PROGRAM STUDI
AKUNTANSI

MODULE AUDITING 1:
Audit and Assurance
Part 1

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FOREWORDS

Assalamu'alaikum Warahmatullahi Wabarakatuh

All praises to The Most Merciful Allah SWT who has given His grace, blessings, and guidance which would allow the author to complete this Audit & Assurance Module. In completing this module, the author received a lot of support and assistances from various parties. For this reason, the author would like to express her deepest gratitude to:

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May Allah SWT grant endless blessings to those who provide support and assistance. Hopefully this module can be useful for readers, especially the students of ACCA Audit & Assurance class, Accounting Study Program, Faculty of Business and Economics, Islamic University of Indonesia.

Wasslamu'alaikum Wr. Wb.

Course Description

Audit and Assurance provides you with an understanding of the knowledge and application skills required to carry out an audit engagement and its application in the context of the professional regulatory framework. This module begins with the nature, purpose, and scope of assurance engagements, including the statutory audit, its regulatory environment, and introduces governance and professional ethics relating to audit and assurance. It then leads into planning the audit and performing risk assessment. Finally, it will end up with the introduction of audit evidence.

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CHAPTER 1

AUDIT AND OTHER ASSURANCE ENGAGEMENTS

Learning Objectives

- Students are able to understand the basic concept of auditing and assurance engagement,
- Students are able to understand the basic concept of stewardship, accountability, and agency,
- Students are able to understand different types of assurance engagement,
- Students are able to understand the overview of audit process,
- Students are able to understand the limitations of external audit.

An assurance engagement is: 'An engagement in which a practitioner obtains sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria’ (International Framework for Assurance Engagements, 7).

According to ISA 200, the objective of an audit of financial statements is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

Further, it also states that the purpose of an external audit engagement is to ‘enhance the degree of confidence of intended users in the financial statements.’ Hence, an external audit engagement is one of the examples of assurance engagement.

An assurance engagement should consist of the 5 element usually abbreviated by CREST:

a. **Criteria**. The subject matter is evaluated or measured against criteria in order to reach an opinion.
b. **Report**. A written report containing the practitioner's opinion is issued to the intended user, in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.
c. **Evidence**. Sufficient appropriate evidence needs to be gathered to support the required level of assurance.

d. **Subject matter**. This is the data to be evaluated that has been prepared by the responsible party. It can take many forms, including financial performance (eg historical financial information), non-financial performance (eg key performance indicators), processes (eg internal control) and behaviour (eg compliance with laws and regulations).

e. **Three party relationship**. The three parties are the intended user, the responsible party and the practitioner.

Types of assurance or opinion (engagement)

Reasonable/Positive Assurance engagements

- Definition : Engagement that gives High but not Absolute level of assurance to the readers
- E.g : **External audit engagement**

(Note, audit involves "Checking" element…but quite extensive)

Let's say firm completes the audit of f/s, and no material misstatements were found, the following conclusions are made:
"In our opinion, the accompanying financial statements **present fairly (truly and fairly)**, **in all respect**, in accordance with IFRS."

Limited/Negative Assurance Engagements

- Definition : Engagement that gives Moderate level of assurance to readers
- E.g. Internal Control Review Engagement or Review of Interim Financial Statement

(Note, review involves Checking as well, but less extensive)

Let's say firm completes the review of f/s and no material misstatements were found, the following conclusions are made:
"Based on the procedures performed, **nothing** came to our attention to indicate that the financial statement on XYZ during January-June 20x9 **is materially misstated.**

The meaning of true and fair

True – information is factual and conforms with reality in that there are no factual errors.

In addition it is assumed that to be true it must comply with accounting standards (such as IAS) and any relevant legislation.

Fair – information is clear, impartial and unbiased, and also reflects plainly the commercial substance of the transactions of the entity

Status or authority of ISA (International Standards of auditing)

(ISAs) are issued by the International Auditing and Assurance Standards Board (IAASB) and provide guidance to auditor for audit.

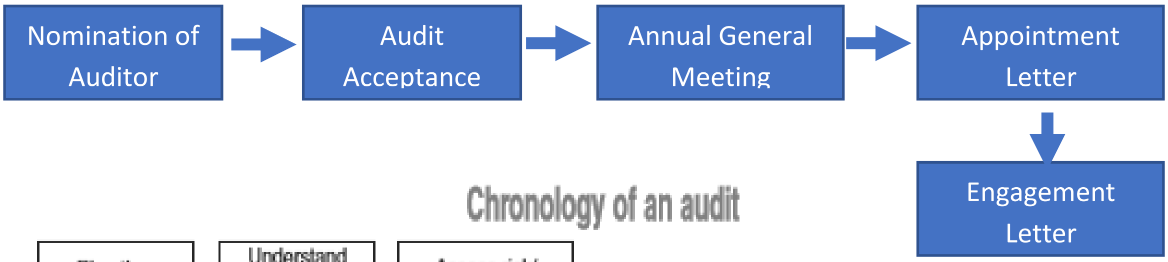
ISAs only apply to the audit of historical financial information.

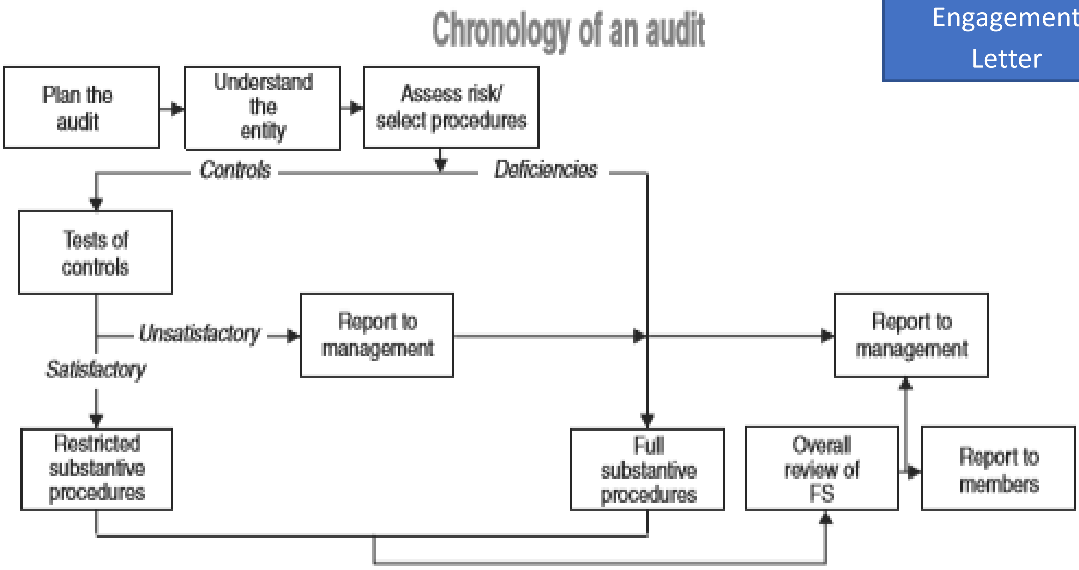
The ISAs contain basic principles and essential procedures together with related guidance in the form of explanatory material and appendices.

No	Criteria	External Audit	Internal Audit
1	Appointed by	Shareholders	BOD/AC
2	Objective	Opinion on Financial Statements	As instructed by BOD/AC, normally their main objective is to check internal control effectiveness
3	Requirement	Statutory	Not compulsory although its recommended by corporate governance
4	Status in company	Outsider (non-employees)	Insider (employees)
5	Internal Control test	Financial Statement controls	All internal Controls
6	Scope of work	Determined by Statute	Determined by BOD or AC
7	Report to	Shareholders	BOD or AC
8	Report type	Formal	Informal – no formal standard formal
9	Completion dateline	Tight Deadline	Set by AC/BOD

You will learn more detailed about Internal Audit on The Second Section of Audit and Assurance Module.

Meanwhile, for the External Audit, here is the big picture of the whole process **prior to the Audit Acceptance (*in blue box*)**, followed by those **after the Audit Acceptance (*in white box*)**.





Limitations of External Audit

An external audit has a number of limitations which reduce its usefulness:

a. Sampling – it is not practical for an auditor to test 100% of transactions and so they have to apply sampling methodologies in selecting balances/transactions to test. Therefore, there could be an error in an item not selected for testing by the auditor.

b. Subjectivity – financial statements include judgmental and subjective areas and therefore the auditor is required to use their judgement in assessing whether the financial statements are true and fair.

c. Inherent limitations of internal control systems – an internal control system is operated by people and hence is liable to human error. In addition, there is the possibility of controls override by management and of collusion and fraud. It is impossible to remove all these inherent limitations and as the auditor relies on the internal control systems, this can reduce the usefulness of the audit.

d. Evidence is persuasive not conclusive – the opinion is based on audit evidence gathered; however, while this evidence can indicate possible issues affecting the audit opinion, evidence involves estimates and judgements and hence does not give a definite conclusion.
e. Audit report format – the format of the opinion is determined by International Standards on Auditing (UK and Ireland). However, the terminology used is not usually understood by non-accountants. This means that users may not actually understand the audit opinion given.
f. Historic information – the audit report is often issued sometime after the year end, and so the financial information can be quite different to the current position. In the current marketplace where companies' financial positions can change quite quickly, the audit opinion may no longer be relevant as it is out of date.

