction.
- The documents to be inspected are named.
- The accounting records to be inspected are named.
- Occurrence – the transaction recorded occurred and relates to the client. This requires selecting entries and examining them against all the relevant **source documents**.
- Accuracy – the transaction has been recorded at the correct amounts (values). Therefore **calculations** (price x quantity) and **additions** (cast) are important when examining accuracy.
- Cut-off – the transaction is accounted for in the correct financial year (**dates** of transactions). By fiddling with cut-off dates management can for example understate (to pay less tax) or overstate your profits (bonuses).
- Classification – the transactions have been posted to the correct accounts. Again you need to examine the source documents and trace them to the **purchases journal** and then to the **general ledger accounts**.
- Completeness – nothing has been left out. Have all the GRNs been recorded?
- Analytical review procedures – by comparing monthly and yearly trends and ratios you can highlight errors.

You can apply the above framework to payments too. As soon as you understand the assertions, envisage the source documents, books of primary entry and the general ledger account you can formulate the substantive procedures for transactions.



ACTIVITY 3.2.3

You are the audit manager and the audit partner has allocated you to the client ExWhy (Pty) Ltd. You intend to formulate the substantive procedures for acquisitions (purchases) in such a way that a junior member on your audit team will be able to understand them and therefore execute them correctly.

Required

- Formulate all of the substantive procedures to audit acquisitions (purchases) (transactions) for the year under audit.

Make sure you can do the activity. I could also have asked you to formulate the substantive procedures for a specific assertion, for example “formulate the substantive procedures to test (vouch) the **accuracy** of purchases for the year under audit”. Therefore read your questions very carefully in the examinations. You must answer what the examiner asks, in other words your procedures must be relevant. If in the scenario reference was made that the auditor wishes you to use CAATs then just incorporate the principles of learning unit 2.2 into your solution. CAATs only help you to extract the information quickly and efficiently.

3.2.6.2 Trade payables (balances at year end)

Remember, when we verify balances at year end we do not go back and vouch the transactions because we do this when we audit the acquisitions and payments. That is why the assertions for balances are different to the assertions for transactions.

- Existence – the balance existed at year end.
- Obligation – their company has an obligation to pay the amounts owing to its creditors.
- Completeness – all the creditors are included at year end.
- Valuation – the balances are stated at the correct carrying value.



Study

Refer to Jackson and Stent, pages 11/49 to 11/51, so that you can do the next activity.



ACTIVITY 3.2.4

You are the audit manager and the audit partner has allocated you to the client ExWhy (Pty) Ltd. You want to formulate the substantive procedures to audit the trade payables balance of R18 152 112 at year end.

Required

- Formulate all of the substantive procedures to audit (verify) trade receivables at year end.

Make sure that you can do the activity. I could also have asked you to formulate the substantive procedures for a specific assertion, for example to formulate the substantive procedures to verify the **completeness** of trade payables at year end. Therefore read your questions very carefully in the examinations.

3.2.7 CONCLUSION

I think that you should now be realising that auditing the revenue and receipts cycle is very similar to the acquisitions and payments cycle – it's only the documents and accounts that differ. So substantive procedures are not so difficult after all. In this learning unit we identified the source documents, books of prime entry and accounts that are relevant to the acquisition and payments cycle. We also looked at the accounting flow of transactions and balances for this cycle. We identified the assertions, but noted that the assertions are different for transactions and balances. Finally we formulated the substantive procedures for acquisitions and payments transactions and the trade payables (balances).

Reflect on the notes that you made during your activities and reflections and go back to the learning outcomes as set out at the beginning of this learning unit. Make sure that you are able to achieve those outcomes before moving on to the next study unit.

As soon as you have completed this learning unit you are required to save Activities 3.2.2 to 3.2.4 on your computer.

(NB: Refer to your “additional resources” for scenario-based activities.)

LEARNING UNIT 3.3

Inventory and production cycle

M la Grange

After having worked through this learning unit you must be able to
<ul style="list-style-type: none"> • identify the source documents for the inventory and production cycle (revision)
<ul style="list-style-type: none"> • describe the functioning of the inventory and production cycle (revision)
<ul style="list-style-type: none"> • describe the assertions pertaining to the inventory account balance and to the presentation and disclosure
<ul style="list-style-type: none"> • formulate substantive procedures for auditing inventory balances and disclosures

3.3.1 INTRODUCTION

Inventory may represent a significant balance in manufacturing, wholesale and retail companies. In retail entities the audit of inventory is simple, as products are bought directly from suppliers and sold to the public. On the other hand, in a manufacturing company, the audit of inventory is more complex as there are various processes involved in using raw material to arrive at a final product.

Inventory forms the link between the revenue business cycle and the expenditure business cycle and therefore the keeping of records about the purchases, sale and returns of merchandise forms part of the inventory process.

In the previous learning units you learnt how to formulate substantive procedures in some of the business cycles. Substantive procedures should be formulated by referring to **how**, **what** and **why** (refer to learning units 2.1 and 2.2 for guidance). The aim of this learning unit is to explain how substantive procedures are formulated in the **inventory and production cycle**. Note that substantive procedures for inventory transactions consist mainly of the audit of movements on the inventory records through purchases, sales, returns and other adjustments, while the substantive procedures for inventory balances and disclosures refer to the balance disclosures reflecting on the statement of financial position.



Revision

You cannot audit a cycle if you do not understand how it works. We already explained how the inventory and production cycle works in AUE2602. Refresh your memory by **revising topic 3 and topic 6 of AUE2602**. The study guide for AUE2602 is attached in your “additional resources” for easy reference.

The payroll and personnel cycle includes the following classes of transactions and account balances.

Statement of financial position	Statement of comprehensive income
Inventory	Cost of sales (note that substantive procedures relating to cost of sales will be dealt with in the acquisition and payment cycle – refer to learning unit 3.2)



Study

Study Jackson and Stent, chapter 12 (Auditing the cycle, but excluding par 5.1 as it relates to tests of controls), as well as ISA 501 (Audit evidence – Specific considerations for selected items), paragraphs .04 to .08.

Note the following in the above study sources:

- Attendance of the inventory count by the auditor includes both substantive procedures and tests of controls.
- **Financial statement assertions** in the inventory and production cycle (remember, the assertions are also described in ISA 315, par A124).
- Make sure that you know the **difference between a test of control and a substantive procedure**. The definitions are described in ISA 330, paragraph 04. Remember, this learning unit deals with substantive procedures only. Tests of controls were dealt with in AUE3701.
- Substantive procedures are performed through **inspecting, observing, external confirmation, recalculating, re-performing, analytical procedures, inquiring or by means of CAATs**.

Formulating substantive procedures in the inventory and production cycle can be illustrated by means of Activities 3.3.1 and 3.3.2.



Recommended study material

Study chapter 13 (Auditing the inventory management process) in *Auditing & assurance services* by Eilifsen, A, Messier Jr, WF, Glover, SM and Prawitt, DF. 2010. (2nd international edition. McGraw-Hill Education).

Self-reflection activity to be submitted

After studying the theoretical concepts above I want you to attempt Activities 3.3.1 and 3.3.2 below under examination conditions. But you mark yourself by awarding 1½ marks for a properly formulated procedure. (Don't look at the comments or solution yet.) You are then required to submit the **percentage** you obtained **and a self-reflection**. The **self-reflection** is the essential part of the activity. **I want you to think about what went wrong and how you can remedy your mistakes – you must come up with suggestions and answers**. Your self-reflection may include questions you ask yourself like: Did I understand the purpose of the question? Did I understand the theoretical principles? Must I read up more (research) the topic? Must I practise more, by repeating the question? What did I learn from doing the activity? What made the question difficult? And so on. The self-reflection exercise is more important than the marks. Self-reflection nurtures critical thinking and at the same time improves your communication skills. These are the soft skills that the accounting and auditing professions require and give recognition for.



ACTIVITY 3.3.1 – FORMULATION OF SUBSTANTIVE PROCEDURES, USING CAATS

You are the audit senior in charge of the audit of CompTech Limited (CompTech). The trainee accountants working on the audit of CompTech prepared the following working paper.

Client: CompTech		A1
Year end: 30 September 20xx	Prepared by: E Erasmus	
Date: 17 October 20xx	Reviewed by: L Link	
Subject: Inventory		
<p>CompTech uses an automated (computerised) inventory system and performs regular physical inventory test counts. All inventories are issued directly to customers from the warehouse at the head office in Sandton.</p> <p>Inventories are measured at the lower of cost or net realisable value. The cost price is determined in terms of the first-in-first-out cost formula.</p> <p>Pre-numbered goods received notes are used to record receipts of inventory, while pre-numbered delivery notes are used to record the issue of goods to customers.</p> <p>Because of the effective working of the inventory system and internal controls in the inventory cycle, no other adjustments due to theft or damages were made to the closing balance of inventory.</p>		

The inventory balance will be audited using data CAATs.

The inventory master file contains the following fields:

- inventory item number
- inventory item description
- date of last purchase per item
- date of last sale per item
- quantity on hand at the beginning of the financial year
- year-to-date sales quantity
- year-to-date purchase quantity
- quantity on hand at the end of the financial year
- unit selling price at year end
- unit purchase price at year end
- value of the inventory at the end of the financial year

Required:

Refer to working paper A1 entitled "Inventory". Describe the substantive procedures that you will perform on the **valuation** of inventory using data CAATs. You are not required to deal with substantive procedures relating to consignment inventory.

Marks

(20)



FEEDBACK ON ACTIVITY 3.3.1

Comments on Activity 3.3.1

The working paper is provided below and analysed line by line in order to guide you in the formulation of your answer. The value-adding comments are indicated in red italics.

Client: CompTech		• A1
Year end: 30 September 20xx	• Prepared by: E Erasmus	
Date: 17 October 20xx	• Reviewed by: L Link	
Subject: Inventory		

CompTech uses an **automated (computerised)** inventory system and performs regular physical inventory test counts. *(Comment: This indicates to you that the audit of the inventory cycle can be performed using CAATs. It also indicates that there are no consignment inventories to other warehouses as all inventories are issued directly to customers.)*

Inventories are **measured at the lower of cost or net realisable value**. The cost price is determined in terms of the **first-in-first-out** cost formula. *(Comment: This points out what the accounting basis is in the financial statements and should be taken into account when recalculating the value of inventory at year end.)*

Pre-numbered goods received notes are used to record receipts of inventory, while pre-numbered delivery notes are used to record the issue of goods to customers. *(Comment: Briefly indicates how inventory is receipted and issued.)*

Because of the effective working of the inventory system and internal controls in the inventory cycle, **no other adjustments due to theft or damages were made to the closing balance of inventory**. *(Comment: This indicates that it won't be necessary to describe audit procedures regarding write off of inventory due to theft or damages.)*

The inventory balance will be audited using data CAATs. *(Comment: You have to make use of CAATs to audit the inventory balance.)*

The inventory **master file** contains the following **fields**: *(Comment: Make use of the master file and its fields to formulate your audit procedures. Most of the fields will be used in your answer and some of them might be used more than once.)*

- Inventory item number (Comment: Inventory item number can be used to identify **duplicate inventory numbers** (refer to procedure in 6.5). You can also use it to extract a sample of inventory to be **physically verified**, but then it relates more to the existence assertion.)
- Inventory item description (Comment: The inventory description field can be used when comparing the inventory items from the master file to the inventory descriptions on the purchase or sales invoices [refer to procedures 3 and 7].)
- Date of last purchase per item (Comment: The date of last purchase per item field and the date of last sale per item field can be used to **identify slow moving or obsolete stock** or when scanning for error conditions [refer to procedures 4 and 6.2].)
- Date of last sale per item (Comment: The date of last purchase per item field and the date of last sale per item field can be used to **identify slow moving or obsolete stock** or when scanning for error conditions [refer to procedures 4 and 6.2].)
- Quantity on hand at the beginning of the financial year (Comment: The quantity on hand at the beginning of the financial year field can be used to **recalculate the opening balance** of inventory and this balance can then be compared with the prior year's closing balance in the master file [refer to procedure 1].)
- Year-to-date sales quantity (Comment: The year-to-date sales quantity field should be used together with the date of last sale per item field to describe a procedure related to identification of **slow moving or obsolete stock** [refer to procedure 4].)
- Quantity on hand at the end of the financial year (Comment: The quantity on hand at the end of the financial year should be used together with the value of the inventory at the end of the financial year field to identify cases where there are **zero quantities** in this field **but a balance** in the value of the inventory at the end of the financial year field [refer to procedure 6.3].)
- Unit selling price at year end (Comment: The unit selling price at year end field should be used to identify cases where the **purchase price exceeds the selling price** [refer to procedure 6.1] or when identifying **negative** values [refer to 6.4]. Also use this field to confirm that the sales prices are correct as described in procedure 7. Lastly, use this field to **calculate the impairment** where the selling price is below the cost price [refer to procedure 8 below].)

- Unit purchase price at year end (*Comment: The unit purchase price at year end should be used to confirm that the **correct price is used in terms of IAS 2** [procedure 3] as per the **purchase invoices**. It should also be used to identify cases where the **purchase price exceeds the selling price** [refer to 6.1].)*)
- Value of the inventory at the end of the financial year (*Comment: The value of the inventory at the end of the financial year field should be used together with the other applicable fields to **recalculate the closing balance** as described in procedure 2 below. It is also used to compare the balance in this field with the balances in the **general ledger and trial balance**. Also use this field when you need to identify cases where **there are amounts in this field but zero** in the quantity on hand at the end of the financial year field [refer to 6.3 below]. If you include **analytical procedures** in your answer also describe the procedure as in point 9.1.)*)

General comments:

- To answer this type of question, you should describe substantive procedures and **not** tests of controls.
- Remember to restrict your answer to the valuation assertion; otherwise you will waste valuable time.
- This question specifically required you to use data CAATs to describe substantive procedures. Therefore do not include procedures where you need to perform the procedure without the use of CAATs.
- The question does not restrict you in terms of analytical procedures and therefore you may include these as they also form part of substantive procedures.
- When you formulate your substantive procedures describe your answer in terms of **how, what** and **why** (refer to learning units 2.1 and 2.2 to refresh your memory).

