



ICPAR
Unlimited possibilities



CPA
RWANDA

Technical Level

Audit and Assurance (AA1.4) Workbook

Institute of Certified Public Accountants of Rwanda
January 2026

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Acknowledgement.

We wish to formally acknowledge and appreciate all parties who contributed to the review and update of the revamped syllabus. Our sincere thanks go to the tutors and lecturers from various training institutions, our partners, and the Ministry of Finance and Economic Planning (MINECOFIN) for their valuable input, collaboration, and continued support.

Contents

Overview of the Module.....	1
Introduction to the Module.....	2
Unit A: Legal and Professional Standards in External Auditing.....	9
Unit B: Organisation's external auditing procedures.....	57
Unit C: Audit Techniques and Planning Methods.....	80
Unit D: Audit Planning and Risk Assessment.....	118
Unit E: Practical Audit Execution.....	155
Unit F: Audit Reporting and Documentation.....	175



Overview of the Module

CPA level	Technical level
Title	Audit and Assurance
Guided learning hours	70
Exam length	3 hrs

Introduction to the Module

The overall aim of this module is to develop your knowledge and understanding of the principles of external audit and the audit process and technical proficiency in the skills used when auditing financial statements.

The first two units set the scene for the audit process. The legal and professional framework, including ethical considerations, form the foundation stones of any audit and it is critical that auditors have a full understanding of these before embarking on the audit process. A full understanding and application of these core principles help ensure that users of audit reports have confidence in the conclusions reported at the conclusion of the audit exercise.

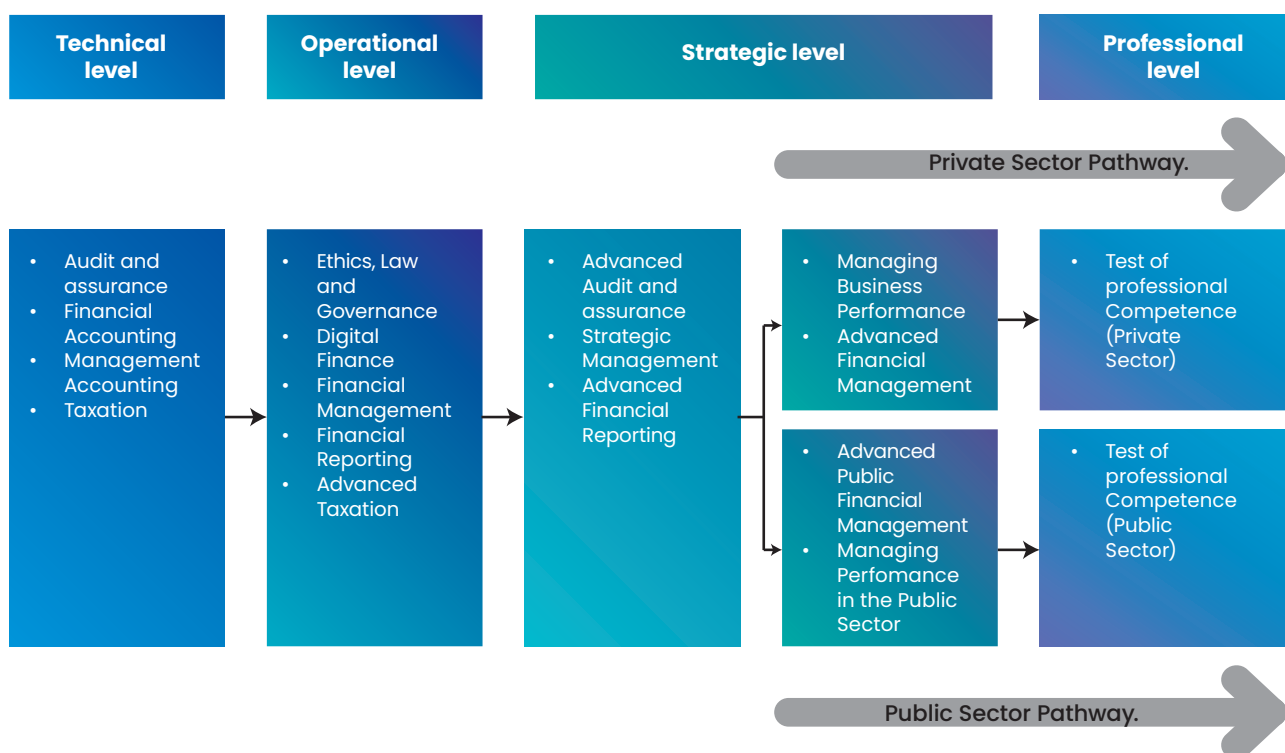
The next four units explain the key steps in the financial statement auditing process. As you progress through these units you will learn about professional requirements and evidence gathering techniques to be used. In particular, you will learn more about:

- **Audit planning** – identifying, analysing and responding to audit risks.
- **Audit execution** – gathering audit evidence and forming appropriate conclusions.
- **Audit reporting** – reporting audit conclusions to shareholders and other stakeholders.

Regulation 44 of 2022¹ requires that accredited auditors in Rwanda are required to comply with International Standards of Auditing (ISAs). As such, this module focuses on enabling you to deliver an ISA compliant audit. These standards are also widely used across the world.