EXERCISE

What is ACCOUNTING? (in your own word)

What is AUDITING? (in your own word)

Let's now move on specifically to AUDIT, let's start by learning what Agency Theory is:

- → In Agency Theory, there is a ________________ and __________________
- → The shareholder is normally the ____________________ and the management is normally the __________________.
- → The shareholders normally hire the Board of directors to RUN THE BUSINESS on their behalf, shareholders will only give decision making authority to the Board of directors.
- → And how do you think the shareholders can decide whether board of directors is doing a good job? By looking at the _________________, prepared by the ____________, however as matter a matter of fact, they are hired by the _____________.
- → So there is a strong chance that the board of directors ask the ACCOUNTANT to manipulate the financial statements in order to impress the shareholders.
- → When shareholders are impressed, they will renew the contract of board of directors and reward them higher pay etc.
- → But shareholders are smart people, they know that the BOARD and ACCOUNTANT could have MANIPULATED the financial statements, so they will then hire an ______________ to "check" or _______________ the _____________ prepared by the _______________ and to see whether the f/s shows true and fair view.

CHAPTER 2

STATUTORY AUDIT AND REGULATIONS

Learning Objectives

- Students are able to differentiate between statutory audit and non-statutory audit,
- Students are able to understand in detail the regulatory aspects of the appointment, removal and resignation of auditors,
- Students are able to understand in detail the regulation on rights and duties of auditors,
- Students are able to explain the steps of issuing International Standards on Auditing (ISAs).

A statutory audit is an audit which is required by the law. Most limited companies are required to have a statutory audit. There are some exemptions, one of which is "*small entities*". A small entity is any enterprise in which:

- There is concentration of ownership/management in a small number of people, and
- One or more of the following are also found:
    - Few sources of income and uncomplicated activities
    - Unsophisticated record-keeping
    - Limited internal controls and potential for management override of internal controls
    - Few personnel, many having a wide range of duties

Meanwhile, non-statutory audit refers to the audit which is voluntarily performed by an entity because of the request from related stakeholders. Here are some advantages for performing a non-statutory audit:

- Means of settling accounts
- Accounts may be more acceptable to taxation authority
- May facilitate the sale of the business, or negotiation of a loan
- Useful for a 'sleeping partner'

The Statutory Regulation on Appointment of Auditors:

- Shareholders appoint external auditors,
- Auditors fulfill all the regulation of auditor,
- Allowed by the regulatory body to act as an auditor or Allowed (authorized) by state to act as an auditor,
- Appointment will be made at the AGM (Annual General Meeting) and will run until the next AGM,
- If there is no AGM, the appointment will be automatic each year unless shareholders make an objection.

The Statutory Regulation on Removal of Auditors:

- Can be removed by the majority at the general meeting of shareholders,
- Sent the special notice within 28 days to auditor.

The Statutory Regulation on Removal of Auditors:

- The auditor may resign but must submit a statement outlining the circumstances of resignation,
- Rights when resigning:
  - To request Extra Ordinary General Meeting (EOGM) to explain the circumstances of resignation,
  - To require the company to circulate notice of circumstances relating to the resignations.

Auditor's rights and Duties… per Company Law

1. Right of access to the company's book and record at any reasonable time to collect the evidence necessary to support the audit opinion.
2. Right to require information and explanations from the company's officers that is necessary to perform their duties as auditors.
3. Right to receive notice of and attend meetings of the company in the same way as any member of the company.
4. Where the company uses written resolutions, a right to receive a copy of those resolutions.
5. Request EGM for resignation purpose.

Summarised scope of work of the auditors.

1. Testing of variety of internal controls, e.g for retail companies, it will test cash related controls.
2. They can do overall review of financial and operational control or performance and provide recommendation to improve the systems.
3. They can perform fraud investigation such as identifying theft, with the focus being collecting to identify the fraudster and quantifying losses.
4. They will do IT system reviews, focusing on …
5. They can do value for money audit, focusing on …
6. They can help in regulatory compliance, preparing report and advising the board on what are the relevant law and regulation that the company need to comply.
7. They can also do best value audit focusing on …

Engagement Letter

Formal contract between the auditor and client that outlines the responsible of both parties

↓

Why need Engagement Letter

1) To agree term of audit such as fees etc.
2) To prevent misunderstanding between management & auditor

↓

Content

1. The objective and scope of audit
2. The responsibilities of auditor
3. The responsibilities of directors
4. Identification of financial reporting framework in preparing f/s
5. Expected form and contents of report to be issues
6. Fees arrangement and billing arrangements

Regulatory body in audit

- IFAC is the International Federation of Accountants, based in New York. IFAC co-operates with member bodies from around the world to initiate, co-ordinate and guide efforts to achieve international technical, ethical, and educational pronouncements for the accountancy profession,
- The International Auditing and Assurance Standards Board (elected from members of the IFAC) issues International Standards on Auditing (ISAs).
- ISAs are specially written to try to incorporate the differences which will exist between accounting under various national laws.
- They do not override national law, but if national law conflicts with the best practice in an ISA, member bodies of IFAC from that country are required to encourage a change in the law to conform to the ISAs.

As the main regulatory body of Audit, IAASB will issue International Standard on Auditing (ISAs) through several steps as follows:

EXERCISE

Please complete the following diagram!

Matters to consider before accepting a client

The firm itself

- Whether the firm has sufficient resources in term of staff and time
- Whether it has sufficient experience, in term of client industry
- If client is based worldwide to do the audit

The client

Previous Auditor

- Communicate with previous auditor to find out if there are professional reasons why firm should not accept the client, e.g. off professional reasons.
- Permission to be obtained from clients first, if not granted, then don’t accept.

Pre-Condition

CHAPTER 3

CORPORATE GOVERNANCE

Learning Objectives

- Students are able to explain the objective and the importance of corporate governance,
- Students are able to explain the international codes of corporate governance,
- Students are able to understand the principles of the UK Corporate Governance Code,
- Students are able to understand different types of corporate governance structure,
- Students are able to identify corporate governance deficiencies and give relevant recommendations to tackle those deficiencies.

Corporate governance is the system by which companies are directed and controlled. Good corporate governance is important because the owners of a company and the people who manage the company are not always the same. Corporate governance is about ensuring that companies are run well in the interests of their shareholders and the wider community.

One of the international codes of corporate governance that is most relevant to auditors is the OECD Principles of Corporate Governance. The OECD Principles of Corporate Governance set out the rights of shareholders, the importance of disclosure and transparency and the responsibilities of the board of directors. OECD Principles of Corporate Governance include:

a. To promote transparency, fair markets, and efficient allocation of resources,
b. To protect shareholders' rights and ensure all shareholders are treated fairly,
c. To provide incentives relating to investment and to allow stock markets to function in a way that supports corporate governance,
d. To recognise the rights of stakeholders and to encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of enterprises,
e. To allow timely and accurate disclosure of material matters, and
f. To ensure companies are effectively guided and monitored.

This OECD Principles of Corporate Governance is then adopted by many nations across the globe, including the United Kingdom. The UK Corporate Governance Code is primarily relevant to listed companies although considered best practice for all companies. It uses ‘**comply or explain**’ principle, which means that the UK Corporate Governance Code is **voluntary** although listed and public interest entities must report on non-compliance and **explain** why the code has not been followed.