Solution: Substantive procedures for the valuation of inventory

Valuation

1. Use CAATs to calculate the **opening balance** of this year by using the applicable fields in this year's master file and comparing this balance with the closing balance of the prior year either by recalculating the closing balance using the same fields in the prior year's master file or with the closing balance in the financial statements. Follow up on differences.

2. Use CAATs to **recalculate the value of the inventory at year end** (1½ marks each) and compare this value with the value in the general ledger and trial balance (1½ marks each).
3. Use CAATs to extract a sample of inventory item numbers and compare the **purchase price** in the master file with purchase prices on the purchase invoices, taking into account IAS 2 where all costs directly attributable to the acquisition of inventory should be taken into account (purchase price, import duties, insurance on imports, transport, handling costs, etc).

Slow moving or obsolete stock

4. Use CAATs to extract an exception report of inventory on hand at year end that reflects **zero year-to-date sales or no sales for more than six months** to identify **slow moving or obsolete stock** and follow up with management.
5. Use CAATs to perform an analytical procedure to identify **slow moving or obsolete stock** by comparing this year's purchases with this year's sales and in the months where the movement of purchases does not correlate to a similar movement in sales, perform a detailed analysis thereof.
6. Use CAATs to scan the inventory master file for **“error” conditions** and follow exceptions up with management. For example (1½ marks each):
 - 6.1 average unit purchase price **exceeds** the unit selling price
 - 6.2 **zero in the quantity field** but the **date of the last purchase is more recent** than the date of the last sale
 - 6.3 **amounts in the value field** but **zero in the quantity field**
 - 6.4 **negative** purchase price or selling price or quantity
 - 6.5 **duplicate** inventory item numbers

Valuation – impairment

7. Use CAATs and select a sample of inventory items from the master file and trace the selling price per item to the most recent sales invoices.
8. Use CAATs to extract items still in inventory at year end that are sold at selling prices below cost prices and discuss the need for write down with management.

Analytical procedures

9. Use CAATs to perform the following analytical procedure:
 - 9.1 Compare the current year closing balance of inventory with the inventory balance of the prior year.

(14 x 1½ = 21, maximum 20)



ACTIVITY 3.3.2 – FORMULATION OF SUBSTANTIVE PROCEDURES, WITHOUT THE USE OF CAATS

You are the audit manager of an existing client, Tiger Trailers (Pty) Limited, which manufactures standard light duty trailers. The manufacturing of trailers is not a complex process and can be easily understood by observing the production process. The risk of material misstatement of inventory is at an acceptable level.

You attended the client's annual inventory count and are satisfied with the counting procedures. You made copies of the final inventory count sheets. The inventory count sheets are computerised and have the following columns: product code with a description, quantity, selling and cost price. The cost accountant gave you the formula costing records. This is a blueprint of a particular trailer with the exact specifications, product codes and costing. From these records the cost price of a particular trailer is determined. The cost price is then utilised to complete the inventory count sheets for each specific trailer indicated on the inventory count sheets.

Cost is determined on the FIFO basis. Direct costs of manufacturing and a proportion of manufacturing overheads, based on normal operating capacity, are included in the cost of manufactured goods

Inventories at cost on 28 February 2013:

	2013	2012
	R'000	R'000
Finished goods	4 280	3 845
Work-in-progress (70% complete)	1 190	1 084
Raw materials	995	799

Required:

Describe the manual substantive procedures that you will perform to ensure that **finished goods** are correctly **valued** at year end.

Marks

(30)



FEEDBACK ON ACTIVITY 3.3.2

Substantive procedures to audit the value of finished goods

Inventory count sheets

1. Recalculate the value of individual items on the final inventory list by multiplying the quantity with the unit price. (1½)
2. Cast the final inventory list. (1½)
3. Agree the total of the final inventory list (audited) to the balance of the inventory control account in the general ledger and the trial balance. (1½)

4. Perform standard analytical tests, including comparisons with previous years' figures and calculating the inventory turnover and gross profit percentages. Obtain acceptable explanations for deviations identified. (1½)
5. Perform an analytical procedure to identify slow moving stock by comparing this year's monthly purchases with this year's monthly sales and in the months where the movement of purchases does not correlate to a similar movement in sales, perform a detailed analysis thereof. (1½)
6. Compare the selling price on the approved price list with cost price on the inventory list to identify instances where the cost price is higher than the selling price. (1½)
7. Determine through enquiries from management and the sales staff, as well as by inspection of the minutes and correspondence files, whether any of the inventory items are subject to special sales conditions/offers. (1½)
8. Confirm the selling prices by inspecting a number of sales invoices before year end with the selling prices on invoices after year end to determine that the selling prices did not drop. (1½)
9. Where selling prices are lower than cost prices, request management to make the required adjustment to net realisable value (if material). (1½)
10. Confirm through inspection of the previous year's financial statements that the accounting policy with regard to inventory is applied consistently. (1½)

Production records

11. Obtain the production records and the formula for the finished goods. Match the formula with that of the previous year for consistency and obtain explanations for deviations. (1½)
12. Cast the formula costing records and agree the unit price of a trailer to the cost price reflected on the finished goods inventory list. (1½)
13. Perform the following test on the formula costing records:

14.1 Raw material component:

- Compare the component codes and unit prices as reflected in the formula costing records with the codes and unit prices reflected in the raw material inventory list to ensure that they are the same. (1½)
- Trace unit price to the relevant supplier's invoices to establish whether the correct prices have been used in terms of the FIFO cost formula. (1½)

14.2 Labour component

- Confirm the allocated labour costs with the approved wages information received from the wages department. (1½)
- Agree the hourly rate in the formula costing records with the hourly wage rate in the wage records and actually paid. (1½)

14.3 Overheads

- Confirm the allocated manufacturing overheads with the approved allocation basis and the use of accurate information pertaining to normal operating capacity. (1½)
 - Evaluate the manufacturing overheads allocation basis, including the periodic changes to this basis, for reasonableness and discuss with the financial manager if required. (1½)
14. Inspect the inventory count sheets and the inventory records for possible obsolete inventory. Discuss with management the possibility of a provision for obsolete inventory. (1½)
 15. Obtain a management representation letter with regard to the inventory value as at year end. (1½)

(20 x 1½ = 30)

Comments on Activity 3.3.2

- To answer this type of question, you should describe substantive procedures and **not** tests of controls.
- Remember to restrict your answer to the **valuation** assertion; otherwise you will waste valuable time.
- This question specifically required you to describe substantive procedures without the use of CAATs. Therefore do not include procedures where you need to perform the audit procedure with the use of CAATs.
- When you formulate your substantive procedures describe your answer in terms of **how, what** and **why** (refer to learning units 2.1 and 2.2 to refresh your memory).



Note: Although Activity 3.3.1 required you to formulate substantive procedures with the assistance of CAATs in contrast with Activity 3.3.2 which required the formulation of substantive procedures without using CAATs, we might combine these requirements in an examination where you could be required to describe substantive procedures which include CAATs (e.g. include substantive procedures by inspecting, observing, external confirmation, recalculating, re-performing, analytical procedures, enquiring or by means of using CAATs).

Also, Activities 3.3.1 and 3.3.2 focused on the “valuation” assertion. Please note that you should be able to describe substantive procedures on the other assertions which relate to the inventory account balance.

3.3.2 CONCLUSION

In this learning unit we discussed and explained substantive procedures (without and with the use of CAATS) for auditing inventory balances and

disclosures. The next learning unit will describe substantive procedures in the payroll and personnel cycle.



Self-assessment

After having worked through the learning unit and the references to the prescribed study material, decide whether you feel comfortable about doing the following:

- Identify the source documents for the inventory and production cycle (revision).
- Describe the functioning of the inventory and production cycle (revision).
- Describe the assertions pertaining to the inventory account balance and to the presentation and disclosure.
- Formulate substantive procedures for auditing inventory balances and disclosures.

As soon as you have completed this learning unit you are required to save Activities 3.3.1. and 3.3.2 (consisting of a percentage and a self-reflection) on your computer. The self-reflection must not be skimpy.

LEARNING UNIT 3.4

Payroll and personnel cycle

K Joubert

After having worked through this learning unit you must be able to
<ul style="list-style-type: none"> • identify the source documents for the payroll and the personnel cycle
<ul style="list-style-type: none"> • show that you understand the functioning of the payroll and personnel cycle
<ul style="list-style-type: none"> • describe the assertions for the payroll and personnel cycle
<ul style="list-style-type: none"> • formulate substantive procedures (with and without the use of CAATs) in the payroll and personnel cycle

3.4.1 INTRODUCTION

In topic 2 you learnt how to formulate substantive procedures in some of the business cycles. Substantive procedures should be formulated by referring to **how**, **what** and **why**. The aim of this study unit is to explain how substantive procedures are formulated in the **payroll and personnel cycle**.

**Revision**

You cannot audit a cycle if you do not understand how it works. We already explained how the payroll and personnel cycle works in AUE2602. Refresh your memory by **revising topic 3 and topic 7 in your AUE2602 study guide**.

The two main types of transactions are processed through the payroll and personnel cycle:

- payment to employees for services rendered (salaries and wages)
- accrual and payment of payroll-related liabilities (employee deductions such as taxes, pension fund and medical aid)

The payroll and personnel cycle includes the following classes of transactions and account balances.

Statement of financial position	Statement of comprehensive income
Bank and cash Accounts payable (accumulated leave, unclaimed wages, SARS, pension fund, medical aid and other)	Wages and salaries (including deductions such as PAYE, UIF, SDL, pension fund, medical aid and other)



Study

Study paragraphs in the section “Auditing the cycle”, except those sections dealing with tests of controls, in chapter 13 of Jackson and Stent.

Note the following in the above study source:

- **Financial statement assertions** in the payroll and personnel cycle (remember, the assertions are also described in ISA 315, par A124).
- Make sure that you know the **difference between a test of control and a substantive procedure**. The definitions are described in ISA 330, paragraph 04. Remember, this study unit deals with substantive procedures only. Tests of controls were dealt with in AUE3701.
- Substantive procedures are performed through **inspecting, observing, external confirmation, recalculating, re-performing, analytical procedures, enquiring or by means of CAATs**.

Self-reflection activity to be submitted

After studying the theoretical concepts above I want you to attempt Activity 3.4.1 below as if under examination conditions. But you mark it yourself by awarding 1½ marks for a properly formulated procedure. (Don't look at the comments or solution yet.) You are then required to submit the **percentage** you obtained **and a self-reflection**. The **self-reflection** is the essential part of the activity. **I want you to think about what went wrong and how you can remedy your mistakes – you must come up with suggestions and answers**. Your self-reflection may include questions you ask yourself: Did I understand the purpose of the question? Did I understand the theoretical principles? Must I read up more (research) the topic? Must I practise more, by repeating the question? What did I learn from doing the activity? What made the question difficult? And so on. The self-reflection exercise is more important than the marks. Self-reflection nurtures critical thinking and at the same time improves your communication skills. These are the soft skills that the accounting and auditing professions require and give recognition for.



ACTIVITY 3.4.1

Clothing-4-U Limited (C4U) is a company that manufactures clothing for all Mr Price outlets in South Africa. Over the past year the company has

grown constantly and currently has 600 permanent wage workers employed at its factory.

Your audit firm is appointed as the auditor of C4U, with you as audit senior in charge of auditing the payroll and personnel cycle. A major concern for you is that you will fail to detect material overstatement of the salary and wage expenses, mainly owing to the following:

- inclusion of fictitious employees on the payroll
- inclusion of time not worked (normal and overtime) in the salary and wage calculations
- calculation of wages at an incorrect wage rate

The following information about the factory wage workers is available to you:

- (1) C4U uses an automated salary and wage system.
- (2) All staff are permanently employed and a complete personnel file containing all the necessary information about the employees is maintained in the human resources department.
- (3) Employees are paid a fixed hourly rate depending on their job grade. The job grade is determined on appointment and reviewed once a year based on experience and years of service at the company.
- (4) Overtime can only be worked if authorised by Mr Hat and may not exceed 30 hours per month.
- (5) The rates per hour for the three different job grades are as follows:

Job grade	Normal rate per hour	Overtime rate per hour
Grade A	R100	R150
Grade B	R125	R175
Grade C	R150	R200

- (6) Rates are increased annually at the beginning of the financial year by 12%.
- (7) Wages are based on actual hours worked (normal and overtime) which are determined by using a biometric reader access system that records the time of entry and exit at the factory. Controls over the biometric reader access system appear to be sound.
- (8) Wages are paid directly into the employees' bank account and are based on the hours worked during the calendar week and are paid the following Friday.
- (9) The employee master file contains the following information:
 - employee name
 - employee number
 - employee identity number
 - employee taxation number
 - employee bank account number

- gender and race
- address and contact information
- date of employment/dismissal/resignation
- job grade
- normal hours worked each month
- overtime hours worked each month
- rate of normal hours worked
- rate of overtime hours worked
- PAYE/SITE amount to be paid each month
- medical aid contribution to be paid each month
- net wages for each month
- net wages year to date

You have decided to use CAATs to perform substantive procedures.

Required:

Marks

Formulate the **substantive procedures** that you will perform in the payroll and personnel cycle of C4U to obtain evidence that no fictitious employees are being paid and that employees are only paid for actual hours worked and at the correct wage rate. Your answer should specifically deal with the **occurrence** and **accuracy** assertions. Limit your answer to substantive procedures **using CAATs**.

(30)

Before you answer the question, think how you would approach the question. Refer to guidance provided in the previous study units, make your own notes and compare your notes with your fellow students, for example share notes on what you have learnt when answering substantive procedure questions, your approach, and so on.