¹ Regulation determining Requirements and Other Conditions for Accreditation of External Auditors for Regulated Institutions

Audit and Assurance is one of the four exam subjects required to be passed at the Technical Level of the ICPAR CPA Qualification. The full structure of the ICPAR CPA Qualification is shown below.



Key Competencies

- Demonstrate an understanding of the legal and professional standards required for an external auditor.
- Demonstrate an understanding of the organisation's external auditing procedures.
- Demonstrate an understanding of a range of auditing techniques and know which to use when planning audits on different aspects of the system.
- Demonstrate an understanding of a range of audit documentation and recognise the appropriateness.

What is Audit?

Google's English language dictionary defines "audit" as:

"An official inspection of an organisation's accounts, typically by an independent body"

This module will focus on audits that comply with International Standards of Auditing (ISAs). ISA 200 states that the objective of an audit is to:

"To enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework".

While it is unlikely that you will ever be examined on the exact definition of "audit", it is important that you have a good understanding of the general ideas around the concept. The essential features of a financial statements audit are shown below.

- An audit involves an examination of financial statements – the auditor is not responsible for the preparation of financial statements; that is the job of the organisation subject to audit. The role of the auditor is to examine the financial statements and issue an opinion on the “truth and fairness” of the information included.
- The result of an audit is an opinion to help the users of the financial statements – auditing therefore relies heavily on professional judgement, not merely facts. The purpose of the audit opinion is to provide additional information – or “assurance” – to the users of the financial statements.
- The auditor’s opinion refers to a true and fair view (being presented fairly in all material respects) – but true and fair is again a matter of judgement – it is not precisely defined for the auditor.

For the user of the information to feel confident in relying on the auditor’s opinion, the auditor should be independent of the entity subject to audit. Independence means the auditor has no significant interest in the organisation being audited. This ensures an objective professional view can be taken.

There is a wider definition of audit which covers any official examination on the nature or state or something (for example, tax audit, performance audit, forensic audit). However, the primary focus here will be the annual audit of the financial statements of limited companies. Where they might occur, any other audit applications will be clearly indicated for you in the text.

Internal v External Audit

This module focuses on external audit engagements. However, you should also be aware of the role and function of the internal auditor. The main differences are presented in the table below.

Aspect	Internal Audit	External Audit
What it does	Check how well an organisation is managing risks, following rules, applying internal controls and running its operations smoothly.	Make sure an organisation’s financial reports are accurate and follow the rules set by the government and other authorities.
Who does it	Staff within the organisation but not directly involved in the areas they are checking.	By external experts hired by the organisation but independent from its management
How often	Regularly, routine check-ups.	Usually happens once a year.
Why it matters	Helps the organisation improve its systems and avoid problems before they become bigger issues.	Gives confidence to investors and other outsiders that the organisation’s financial information can be relied upon.
Who is in charge	The organisation itself is responsible for planning and conducting internal audits.	External audit firms or individual CPAs hired by the organisation.

In summary, internal audits focus on how well an organisation is managing itself internally. In contrast, external audits focus on making sure the organisation's financial reports can be relied upon by external users.

Key Audit Concepts

As you progress through the module you will learn about many different audit concepts with detailed examples and explanations. However, for now, you should have a general understanding of the basic concepts shown below.

- **Code of Ethics:** auditors must behave (and be seen to behave) in a highly ethical way so that users of the financial statements have confidence in the audit opinion issued. ISA 200 requires that auditors follow the International Code of Ethics for Professional Accountants, issued by the International Ethics Standards Board for Accountants (IESBA). This is also commonly referred to as "the IESBA Code of Ethics."
- **Independence:** for the auditor's report and opinion on the Financial Statements to be believed and trusted, the auditor must be clearly independent of the organisation subject to audit.
- **Reasonable Assurance:** the audit provides confidence to users that the financial information presented can be relied upon. However, auditing is not an exact science; we must undertake audits to provide only reasonable assurance – not 100% certainty (i.e., it is "not absolute assurance").
- **Financial Statements:** reports that show a company's financial health. They include details about amounts earned (revenue), costs incurred (expenses), what it owns (assets), and what it owes (liabilities). These statements are like a report card for a business, helping owners, investors, and others understand how well the company is doing financially.
- **Assertions:** during the audit we will need to rely on assertions from management on various aspects of the Financial Statements. The audit process tests to what extent these assertions are valid.
- **Audit Evidence:** to form opinions on the Financial Statements we must obtain sufficient, appropriate audit evidence on which to base that opinion. We must also ensure that all steps in the audit process are fully documented.
- **Sampling:** testing a selection of items or transactions to form a conclusion about the population.
- **Professional Scepticism:** the auditor should adopt a questioning approach and a critical assessment of audit evidence obtained. This should include:
 - **A questioning mind** – being curious and not taking information at face value.
 - **A critical assessment of audit evidence** – evaluate the sufficiency and appropriateness of audit evidence obtained.
 - **Alertness to conditions** – always being aware of circumstance that may indicate possible audit issues.
- **Materiality:** we must ensure that the time and resources we put into an audit are worth any potential errors that we might find. For the audit of Financial Statements, a misstatement is only material if it will affect the views of users.