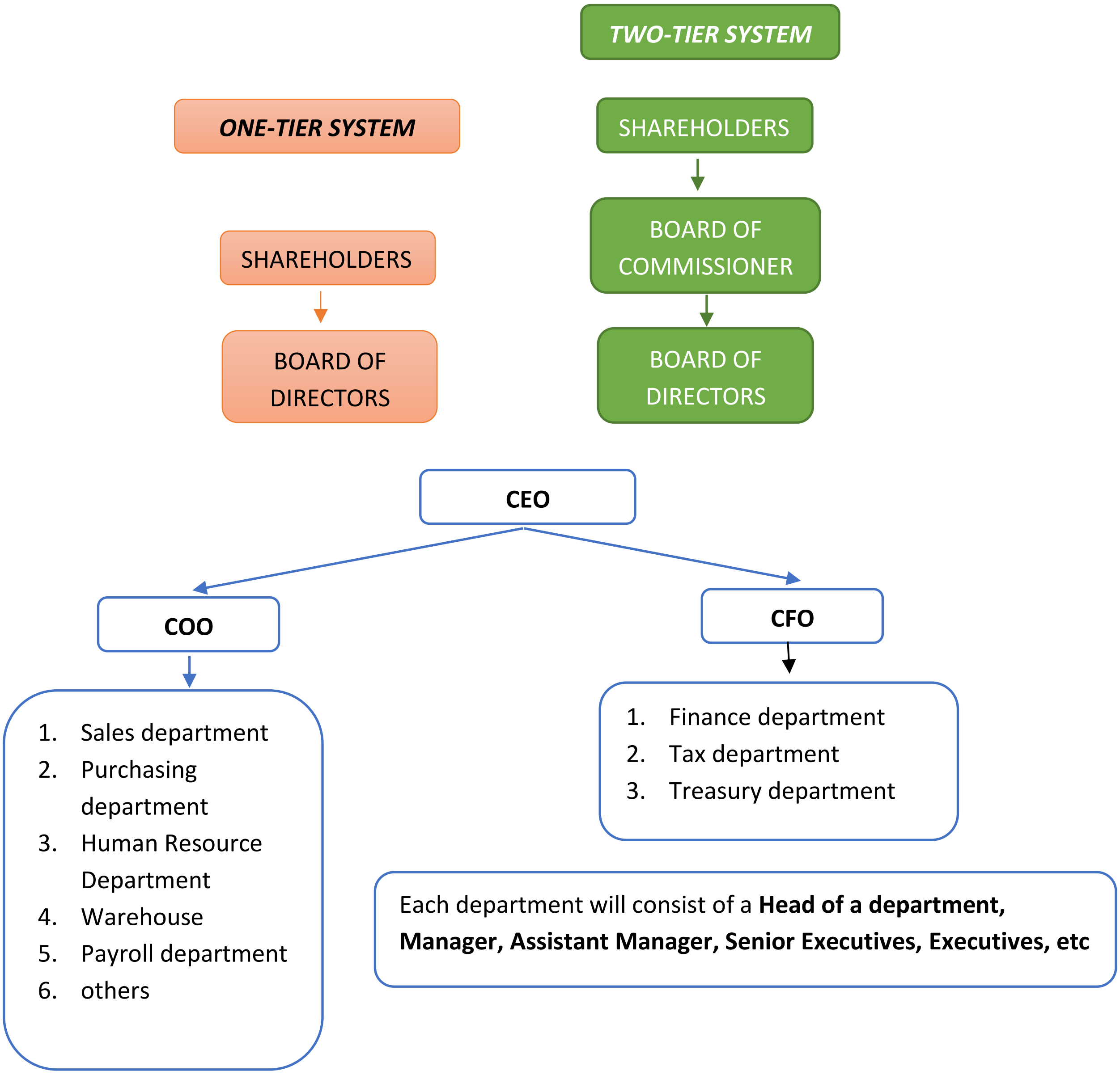
Principles of the UK Corporate Governance Code are as follows:

a. Board Leadership and Company Purpose
    i. Effective board leadership,
    ii. Promote long-term sustainable success, and
    iii. Directors should lead by example.
b. Division of responsibilities
    i. Independent chair leads the board,
    ii. CEO and chair should not be the same person, and
    iii. At least 50% of the board should be non-executive.
c. Composition, Succession, and Evaluation
    i. Board appointments made by Nomination committee (majority INEDs),
    ii. Appointments based on merit – best person for the job,
    iii. Combination of skills and experience
    iv. Annual re-election of all directors, and
    v. Chairman must be replaced after 9 years.
d. Audit, Risk, and Internal Control
    i. Board should ensure independence of Internal Audit and External Audit functions,
    ii. Board should manage risks and oversee internal controls,
    iii. Audit committee must be established (min 3 NEDs for large companies or 2 NEDs for small companies),
    iv. Chairman should not be a member of audit committee, and
    v. Audit committee should comprise of at least one member with financial experience.
e. Remuneration
    i. Remuneration set by Remuneration committee (min 3 NEDs),
    ii. Remuneration should promote long-term sustainable success,
    iii. Policy for setting remuneration should be formal and transparent,
    iv. No director should be involved in setting his own pay,
    v. Workforce pay should be considered when setting executive director’s pay, and

vi. NEDs paid according to time commitments and responsibilities.

Across the globe, there are two prominent types of corporate governance structure as follows:

- One-tier board system: is a corporate structure system which allows a single Board of Directors to make a strategic decision for a company. It comprises of executive and non-executive directors.
- Two-tier board system: is a corporate structure system that consists of two separate Boards of directors that govern a corporation. The roles and relationships between the two boards vary across countries. The structure is composed of two boards, the "Management Board" (Board of Directors), and the "Supervisory Board" (Board of Commissioners) where each of these have different roles.



Audit committee

Created to assist the board of directors in satisfying its oversight responsibilities in relation to financial reporting, external audit, internal audits, internal controls, and risk assessment systems.

Normally appointed from organization's BOD. It consists of at least 3 Non-Executive Directors.

AC can help reduce the workload of the Full Board

→ AC can play a role in protecting shareholders confidence

EXERCISE

The board of directors of Brother Co is concerned that they are not currently applying best practice in terms of corporate governance and are seeking to make improvements. The company currently has three non-executive directors (NEDs) on the board, who are paid a fee which changes annually depending on company performance. The NEDs all sit on the audit, nomination and remuneration committees. There are currently no formal documents setting out the responsibilities of these committees.

At present, Brother Co does not have an internal audit function, but the directors are establishing a team which will be responsible for a range of internal audit assignments. The only role still to be filled is the Head of internal audit. There are two potential candidates: Paul Belling, a consultant who helped design and implement the company's current control system, and Maria Marquez, who is currently an audit manager at Rossi & Bell, an audit firm which has never been used by Brother Co.

Out of the other three members of the proposed lA department, two of them have moved from other departments in Brother Co and one of the audit assistants has audit experience.

1. Which of the following should be included in a formal document regarding the responsibilities of the audit committee?
   (1) To monitor and review the effectiveness of the newly established internal audit function
   (2) To evaluate the balance of skills, experience and independence of board members
   (3) To take responsibility for the appointment and removal of the external auditors
   (4) To monitor and review the effectiveness of internal financial controls established by the company
   a. 1 and 2
   b. 3 and 4
   c. 1 and 4
   d. 2 and 3

2. Indicate which of the following options correctly describes the deficiency relating to NEDs' remuneration and makes a valid recommendation for improvement.
    a. Compromises NED Independence, NED should be remunerated on the same basis as the executive team
    b. Compromises NED motivation, NED remuneration should be based on the profit targets
    c. Compromises NED Independence, NED remuneration should be based on the time committed
    d. Compromises NED motivation, NED remuneration should be linked to the individual performance

3. Considering the following statements
    a. The OECD principles state that an annual audit should be carried out by an independent, competent, qualified auditor to provide assurance to the board and to shareholders.
    b. The board should effectively monitor management and be accountable to the company and shareholders.

   Indicate the true/false statement if any
    a. Both statements are true
    b. Both statements are false
    c. Only statement 1 is true
    d. Only statement 2 is true

4. Complete the sentences below with the most appropriate answers (choose one out of three available options).
   The head of internal audit should report to (finance director / audit committee / Chief executive). (Maria Marquez / Paul Belling) should be appointed as head of internal audit. The audit team requires (More senior staff with audit experience / No change to its current composition / more external staff to be appointed).

5. Communication of audit matters is the responsibility of whom?
    a. Chief Executive
    b. Chairman
    c. Auditors
    d. Those Charged With Governance