Hints for approaching this question

Keep the following **general** points in mind when answering the question:

- This question requires you to limit your answers to **specific assertions** and therefore you have to describe substantive procedures that deal with those assertions only.
- You have to make **use of CAATs** when formulating your procedures.
- You have to **use the information provided in the question** when formulating your substantive procedures.
- When you formulate your substantive procedures describe your answer in terms of **how, what** and **why** (refer to learning unit 2.2 to refresh your memory).



FEEDBACK ON ACTIVITY 3.4.1

Substantive procedures in the payroll and personnel cycle

Occurrence

- Use CAATs to select a sample of **employees** from the employee master file of C4U and follow up on differences with management (1½ marks each):
 - Verify all information against the **personnel files** kept in the human resources department, for example inspect employee contracts, copies of identity documents, banking details and taxation numbers.
 - Perform **physical positive identification** of the employees on a surprise basis by inspecting the information on the staff card.
 - Inspect the returns made to **outside entities**, for example SARS, to ensure that the employees in the sample are included on the SARS return.
 - **Enquire with managers** to whom the employee reports whether the employee has been employed throughout the year.

- Use CAATs to extract and compare a **list of employees** from the employee master file of C4U for the prior year and for the current year in order to **identify additions or removals of employees** and compare the information with supporting documents in the personnel files (employee contract/resignation letter, etc), **or**

Use CAATs to extract a **list of employees** with information in the **date of employment/dismissal/resignation fields** and compare the information with the supporting documents in the personnel files (employee contract/resignation letter, etc).
- Use CAATs to scan the employee master file of C4U for **“error” conditions** and print an exception report to discuss these cases with management. For example (1½ marks each):
 - duplicated **identity numbers or bank account numbers or employee numbers or taxation numbers**
 - where an employee **has resigned or has been dismissed**, but **still has a value** in the net wages field after the date of resignation or dismissal

(8 x 1½ = 12)

Accuracy

- Use CAATs to **recalculate** net wages to confirm the accuracy of net wages.
- Use CAATs to **compare** total of the net wages in the master file with the balance in the **general ledger and trial balance**.

- Use CAATs to extract a sample of employees indicating the normal or overtime hours worked and **compare with the hours logged by the biometric reader access system.**
- Use CAATs to scan the employee master file for **any job grade or rate changes during the year** and follow differences up with management. (There should be no changes because job grade and rate changes are only reviewed annually.)
- Use CAATs to compare the rate of **job grades A, B and C** with applicable rates for normal hours and overtime hours in the master file of C4U and print an exception report whenever the wrong rate is used for a specified job grade. Follow exceptions up with management.
- Use CAATs to extract a sample of employees reflecting the **rate and job grades** and verify these details with details described in the personnel file in the human resources department. Follow up on any differences.
- Use CAATs to extract a sample of employees indicating their **deductions** and inspect whether all deductions are in accordance with appropriate tables and rules by comparing these with supporting documentation (e.g. **medical aid billings, PAYE/SITE tables**).
- Use CAATs to extract a sample of employees indicating their deductions and **recalculate the deductions** (PAYE, medical aid) to confirm that calculations are performed correctly. Follow differences up with management.
- Use CAATs to scan the employee master file of C4U for **“error” conditions** and print an exception report to discuss these cases with management. For example (1½ marks each):
 - **negative** wages, hours worked, rates or deductions
 - **no amounts in the “net wages”** field where an employee **has been employed**
 - net wages **greater** than gross earnings
 - **overtime hours** worked exceeding **30 hours** per month

(12 x 1½ = 18)

Analytical procedures

- Perform analytical procedures by using CAATs to compare the following:
 - The total wage expense for the **current year** with the total wage expense for the **prior year**. Follow up on any differences above or below the **12% increase** with management (*accuracy/occurrence*).
 - Current year wage expense compared with the **budget**. Follow up on any differences with management (*accuracy/occurrence*).
 - Compare the **month to month wages** and follow up on any material differences (*accuracy/occurrence*).
- By using CAATs and the fields available in the master file of C4U perform analytical procedures by comparing the **total of the net wages value per month** for each employee with the **total net wages year to date value** for each employee. Follow differences up with management (*accuracy*).

- Perform the following analytical procedures by using CAATs:
 - Calculate the **average wages per employee for each month** by dividing the total wages by the number of employees and follow up on any material differences when comparing the average per month against the different months (*accuracy*).
 - Compare the number of employees of this year with the prior year (*accuracy/occurrence*).

(6 x 1½ = 9)

(Maximum for the question: 30 marks)

(1½ marks for each substantive procedure which is described correctly)



Comments

- (1) Make sure that the substantive procedures that you describe in your answer deal with **occurrence and accuracy**. Chapter 13 in Jackson and Stent has very good examples of such substantive procedures. Just make sure that you **describe the substantive procedures as substantive procedures where you make use of CAATs**. This is easy: just think about it and convert the substantive procedure. This could be illustrated by the following example.

Substantive procedure:

Select a sample of employees from the salaries register and inspect the documentation in the employee's personnel file and employee contract.

Substantive procedure using data CAATs:

Use CAATs to select a sample of employees from the employee master file and verify all information in the master file against the personnel file and employee contract.

- (2) Do not think that you will receive marks if you say you made use of CAATs. Your substantive procedure has to be **logical** and **meaningful**. This could be illustrated by the following example:

Student's answer:

Use CAATs to inspect a sample of personnel files in the human resource department.

How can a computer inspect a personnel file? Think about it, it is not possible. The computer can only extract samples and compare these with information stored in its memory.

- (3) As mentioned previously, you need to **apply your knowledge to the information provided in the question**. Before formulating your solution, read through the information line by line and identify what will be applicable to your solution. For example, in the question it is mentioned that the job grade is determined

on appointment and reviewed once a year. This implies that there should be no changes to the job grade during the year and that it might be possible for you to generate an exception report on this. Another example is that overtime may not exceed 30 hours per month. Can you see that you have to use this information and indicate that you will use CAATs to generate an exception report if overtime exceeds 30 hours?

(4) Students often ask me how they should **use the fields in the master file**. The fields indicate the information available to you. For example, for the accuracy assertion, you will use CAATs to recalculate the net wages. By providing you with the fields, you should be able to describe exactly how you will use CAATs to recalculate net wages. When you work through the solution you should be able to identify how most of the fields in the master file are used to formulate the substantive procedures. You will also find that some of the fields are not used. Examples of such fields include gender and race as well as address and contact information. Now, try to think of an example of a substantive procedure where you use these fields. There is no such example, because duplication of address and contact information, for example, will have no influence on the financial statements. It is quite possible that employees might have the same contact information, for example if a husband and his wife work for the same company.

(5) Depending on the required assertion in the question, it is quite possible that you can have the same substantive procedure for most of the business cycles, for example use CAATs and print exception reports on negative values, duplication of information and missing information. Keep this in mind and if relevant write these down when you formulate your substantive procedures for all of the business cycles.

(6) Remember that substantive procedures include analytical procedures. You can therefore include analytical procedures in your answer if you are required to formulate substantive procedures.

In brief, according to ISA 520 which deals with analytical procedures, analytical procedures can include

- comparisons of the entity's financial information, for example with
 - prior periods
 - anticipated results of the entity, such as budgets and forecasts or expectations of the auditor
 - similar industry information
- consideration of relationships, for example
 - among the entity's financial information, such as the gross profit percentage
 - between financial information and non-financial information, such as payroll costs to the number of employees



Note: The question in Activity 3.4.1 is one example of what could be required of you in the examination in terms of substantive procedures in the payroll and personnel cycle. We can also require you to ...

- formulate substantive procedures without the assistance of CAATs
- formulate substantive procedures including CAATs (e.g. include substantive procedures by inspecting, observing, external confirmation, recalculating, re-performing, analytical procedures, enquiring or by means of using CAATs)
- formulate substantive procedures on classes of transactions dealing with the other assertions as in Activity 3.4.1
- formulate substantive procedures on account balances

3.4.2 CONCLUSION

This learning unit explained how substantive procedures are formulated in the payroll and personnel cycle. The next learning unit will explain how substantive procedures are performed in the finance and investment cycle.



Self-assessment

After having worked through this learning unit and the references to the prescribed study material, decide whether you feel comfortable about doing the following:

Formulate substantive procedures in the payroll and personnel cycle.

As soon as you have completed this learning unit you are required to save Activity 3.4.1 (consists of a percentage and a self-reflection) on your computer. The self-reflection must not be skimpy.

LEARNING UNIT 3.5

Finance and investment cycle

L Ferreira

After having worked through this learning unit you must be able to
<ul style="list-style-type: none"> • identify the source documents for the finance and investment cycle (revision)
<ul style="list-style-type: none"> • show that you understand the functioning of the finance and investment cycle (revision)
<ul style="list-style-type: none"> • describe the assertions for the finance and investment cycle
<ul style="list-style-type: none"> • formulate the substantive procedures for share capital and reserves, long-term loans and finance leases, property, plant and equipment and investments

3.5.1 INTRODUCTION

In your personal capacity you have to, or will have to soon, raise capital (loan) to buy your own car or home (non-current asset). Just persevere with your studies until you complete your CA(SA) qualification so that you can earn a decent salary. You may even consider starting your own business and create employment. Soon you will be generating surplus funds and start saving (for retirement) (e.g. buy shares, property). Just imagine you inherit a couple of Apple or Google shares from an unknown family member who resided in the USA! The point I want to raise is that you are or will also soon be exposed to the finance and investment cycle – therefore, again, the concept is not something abstract. In this learning unit you are going to learn how to formulate the substantive procedures for the finance and investment cycle for a business (audit). This learning unit covers our final cycle and I think if you reflect back on topic 2 and all the cycles that you have mastered so far, things are beginning to make sense to you. Maybe you have even gained confidence and can tell a friend that formulating substantive procedures is really easy!

This is a long learning unit but the principles are the same for all accounts in the finance and investment cycle. You just need to take care that you know the source documents and accounting treatment of each account.

Remember, to save your answers to the questions and activities as soon as you have completed the learning unit.

3.5.2 THE ACCOUNTING SYSTEM

In your financial accounting modules you learnt how to account for the raising of capital (share issue or non-current loans), revaluation surpluses and investing capital (e.g. the acquisition of property plant and equipment – and journal entries for depreciation), IAS requirements for finance and operating leases and, very importantly, the underlying principles of the fair value concept. Knowledge was also acquired in topic 8 of the AUE2602 study guide, and all of this knowledge is very important for this learning unit because you are then able to visualise the accounting process of transactions and balances for the finance and investment cycle.

Remember what I have drilled into you: before you can audit a cycle you must first be able to **name** the source documents and visualise the business environment and the transaction flow from initiation of the transaction through to recording it in the accounting books of prime entry and general ledger and its presentation and disclosure in the AFS. Let's begin with a revision activity to get you oriented.



ACTIVITY 3.5.1

- Compile a table and list the **source documents** and **accounting records** for the purchase of property plant and equipment, investments, share issues, obtaining long-term loans and finance lease liabilities. This is necessary if you have to test the occurrence of the transaction.

(To answer this question, refer to study unit 3.1 in your AUE2602 study guide and to chapter 14 in Jackson and Stent. You may also need to refer to your accounting books.)

3.5.3 FUNCTIONING OF THE FINANCE AND INVESTMENT CYCLE

The finance and investment cycle is different from the other cycles, because finance and investment transactions usually occur less frequently and the amounts are substantial. Therefore the focus of the auditor shifts to the authorisation and approval of the transactions (budgets, powers in terms of the MOI, minutes of meetings, etc).

The finance cycle relates to funding (inflow) while the investment cycle relates to investment or capital expansion (outflow). In this cycle remember to incorporate your Companies Act knowledge and accounting disclosure and presentation requirements.



Study

Refer to Jackson and Stent, pages 14/2 to 14/5.

- Identify the possible risks relating to this cycle (this affects your focus of testing – relevance).
- For those who do not have practical experience, are you able to visualise ProRide (Pty) Ltd's authorisation procedures and controls over their finance and investment cycle?

Now that you are able to visualise the cycle you can audit it.

3.5.4 AUDITING THE FINANCE AND INVESTMENT CYCLE

Remember, I have said that the audit procedures must be spot on the target (bull's eye) and anything that misses the target will waste time and cost money. To be relevant you must identify the risks and the assertions for transactions and balances.



Reflect and discuss

You own a business (75% of the share capital) that through hard work has grown into a large business and you issued additional shares (25%) to help finance its growth. You are no longer involved in the day-to-day running of the business but have appointed competent people to run the business on behalf of you and the other shareholders. You also wish to expand your business into the rest of Africa and invest surplus funds in medium-sized companies that show growth potential.

Reflect and discuss how you would like the finance and investment cycle to be managed so that your business does not lose profits due to fraud or bad business decisions.

Example

- Good planning through budgets, best financing decision methods, and so on

Designing your substantive procedures to target risks and collecting sufficient appropriate audit evidence to support the assertions makes good sense – but the auditor will not always know where all the risks are hidden until some testing has been performed. The auditor has to consider risks at financial statement level, at account balance level and at transaction level and then to design the audit procedures to target those risks, to be in a position to express an opinion of the AFSs in spite of the risks. Because the finance and investment cycle involves huge amounts, approval of such transactions by authorised persons is crucial.

Assertions for the finance and investment cycle



Study

Refer to Jackson and Stent, page 14/6 (Responding to risk at assertion level). It is very important that you notice there are assertions for **transactions** (vouching), for **balances** (verifying) and for **presentation and disclosure**. Transactions begin with approval, matching and inspecting source documents (details) and vouching these source documents to the recorded amounts in supporting registers (e.g. fixed asset registers and the general ledger). Usually the general ledger account for the finance and investment cycle has an opening balance (previous acquisitions); the transactions for the year are added or deducted to arrive at the closing balance and this balance is reflected in the balance sheet.