- **Material Misstatement:** inaccuracies or omissions in financial statements significant enough to influence the economic decisions of users based on those statements.
- **True and Fair:** the financial statements of an entity provide an accurate, unbiased, and comprehensive representation of its financial performance and position.
- **Audit Risk:** from the auditors' point of view, Audit Risk is the level of risk that we are willing to accept in relation to issuing an incorrect audit opinion. Essentially, the more audit work we do, the lower the audit risk. Audit risk can never be zero.

Public Sector v Private Sector Audit

This module will focus on the audit of private sector organisations such as limited liability companies. However, you should be aware that public sector organisations (e.g., central and local government, publicly owned companies) are also subject to audit. While the process followed is similar, you should be aware of some key differences; these are presented in the table below:

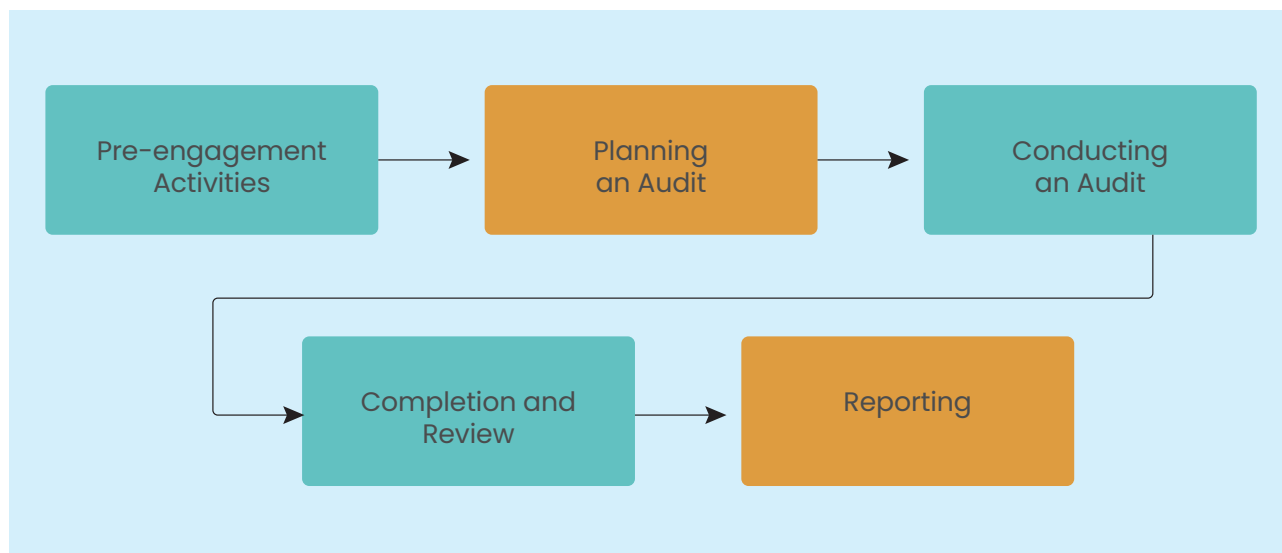
Aspect	Private Sector Audit	Public Sector Audit
Who they check	Businesses that are not run by the government. These could be small companies, big corporations, or non-profit organisations.	Government bodies and organisations that use taxpayer money. This could include anything from local city councils to big central ministries.
Why are external audits performed	To make sure these businesses are reporting their financial affairs correctly. This helps reassure the owners, investors, and others involved in the organisation that they can rely on the financial statements presented.	The main goal of public sector audit is to make sure taxpayer money is being spent wisely and following the rules. This helps keep government officials accountable and ensures transparency.
Who pays for the external audit	The organisation or its owners usually pay for these audits.	Governments pay for these audits using taxpayer funds
Rules to be applied in conducting the external audit	International standards of auditing (ISA) as well as any relevant national legislation.	International standards of supreme audit institutions (ISSAI) – essentially international standards of auditing with additional requirements relevant when auditing public sector bodies. Mandate and reporting requirements normally specified in law.

In conclusion, private sector audits check on businesses, making sure they are reporting their financial affairs properly. Public sector audits do the same but for government organisations, ensuring taxpayer money is used wisely and transparently.

In Rwanda, public sector audit is carried out by the Office of the Auditor General of State Finances headed by the Auditor General.

Overview of the Audit Process

An overview of the external audit process is shown in the diagram below.



Pre-Engagement Activities

The financial audit process commences with pre-engagement activities. In the context of private sector audit, the auditor conducts an assessment as to whether the audit engagement can be accepted or whether there are any professional reasons why it cannot.

A purpose of conducting the pre-engagement activities is, among others, to see whether the pre-conditions for audit exist. The pre-conditions for an audit imply that before the auditor accepts the engagement to conduct an audit of the financial statements of a client, the following must be in place:

- (i) The client should have applied an acceptable financial reporting framework.
- (ii) The client must understand its management responsibilities.
- (iii) The client must be prepared to provide to the auditor access to all the relevant documentation and any other information that will be sufficient and appropriate evidence.

The auditors will also perform other specific activities as part of the pre-engagement activities: assessing the ethical requirements and the competency of the team, preparing and issuing the audit engagement letter, conducting the audit entry conference, etc.

The satisfactory completion of the pre-engagement activities needs to be reviewed and signed off by the audit Engagement Partner (i.e. the most senior member of the audit team responsible for the audit).