CHAPTER 4

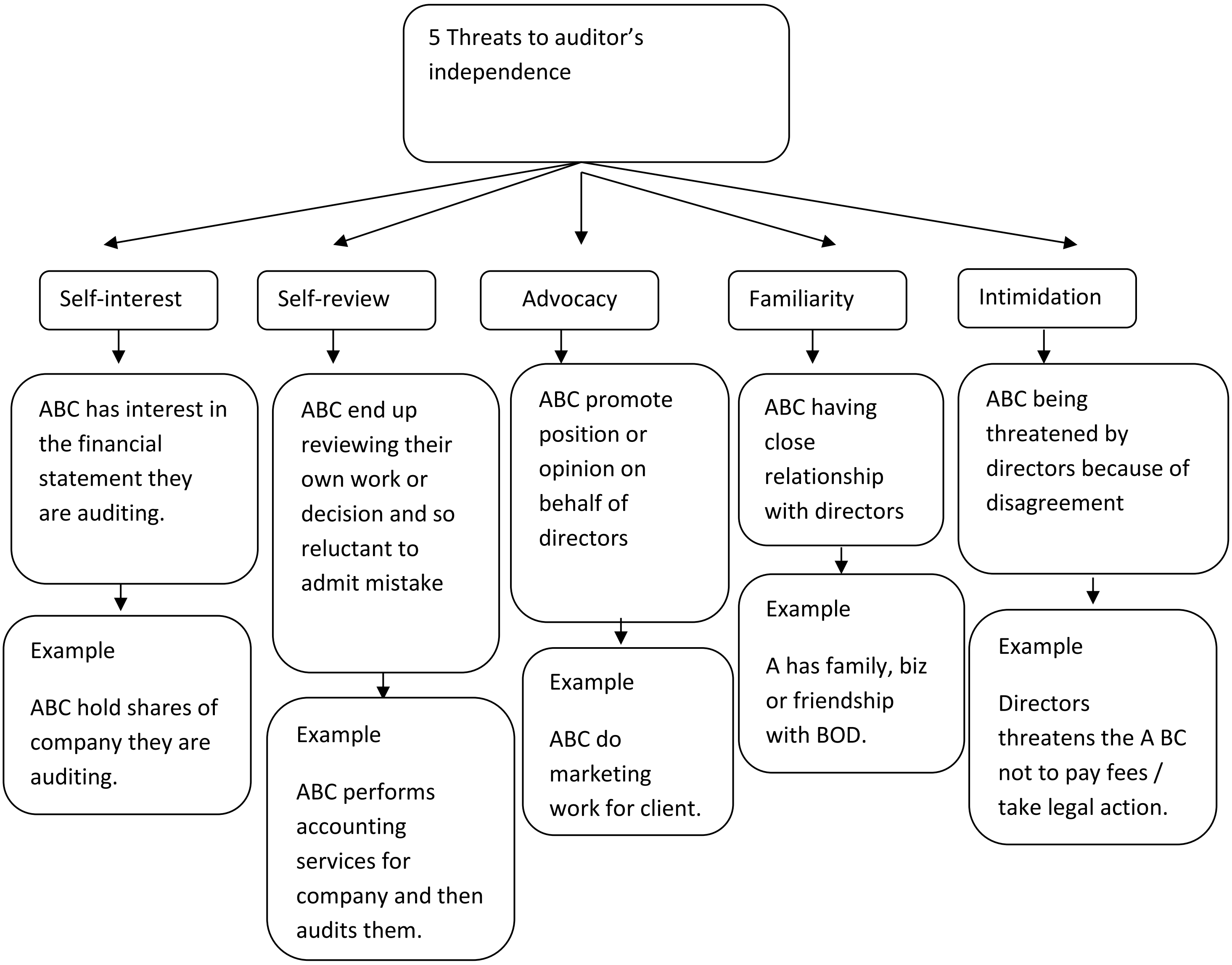
PROFESSIONAL ETHICS

Learning Objectives

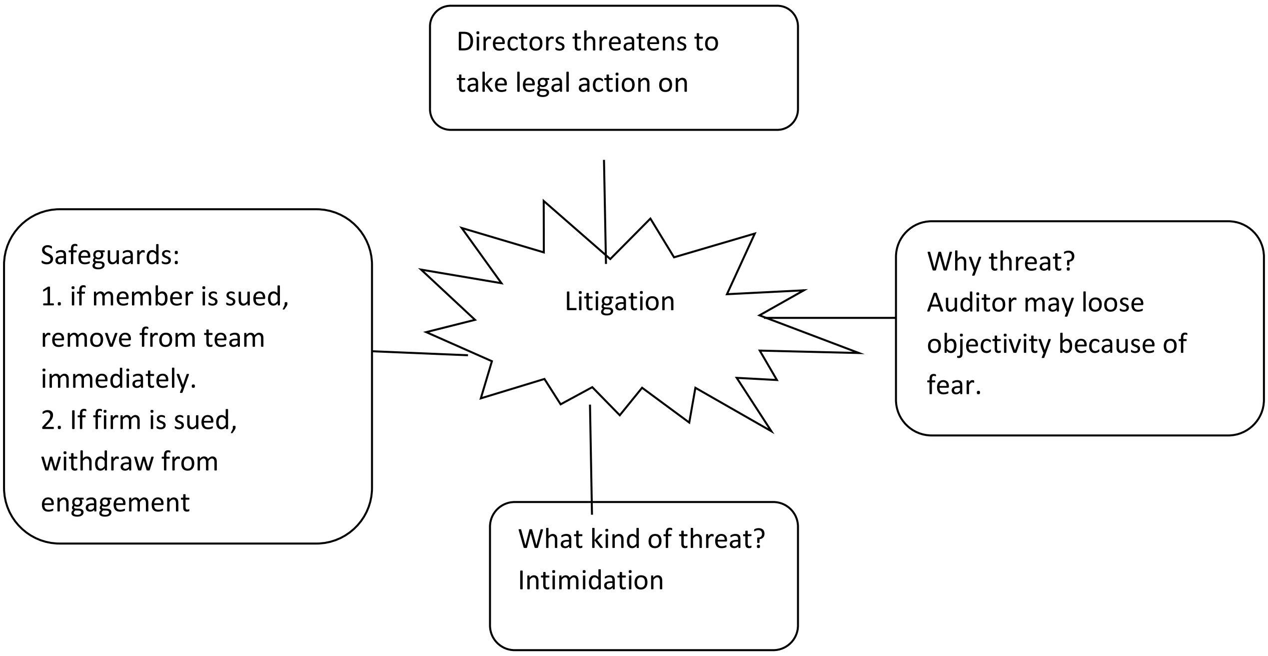
- Students are able to understand fundamental principles of professional ethics,
- Students are able to identify the threats to fundamental principles,
- Students are able to explain the safeguards to reduce the threats,
- Students are able to understand the appointment ethics prior to accepting the client.

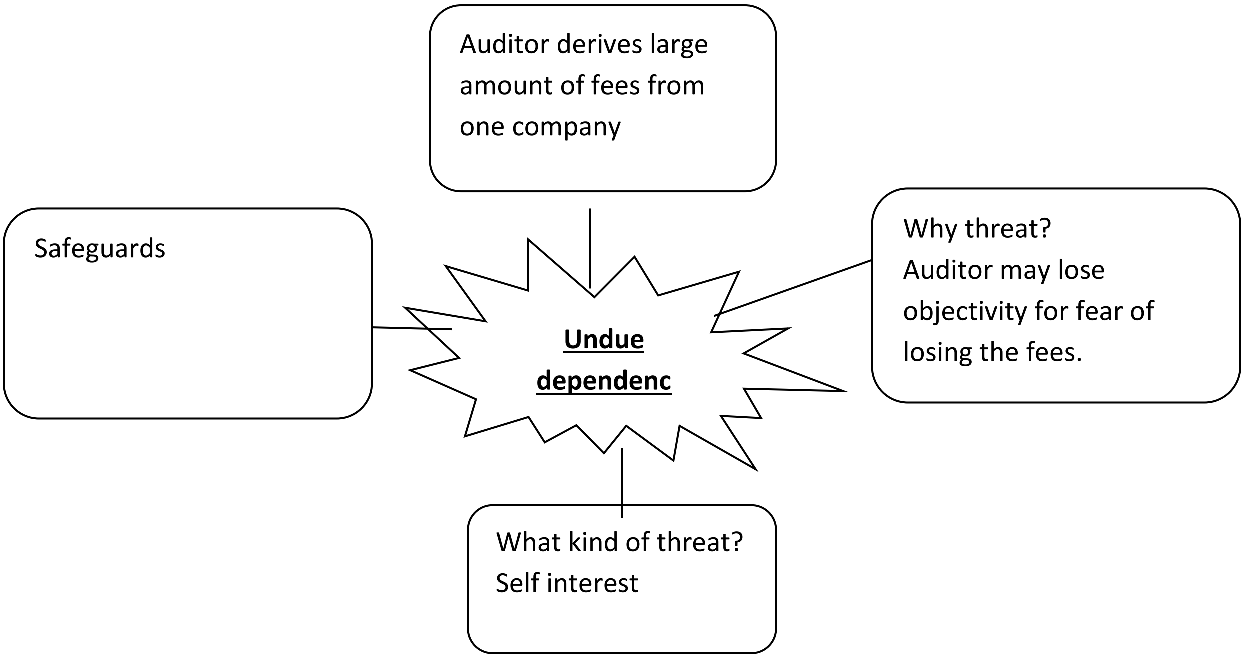
The ACCA's Code of Ethics and Conduct (2017) sets out the five fundamental principles of professional ethics and provides a conceptual framework for applying them. Those five fundamental principles (abbreviated by **OPPIC**) are as follows:

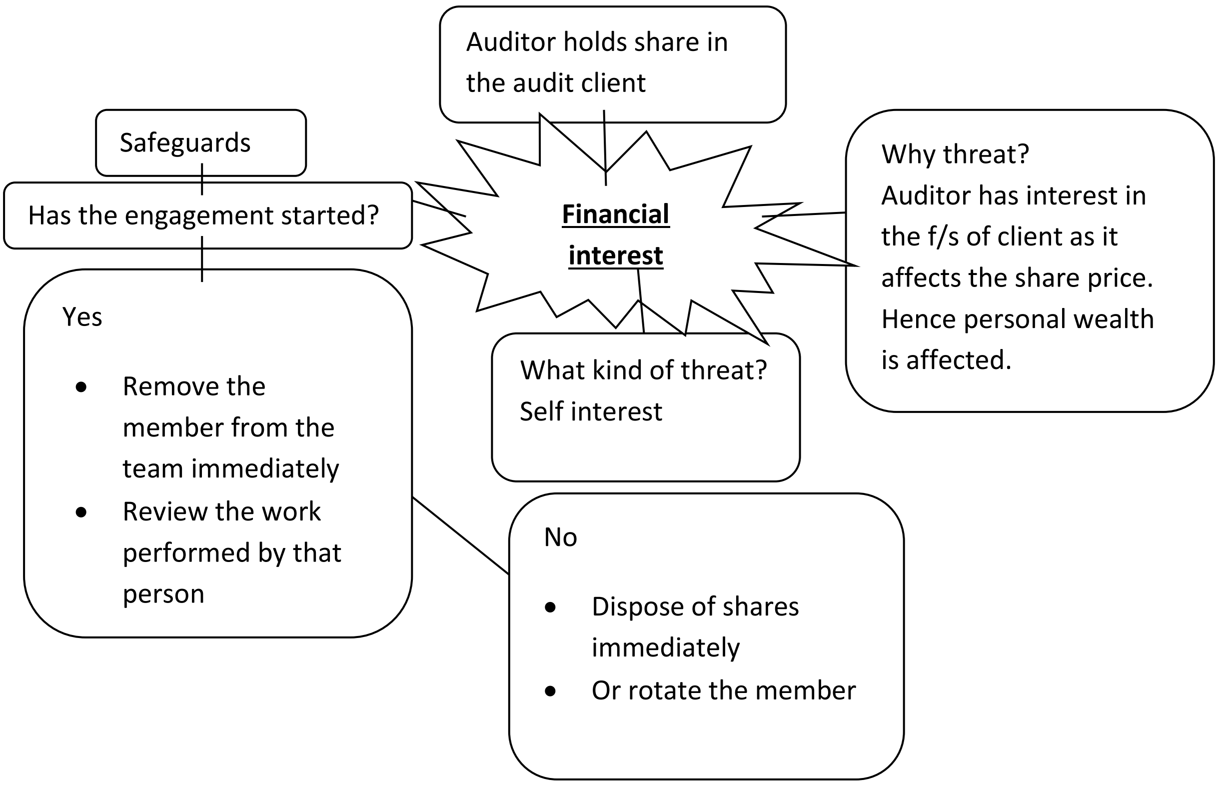
- **Objectivity –** Not bias, no conflict of interest,
- **Professional Competence and Due Care –** Do not accept work where it is out of our competency and should be diligent to update knowledge and skills,
- **Professional behavior –** Do behave with courtesy and consideration. A professional accountant should act in a manner consistent with the good reputation of the profession,
- **Integrity –** Be straightforward and honest in all professional relationship, and
- **Confidentiality –** Do not release data obtained during the audit work to the third party without any consent of the client.

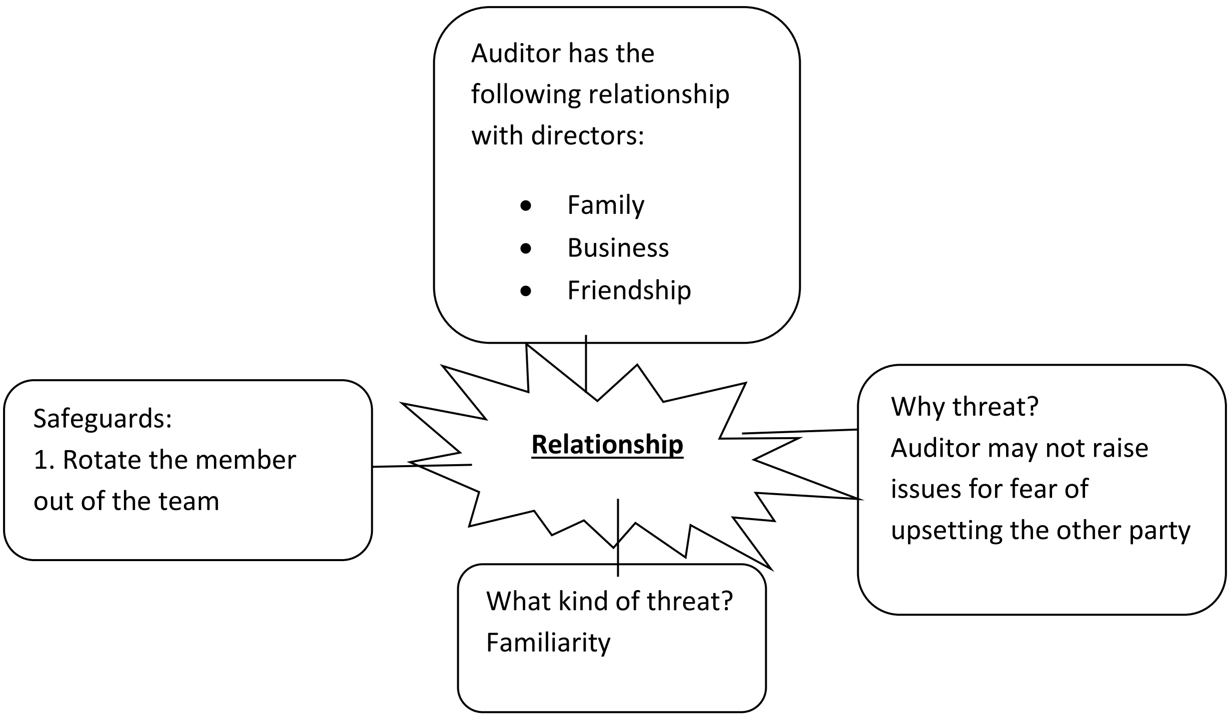

5 Threats to auditor’s independence
Self-interest
ABC has interest in the financial statement they are auditing.
Example
ABC hold shares of company they are auditing.
Self-review
ABC end up reviewing their own work or decision and so reluctant to admit mistake
Example
ABC performs accounting services for company and then audits them.
Advocacy
ABC promote position or opinion on behalf of directors
Example
ABC do marketing work for client.
Familiarity
ABC having close relationship with directors
Example
A has family, biz or friendship with BOD.
Intimidation
ABC being threatened by directors because of disagreement
Example
Directors threatens the A BC not to pay fees / take legal action.

Let's consider some scenario in detail






Financial interest
Auditor holds share in the audit client
Why threat?
Auditor has interest in the f/s of client as it affects the share price. Hence personal wealth is affected.
What kind of threat?
Self interest
Safeguards
Has the engagement started?
Yes
• Remove the member from the team immediately
• Review the work performed by that person
No
• Dispose of shares immediately
• Or rotate the member


Relationship
Auditor has the following relationship with directors:
• Family
• Business
• Friendship
Why threat?
Auditor may not raise issues for fear of upsetting the other party
What kind of threat?
Familiarity
Safeguards:
1. Rotate the member out of the team

Loan

Loan given to or taken from the client

Why threat?
1) Auditor fear collectability of the loan and may not raise issue.
2) Auditor may be obliged to please the client because have borrowed from them

Safeguards:
1. No loan can be given or taken from the client

What kind of threat?
Self-interest and intimidation

Gift & Hospitality

Auditor receiving present and services from the client

Why threat?
Auditor may lose their objectivity….may not raise issues so that they don't hurt the client

Safeguards:
1. Auditor can't receive gifts from the client unless it is modest

What kind of threat?
Self interest

Professional Duty of Confidence

- Information obtained should not be disclosed to 3rd party w/o client permission
- Don't use info for the personal advantage

Exceptions

Obligatory disclosure
1) if client perform treason, drug trafficking or terrorist offence

Voluntary disclosure

Conflict of interest

An Auditor
1) Competes directly with client
2) In business relationship with competitor of client
3) Perform service for 2 clients/competitors in dispute

Safeguards
1) inform client of the issue and obtain consent to act
2) Create Chinese walls within firm (Totally different team members)
3) Issue guidelines to members of engagement team on confidentiality
4) Get audit team member to sign confidentiality agreements
5) Send team members for training to get more knowledge on confidentiality ad conflict of interest

Meanwhile, there are also several issues need to be considered before accepting a new engagement or client, as follows:

- Independence & Objectivity
- Management integrity
- Professional Clearance
- Preconditions for an audit
- Money laundering (client due diligence)
- Reputation of the client
- Resources
- Professional competence
- Fees, and
- Risks.

There are thousands of scenarios that your examiner can create for exams, you have to be able to think of what goes wrong, link it to the threat and answer the question accordingly. Let’s look at the exercise here!

EXERCISE

UNISI Stores Co (UNISI) has been opening more than 20 stores. You are the audit senior of ABC Co and are planning the audit of UNISI Co for the year ended 31 December 20X8. This is a new client for your firm and your first year as an auditor, in order to familiarize yourself with UNISI, the audit manager has asked you to undertake some research in order to gain an understanding of UNISI, so that you are able to assist in the planning process.