In learning unit 1.6 we dealt with the auditing of accounting estimates as part of collecting audit evidence. One of the study references was Jackson and Stent, page 14/7, for auditing fair value. Now you can see where it fits into the cycles and why it is so important.



ACTIVITY 3.5.2

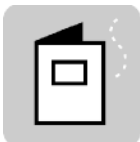
Describe the assertions for

- share capital
- reserves
- long-term loans
- finance lease liabilities
- property, plant and equipment
- investment in shares

3.5.5 FORMULATE SUBSTANTIVE PROCEDURES

Now that you have learnt the assertions for this cycle, we are ready to formulate the substantive procedures for transactions, balances and disclosure and presentation. Remember transactions are vouched (throughout the year) but a balance (at year end) is verified. Transactions are like a movie, while balances are like a snapshot. With the finance and investment cycle the transactions are so few; therefore the transaction and balance components are usually combined. You start with the opening balance, vouch the transactions and verify the final balance.

3.5.5.1 Share capital and reserves



Study

Refer to Jackson and Stent, pages 14/8 to 14/10, to do the following activity.



ACTIVITY 3.5.3

You are the audit manager of ProRide (Pty) Ltd. You are provided with the trial balance at year end, indicating that share capital amounts to R1,5 million (Cr). The balance on the revaluation surplus amounts to R650 000.

Required

- Formulate the audit procedures to verify the share capital account at year end.
- Formulate the audit procedures to verify the revaluation surplus at year end.

3.5.5.2 Long-term loans and finance lease liabilities

Note that both the long-term loan and finance lease liabilities have important accounting features that you must apply from your accounting studies.



Study

Refer to Jackson and Stent, pages 14/12 to 14/15.



ACTIVITY 3.5.4

You are the audit manager of ProRide (Pty) Ltd. You are provided with the trial balance at year end, indicating that the long-term loans balance amounts to R550 000 (Cr) (previous year R0).

Required

Formulate the audit procedures to verify long-term loans at year end.

(The above study reference will enable you to formulate the answer to the activity.)

3.5.5.3 Property, plant and equipment



Study

Refer to Jackson and Stent, pages 14/19 to 14/26.



ACTIVITY 3.5.5

You are the audit manager of ProRide (Pty) Ltd. You are provided with the trial balance at year end, indicating that the property plant and equipment (PPE) balance amounts to R1 550 000 (Dr) (previous year R550 000).

Required

Formulate the audit procedures to verify PPE at year end.

(The above study reference will enable you to formulate the answer to the activity.)

3.5.5.4 Investment in shares



Study

Refer to Jackson and Stent, pages 14/26 to 14/28.



ACTIVITY 3.5.6

You are the audit manager of ProRide (Pty) Ltd. You are provided with the trial balance at year end, indicating that investments in shares at year end amount to R450 000 (Dr) (previous year R150 000).

Required

Formulate the audit procedures to verify investment in shares at year end.

(The above study references will enable you to formulate the answer to all the activities.)

Note: In all of the activities I required you to formulate all the procedures but in the examination one or two assertions may be examined (e.g. valuation or presentation and disclosure). Therefore read the question carefully.

3.5.6 CONCLUSION

In this learning unit we identified the authorisation processes, source documents, supporting registers and accounts that are relevant to the finance and investment cycle. We also looked at why this cycle is different from the revenue and purchases (acquisition) cycles. We identified the assertions, but noted the difference between transactions and balances (opening balance plus/minus additions/disposals [transactions] = closing balance). Finally we formulated the substantive procedures for share capital and reserves, long-term loans, finance leases, property, plant and equipment and investments.

Reflect on the notes that you made and go back to the assessment criteria at the beginning of this learning unit. Make sure that you are able to achieve those outcomes before moving on to the next learning unit.

As soon as you have completed this learning unit you are required to save Activities 3.5.1 to 3.5.4 on your computer.

(NB: Refer to your “additional resources” for scenario-based activities.)

TOPIC 4

Evaluating, concluding and reporting

L Ferreira

Topic overview

This topic deals with the final stage of the audit. I know that students often neglect this topic because the time has run out (or is close to running out) because of bad planning or whatever reason. However, evaluating, concluding and reporting is a **very** important stage of the audit process because it directly affects the audit report.

During this stage of the audit everything comes together and the auditor applies his/her mind (professional judgment) to form an opinion and express an opinion in the audit report. The audit report is relied upon by investors and decisions affecting the economy are based on the outcome of the audit report. If the decisions are wrong based on incorrect information then many suffer – food is removed from someone's plate. Think of pension funds.

During this final stage of the audit you will have accumulated the material misstatements that the audit procedures detected. You the auditor must know what to do with these differences. In addition before signing off the audit report, the auditor is also expected to look into the crystal ball by performing audit procedures to identify and detect subsequent events, provisions and contingent liabilities and consider the effect of related party transactions. The auditor must also consider if the client will still continue with operations – if not – investors need to know! Therefore the audit report and the correct wording thereof is so important. The audit report is the grand finale of the auditor's hard intellectual work.

On a personal note, what motivated me as a young student was a copy of an audit report signed by **me**. That reminded me what I was aspiring to achieve. Framed in my study, the audit report with my name kept me motivated. When I felt overwhelmed by all the work I just looked up to the framed audit report and reminded myself that I want to sign audit reports.

This topic is divided into the following learning units.

Learning unit	Title
4.1	Evaluation of misstatements during the audit
4.2	Related party transactions
4.3	Subsequent events
4.4	Provisions and contingent liabilities
4.5	Going concern and factual insolvency
4.6	Audit report

Learning outcomes

The learning outcomes of each of the learning units are set out in the separate learning units.

LEARNING UNIT 4.1

Evaluation of misstatements identified during the audit (ISA 450)

L Ferreira

After having worked through this learning unit you must be able to

- define the term “material misstatements”
- show that you can distinguish between the types of misstatements
- formulate the steps in evaluating material misstatements
- integrate material misstatements with reportable irregularities

4.1.1 INTRODUCTION

During the audit you would have formulated audit procedures for the cycles and the audit team would have visited the client and performed all the audit procedures that you have designed. The next question would be, what does the auditor (you) do with all the differences that were identified while executing the audit procedures? In this learning unit we are going to tackle this issue as prescribed in ISA 450 (Evaluation of misstatements identified during the audit).

Remember, save your answers to the questions and activities as soon as you have completed the learning unit.

4.1.2 WHAT IS A MISSTATEMENT?

We must first master what is a misstatement and get some idea of what we are trying to achieve.



Study

Study ISA 450, paragraphs 3 and 4, and A1. Define the concepts of “misstatement” and “uncorrected error” and explain the auditor’s objective in evaluating misstatements. If one of the examples as listed in ISA 450,

paragraph A1, is written into a scenario examination, will you recognise that the examiner is possibly examining this ISA?

Now that we know what misstatements are all about, the next question would be what are the steps that the auditor must perform when evaluating misstatements? This is a very important question, so let's go and search for the answer. While searching for the answer I want you to remember that it is not a complex process: in fact it is logical and you will see why I say so.



Reflect and discuss

Let's assume in your spare time you do some waitressing at a restaurant (to pay for your Unisa studies). You keep a record of your tips for the evening (the customer pays at the till). However, at the end of the evening the following happens.

You calculated that your tips for the evening should amount to R450. But you only receive R250. List the the steps that you would take to resolve this difference.

Now assume exactly the same details as above – but you receive R445. Your reaction will be less drastic, not so?

4.1.3 CONSIDERATIONS WHEN EVALUATING MATERIAL MISSTATEMENTS

You are at the client performing the audit and you picked up misstatements. What points should you consider?



ACTIVITY 4.1.1

Study ISA 450, paragraphs 5 to 15, to get the bigger picture first; we will look at the details in a moment. Jot down the bolded headings in the text and write a short explanation below each heading. Do you notice that we measure the differences against final materiality, look at the nature of the misstatement, consider how it affects the audit, communicating the findings to management and request the client to correct these misstatements? What do you do if they refuse? Very similar to the self-reflection exercise above, not so?

You have jotted down the bolded headings; now let's zoom into the details.

4.1.4 FORMULATE THE STEPS IN EVALUATING MISSTATEMENTS IDENTIFIED DURING THE AUDIT

We move to a very important activity that you must do yourself. I will guide you on how to do it in the next study activity.



ACTIVITY 4.1.2

Let's assume the following. You are the senior manager on the audit and will soon become a partner. In the audit team you have identified a senior trainee accountant who will replace you as audit manager. You want this person to know exactly how to evaluate the schedule of errors accumulated during the audit. You think the best way to do this is to formulate all the steps that this trainee accountant should consider.

Required

Formulate the steps that the auditor should consider when evaluating misstatements identified during the audit. (This could easily be asked in the examination.)



Study

Study the following paragraphs to help you do the above activity. Look at the structure and steps:

- **Accumulation of identified misstatements: ISA 450 (pars A2–A6)**

1. Designate an amount that is regarded as trivial.
2. Distinguish between factual, judgmental and projected misstatements.

Now continue formulating these steps by using the following study references:

- communication and correction of misstatements: ISA 450 (pars A7–A10)
- evaluating the effect of unrecorded misstatements: ISA 450 (pars A11–A18)
- written representation: ISA 450 (par A24)
- documentation: ISA 450 (par A24)

4.1.5 REPORTABLE IRREGULARITIES

We often remind students that they must be able to integrate their knowledge. When evaluating misstatements it is easy to work integration into a scenario. For example when considering the nature of the misstatement you must also consider whether it's a reportable irregularity and what to do if it is not rectified. Revise this topic from the pronouncements issued by the IRBA in your SAICA handbook (IRREG "Reportable irregularities" – near the end in volume 2).

4.1.6 CONCLUSION

In this learning unit we learnt what a misstatement entails and the various categories of misstatements. We also formulated the steps that the auditor must perform when considering and evaluating the misstatements. Finally we noted that evaluating material misstatements can easily be integrated with other duties that the auditors have in terms of reportable irregularities. Reflect on the notes that you made. Now go back to the assessment criteria

at the beginning of the learning unit and make sure that you are able to achieve those outcomes before moving on to the next study unit. To see the bigger picture (revision) study this document: http://files.nsoa.co.za/uploads/ISA_450_Understanding_the_evaluation_of_misstatements_identified_during_the_audit_1295.pdf

As soon as you have completed this learning unit you are required to save Activity 4.1.2 on your computer.

(NB: Refer to your “additional resources” for scenario-based activities.)

LEARNING UNIT 4.2

Related parties (ISA 550)

L Ferreira

After having worked through this learning unit you must be able to
<ul style="list-style-type: none"> • identify a related party relationships and transactions
<ul style="list-style-type: none"> • describe the auditor's responsibility regarding related party relationships and transactions
<ul style="list-style-type: none"> • formulate audit procedures to identify related party transactions
<ul style="list-style-type: none"> • describe the responses of the auditor when a related party association or transaction is discovered
<ul style="list-style-type: none"> • evaluate the adequacy of disclosure of related party relationships and transactions

4.2.1 INTRODUCTION

What is a related party? Is it a big party where you and your cousins, brothers and sisters come together and enjoy yourselves with food and drink – like in the Mafia movies? Obviously not, but in a sense close – there is some form of a family relationship involved. The related party concept that we are going to learn about refers to a business relationship. Related business relationships often happen in business because it makes good business sense: think for example of a holding company (the mother or father) and subsidiary (brother or sister) relationship. But why then can a related party relationship be a problem for the auditor? The holding company has more “say” or “influence” on the subsidiary and therefore the transactions. Where this influence and control is abused and manoeuvred to transact illegal or unethical transactions, it becomes the auditor's problem and the auditor must be on the lookout (alert) for such transactions. Just read the newspapers and notice how power and influence is often abused and most of the time linked to greed (financial gain). Therefore related party transactions can pose a high inherent risk to the auditors (<https://www.youtube.com/watch?v=NatQYZVII84>)

Remember, save your answers to the questions and activities as soon as you have completed the learning unit.

4.2.2 RELATED PARTY AND NEED FOR THE AUDITOR

Related party relationships allude to exerting control or influence over the reporting entity. However, keep in mind that being related in business does not necessarily imply that it is wrong to do so. The problem lies when control and influence is exerted to benefit the controller and when it is no longer an “arm’s length transaction”. This happens when there is some sort of illegal scheme behind the transaction. In other words, I am referring to those transactions (illegal schemes) that you don’t want the press to publish, because you know it is wrong. For example, how can you sell the newly purchased luxury company vehicle to the director’s wife at cost less 80% and justify it?



Study

Read ISA 550, paragraph 2. Are you able to describe the nature of a related party relationship and transaction to a friend? If you still do not understand, do some of your own research by just Googling “related party transactions”.

The auditor must always be on the lookout (alert) for transactions that have a high risk attached to them and can often be embedded in complex related party transactions. SARS also views related party transactions as something to flag (e.g. transfer pricing: <http://www.intellifin.co.za/uncategorized/inter-company-transactions-beware-the-tax-trap-2>). When you complete the tax return for companies you will notice the questions they ask you in this regard. As you climb the career ladder don’t get involved in transactions that are ethically not sound, or get bullied into such transactions – it is not worth it – say “**No way**”.

Auditing does not happen in a vacuum – you have to consider legal issues, risk, tax, accounting and many other points that all play a role in producing the final product, namely the annual financial statements. Therefore always remember, while learning your other subjects, not to box in that knowledge but to think laterally. Ask yourself, how can I integrate this knowledge into auditing? For this learning unit, you must be able to integrate IAS 24 (Related party disclosures) into ISA 550.



Study

- Read IAS 24 and make sure that you know the fair presentation frameworks. Why is this important? Because the auditor must form an opinion on the fairness of the presentations and disclosures!
- Study the definitions in ISA 550.10 and ISA 550, and A4 and A5, with the view to **understanding** the concepts.
- Study the objectives of the auditor – ISA 550, paragraph 9. This is what your responsibility as auditor culminates in when you audit related party

transactions. Study with the objective in mind to make a short “I am responsible for” list.