Audit Planning

Based on the completion of pre-engagement activities, the next step is to prepare the audit plan for conducting the audit of the financial statements. ISAs are built upon a risk-based audit approach. At this stage of the process, the auditors mainly identify and assess the risks of material misstatements in the financial statements due to either fraud or error and, determine materiality. ISA 315 requires an assessment of the risk of material misstatements through obtaining an understanding of the entity and its environment. Based on the risk assessment, the auditor is required to identify the controls in place that would mitigate or eliminate the risks and to test the operating effectiveness of these controls. As a risk response (ISA 330), the auditors are required to design audit procedures, e.g. test of controls and substantive tests.

The audit plan needs to be reviewed and signed off by the engagement partner and to be updated until the completion of the audit and the issuance of the audit report.

Audit Execution

In the execution phase, which mainly involves fieldwork, the auditors perform the audit procedures designed at the planning stage, gather audit evidence and document conclusions based on audit procedures performed. The audit procedures performed by the auditors and the conclusions documented need to be reviewed and signed off by the engagement partner.

Completion and Review

ISA 500 requires auditors to gather sufficient appropriate audit evidence to provide an audit opinion on the financial statements. The audit evidence is gathered by performing specific audit procedures that respond to the risks identified at the assertion level or the financial statement level. In this phase of the audit process, the auditors evaluate the audit evidence gathered during the execution phase. The audit evidence needs to be evaluated for sufficiency and appropriateness, and it forms the basis for providing an audit opinion on the financial statements.

In this phase, the engagement partner considers the opinion and observations prepared by the auditor, ensuring that both are adequately supported by audit evidence and that professional judgement has been applied appropriately. All audit team members should ensure that the audit plan was followed in conducting the audit, hence the work performed by auditors needs to be reviewed and signed off.

Reporting

Based on the evaluation and review of the work done by auditors, the next step is to prepare and issue the final audit report. Typically, the audit report contains the auditor's opinion on the financial statements. The opinion is based on the evidence as to whether the financial statements are fairly presented or presented in accordance with the financial reporting framework. The final audit report should be reviewed and signed off by the engagement partner.

Unit A: Legal and Professional Standards in External Auditing.

Learning outcomes

- A.1 Explain the legal and ethical duties of auditors, including the content of reports and the definition of proper records.
- A.2 Explain the liability of auditors under contract and negligence including liability to third parties.
- A.3 Explain the relevant legislation and auditing standards.
- A.4 Define audit risk and how it applies to external audit.
- A.5 Define materiality and explain its application in auditing.

Introduction to Unit A

This unit begins to build your understanding of audit and assurance engagements. Before looking at the processes involved in conducting an audit assignment, we will look first at the foundations stones which set the context for any audit. We will consider the legal, regulatory and ethical framework; these are core to the audit process and without understanding these it will be difficult to put other pieces in their correct place.

The last two sections explain the two most important concepts in modern audit: audit risk and materiality. These concepts will be developed more in later units, but for now we need to build a decent understanding of the concepts both individually and how they relate to each other.

Purpose and Scope of Audit

As described above, the need for an external audit is related to the requirements of the users of the financial statements. While the primary users are shareholders (in the case of limited liability companies), there are also many other external parties who use the financial statements as a basis for making decisions regarding a company. Bankers, suppliers and lenders as well as potential investors, customers and employees all have an interest in the state of the company's financial affairs. The independent audit requirement fulfils the need for a professional opinion on whether those financial statements are objective, free from bias and manipulation and relevant to the needs of the users. In turn, this then allows users to place reliance (or not!) on the information reported upon which they can then make well informed decisions.

Advantages of an External Audit

The need for an external audit for companies primarily arises because the owners (typically shareholders) are not the ones managing the company. External audits provide owners with assurance that the financial information as presented by management can be relied upon. There are, however, certain advantages in having financial statements audited even where no statutory requirement exists for such an audit – in the case of a sole trader, partnership, club or society for example.

These advantages include:

- Any audit will give assurance to readers of the accounts (e.g. current investors, potential investors, senior managers of the business) that the accounts have been properly drawn up and give a fair presentation of the financial position of the business. For example, the members of a sports club might choose to have the club's accounts audited each year, to give assurance to the members that their subscription paid have been used properly and as reported in the financial statements.
- Disputes between stakeholders may be settled more easily. For instance, a partnership which has complicated profit-sharing arrangements may require an independent examination of those accounts to ensure as far as possible an accurate assessment and division of those profits.
- Major changes in ownership may be facilitated. If past accounts contain an independent auditor's report, for instance, where potential buyers require reliable financial information on which to base a realistic valuation.
- Applications to third parties for finance may be strengthened by the submission of audited accounts, as it adds credibility to the figures. For example, where a bank looks for security on which to provide loan financing.
- The audit is likely to involve an in-depth examination of the business and so will enable the auditor to give constructive advice to management on improving the efficiency of the business.

Disadvantages of an External Audit

There are some disadvantages to audit. These include:

- The cost of the audit must be paid by the organisation.
- The audit involves the client's staff and management in giving time to providing information to the auditor.