Mr Leonardo is the Chief Executive Officer and Chairman of the Board of UNISI. He appoints and maintains a board of five executive and two non-executive directors. While the board sets performance targets for the senior managers in the company, no formal targets are set for each director and no review of board policies is carried out. Board salaries are therefore set and paid by Mr Leonardo based on his assessment of all the board members, including himself, and not their actual performance.

Internal controls in Atheltico are monitored by the senior accountant, although the company assumes that, as external auditors, your firm will carry out a detailed review of internal controls. UNISI does not have an internal audit department. Annual financial statements are produced, providing detailed information on past performance.

The company has established an audit committee, and all existing NEDs are members excluding the chairman who chairs the committee. All three members of the audit committee were previously involved in sales or production related roles. However, the company has not established an internal audit function to monitor internal controls.

ABC Co has been approached by UNISI Co to represent them in negotiations to resolve some outstanding issues with the taxation authorities. In addition to that, ABC & Co also provide several non-audit services with the current year fees to be received from UNISI Co will represent 17% of the firm's total fee income for the two consecutive years.

At today's date, 18% of last year's audit fee is still outstanding and was due to be paid three months ago. To compromise the late payment, the finance director has recommended to the audit committee of UNISI Co that this year's audit fee would be based on the company's profit before tax

There is expected to be considerable time pressure on the audit this year because the board want to get the audit done by the middle of February 20X9 so they can focus on operational issues.

Required:

Please identify and elaborate minimum 3 (three) ethical threat & its safeguard.

CHAPTER 5

AUDIT PLANNING AND DOCUMENTATION

Learning Objectives

- Students are able to explain the importance of audit planning,
- Students are able to explain the use of audit plan and audit strategy,
- Students are able to explain the objectives of audit documentation, and
- Students are able to explain differences between current and permanent audit files
- Students are able to explain differences between interim and final audit.

Audit planning is a very important part of the audit process because it sets the direction for the audit, based on an assessment of the risks relevant to the entity. An effective and efficient audit relies on proper planning procedures. The planning process is covered in general terms by ISA 300 Planning an Audit of Financial Statements (para. 4), which states that the auditor shall plan the audit so that the engagement is performed in an effective manner.

Audit strategy comes before the audit plan. The auditor formulates an overall audit strategy which is translated into a detailed audit plan for audit staff to follow. Audit strategy sets the scope, timing, and direction of the audit and it facilitates the development of audit plan. The audit strategy and audit plan shall be updated and changed as necessary during the course of the audit, with any changes, and reasons for them, documented. Factors to be considered in Audit Strategy:

1. Characteristics of the engagement
    - ✓ What financial reporting framework is being used
    - ✓ Any results of previous audits
    - ✓ Personnel involved in the audit
    - ✓ Locations involved
    - ✓ Information Technology used
2. Reporting Objectives and Nature of Communication
    - ✓ Audit timetable for reporting. Whether there will be an interim audit followed by final year end audit
    - ✓ Organization of all meetings with management needs be pre-planned

- ✓ All communication with third parties must be planned ahead

3. Significant factors
   - ✓ Materiality levels
   - ✓ Unusual / significant events
   - ✓ Selection of team members for the engagement
   - ✓ High-risk areas
4. Nature, Extent, and Timing of Resources
   - ✓ Level of seniority/expertise of team members
   - ✓ Quality control team of the audit engagement
   - ✓ Audit budget

The audit plan must include the following:

a. Nature, timing & extent of planned risk assessment procedures
b. Nature, timing & extent of further audit procedures at assertion level
c. Any other planned audit procedures required to comply with ISAs

All audit work including the audit plan must be documented: the working papers are the tangible evidence of the work done in support of the audit opinion. ISA 230 Audit Documentation (para. 7), states that 'the auditor shall prepare audit documentation on a timely basis'. It is important to document audit work performed in working papers for the following objectives:

- ✓ Enable reporting partner to ensure all planned work has been completed adequately
- ✓ Provide details of work done for future reference
- ✓ Assist in planning and control of future audits
- ✓ Encourage a methodical approach

Audit documentation: It's a record of auditor's work and also known **as working papers**

Importance of Audit working paper

1. Provides evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the audit.
2. Provides evidence that the audit was planned and performed in accordance with SAs.
3. Assists members of the partners and managers to direct, supervise and review the audit work.
4. Enables the engagement team to be accountable for its work
5. Retains a record of matters of continuing significance to future audit

Contents

1. Name of client – identifies the client being audited.
2. Year-end date – identifies the year end to which the audit working papers relate.
3. Subject – identifies the area of the financial statements that is being audited, the topic area of the working paper, such as receivables circularization.
4. Working paper reference – provides a clear reference to identify the number of the working paper, for example, R12 being the 12th working paper in the audit of receivables.
5. Preparer – identifies the name of the audit team member who prepared the working paper, so any queries can be directed to the relevant person.
6. Date prepared – the date that the audit work was performed by the team member; this helps to identify what was known at the time and what issues may have occurred subsequently.

For recurring audits, working papers may be split between **permanent audit files** and **current audit files.** Permanent audit files contain information of continuing importance to the audit. Current audit files contain information of relevance to the current year's audit.

Permanent audit files may include the following:

- Engagement letters
- New client questionnaire
- The memorandum and articles
- Other legal documents such as prospectuses, leases, sales agreement
- Details of the history of the client's business
- Board minutes of continuing relevance
- Previous years' signed accounts, analytical review, and reports to management
- Accounting systems notes, previous years' control questionnaires

Current audit files may include the following:

- Financial statements
- Accounts checklists
- Management accounts details
- Reconciliations of management and financial accounts
- A summary of unadjusted errors
- Report to partner including details of significant events & errors

- Review notes
- Audit planning memorandum
- Time budgets and summaries
- Representation letter
- Report to management
- Notes of board minutes
- Communications with third parties such as experts or other auditors

Current audit files must also contain working papers covering each audit area (e.g. inventory, cash, revenue etc) and these should include:

- A lead schedule including details of the figures to be included in the financial statements
- Problems encountered and conclusions drawn
- Audit programs
- Risk assessments
- Sampling plans
- Analytical review
- Details of substantive tests and tests of control

Interim audit

The interim audit is that part of the audit which takes place before the year end. The auditor uses the interim audit to carry out procedures which would be difficult to perform at the year end because of time pressure. There is no requirement to undertake an interim audit; factors to consider when deciding upon whether to have one include the size and complexity of the company along with the effectiveness of internal controls.

Final audit

The final audit will take place after the year end and concludes with the auditor forming and expressing an opinion on the financial statements for the whole year subject to audit. It is important to note that the final opinion takes account of conclusions formed at both the interim and final audit.

EXERCISE

<u>Let's do a simple timeline analysis.</u>

Client A approaches your audit firm on 30th Sept 2020 to become their auditor for the current year end.

Client A's current year end is 31/12/2020 (note: 31/12/2019 has been audited by other firms)

Based on the timeline below, what are the activities that will take place and when?

30/9/2019 → 30/10/2020 → 30/12/2020 → 15/1/2021 → 15/3/2021 → 15/4/2021

CHAPTER 6

RISK ASSESSMENT

Learning Objectives

- Students are able to differentiate between business risk and audit risk,
- Students are able to explain the components of audit risk,
- Students are able to differentiate between materiality and performance materiality, and
- Students are able to identify audit risk and how auditor's response to address those risks.

First, you should be able to distinguish between Audit Risk and Business Risk

Business Risk: Risk that could lead to a business failure,

Audit Risk: Risk that the auditors give an inappropriate opinion on financial statement.

Inherent risk is the susceptibility of an assertion to a misstatement that could be material, individually or when aggregated with other misstatements, **assuming there were no related internal controls**.

Control risk is the risk that a material misstatement that could occur in an assertion and that could be material, individually or when aggregated with other misstatements, **will not be prevented or detected** and corrected on a timely basis **by the entity's internal control**.

Detection risk is the risk that the **auditor's procedures will not detect a misstatement** that exists in an assertion that could be material, individually or when aggregated with other misstatements**.**

Audit Risk (AR)

- Risk that Auditor expresses **WRONG AUDIT OPINION**
- Function of **RISK OF MATERIAL MISSTATEMENT (RMM) & Detection risk (DR)**

RMM

- Risk of f/s containing material misstatement **prior to audit**
- **Hence Auditor ASSESSES RMM**

RMM

- Risk that audit procedures performed by the **auditor fail to detect a material misstatement.**

Materiality

Misstatement, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

Quantitative (amounts)
Relative size...of the amount

Benchamarks

5 to 10% of PBT
1-2% of Total Assets
½ -1% of turnover

A to consider individual error with LOW VALUE but when combined may become material in value

Quantitative (Nature)
Amount maybe low, but could influence decisions of users due to its prominence.

e.g.

Auditor needs to consider both quantitative and qualitative materiality individually and together as well.