Reflect and discuss

Why do you think the auditor should be responsible for looking at related party relationships and transactions during an audit?

(Now compare your reflection to ISA 550, pars 3–7.)

4.2.3 THE AUDITOR'S RESPONSIBILITY REGARDING RELATED PARTY RELATIONSHIPS AND TRANSACTIONS

Knowing why the auditor should be on the lookout for related party transactions, the first question that comes to mind is: When will the auditor become **aware** of related party relationships at a client? The answer: During the risk assessment procedures, where the auditor obtains an understanding of the client's business environment to assess the risk of material misstatement (ISA 315) and considers the possibility of fraud (ISA 240). So there need to be discussions among members of the engagement team, enquiries directed to management, reviewing of policy and control documents and so on.



ACTIVITY 4.2.1

- Describe the steps that the auditor can perform to understand an entity's related party relationships and transactions as part of the risk assessment procedures. Include the people that you would question (e.g. the internal auditors).
(Reference to develop the solution: ISA 550, pars 13–14 and A9–A21.)
- List all the possible documents or records that the auditor could inspect that may provide information about related party transactions and why you think those documents may be useful. (CIPC searches are also useful)
(Reference to develop the solution: ISA 550, A22 & A23.)
- List the examples of transactions that may be regarded as transactions outside the entity's normal course of business.
(Reference to develop the solution: ISA 550, par A25.)
- Describe the risk factors that could lead to the material misstatements associated with related party relationships and transactions.
(Reference to develop the solution: ISA 550, pars A29 & A30.)

With the knowledge that you have gained from the above exercises, you are able to identify a related party transaction from a scenario and also where to go and look for the evidence. You also know when to be alert and where to focus. Therefore you are in a position to formulate good audit procedures (i.e. specific instructions to the trainee accountant!). (Just remember to include ISA 550, par 26.)



Reflect and discuss

Let's assume that you formulated these good audit procedures to identify related party transactions at a client and you identified that a material related party transaction does exist. What do you think the auditor must do next? Have you come up with some ideas?



Study

Study ISA 550, A31–A50. This is a lot of reading but it is very important. Make yourself a mind map or decision tree to assist you with this section. Once you have completed it, compare it to the above reflection and discussion.

4.2.4 DISCLOSURE OF RELATED PARTY RELATIONSHIPS AND TRANSACTIONS

At the beginning of this study unit I referred you to ISA 315 and this is why your accounting knowledge is important.



Reflect and discuss

How would you feel about the following situation? Let's assume that there is a material related party transaction at a client but that it has been adequately disclosed in the AFS. Will this related party transaction still bother you? Substantiate your answer.



Study

Study ISA 550, paragraphs A46 to A48 and A50.

4.2.5 CONCLUSION

In this learning unit we looked at the concept of related party relationships and transactions and why these transactions are often loaded with risk. We also examined where and how to look for these transactions. We learnt how to deal with such transactions and why proper disclosure is so important (and the effect of non-disclosure). Reflect on the notes that you made. Now go back to the assessment criteria at the beginning of the learning unit and make sure that you are able to achieve those outcomes before moving on to the next learning unit.

As soon as you have completed this learning unit you are required to submit Activity 4.2.1 online on myUnisa.

(NB: Refer to your “additional resources” for scenario-based activities.)

LEARNING UNIT 4.3

Subsequent events

M la Grange

After having worked through this learning unit you must be able to
<ul style="list-style-type: none"> ● explain the definition of <ul style="list-style-type: none"> - date of the financial statements - date of approval of the financial statements - date of the auditor's report - date that the financial statements are issued - subsequent events
<ul style="list-style-type: none"> ● explain the auditor's and management's treatment of subsequent events
<ul style="list-style-type: none"> ● formulate audit procedures relating to subsequent events: <ul style="list-style-type: none"> - period up to report date - period after report date up to date of issue of AFS - period after AFS has been issued

4.3.1 INTRODUCTION

One of the factors to consider during the last step of the audit process, namely evaluating, concluding and reporting, is subsequent events. This is an important factor as it may influence the audit report. ISA 560 (Subsequent events) deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.



Study

Study ISA 560 (Subsequent events) and the relevant sections dealing with subsequent events in chapter 17 of Jackson and Stent.

Note the following in the above study sources:

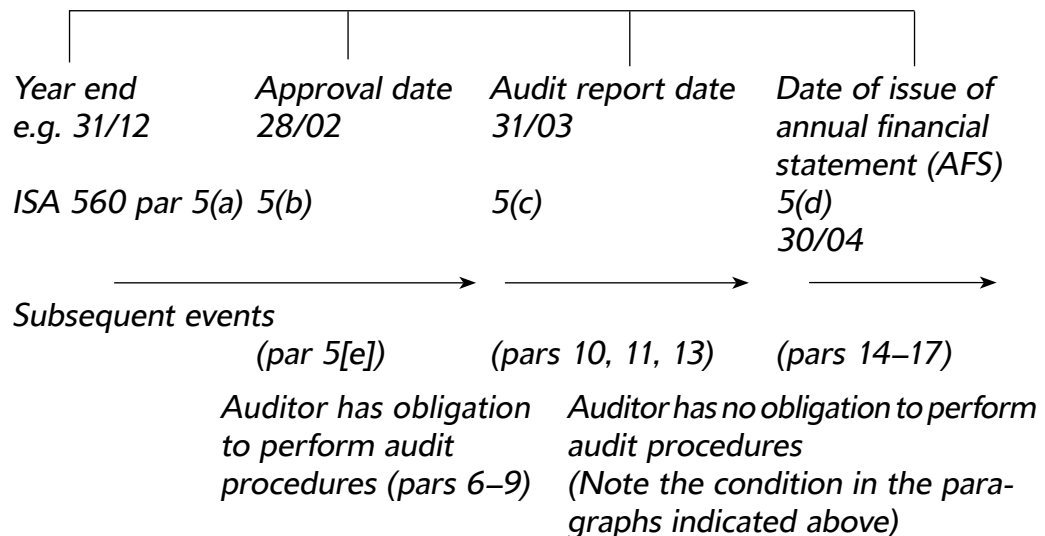
- the definitions of "Date of the financial statements", "Date of approval of the financial statements", "Date of the auditor's report", "Date the financial statements are issued" and "Subsequent events" (ISA 560, pars .05, A2 to A4)

- the two types of subsequent events: “Those that provide evidence of conditions that existed at the date of the financial statements” and “Those that provide evidence of conditions that arose after the date of the financial statements” (ISA 560, par .02)
- the differences in the auditor’s obligation to perform audit procedures and the auditor’s reaction depending on the **specific timeline of the subsequent event**

The following timelines refer:

- events occurring **between the date of the financial statements and the date of the auditor’s report** (ISA 560, pars .06 to .09, A6 to A9)
- facts that become known to the auditor **after the date of the auditor’s report but before the date the financial statements are issued** (ISA 560, pars .10, .11, .13, A11, A13, A15 to A16)
- facts which become known to the auditor **after the financial statements have been issued** (ISA 560, pars .14 to .17, A18)

To help you understand the above, we include the following presentation of a timeline demonstrating the sequence of events for a client with a 31/12 year end.



Note: The timeline indicates that annual financial statements cannot be **issued** before the date of the audit report; therefore the date on the audit report cannot be later than the date on which the AFS was issued.

Self-reflection activities, to be submitted

After studying the theoretical concepts above I want you to attempt Activities 4.3.1 to 4.3.4 below as if under examination conditions. But you mark yourself by awarding 1½ marks for a properly formulated procedure. (Don’t look at the comments or solution yet.) You are then required to submit the **percentage** you obtained **and** a **self-reflection**. The **self-reflection** is the essential part of the activity. **I want you to think about what**

went wrong and how you can remedy your mistakes – you must come up with suggestions and answers. Your self-reflection may include questions you ask yourself: Did I understand the purpose of the question? Did I understand the theoretical principles? Must I read up more (research) the topic? Must I practise more, by repeating the question? What did I learn from doing the activity? What made the question difficult? And so on. The self-reflection exercise is more important than the marks. Self-reflection nurtures critical thinking and at the same time improves your communication skills. These are the soft skills that the accounting and auditing professions require and give recognition for.



ACTIVITY 4.3.1

The following events took place at various audit clients of your audit firm:

- (1) A final judgment was given by the court (after the client's reporting period) in a case in which the audit client was successfully sued for damages amounting to R4 million. The case commenced during the client's previous financial year end. At the date of the financial statements the client had provided R2 million in respect of this claim.
- (2) A fire at the audit client's factory (after the financial year end) resulted in the directors announcing a plan to discontinue that specific manufacturing operation.
- (3) The company declared a dividend of 30 cents per share to its ordinary shareholders after the date of the financial statements.
- (4) The collapse of the audit client company's market in Japan after the date of the financial statements has resulted in the going concern assumption no longer being appropriate.

Required

Classify each of the above cases as either an adjusting or a non-adjusting event. You should also justify your reasoning.



FEEDBACK ON ACTIVITY 4.3.1

Classification and justification	
(1)	Adjusting <ol style="list-style-type: none"> (a) Increase of R2 million required – known obligation at date of financial statements relating to circumstances that existed at year end.
(2)	Non-adjusting <ul style="list-style-type: none"> • Discontinuation did not “exist” at the date of financial statements; disclosure should be made as it is a material matter.

Classification and justification	
(3) Non-adjusting	<ul style="list-style-type: none"> • No liability at year end; no adjustment, but disclosure is required.
(4) Adjusting	<ul style="list-style-type: none"> • Although collapse took place after financial year end, the financial statements should be adjusted so as not to be presented on the going concern basis.



Comments on Activity 4.3.1

- In each of the specific timelines of subsequent events (i.e. between the date of the financial statements and the date of the auditor's report, after the date of the auditor's report but before the date that the financial statements are issued, and after the financial statements have been issued), it is important to identify whether there is an **adjusting event** or a **non-adjusting event/condition**.

- An **adjusting event** is an event that provides additional information to determine the amounts relating to conditions that **existed** at balance sheet date.

- A **non-adjusting event/condition** is an event/condition that arose **after the balance sheet date**. If you arrive at the conclusion that a subsequent event should be treated as a non-adjusting event, it is important always to consider whether the event is **material**. If material, **disclosure** should be made thereof in the financial statements.



ACTIVITY 4.3.2

15 May 2013: An explosion in the new warehouse destroyed inventory with a cost price of R100 000. While investigating this matter, the auditor discovers an error in the allocation of overheads to inventory resulting in other inventory (other than inventory lost in the explosion) being overstated by R350 000. The company's year end is 31 March 2013 and as at 15 May 2013 the auditor has not yet issued the audit report. Materiality was set at R250 000.

Required

Identify the events and state how they should be treated in the financial statements at 31 March 2013. Give reasons for your answer.



FEEDBACK ON ACTIVITY 4.3.2

As you gathered, there are two events, namely the explosion and the overstatement of the inventory.

- The explosion would seem to be a **non-adjusting event**.
- This event occurred **after the date of financial statements** and concerns conditions which did not exist at the date of financial statements.
- This would appear therefore to be an item to be **disclosed** rather than an adjusting event.
- The auditor would have to ascertain whether the company was insured against this sort of loss to determine the net amount of the loss to be disclosed in the financial statements.
- The discovery of the fact that inventory was overvalued by R350 000, as a result of the misallocation of overheads, is an **adjusting event**, because it gives more information about a condition that **existed** at the date of financial statements (misallocation of overheads during the year).
- It is certainly quantitatively material in relation to the set materiality (R350 000 versus R250 000).



Comments on Activity 4.3.2

- You first need to identify into which specific timeline bracket the subsequent events in the given scenario fall (i.e. between the date of the financial statements and the date of the auditor's report, after the date of the auditor's report but before the date the financial statements are issued, after the financial statements have been issued), as this will influence the auditor's reaction and obligation to perform audit procedures.
- In this scenario the subsequent events fall within the timeline bracket between the date of the financial statements and the date of the auditor's report, as the question states: "The company's year end is 31 March 2013 and as at 15 May 2013 the auditor has not yet issued the audit report."
- After identifying the timeline bracket, you had to identify the events that took place (in this case it was the explosion and the overstatement of the inventory). Each of these events had to be evaluated separately to classify it as an **adjusting event** or a **non-adjusting event**.
- Pay attention to the reasoning behind the decision to categorise the event as an adjusting or a non-adjusting event.



ACTIVITY 4.3.3

Your audit firm, Super Auditors Inc, has been the auditor of Maxishare Ltd (Maxishare) for a number of years. The company provides property investment opportunities to the general public, and has a 31 March year end.

Maxishare was a relatively unknown company until the appointment of Mr Pothier, the new Chief Executive Officer (CEO), three years ago. Soon after the appointment of Mr Pothier, Maxishare started a property investment scheme which was marketed widely. They raised millions of rand from the public for the development of two new shopping centres, one built in the east and the other in the north of Pretoria. The major attraction for the investors is that they are earning interest on their investment from the start, even while the centre is still under construction and not generating any rental income.

Mr Wilson, one of the partners at your audit firm, has been the partner in charge of the audit of Maxishare since its incorporation.

In June 2013, while finalising the 2013 audit, some investors who invested in the two shopping malls made claims with regard to interest that had not been paid to them for the past three months. This was followed up by an independent forensic investigation.

Mr Pothier immediately held a meeting with Mr Wilson and demanded that the audit be finalised within the next week. He also insisted on an unmodified audit opinion to protect the company against possible claims. Mr Wilson decided not to confront Mr Pothier and issued an unmodified audit opinion, backdated to 13 May 2013, on the financial statements for the year ended 31 March 2013.