It is also worth pointing out that audits are of most use when there is a separation of ownership and management of an entity. However, in many cases the directors may also be the majority shareholders, even in relatively large companies. In these circumstances the need for audit would focus on the requirements of external parties, e.g., banks, tax authorities.

Accounting Records

All businesses need to satisfy the information needs of a wide range of stakeholders. Examples of typical stakeholders and their informational requirements include:

- Shareholders – information about company performance to aid investment decisions (e.g. whether to sell shares).

- Lenders/financial institutions –information about the liquidity of a business to make lending decisions (E.g. to provide a secured loan against the value of the business).
- Government institutions –information to support the calculation and payment of relevant corporation and income taxes.
- Management –information to support operational decisions and business strategy.
- Employees –information relating to the liquidity and performance of a business to assess job security and remuneration potential. Also useful in collective bargaining pay negotiations.
- Customers/suppliers – information about the liquidity of a business to decide whether to commit to long term trading partnerships. (e.g. how much credit to allow and on what terms).
- The public – require a wide range of data depending on the nature of the organisation.

Each stakeholder requires good quality information to assist their decisions. If the information they use is of poor quality, then they are likely to make bad decisions. To meet these requirements, company directors/management prepare reports for use by stakeholders. Some of the key documents are:

- Management accounts – these are typically used internally by management and employees for internal, operational and financial decisions. They include budgets/targets, performance to date and management commentaries. These are occasionally provided to lenders or potential investors to support loan/finance applications.
- Taxation computations and returns – these include summaries of sales and purchases to support sales tax and corporate tax payments and payroll reconciliations to support the payment of income taxes and social security payments.
- Financial statements – these incorporate summaries of historical financial performance (statements of comprehensive income and cash flows) and summaries of year-end assets and liabilities (statement of financial position). These are usually required by law for most companies and are used primarily by shareholders, although they are normally also made publicly available by regulators and/or the companies themselves.

Whilst there are different requirements for each piece of information produced there are two specific requirements of information reported in the financial statements that are significant. In accordance with the IFRS Conceptual Framework for Financial Reporting (Conceptual Framework), information presented in the financial statements must:

- Be relevant, meaning that the information must be capable of influencing the users' decisions.
- Faithfully represent the transactions and balances it is reporting; meaning it must be complete, neutral and free from error.

Financial information must also be understandable, produced on a timely basis, be comparable and be verifiable. It is vital that management have systems in place that support the preparation of this information. Management must also establish systems sufficient to keep such records if they are required by stakeholders and national regulatory authorities.

Duties and Rights of the Auditor

The auditor will typically have various detailed duties to perform to achieve the overall duty to report on whether the financial statements present a true and fair view. To fulfil these duties, various rights (or powers) are often given to the auditor.

The terms “rights” and “duties” are frequently used in legal terms. You may want to think of ‘duties’ in terms of “what the auditor is expected to do” and “rights” as “the authority which the auditor possesses – the power to carry out the necessary duties.”

Auditor Duties

The typical duties of the auditor are:

- To report to the shareholders on whether the financial statements of the company show a true and fair view and have been properly prepared in accordance with appropriate legislation.
- To consider whether the ‘other information’ in published documents which have not been specifically audited, such as the Directors’ Report (often required to be published as part of the company’s annual report and accounts) is consistent with the financial statements and if not, to state the fact in the audit report.
- To give the details required by statute in the auditor’s report, if not given in the financial statements themselves. These might include, for example:
 - Particulars of directors’ emoluments, pensions and compensation for loss of office.
 - Details of loans to officers.
 - Particulars of any directors’ emoluments waived.
 - Disclosure of transactions involving directors and other connected persons.
- To form an opinion as to whether certain defined statutory requirements have been complied with by the company.

Specific auditor reporting requirements in Rwanda are governed by Article 135 of the Companies Act 2021.

Companies Act 2021 – Article 135 – Auditors Report

The auditor’s report must comply with applicable auditing and assurance standards and state:

1. the scope and limitations of the audit;
2. whether the auditor has obtained all information and explanations that he or she has required;
3. whether proper accounting records have been kept by the company;
4. the proof that there is no relationship no interests and debt in the company;

5. whether the annual balance sheet complies with the international accounting standards;
6. the auditor's opinion and problems that are linked with the company's management;
7. the auditor recommends actions to correct problems identified during the audit; and
8. whether, in the auditor's opinion, according to the best of his information and the explanations given to him as shown by the accounting and other documents of the company, the annual accounts comply with Article 125 and Article 127 of this Law as the case may be, and where they do not, the areas in which they fail to comply.

The auditor of a company must submit the report under Paragraph One of this Article to the shareholders of the company.

In the case of a public company listed on the stock exchange the audit report is published in at least one (1) of the most widely circulated newspapers in Rwanda.

It is important to remember that the auditor has no specific statutory duty to detect fraud. However, if a material fraud affects the truth and fairness of the financial statements then this should be detected by audit work; the auditor has a duty to design procedures to give reasonable assurance of detecting material misstatements whether caused by fraud or error as set down in ISA 250.

Auditor Rights

The rights or powers given to auditors by legislation are designed to ensure that they can fulfil their duties and responsibilities to the shareholders. These rights are fundamental to their independence.