Auditor can choose to calculate Performance Materiality... this is an amount that is below the materiality amount...and used for certain accounts only.

AUDIT RISK AND RESPONSE

For audit risk, there are at least 11 frequent types of risk appeared on the exam, so called "**FINDING ACID**" (**F**raud, **I**ncentive to manipulate, **N**on-compliance with laws and regulations, **D**isclosures are incomplete and inappropriate, **I**nappropriate management estimate/policy, **N**on-compliance with IAS/IFRS, **G**oing-concern assumption is inappropriate, **A**nalytical review, **C**ut-off error, Inappropriate transition from old to new system, and **D**etection risk). In answering the audit risk, you need to identify the risk by stating what kind of risk and state the reason why it is considered as a risk.

For audit response, there are 3 most-frequent types of responses appeared on the exam, such as Discuss (Oral) / Review (Document) / Reperform (Process/Work). In answering the audit response, your answer must include WHAT TO DO, WITH WHOM / WHAT DOCUMENT, FOR WHAT)

Types of Common Audit Risk	Audit Risk (what and why)	Auditor Response (how)
Fraud	There is risk that there are fraudulent transactions which need to be adjusted. Or if the frauds are undetected, the financial statements may contain error.	Discuss with director about what director do to detect another fraud/the details of investigation result/what they do to adjust financial statement Perform full substantive procedure in the high-risk area Audit team should maintain professional scepticism and be alert to the risk of further fraud
Incentive to manipulate (e.g. loan covenant, sales target)	There is a risk that profit will be overstated because there is incentive to manipulate	Review the significant estimate and judgement to detect any risk of material misstatement Audit team should maintain professional scepticism in order to detect any risk of material misstatement

Non-compliance with laws and regulations	There is a risk that (provision & expense will be understated or contingent disclosure will be required) because non compliance with laws and regulation Record Provision if it is probable >50%, or Contingent disclosure if it is possible <50%	Write a letter to company lawyers to know probability or likelihood success of any claim from customer/government/society The result of our letter to lawyer should be used to record provision or contingent disclosure.
Disclosures are inappropriate & incomplete	There is a risk that a disclosure of (PPE revaluation/inventory valuation/liability/share issue/bonus issue/proposed dividend/remuneration) is not complete or not appropriate.	Review a disclosure of liability in the financial statement to ensure compliance with relevant accounting standard/local legislation
Inappropriate management estimate/ policy	There is a risk that (depreciation) expense will be understated because of inappropriate management estimate or policy	Discuss with management about the depreciation policy to know the reasonableness. Review supporting documentation to assess the appropriateness.
Non-compliance with IAS/IFRS	There is a risk that expense may be understated and intangible assets overstated because of non-compliance with IAS/IFRS.	Detailed cost and net realisable value testing to be performed to assess how much the inventory requires writing down by. The auditor should discuss with the management related to their action to know the reasonableness The auditor should discuss with management about the accounting treatment and any necessary

		adjustments to ensure the compliance with IAS/IFRS IAS 2 (inventory) /IAS 10 (events after reporting period) / IAS 16 (PPE) /IAS 36(impairment loss) /IAS 37 (provisions) /IAS 38 (intangible assets)
Going-concern assumption is inappropriate	There is a risk that going concern assumption is inappropriate because liability is significantly increased	Discuss with the management about the going concern assumption to ensure going concern basis is reasonable Perform going concern testing, including the review of the cash flow forecast and other underlying assumption
Analytical Review	Operating margin (GP-operating expense) increase, gross margin (sales-COGS) decrease, there is a risk that operating expense understated and COGS overstated because there may be misclassification	Review the classification of operating expense and cogs to ensure appropriate classification of each account / to investigate any inconsistency/inappropriateness.
Cut-off error (e.g. goods in transit/cash in transit)	There is a risk of misstatement that the receivable is overstated and the cash is understated because of the cut-off error Goods in transit	Discuss with management as to whether the remaining plant and machinery ordered have arrived; if so, physically verify a sample of these assets to ensure existence and ensure only appropriate assets are recorded in the non-current asset register at the year end. Determine if the asset received is in use at the year-end by physical observation and, if so, if depreciation has commenced at an appropriate point. The auditor should perform detailed cut-off testing procedure around the year

		end to ensure the completeness and the accuracy of the receivable
Inappropriate transition from old to new system	A new sales ledger system There is a risk that sales is under/overstated due to incomplete/inappropriate transition from old to new system.	The auditors should discuss with the management about the details of the transition process and any control applied to ensure the completeness and accuracy. Review all data was transferred to the new system. Perform test of control and detail substantive procedures.
Detection Risk	Reliance on the IA (internal control / risk management/ financial statement) work There is a detection risk that an external auditor has difficulty in (plan the audit/understand entity/assess risk/test of control/perform substantive procedure) because of (time pressure/limited staff)	The engagement partner should discuss the timing of the audit with the finance director to understand if the audit can commence earlier, so as to ensure adequate time for the team to gather evidence. If this is not possible, the partner should politely inform the finance director that the team will undertake the audit in accordance with all relevant ISAs and quality control procedures. Therefore, the audit is unlikely to be completed earlier.

You are the audit supervisor of Fathimah & Co and are currently planning the audit of an existing client, Zhafran Pharmacies Co (Zhafran), whose year-end was 31 March 20x9. Zhafran Pharmacies is a pharmaceutical company, which manufactures and supplies a wide range of medical supplies, and has been your client for several years. The audit manager has attended a planning meeting with the new finance director and has provided you with the following notes of the meeting and financial statement extracts. You have been asked by the audit manager to undertake preliminary analytical procedures using the financial statement extracts.

Zhafran previous finance director left the company in April 20x8 after it was discovered that he had been claiming fraudulent expenses from the company for a significant period of time. A new finance director was appointed in Mei 20x8 who was previously a financial controller of a bank, and she has expressed surprise that Zhafran & Co had not uncovered the fraud during last year's audit.

The company started a number of initiatives during the year in order to boost revenue. Zhafran Co made an announcement in October 20X8 of its 'price promise': that it would match the prices of any competitor for similar products purchased. Customers who are able to prove that they could purchase the products cheaper elsewhere are asked to claim the difference from Zhafran Co, within one month of the date of purchase of goods, via its website. The company intends to include a refund liability of $0·25m, which is based on the monthly level of claims to date, in the draft financial statements.

In August 20x8, the financial controller of Zhafran Co was dismissed. He had been employed by the company for over 20 years, and he has threatened to sue the company for unfair dismissal.

Financial Statement Extracts for the Year Ended 31 March

	Draft	Actual
	20x9	20x8
	$'000	$'000
Revenue	25,230	21,180
Cost of sales	(15,840)	(14,015)
Gross profit	9,390	7,165
Operating expenses	(4,903)	(3,245)
	4,487	3,920
Inventory	2,360	1,800
Trade receivables	1,590	1,250
Cash	–	480
Trade payables	3,500	2,800
Overdraft	580	–

Calculate THREE ratios, for BOTH years, which would assist you in planning the audit of Zhafran Co.

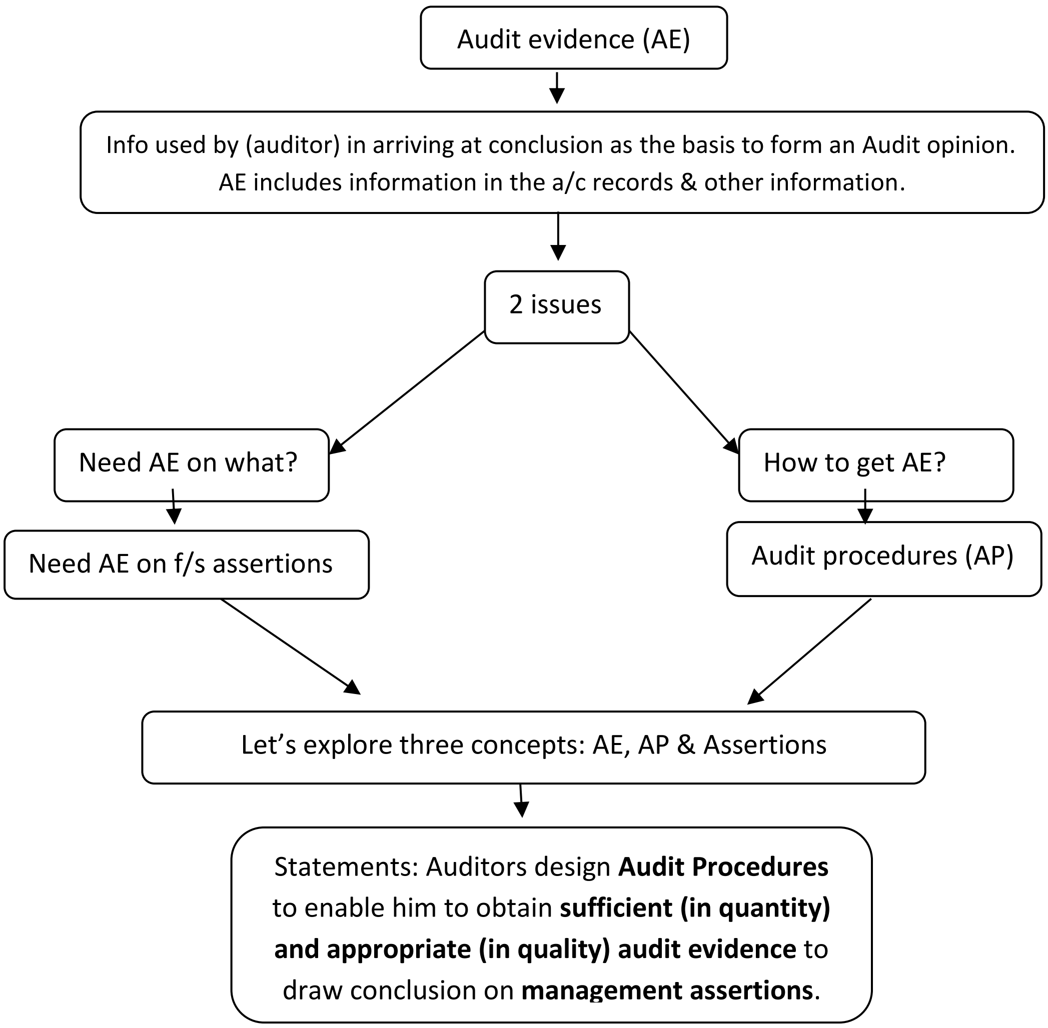
From a review of the provided information and calculated ratios, please describe **SIX audit risks** and explain the **auditor's response** to each risk in planning the audit of Zhafran Co.