By the end of June 2013 the independent forensic auditors found a few instances where Maxishare was using money from new investors to pay interest to existing investors. These cases of fraud raised substantial doubt about the entity's ability to continue as a going concern.

Required

Discuss critically the work of the auditors with reference to the forensic audit findings.



FEEDBACK ON ACTIVITY 4.3.3

- ISA 560, paragraph .06, requires the auditor to 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. This was not done because Mr Wilson failed to
 - investigate the claims through enquiry of the legal advisors
 - consider whether the claims must be disclosed or the financial statements adjusted

- request management to adjust the financials and to audit these adjustments
- The date of the auditor's report informs the reader that the auditor has considered the effects of events and transactions of which the auditor becomes aware and that occurred up to that date.
- Mr Wilson backdated the audit report to try to indicate that it was issued before all the claims came to light.
- Mr Wilson did not use professional judgement and did not consider all material events between the date of the statement of financial position and the date of signing the auditor's report.
- Mr Wilson should have requested management to perform an assessment on the going concern assumption and to prepare the financial statements on the appropriate basis.
- Mr Wilson should have requested management to make the necessary disclosures about the fraud.
- The auditor should not have backdated his audit report and should have modified his audit report if management refused to adjust the financial statements with regard to the forensic audit findings.
- Because of the audit report already being backdated and issued, the auditor should take the necessary steps to prevent reliance on the unmodified audit opinion. For example:
 - send a notice to each person that the auditor knows will rely on the financials
 - make a public announcement about it
- Mr Wilson should have considered whether the claims constituted a reportable irregularity. (Reportable irregularities will be dealt with in learning unit 4.5.)



Comments on Activity 4.3.3

- You first need to identify into which specific timeline bracket the subsequent events in the given scenario fall (i.e. between the date of the financial statements and the date of the auditor's report, after the date of the auditor's report but before the date the financial statements are issued, after the financial statements have been issued), as this will influence the auditor's reaction and obligation to perform audit procedures.
- In this scenario the subsequent events fall within the timeline bracket between the date of the financial statements and the date of the auditor's report, as the question states: "... has a 31 March year end" and "[i]n June 2013, while finalising the 2013 audit, some investors who invested in the two shopping malls made claims with regard to interest that had not been paid to them for the past three months".

- After identifying the timeline bracket, you had to identify the event that took place (in this case it was the claims made by investors that interest had not been paid to them). This event had to be evaluated to classify it as an **adjusting event** or a **non-adjusting event**.

- Also note that the event (i.e. fraud) that occurred raised doubt about the entity's ability to continue as a going concern. In such a case, the financial statements may not be prepared on the going concern basis.



ACTIVITY 4.3.4

Isakhiwo Contractors Ltd (Isakhiwo) is a construction company involved in the building of both commercial and residential properties.

Your firm has been the auditor of the company for the last few years and you have been assigned as the audit manager for the 31 March 2013 financial year-end audit. Early in May, the company was ready for the financial statement audit and provided you with draft financial statements. You are currently performing procedures as part of the audit finalisation stage. The client wants the audit to be finalised by 15 June 2013, as it needs audited financial statements to extend its bank overdraft.

Subsequent events review

During the performance of the subsequent events review in the first week of June, you identified the following matter that has to be considered before finalising the financial statements.

During February 2013, one of Isakhiwo's new delivery trucks, valued at R600 000, was hijacked. The truck was insured and has not been seen since the incident. The financial director wrote the vehicle off on 31 March 2013. She also recognised a small loss that was anticipated when taking into account the expected payout from the insurance company. The insurance claim was raised as a debtor. You were satisfied with this accounting treatment. However, late in May 2013, the insurance company notified Isakhiwo that it would not be paying out any amount in respect of the hijacked vehicle as its investigation revealed that the driver of the hijacked vehicle had been involved in the hijacking. The driver, who was an employee of Isakhiwo, resigned from the company shortly after the incident. Isakhiwo referred the matter to its lawyers who indicated that, in terms of a strict interpretation of the insurance policy, the insurance company could be correct. They recommended that the matter be taken to court and Isakhiwo intends doing this.

Required

Explain your consideration of how the subsequent events should be dealt with in the financial statements as at 31 March 2013.



FEEDBACK ON ACTIVITY 4.3.4

- The financial statements at 31 March are presently incorrectly.
- This represents an adjusting event.
- The insurance company cannot be raised as a debtor, as it has stated that it will not pay Isakhiwo out.
- In terms of IAS 37 any income from the insurance company can only be recognised if its receipt is virtually certain. In this case it is not.
- The subsequent event (notification by the insurance company that no payment would be made) gives additional information about a situation which existed at 31 March 2013.
- As the existence of the truck at financial statement date could not be confirmed/established, it was correct to remove it from the accounting records (AFS).
- The full loss on the theft of the truck should be recognised in the statement of comprehensive income at 31 March 2013.
- A note, giving a full explanation, including the intention to take the insurers to court, should be included in the director's report.
- A note with any additional information relating to this matter could also be included in the financial statements for transparency purposes.

4.3.2 CONCLUSION

In this learning unit we explained the sequence of events for a client, the difference between adjusting and non-adjusting events (via an activity), and what an auditor should consider in order to determine the manner in which subsequent events should be treated in the financial statements (via activities).



Self-assessment

After having worked through the learning unit and the references to the prescribed study material, decide whether you feel comfortable about doing the following:

- Explain the auditor's and management's treatment of subsequent event(s).
- Formulate audit procedures in relation to subsequent events.

As soon as you have completed this learning unit you are required to save Activities 4.3.1 to 4.3.4 (consisting of a percentage and a self-reflection) on your computer. The self-reflection must not be skimpy.

LEARNING UNIT 4.4

Provisions and contingent liabilities

M La Grange

After having worked through this learning unit you must be able to

- | |
|--|
| <ul style="list-style-type: none"> • formulate audit procedures for provisions and contingent liabilities |
| <ul style="list-style-type: none"> • write an appropriate auditor's report on given practical situations concerning provisions and contingent liabilities |

4.4.1 INTRODUCTION

Imagine the following scenario: you are involved in a car accident, where the passenger of the other car which collided with your car suffered leg injuries. According to your police statement, you refuse to take responsibility for the injuries incurred by the passenger as he caused the accident by driving at a high speed. Unfortunately there were no eye witnesses. A week later you are informed that the passenger has started a lawsuit against you to pay for his medical expenses.

From the above scenario, can you see that you might or might not pay for his medical expenses based on the outcome of the lawsuit? It fits perfectly into the definition of a contingent liability, as a contingent liability can be defined as a possible obligation (i.e. you may or may not pay for the medical expenses) that arise from past events (i.e. the car accident) and the existence of which will be confirmed only by the occurrence or non-occurrence of an uncertain future event (i.e. winning or losing the lawsuit) not wholly owned by or in the control of the entity (i.e. not in your control). If for example a company, rather than a person, is involved in a lawsuit which falls within the definition of a contingent liability, it should be **disclosed** in the financial statements. The onus is then on the auditor to follow audit procedures to obtain sufficient, appropriate audit evidence regarding the financial statement assertions applicable to it.

Provisions are very similar to contingent liabilities, with one exception: provisions are more **certain**. For example: a mining company needs to provide, on a yearly basis, for environmental clean-up costs which will be incurred by the company at the end of the mine's lifespan. In this instance, the company has a present obligation as a result of a past event (i.e. the company has to incur environmental clean-up costs due to its mining

activities); it is probable that an outflow of resources will be required to settle the obligation (i.e. there are environmental laws in place that force mining companies to rehabilitate the environment, so an outflow of money will be incurred by the mining company). Lastly, a reliable estimate can be made of the amount of the obligation (i.e. environmental mining experts will be able to make a reliable estimate which takes into account the time value of money). In this case, the mining company should **recognise** the provision in its financial statements. The onus is then, once again, on the auditor to follow audit procedures to obtain sufficient, appropriate audit evidence regarding the financial statement assertions applicable to it.

From these two examples, do you understand the difference between a contingent liability and a provision?

Please note that provisions and contingent liabilities are related to subsequent events which were dealt with in learning unit 4.3.



Study

Study the relevant sections referring to “Litigations and claims” in ISA 501 (Audit evidence – specific considerations for selected items), paragraphs .09 to .12, and the relevant section dealing with “Provisions, contingent liabilities and contingent assets” in chapter 14 of Jackson and Stent.

Note the following in the above study sources:

- Definitions of a **provision, liability** and **contingent liability**.
- The treatment of a provision and contingent liability in terms of the **recognition** or **disclosure** thereof.
- The audit procedures performed by an auditor for the applicable financial statement assertions (Jackson and Stent, and ISA 501, pars .09, .10 & .12).
- Reporting is dealt with in ISA 700, 705 and 706 (learning unit 4.2). It is essential to refer to these auditing standards as you need to master the reporting considerations about matters concerning a company’s provisions and contingent liabilities.

Self-reflection activities, to be submitted

After studying the theoretical concepts above I want you to attempt Activities 4.4.1 and 4.4.2 below as if under examination conditions. But you mark yourself by awarding 1½ marks for a properly formulated procedure. (Don’t look at the comments or solution yet.) You are then required to submit the **percentage** you obtained **and** a **self-reflection**. The **self-reflection** is the essential part of the activity. **I want you to think about what went wrong and how you can remedy your mistakes – you must come up with suggestions and answers.** Your self-reflection may include questions you ask yourself: Did I understand the purpose of the question? Did I understand the theoretical principles? Must I read up more (research) the topic? Must I practise more, by repeating the question? What did I learn from doing the activity? What made the question difficult?

And so on. The self-reflection exercise is more important than the marks. Self-reflection nurtures critical thinking and at the same time improves your communication skills. These are the soft skills that the accounting and auditing professions require and give recognition for.



ACTIVITY 4.4.1

You are the auditor of Mobi (Pty) Ltd (Mobi), a company which farms with grapes, for the financial year ending 31 March 20xx. Mobi allegedly entered into a price-fixing scheme with its major competitors where they agreed among themselves to supply their grapes to grocery stores at a fixed amount of R15 per kilogram. This price-fixing scheme was exposed by the media, whereafter legal steps were taken against these grape farmers.

Required

Describe the audit procedures that an auditor should perform in order to identify litigations and claims involving Mobi (i.e. the completeness of litigations and claims).



FEEDBACK ON ACTIVITY 4.4.1

Refer to ISA 501, paragraphs .09, .10 and .12, and the relevant sections under the “completeness” assertion in chapter 14 of Jackson and Stent.

Comments on Activity 4.4.1

- In this activity you were only required to describe audit procedures relating to the “completeness” financial statement assertion. You will not earn marks if you list audit procedures in relation to other financial statement assertions such as “valuation”. It is therefore important to read your question carefully.
- If you know paragraphs .09, .10 and .12 of the ISA and studied Jackson and Stent, you should have been able to answer this question. Can you see that it is important to study your reference sources?
- Also note that this question was purely theoretical in the sense that you didn’t work through a scenario to determine which of the audit procedures listed in paragraphs .09, .10 and .12 and Jackson and Stent are applicable for your answer. Please note that in the examination you will be provided with a scenario – you should then base your procedures on the information in the scenario.



ACTIVITY 4.4.2

You are the auditor of ZZZ (Pty) Ltd for the financial year ending 31 March 20xx.

While conducting the year-end audit, you discovered that pending litigation claims which are material, but not pervasive in nature, were not disclosed in the financial statements. Discussions with management revealed that they are unwilling to include such a disclosure in the financial statements.

Required

Decide which type of audit opinion would be included in the audit report.



FEEDBACK ON ACTIVITY 4.4.2

An “except for” audit opinion would be included in the audit report.

Comments on Activity 4.4.2

- Reporting is dealt with in ISA 700, 705 and 706 (learning unit 4.2). Please refer to these sources if you are unsure about the answer to this activity.

4.4.2 CONCLUSION

In this learning unit we discussed the audit procedures to be followed by the auditor regarding litigations and claims involving the entity and the influence of matters concerning litigations and claims on the auditor’s report.



Self-assessment

After having worked through the learning unit and the references to the prescribed study material, decide whether you feel comfortable about doing the following:

- Formulate audit procedures for provisions and contingent liabilities.
- Write an appropriate auditor’s report on given practical situations concerning provisions and contingent liabilities.

As soon as you have completed this learning unit you are required to save Activities 4.4.1. and 4.4.2 (consisting of a percentage and a self-reflection) on your computer. The self-reflection must not be skimpy.

LEARNING UNIT 4.5

Going concern and factual insolvency

M la Grange

After having worked through this learning unit you must be able to
<ul style="list-style-type: none"> • describe how management should deal with the uncertainties that affect the entity's ability to continue as a going concern
<ul style="list-style-type: none"> • describe audit procedures when there is a material uncertainty relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern
<ul style="list-style-type: none"> • write an appropriate auditor's report on given practical situations with respect to the going concern assumption
<ul style="list-style-type: none"> • describe the actions to be taken by an auditor when a company is insolvent

4.5.1 INTRODUCTION

The going concern assumption is a fundamental principle in the preparation of any set of financial statements as various stakeholders, who include for example the company's investors, need assurance that the company is financially sound and suffers no short-term threat to its continued existence. Under the going concern assumption an entity is normally viewed as a going concern, which means that the entity will continue in business into the foreseeable future, which is at least 12 months after the statement of financial position date. The entity should neither have the intention nor the necessity to go into liquidation or to cease trading in the period after the year end.

**Study**

Study ISA 570 (Going concern) and the relevant sections in chapter 15 of Jackson and Stent which refer to "going concern" and "factual insolvency".