Typically, statutory rights of the auditor are as follows:

- The right of access at all times to the books, records, documents and accounts of the company. The auditor must obviously exercise this right with discretion so as not to disrupt unnecessarily the company's operations. Equally, if the client refuses access to the records, the auditor will never seek access to them forcibly, or even through the courts. The auditor would instead consider either resigning or modifying the auditor's report. Auditors must report to members if in their view proper accounting records have not been maintained and this could not be done without the right of access to such records.
- The right to require from the officers (principally the "directors") of the company such information and explanations as the auditors think necessary for the performance of their duties. The auditors must report to shareholders if they have not received the explanations or information required from the management and directors. It follows that they must be given the right to require such information and explanations. An officer intentionally making a false statement to the auditors, knowing it to be false, may be committing a criminal offence.

Companies Act 2021 – Article 134 – Auditor’s right of access to information

“The Board of Directors of a company ensures that its auditor has a right of access at all times to the accounting records and other documents of the company, and that the auditor is entitled to require from any director or employee of the company such information and explanation as the auditor thinks necessary for the performance of his or her duties as auditor”.

- **The right to:**

- Receive all notices relating to any shareholders’ meeting of the company.
- Attend any shareholders’ meeting (CA 2021 Art 136).
- Be heard at any shareholders’ meeting on any part of the business which concerns them as auditor. It is obviously important for the proper discharge of their duties that the auditor should be aware at first hand of what happens at shareholder meetings. Their right to speak at a meeting does NOT, if exercised, relieve them of their duty to make a comprehensive auditor’s report to the shareholders at the end of the audit process.
- Be sent by the company a copy of a notice of intention to propose their removal or replacement and the right to make written representations to shareholders about information relevant to the change of auditor of which they should be made aware. For example, any potential disagreements with management. (CA 2021 Art 140).
- Upon resignation, to require the directors to call an extraordinary general meeting.
- To attend and be heard at that and any other meeting.

Professional Scepticism

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

ISA 200 (Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs) states that auditors must plan and perform an audit with an attitude of professional scepticism, recognising that circumstances may exist that cause the financial statements to be materially misstated. This requires the auditor to be alert to:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by ISAs.

Professional scepticism needs to be maintained throughout the audit to reduce the risks of overlooking unusual transactions, over-generalising when drawing conclusions, and

using inappropriate assumptions in determining the nature, timing and extent of audit procedures and evaluating the results of them.

Professional scepticism is also necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses from management and those charged with governance.

Professional Judgement

Professional judgement is the application of relevant training, knowledge and experience in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

ISA 200 also requires the auditor to exercise professional judgement in planning and performing an audit of financial statements. Professional judgement should be applied throughout the audit process but is especially relevant in considering the following areas:

- Materiality and audit risk.
- Nature, timing and extent of audit procedures.
- Evaluation of whether sufficient appropriate audit evidence has been obtained.
- Evaluating management's judgements in applying the applicable financial reporting framework.
- Drawing conclusions based on the audit evidence obtained.

Auditors Report

You should have a general awareness of the format and content of an independent auditor's report. This will be considered in more detail later in the module.

ISAs 700, 701, 705 and 706 give detailed guidance on how audit opinions should be formed and structured. They also include examples of reports that can be tailored to suit specific circumstances, depending on the audit being performed. An example from ISA 700 is presented below. You should note the following key headings within the example report:

- a title identifying the person(s) to whom the report is addressed
- the auditor's opinion on the financial statements.
- the basis of the auditor's opinion.
- responsibilities of management.
- responsibilities of the auditor.
- the auditors' signature and address.
- the date of the auditor's report.

ISA 570 also addresses audit reporting requirements in relation to "going concern" to be covered in the Strategic Level course on Advanced Audit and Assurance.

Example Audit Report – ISA 700

INDEPENDENT AUDITOR’S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Opinion

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

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

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor’s Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants’ Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701.]

Other Information [or another title if appropriate such as “Information Other than the Financial Statements and Auditor’s Report Thereon”]

[Reporting in accordance with the reporting requirements in ISA 720 (Revised) – see Illustration 1 in Appendix 2 of ISA 720 (Revised).]

Responsibilities of Management and Those Charged with Governance for the Financial Statements²

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

- In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.
- Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation or national auditing standards. The matters addressed by other law, regulation or national auditing standards (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the ISAs may be combined (i.e., included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the ISAs where such a difference exists.

The engagement partner on the audit resulting in this independent auditor's report is [name].

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

[Auditor Address]

[Date]

An unmodified opinion provides reasonable assurance (not a guarantee) that an independent audit has not discovered any uncorrected material (i.e. significant) misstatements and that the financial statements give a true and fair view.

You should note that it is also possible for the auditor to issue a modified opinion. This may occur when the auditor is either of the opinion that there is a material misstatement in the financial statements, or when the auditor has been unable to obtain sufficient appropriate evidence upon as a basis for the audit opinion.

Ethical Considerations

As already mentioned above it is critical that auditors adhere to the highest ethical standards in everything they do. It is vital to the public image and credibility of the profession that the auditor is seen to be behaving in an acceptable manner in addition to actually complying with the ethical requirements. It is important that users of the financial statements have confidence that they can rely on the audit opinion issued on the financial statements so that they are able to place reliance on the information reported.

International Standards state that auditors should comply with the highest ethical standards and provide guidance on how, specifically, auditors should ethically behave.