CHAPTER 7

INTRODUCTION TO AUDIT EVIDENCE

Learning Objectives

- Students are able to define audit evidence,
- Students are able to explain the attributes of audit evidence,
- Students are able to explain financial statement assertions, and
- Students are able to identify relevant audit procedures to obtain a required audit evidence.



Management assertions

Expressions by management (expressed / implicit) via the f/s

Transaction and Event (T&E)

1. Occurrence-All T&E record (f/s), have occurred
2. Completeness-All T&E that should have been recorded, have been recorded
3. Accuracy- Amount for T&E have been recorded correctly
4. Cut off-All T&E have been recorded in the correct period
5. Classification-T&E recorded in the correct period
6. Presentation and disclosure-All transaction and event amount are presented appropriates and disclosures are complete and accurate as per relevant IFRS

Account Balance (A/B)

1. Existence-All A/B recorded f/s, exist…
2. Completeness-All A/B that should have been recorded, have been recorded
3. Right and obligation-company hold rights to assets and have obligation to liabilities
4. Valuation and allocation- A/B recorded at appropriate amount and valuation adjustment taken up
5. Classification: All account balances have been classified in the correct account
6. Presentation and disclosure: All transaction and event amounts are presented appropriates and disclosures are complete and accurate as per relevant IFRS

- Assertions for classes of **transactions**

Assertions	Original F/s amounts (b4 audit) Sales	What if? Auditor (DURING AUDIT) found that	Correct figure (After Audit)	Impact on the original figure is …
Occurrence (all transaction in the f/s happened during the year)	IDR 1 Million (Director asserts that 1 million sales happened during the year)	From the sales transaction in the f/s or ledger..IDR 200K sales actually didn't happen	IDR xxx (the correct figure after the auditor examines the account based on what the director said)	
Completeness (All transaction that should have been recorded, have been recorded)	IDR 1 Million (Director asserts that the sales figure above is complete, i.e. no sales transaction were missed out in the accounts)	The sales transaction in the f/s and ledger is not complete by IDR 200k…	IDR xxx (the correct figure after the auditor examines the account based on what the director said)	
Accuracy (All transaction have been recorded correctly in the financial statements)	IDR 1 Million (director assert that the sales figures above have been recorded correctly. i.e. all the sales transaction have been recorded correctly)	The transaction in the f/s and ledger are not correct by RM200k….	IDR xxx (the correct figure after the auditor examines the account based on what the director said)	

Assertions	Original F/s amounts (b4 audit) Sales	What if? Auditor (DURING AUDIT) found that	Correct figure (After Audit)	Impact on the original figure is …
Cut off (all transaction have been recorded in the correct period in the financial statements)	IDR 1 Million (Director asserts that the sales figures above have been recorded in the period it happened and not from other period)	200k worth of sales transaction in the ledger recorded belong to another period. i.e. the transaction happened in a different period but recorded wrongly in the current period	IDR xxx (the correct figure after the auditor examines the account based on what the director said)	
Classification (all transaction have been recorded in the correct accounts)	IDR 1 Million (Director asserts that the sales figures above have been recorded in the correct accounts)	200k worth of sales transactions in the ledger belongs to other income	IDR xxx (the correct figure after the auditor examines the account based on what the director said)	

- Assertions for classes of **account balances**

Assertions	Original F/s amounts (b4 audit) PPE	What if? Auditor (DURING AUDIT) found that	Correct figure (After Audit)	Impact on the original figure is ...
Existence (All accounts balance recorded in the financial statements exist)	IDR 1 Million (Director asserts that 1 million worth of PPE Physically exist in the company in the current year)	From the PPE ledger/account it was noted that 200k worth of fixed assets did not exist….	IDR xxx (the correct figure after the auditor examines the account based on what the director said)	

Assertions	Original F/s amounts (b4 audit) PPE	What if? Auditor (DURING AUDIT) found that	Correct figure (After Audit)	Impact on the original figure is ...
Completeness (All accounts balance that should have been recorded)	IDR 1 Million (Director asserts that 1 million worth of PPE is complete …i.e. there was no PPE missed out)	The PPE ledger is not complete by 200k, i.e. the fixed asset ledger is not complete….some of the fixed assets were not recorded despite physically existing in the premises	IDR xxx (the correct figure after the auditor examines the account based on what the director said)	
Valuation (all account balance has been recorded in the appropriate amount)	IDR 1 Million (Director asserts that the PPE figures above have been recorded correctly, i.e. all the PPE REALTED AMOUNTS have been recorded correctly)	The PPE ledger was over or under valued by 200k	IDR xxx (the correct figure after the auditor examines the account based on what the director said)	
Right and obligation (company holds right to assets and obligation to pay liabilities)	IDR 1 Million (Director asserts that the COMPANY owns assets and have obligations to settle all the liabilities)	200k worth of PPE does not belong to the entity but picked up in the ledger	IDR xxx (the correct figure after the auditor examines the account based on what the director said)	

Audit procedures (AP)

Designed to ensure that **MANAGEMENT ASSERTIONS** are correct

Analytical procedures

- Evaluation of financial & other information, & the review of plausible relationship in that information. It includes identifying fluctuations & relationship don't appear consistent with other relevant information or results

External confirmation

- Written response obtained directly from 3rd party, can be paper form, electronic form, etc
- Debtor/Creditor confirmation, Legal confirmation

Inspection

- Examination of records or documents (internal/external), (paper/electronic) can also include physical examination of non-current assets etc

Inquiry

- Interview / questioning process, seeking information from knowledgeable persons.
- Formal / Oral

Observation

- Looking at process/procedures performed by the client
- E.g. **Observation** of inventory count being conducted by the client staff

Re-computation

- Verifying Mathematical accuracy of figures
- Also called Recalculation
- E.g. Recalculation of interest charged for bank loan

Reperformance

- Independent execution of procedures / controls that was originally performed by the client
- E.g. the accountant (client) will normally match the 3

ACCA Past Exam December 2008 (Amended)

You are the audit manager in the firm of WSD & Co, an audit firm. You are planning the audit of Truse Co, which operates as a high street retailer and has 15 shops. All of the shops are owned by Truse Co and have always been included in the financial statements at cost less depreciation. The shops are depreciated over 50 years. However, you know from discussions with management that the company intends to include one of the shops, the flagship store, at a revalued amount rather than cost in the current accounting period. The revalued amount is expected to be materially above the carrying value of the shop. The valuation will be based on a management estimate. Management has explained that the reason for the revaluation is because the flagship store is located in an area where property prices have risen much more quickly compared to other shop locations. They consider the flagship store to be significantly undervalued on the statement of financial position. Management will not depreciate the revalued amount allocated to the flagship store's building because they maintain the building to a high standard.

1. Please identify the relevant assertions related to the audit of tangible non-current assets.
2. Please identify relevant procedures to provide appropriate audit evidence in respect of the completeness of non-current assets!
3. Please rank according to its reliability level! The audit junior has been assigned to the audit of the bank and cash balances of Truse Co. He has noted down the audit evidence he plans to obtain in respect of the bank and cash balances:
    a. Bank reconciliation carried out by the cashier
    b. Bank confirmation report from Truse Co's bank
    c. Verbal confirmation from the directors that the overdraft limit is to be increased
    d. Cash count carried out by the audit junior himself

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