Note the following in the above study sources:

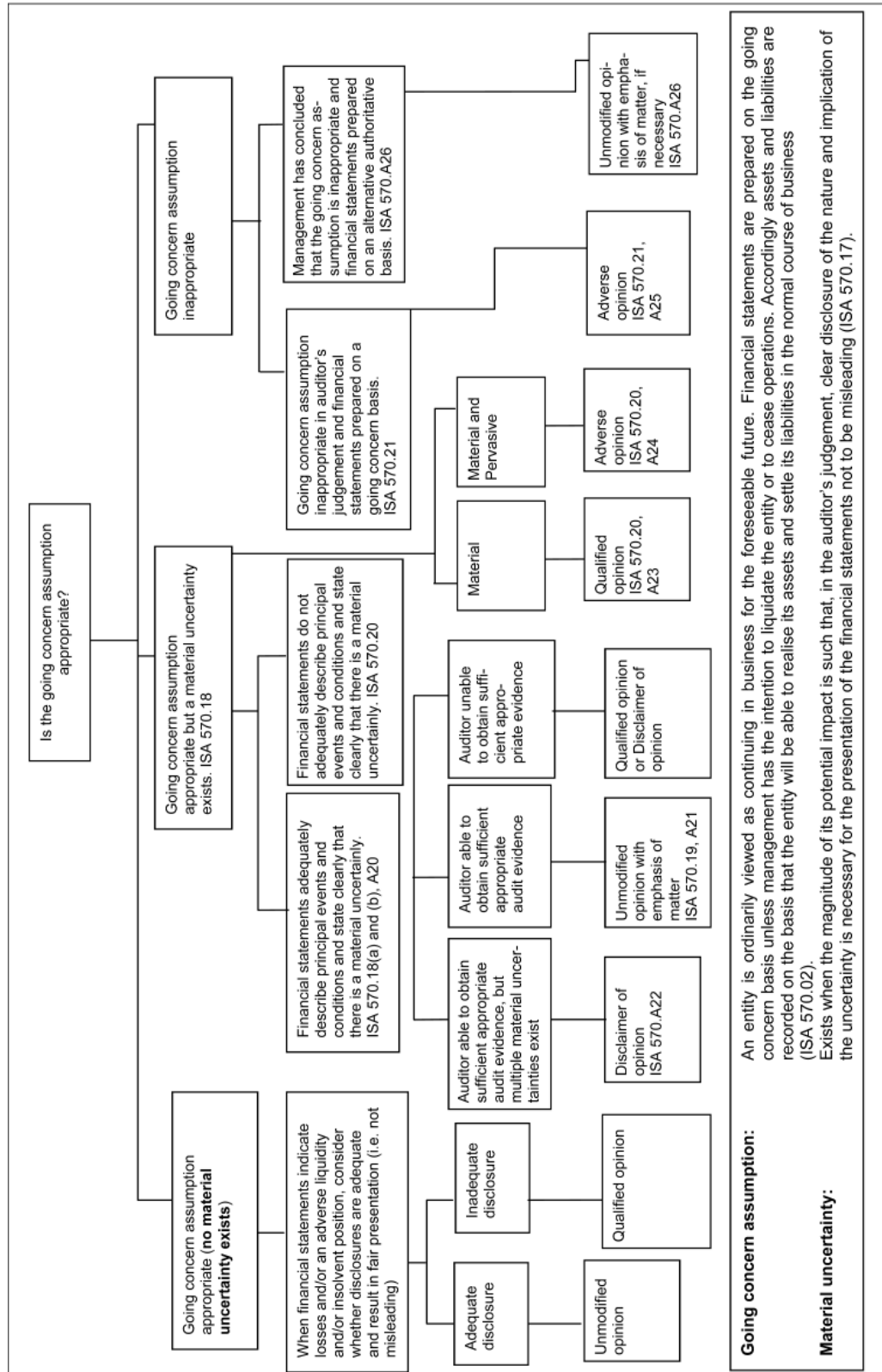
- The definition of "Going concern assumption" (ISA 570, par .02).
- The **auditor's objectives** regarding the going concern assumption (ISA 570, par .09).

- The auditor will perform procedures to assess the applicability of the going concern principle. Ensure that you are able to describe these procedures (ISA 570, pars .10, 16 and A15 to A18).
- ISA 570 provides examples of events or conditions which may cast doubt about the entity's ability to continue as a going concern specifically **financial, operating and other** events or conditions (ISA 570, par A2). In a situation where these conditions suggest that going concern is at risk, **mitigating factors** (factors which reduce the risk) should also be considered (ISA 570, par A16).
- Reporting is dealt with in ISA 705 and 706 (learning unit 4.2). However, it is essential to refer to these auditing standards as you need to master the reporting considerations regarding the going concern principle. Make sure that you can formulate the various types of audit opinions as set out in ISA 570, paragraphs .17-.21 and A20–A27.
- The **definitions** of the **two categories of factual insolvency** that have been recognised by law (refer to Jackson and Stent).
- The link between **factual insolvency** and **section 22 of the Companies Act 2008** (refer to Jackson and Stent).
- The potential link between **factual insolvency** and a **reportable irregularity** (refer to Jackson and Stent).
- The **criteria** of the definition of a **reportable irregularity** that need to be satisfied (in terms of section 1 of the Auditing Profession Act 2005) to enable an auditor to determine whether there is a reportable irregularity. If a reportable irregularity occurs, it needs to be reported to the IRBA in terms of section 45 of the Auditing Profession Act 2005 (refer to Jackson and Stent).



Reporting considerations regarding the going concern principle – decision tree

- The following going concern decision tree (*SAICA handbook 2010/2011* – adapted) will help you answer questions dealing with the link between going concern considerations and the types of audit opinions.



Self-reflection activities, to be submitted

After studying the theoretical concepts above I want you to attempt Activities 4.5.1 to 4.5.3 below as if under examination conditions. But you mark yourself by awarding 1½ marks for a properly formulated procedure. (Don't

look at the comments or solution yet.) You are then required to submit the **percentage** you obtained **and** a **self-reflection**. The **self-reflection** is the essential part of the activity. **I want you to think about what went wrong and how you can remedy your mistakes – you must come up with suggestions and answers.** Your self-reflection may include questions you ask yourself: Did I understand the purpose of the question? Did I understand the theoretical principles? Must I read up more (research) the topic? Must I practise more, by repeating the question? What did I learn from doing the activity? What made the question difficult? And so on. The self-reflection exercise is more important than the marks. Self-reflection nurtures critical thinking and at the same time improves your communication skills. These are the soft skills that the accounting and auditing professions require and give recognition for.



ACTIVITY 4.5.1

- (1) During the audit of Viva (Pty) Ltd for the financial year ending 31 August 20xx, you became aware of conditions and related business risks that cast significant doubt on the entity's ability to continue as a going concern.

Required

Describe the further audit procedures that you will perform after you have discovered the above conditions and business risks.

- (2) After you have performed the further audit procedures, you are of the opinion that the going concern assumption is still appropriate, but a material uncertainty exists. You are satisfied that note 10 in the financial statements adequately discloses the conditions, the fact that the company incurred a loss of R8 million during the current financial year and the fact that its current liabilities exceeded its total assets by R2 million.

Required

Draft the relevant paragraph pertaining to the above that you would include in your audit report.



FEEDBACK ON QUESTION (1) OF ACTIVITY 4.5.1

Refer to ISA 570, paragraph A15.

Comments on question (1) of Activity 4.5.1

- If you knew paragraph A15 of your standard, you should have been able to answer this question. Can you see that it is important to study your auditing standards?

- Also note that this question was purely theoretical in the sense that you didn't work through a scenario to determine which of the audit procedures listed in paragraph A15 is/are applicable for your answer. Please note that in the exam you will be provided with a scenario – you should then base your procedures on the information in the scenario and make the procedures as per paragraph A15 applicable.



FEEDBACK ON QUESTION (2) OF ACTIVITY 4.5.1

Without qualifying our opinion, we draw attention to **note 10** in the financial statements, which indicates that the company incurred a **net loss of R8 million** during the year ended 31 August 20XX and, as at that date, the company's **current liabilities exceeded its total assets by R2 million**. These conditions, along with other matters as set forth in note 10, indicate the existence of a **material uncertainty** which may cast **significant doubt on the ability of the company to continue as a going concern**.

Comments on question (2) of Activity 4.5.1

- Please refer to the decision tree provided to you in this learning unit to help you answer this question.



ACTIVITY 4.5.2

An entity incurred losses during the past four years, and its current liabilities exceed its total assets. The entity is in breach of its loan covenants and has been negotiating with the relevant financial institutions in order to maintain their support for its business. These factors raise substantial doubt about the entity's ability to continue as a going concern.

Required

Describe how management should disclose uncertainties that affect the entity's ability to continue as a going concern. In addition, describe the effect on your audit opinion if management refuses to disclose the above.



FEEDBACK ON ACTIVITY 4.5.2

Management should **disclose any uncertainties** that may cast significant doubt on the **entity's ability to continue as a going concern** in **the directors' report** and the **notes to the annual financial statements**.

Management should disclose details of the uncertainty, as well as an **explanation** of the uncertainties and the **actions proposed** to deal with

the situation. Management should also disclose the possible effects on the **financial position**, or that it is **impracticable to measure them**.

Additionally, management should state whether or not the financial statements include any **adjustments that might result from the outcome of these uncertainties**. In particular, if bank borrowings have been disclosed as non-current in the assumption that discussions with the bank will result in an extension of the loan facilities, details of this fact should be disclosed.

Should management refuse to disclose the above, this will result in a qualified or adverse audit opinion, as appropriate. **(Sufficient information is not provided to conclude. Note, however, that in the exams you will be provided with enough information to make a conclusion.)**

Comments on Activity 4.5.2

- Please do not forget to discuss the impact on the audit report. Make sure you deal with everything as required.



ACTIVITY 4.5.3

During the audit of Hiki (Pty) Ltd for the year ending 31 December 2013 you discovered that Hiki (Pty) Ltd is factually insolvent (i.e. liabilities exceed assets, fairly valued). The managing director is confident that the company will return to profitability in the new financial year as certain large new contracts have been secured. Management is unable to satisfy you (as the auditor) that Hiki (Pty) Ltd will restore its solvency in the foreseeable future.

Required

State, giving reasons, what actions you would take given the circumstances that management is unable to satisfy you that Hiki (Pty) (Ltd) will restore its solvency in the foreseeable future. Your answer should include a discussion of

- sections 1 and 45 of the Auditing Profession Act 2005
- section 22 of the Companies Act 2008
- common law fraud
- the considerations to formulate an audit opinion on the company's financial statements



FEEDBACK ON ACTIVITY 4.5.3

1. Continuation of operations in the present circumstances may be considered to be a reportable irregularity in terms of **section 1 of the Audit Profession Act** as the company will be trading while factually insolvent.
2. This is because in terms of **section 22 of the Companies Act** a company must not carry on its business recklessly, with gross negli-

gence, with the intent to defraud creditors or for any other fraudulent purpose, or trade under insolvent circumstances.

- 2.1 Because the management accounts reflect the factual insolvency, and the directors have not taken **appropriate** remedial action, an unlawful act has been committed by persons responsible for the management of the entity.
 - 2.2 Trading while factually insolvent, with no concrete strategy to restore solvency, is fraudulent and will give rise to material financial losses on the part of the company's creditors.
3. I would therefore, without delay, send a written report to the IRBA, giving particulars of the reportable irregularity in terms of **section 45 of the Auditing Profession Act**.
 4. Within three days of sending the report to the Regulatory Board, I would notify the members of the board of Hiki (Pty) Ltd in writing of the sending of the report to the IRBA and the provisions of this section.
 5. As soon as reasonably possible but no later than 30 days from the date on which the report was sent to the IRBA, I would
 - (a) take all reasonable measures to discuss the report with the members of the management board of the entity
 - (b) afford the members of the management board of the entity an opportunity to make representations in respect of the report
 - (c) send another report to the IRBA, including a statement, with supporting information, that I am of the opinion that
 - no reportable irregularity has taken place or is taking place, or
 - the suspected reportable irregularity is no longer taking place and that adequate steps have been taken for the prevention or recovery of any loss as a result thereof, if relevant, or
 - the reportable irregularity is continuing
 6. I would further advise the directors that, in terms of case law, they could be found guilty of **common law fraud** for incurring debts the company may not be able to pay.
 7. At year end, the effect of the deficit will have to be considered in **formulating an audit opinion** on the company's financial statements.
 8. Use of the going concern assumption in these circumstances would appear to be inappropriate; the annual financial statements should be prepared on the liquidation basis, with full disclosure.
 9. Should this not be done, an **adverse audit opinion** should be expressed, as the matter is **material and pervasive** (as the financial statements are rendered meaningless and/or misleading).

Comments on Activity 4.5.3

- Note that you should, in your answer, refer to the Audit Profession Act, Companies Act, common law fraud and the effect on the audit opinion (refer to the required part of this question). Make sure you deal with all of these areas.

- In the feedback on Activity 4.5.3, I have emphasised the areas referring to the Audit Profession Act, Companies Act, common law fraud and the effect on the audit opinion.

4.5.2 CONCLUSION

In this learning unit we discussed the responsibilities of the auditor and management regarding the going concern principle, the influence of going concern on the auditor's report, as well as the actions to be taken by the auditor when a company is insolvent.



Self-assessment

After having worked through the learning unit and the references to the prescribed study material, decide whether you feel comfortable about doing the following:

- Describe how management should deal with the uncertainties that affect the entity's ability to continue as a going concern.
- Describe audit procedures when there is a material uncertainty relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- Write an appropriate auditor's report on given practical situations with respect to the going concern assumption.
- Describe the actions to be taken by an auditor when a company is insolvent.

As soon as you have completed this learning unit you are required to save Activities 4.5.1 to 4.5.3 (consisting of a percentage and a self-reflection) on your computer. The self-reflection must not be skimpy.