ISA 200 defines requirements relating to an audit of financial statements.

“The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise Parts A and B of the International Ethics Standards Board for Accountants’ Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements together with national requirements that are more restrictive.”

ICPAR has issued an ethical framework² which provides principles which are closely aligned to the IESBA Code. The ICPAR Code of Ethics also provides more guidance by way of examples of potential issues and suggested mitigating measures. These principles, with some examples, are provided in more detail below.

The ICPAR code of ethics lays out the fundamental principles to be followed by ICPAR members:

- Integrity. A member should be straightforward and honest in all professional and business relationships.
- Objectivity. A member should not allow bias, conflict of interest or undue influence of others to override professional or business judgements.
- Professional competence and due care. A member has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service.
- Confidentiality. A member should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there

² https://www.icparwanda.com/download_dir/14.pdf

is a legal or professional right or duty to disclose. Any information acquired should not be used for the personal advantage of the member or third parties.

- Professional behaviour. A member should comply with relevant laws and regulations and should avoid any action that discredits the profession.

The ICPAR conceptual framework requires each member to identify, evaluate and address threats to compliance, rather than merely complying with a set of specific rules such as those laid down in the IESBA Code.

If the threats are significant, then you need to identify and apply safeguards to eliminate the risk arising from the ethical threat or to reduce it to an acceptable level. If no appropriate safeguards are available, then you need to eliminate the activities causing the threat or decline the engagement or discontinue it as the case may be.

Advantages of an Ethical Framework

The circumstances in which members operate may give rise to specific threats to compliance with the fundamental principles. However, it is impossible to define every situation that creates such threats and to specify the appropriate mitigating action. In addition, the nature of engagements and work assignments may differ. Using such a framework has several advantages.

- A framework allows you to consider the ethical threats for every given situation and to act accordingly.
- Rules do not always cover all situations.
- Rules need to be constantly amended to live in a rapidly changing environment.

Integrity, Objectivity and Independence

Auditor integrity, objectivity and independence is essential to ensure that the work and professional opinion of the auditor can be relied upon. The auditor should ensure that they perform their work in a manner which is honest and straightforward.

Auditors should be able to demonstrate that they have acted in an honest and straightforward manner by, for example:

- Preparation, and agreement, of a letter of engagement with each client to confirm the nature and extent of services to be provided.
- Communication and agreement in advance regarding the basis upon which audit fees will be charged, which is normally included in the letter of engagement.
- Not having a personal interest in the business activities of a client, other than as auditor and professional accountant, for which audit fees will be charged on an agreed basis.
- Compliance with all relevant laws and professional regulations guiding the conduct of the audit engagement.

It is important that the auditor can provide an independent opinion of the financial statements subject to audit.

- An auditor needs to be and seen to be independent. He must have independence of mind and independence in appearance.

- Independence is a state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allows an individual to act with integrity and exercise objectivity and professional judgement.
- An auditor needs to avoid facts and circumstances that are so significant that a reasonable and informed third party would reasonably conclude an auditor's integrity, objectivity or professional scepticism has been compromised.
- Public confidence in the operation of capital markets and in the conduct of public interest entities depends upon the credibility of the opinions and reports issued by auditors.

There are several potential threats to independence that can be broadly classified into the following categories:

- Self-interest: the auditor has a financial or other personal interest that could influence their professional judgement or objectivity.
- Self-review: the auditor reviews their own work, or the work performed by their firm as part of the audit. This threat can lead to biased judgements, as the auditor may be inclined to overlook errors or issues in their previous work to avoid admitting mistakes.
- Management threat: the auditor assumes the role or responsibilities of management or is perceived to do so.
- Advocacy: the auditor acts in a way that supports or advocates for the client's position or interests to the extent that their objectivity and independence are compromised.
- Familiarity: the auditor becomes too familiar with or too sympathetic to the client, its management, or employees, which can impair their objectivity and professional scepticism. This type of threat can develop over time, especially when auditors have a long-standing relationship with the client.
- Intimidation: the auditor feels pressured or coerced by the client or its management in a way that may compromise their independence, objectivity, or professional judgement. This threat can may lead auditors to refrain from challenging the client's assertions or to alter their audit approach to accommodate the client's wishes.

The table below identifies some potential threats to auditor integrity, objectivity and independent with some possible mitigation measures. Note that these are only examples, and an auditor should be guided by the principles at all times. If in doubt, take the more cautious approach!