LEARNING UNIT 4.6

Audit report

K Joubert

After having worked through this learning unit you must be able to

- express an opinion on financial statements (ISA 700)
- formulate an unmodified audit opinion (ISA 700)
- formulate a modified audit opinion (ISA 705)
- formulate an emphasis of matter and paragraphs on other matter in the audit report (ISA 706)

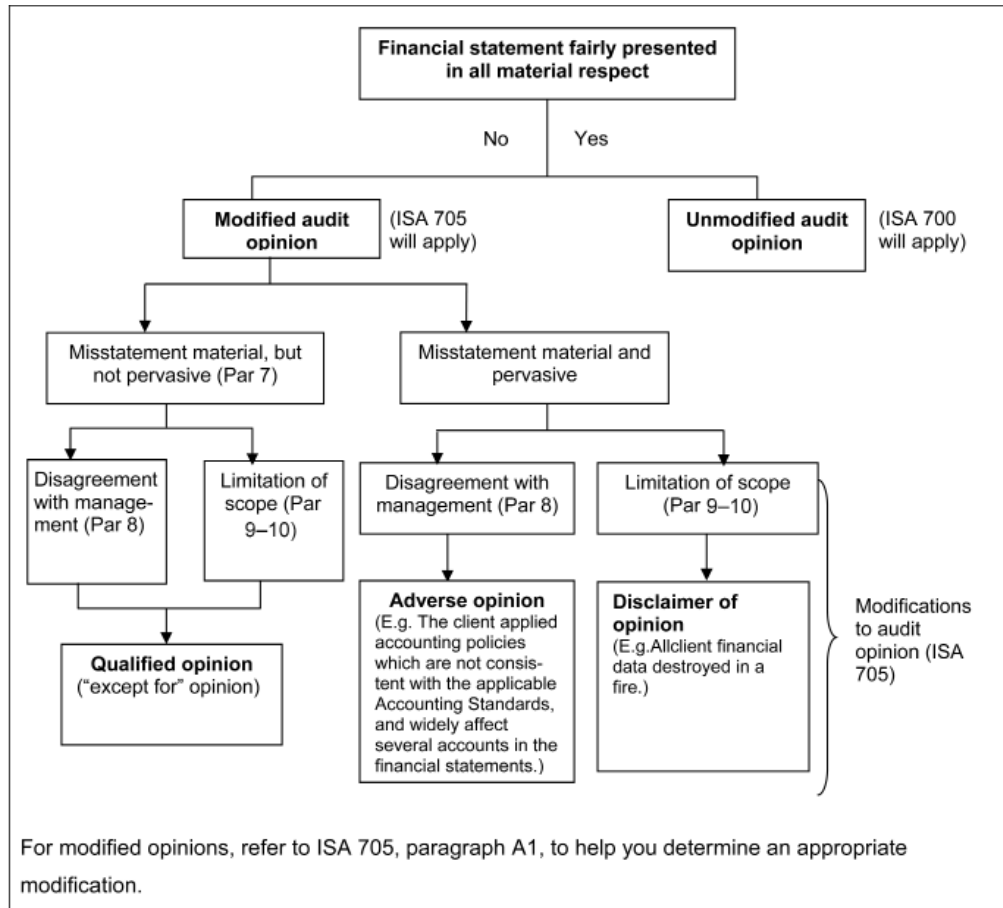
4.6.1 INTRODUCTION

When you get back from your holiday, you upload photos and post on your social media wall about the wonderful time you had. You have formed an opinion about your holiday (wonderful time), substantiated your claim with evidence gathered (photos) and now you have issued a report (posted on your social media wall).

Similarly an auditor forms an opinion about an audit based on all the audit evidence she gathered and evaluated. An audit report is then issued as the final product of an auditor's work.

A variety of opinions can be expressed after an auditor has applied her skill and professional judgment.

The following figure 4.6.1 illustrates the different kinds of audit opinions that can be issued.



Study

- Study chapter 18 in Jackson and Stent and ISA 700 (Forming an opinion and reporting on financial statements), paragraphs 10 to 19. Concentrate on **forming an opinion about the financial statements**.



ACTIVITY 4.6.1

Required

Write down the steps listed by Jackson and Stent on how the auditor must form an opinion. Think of anything else that is important for the auditor to consider before an opinion can be formed and write it down.



FEEDBACK ON ACTIVITY 4.6.2

One additional step that is not clearly stated by Jackson and Stent concerns making sure that the requirements of section 45 of the Auditing Profession Act 26 of 2005 on reportable irregularities have been properly adhered to.

This is an example of how you should think to integrate all your auditing knowledge. It is important to practise this process of integration if you want to become an auditor in practice.



Study

- Study chapter 18 of Jackson and Stent and ISA 700 (Forming an opinion and reporting on financial statements), paragraphs 20 to 45, to become familiar with the content of the **auditor's report**.

Paragraphs 34 to 37 explain the opinion that an auditor expresses to the users of the audited financial statements. This opinion is known as an **unmodified opinion**, meaning the same as a “wonderful” holiday. Study example 3 in part B of SAAPS 3 (South African Auditing Practice Statement 3 – Revised) . Please note that the introductory paragraph of the examples in SAAPS 3 does not include the Directors' Report.

However, based on the auditor's evaluation of the audit findings, various possibilities of expressed opinions exist, as explained in the table below.

Now it is time to study ISA 705 (Modification to the opinion of the independent auditor's report).

Remember your report after returning from a holiday; it could be
It was FINE!!
Or
Yah, except for the bad food the rest was fine
Or
The photos in the magazines do not give you a fair idea about the holiday!!!
Or
It was sooo bad; I cannot even express my displeasure!

Table 4.6.1: Explanation of audit opinions

ISA 700	ISA 705		
Unmodified	Qualified	Adverse	Disclaimer
<ul style="list-style-type: none"> • Financial statements are fairly presented in all material respects • Only an “Opinion” paragraph 	<ul style="list-style-type: none"> • “Except for ... financial statements are fairly presented” (certain accounts/ classes of transaction are materially misstated) • 2 paragraphs: <ul style="list-style-type: none"> – Basis for qualified opinion – Qualified opinion 	<ul style="list-style-type: none"> • “Financial statements are not fairly presented” • 2 paragraphs: <ul style="list-style-type: none"> – Basis for adverse opinion – Adverse opinion (note the definition of pervasive in par 5[a]) 	<ul style="list-style-type: none"> • “We do not express an opinion on the financial statements” • 2 paragraphs: <ul style="list-style-type: none"> – Basis for disclaimer of opinion – Disclaimer of opinion



Study

- Study chapter 18 of Jackson and Stent and ISA 705 (par 5) to learn the definitions used in this auditing standard and elsewhere in your studies. For example:

- **pervasive**



Many things about this holiday were bad, the flight, the hotel, the food, the weather; I can hardly pinpoint the positives... !!!!!

- a qualified opinion



Yah, except for the bad food the rest was fine

- an adverse opinion



The photos in the magazines, do not give you a fair idea about the holiday!!!

- disclaimer of opinion



It was sooo bad; I cannot even express my displeasure

- ISA 705 (Modification to the opinion of the independent auditor's report), paragraphs 6 to 28



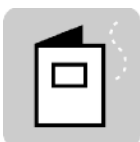
Basis for modified opinion paragraph

- learn that an extra paragraph is added if you compare this audit report to an audit report containing an unmodified opinion.



- The wording of the opinion paragraph is also different, to make the reader understand how badly your opinion is affected by the **information** in the paragraph on the basis for modified opinion.
- **Sometimes** you need to explain something in the financial statements a little more, to help the readers understand an important matter, although this matter does not affect the auditor's opinion.

Just remember: seeing the surrounding islands from the main island on which you spend your holiday will not change your opinion that you had a perfect holiday on the main island



Study

- Study chapter 18 of Jackson and Stent and ISA 706 (par 5) to learn the definitions necessary to understand the rest of this auditing standard.
- Study ISA 706 (pars 6–8) to learn about the emphasis of matter and other paragraphs in the audit report.

Figure 4.6.3: To summarise, the following are types of modifications made to your audit report which do not modify your audit opinion.

ISA 706	
Emphasis of matter and other paragraphs on matter can be an addition to any of the above opinions.	
Emphasis of matter (pars 6–7)	Other matter (par 8)
<ul style="list-style-type: none"> • The matter being emphasised should not be materially misstated in the financial statements. • You only emphasise information that is disclosed in a note to the financial statements. 	<ul style="list-style-type: none"> • This emphasises information not required to be disclosed or presented in the financial statements, but which is relevant to a user's understanding of the audit.
<ul style="list-style-type: none"> • Neither of these paragraphs is a substitution for any modification (as per ISA 705) or disclosures required to be made (by management). • They do not affect the auditor's opinion; therefore they are included (if applicable) in addition to the opinion that the auditor expresses (i.e. after the relevant opinion paragraph). 	



Study

- Study ISA 720 (The auditor's responsibilities relating to other information in documents containing audited financial statements), all paragraphs. Study SAAPS 3.

Self-reflection activities, to be submitted

After studying the theoretical concepts above I want you to attempt Activities 4.6.2 to 4.6.6 below as if **under examination conditions**. But you mark yourself by awarding 1 mark for each sentence. You are then required to submit the **percentage** you obtained **and a self-reflection**. The **self-reflection** is the essential part of the activity. **I want you to think about what went wrong and how you can remedy your mistakes – you must come up with suggestions and answers**. Your self-reflection may include questions you ask yourself: Did I understand the purpose of the question? Did I understand the theoretical principles? Must I read up more (research) the topic? Must I practise more, by repeating the question? What did I learn from doing the activity? What made the question difficult? And so on. The self-reflection exercise is more important than the marks. Self-reflection nurtures critical thinking and at the same time improves your communication skills. These are the soft skills that the accounting and auditing professions require and give recognition for.



ACTIVITY 4.6.2

After you have completed the audit work for CRI Limited you have found no material errors and are satisfied that an unmodified audit report is appropriate.

Required

Write the opinion paragraph as it appears in SAAPS 3.



FEEDBACK ON ACTIVITY 4.6.2

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of CRI Limited as of 31 January 2008, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards and the Companies Act of South Africa.



ACTIVITY 4.6.3

Imagine that during the audit of CRI Limited you found the inventory to be overvalued by a material amount (R3 million) and the directors refuse to correct the error.

Required

Write down the two paragraphs, as indicated in table 4.6.1 of this learning unit, applicable to the facts in this activity.



FEEDBACK ON ACTIVITY 4.6.3

- (1) **Basis for qualified opinion:** CRI Limited overvalued inventory to the value of R3 million, thereby materially overstating assets. Cost of sales has been undervalued with the same amount resulting in an overstatement of profit for the year.
- (2) **Qualified opinion:** In our opinion, **except for the possible effects of the matters described** in the paragraph on basis for qualified opinion, **the financial statements present fairly**, in all material respects, the financial position of CRI Limited as at 30 June 2013, and its financial performance and cash flows for the year then ended, in accordance with the International Financial Reporting Standards and the Companies Act of South Africa.



ACTIVITY 4.6.4

For this activity, assume that in addition to the information in Activity 4.6.3 of this learning unit, the company refused to adjust the value of a building

according to an independent valuation, which caused the financial statements to contain materially misstated amounts throughout.

Required

Write down the two paragraphs, as indicated in table 4.3.1 of this study unit, applicable to the facts in this activity.



FEEDBACK ON ACTIVITY 4.6.4

- (1) **Basis for adverse opinion:** The company's practice is to use its building for its entire economic life; however, the company did not review its useful life at the reporting date in accordance with International Financial Reporting Standards (IAS 16 – Property, plant and equipment). The building is depreciated over a period of 20 years with the remaining useful life at 30 June 20xx assessed as four years. An independent valuer has assessed the remaining economic life of the building at 50 years; consequently, land and buildings, included in note x to the financial statements is understated by Rxxx (20x0: Rxxx), while income tax, net income and shareholders' equity is understated by Rxxx (20x0: Rxxx), Rxxx (20x0 Rxxx) and Rxxx (20x0 Rxxx) respectively. These required adjustments are considered pervasive to the financial statements as a whole.
- (2) **Adverse opinion:** In our opinion, because of the significance of the matter discussed in the paragraph on basis for adverse opinion, the financial statements do not present fairly the financial position of ABC Limited as at 31 December 20X1, and its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards and the requirements of the Companies Act of South Africa.



ACTIVITY 4.6.5

For this activity, assume that in addition to the information in Activity 4.6.3, almost all of the accounting records of CRI Limited were destroyed in a flood. As a result, you could not perform adequate audit procedures to arrive at any meaningful opinion.

Required

Write down the two paragraphs, as indicated in table 4.3.1 of this learning unit, applicable to the facts in this activity.



FEEDBACK ON ACTIVITY 4.6.6

- (1) **Basis for disclaimer of opinion:** As indicated in the directors' report, the accounting records were destroyed during a flood and no other documentation was obtainable to substantiate the amounts presented in the financial statements.

- (2) **Disclaimer of opinion:** Because of the significance of the matter described in the paragraph on basis for disclaimer of opinion, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an opinion. Accordingly we do not express an opinion on the financial statements.

4.6.2 CONCLUSION

In this learning unit we discussed and explained the forming of an audit opinion and a variety of audit reports, each of which relates to a specific opinion formed by the auditor.



Self-assessment

After having worked through the study unit and the references to the prescribed study material, decide whether you feel comfortable about doing the following:

- Express an opinion on the financial statements (ISA 700).
- Formulate an unmodified audit opinion (ISA 700).
- Formulate a modified audit opinion (ISA 705).
- Formulate an emphasis of matter and paragraphs on other matter in the audit report (ISA 706).

As soon as you have completed this learning unit you are required to save Activities 4.6.1 to 4.6.6 (the activities from 4.6.2 are self-reflection activities and consist of a percentage and a self-reflection) on your computer. The self-reflection must not be skimpy.

You are now ready to submit assignment 03:

Make sure that you have numbered the questions and activities correctly, copy all the activities that you have saved thus far on one document. Save the document as assignment 03 in a pdf format and submit it online before the due date. The unique code for this assignment is provided in learning unit 0.