Threat	Possible Mitigating Actions
Self Interest	
<p><u>Gifts and hospitality</u></p> <p>Acceptance of goods (or money), services or hospitality from an audit client can create self-interest and familiarity threats as the auditor may feel indebted to the client.</p>	<p>Normally, gifts may only be accepted by a firm or audit team member if:</p> <ul style="list-style-type: none"> • Trivial and inconsequential. • Offered in the normal course of business without intention to influence decision making. <p>The offer of gifts and hospitality should be documented in the audit file even if refused.</p>
<p><u>Owning shares/financial interests</u></p> <p>The auditor may want to maximise return from the investment and overlook audit adjustments that would negatively affect the value of their investment.</p>	<p>Any member of the audit team or their immediate family must not have a financial interest in the audit client therefore they must dispose of the shares immediately or be removed from the team.</p>
<p><u>Potential employment with an audit client</u></p> <p>If a member of the engagement team has reason to believe they may become an employee of the client, they will not wish to do anything to jeopardise their potential future employment</p>	<p>The policies and procedures of the firm should require such individuals to notify the firm of the possibility of employment with the client.</p> <p>Remove the individual from the assurance engagement.</p> <p>Review by an appropriate reviewer (separate from the core audit team) of any work/decisions made by that individual during the audit.</p>
Self - Review	
<p><u>Accounting and bookkeeping services</u></p> <p>Audit firm provide accounting services on information subject to audit.</p>	<p>Do not provide accounting and bookkeeping services, including payroll services, unless:</p> <ul style="list-style-type: none"> • Services are of a routine or mechanical nature. • Safeguards are implemented (e.g. separate teams provide accounting services and the audit)
<p><u>Tax planning and other advice</u></p> <p>Tax advice provided related to information subject to audit.</p>	<p>The firm should not provide tax advice that depends on a particular accounting treatment and is material to the financial statements.</p> <p>Other tax advice is allowable with safeguards – for example, by using separate teams.</p>

Threat	Possible Mitigating Actions
Management Threat	
<p><u>Temporary staff assignments</u></p> <p>A self-review threat will be created if staff are seconded from the audit firm to the client. If the person was assigned to the audit, they would be evaluating work for which they had been responsible during the temporary assignment and may not detect errors in their work or be willing to report such issues if they are identified.</p>	<p>The person should not assume management responsibilities.</p> <p>The client should be responsible for directing and supervising the person.</p> <p>The loaned staff member should not be a member of the audit team.</p>
Advocacy	
<p>Representing the client in court or in any dispute where the matter is material to the financial statements.</p>	<p>Likely that no mitigating action would reduce threat to an acceptable level. Do not provide the advocacy service or do not perform the audit.</p>
Familiarity	
<p><u>Long association of senior personnel</u></p> <p>Using the same senior personnel in an engagement team over an extended period may cause the auditor to become too trusting/less sceptical of the client resulting in material misstatements going undetected.</p> <p>The firm should consider:</p> <ul style="list-style-type: none"> • The length of time on the audit team. • The structure of the firm. • Whether the client's management team has changed. • Whether the complexity of the subject matter has changed 	<p>Rotate senior personnel off the audit team.</p> <p>Independent internal or external quality reviews of the engagement</p>

Threat	Possible Mitigating Actions
<p><u><i>Family and other personal relationships</i></u></p> <p>A familiarity threat (and self-interest threat or intimidation threat) may occur when a member of the engagement team has a family or personal relationship with someone at the client who is able to exert significant influence over the financial statements.</p> <p>Consideration should be given to the possibility that such a threat may also arise when a partner (or employee) of the firm has a family or personal relationship with someone at the client who is able to exert significant influence over the financial statements, even when the individual is not a member of the engagement team.</p>	<p>Remove the individual from the engagement team.</p> <p>Structure the engagement team so that the individual does not deal with matters that are the responsibility of the close family member.</p> <p>Record all such relationships in the audit file and discuss with the wider team. (transparency)</p> <p>Note – Article 133 (2) of the Companies Act 2021 prohibits anyone being appointed as an auditor where their partner is a director or employee of the company subject to audit.</p>
<p><u><i>Audit staff leave the firm to join the client</i></u></p> <p>A self-interest, familiarity or intimidation threat may arise where an employee of the firm becomes a director or employee of an audit client (in a position to exert considerable influence over the financial statements).</p> <p>The threat is significant if significant connection remains between the employee and the audit firm such as entitlement to benefits or payments from the firm, or participation in the firm's business and professional activities.</p>	<p>Perform an engagement quality review.</p> <p>Assign additional senior staff with awareness of the responsibilities of the previous audit firm employee/partner.</p>

Threat	Possible Mitigating Actions
<p>The firm should consider:</p> <ul style="list-style-type: none"> • The position taken at the client. • The involvement the person is likely to have with the audit team. • The length of time since the individual was a member of the audit team 	
Intimidation	
<p><u>Fee dependency</u></p> <p>Over-dependence on an audit client could lead the auditor to ignore adjustments required in the financial statements for fear of losing the client (and associated fees).</p>	<p>If fees from an audit client represent a substantial proportion of the firm's total fees, the firm should implement safeguards such as:</p> <ul style="list-style-type: none"> • Increasing the client base to reduce dependence on the client. • Having an appropriate external reviewer review the audit work.

Confidentiality

There is a duty of confidence to the client and auditors should always respect the privacy of information relating to client affairs. The principle is twofold. Firstly, you should refrain from disclosing any information acquired without proper authority to do so unless there exists a legal or professional right or duty to disclose. Secondly, you should refrain from using any information acquired for your own personal advantage or that of a third party.

An auditor should maintain confidentiality even in a social environment and even needs to comply with the principle even after the end of the professional relationship.

While there is an obligation to respect the confidentiality of information about a client or employers' business transactions and status acquired in the course of work activities, there are some exceptions. These include:

- Disclosure permitted by law and authorised by client.
- Disclosure by law e.g. production of documents during legal proceedings or disclosure to appropriate public authorities of infringements of law that have come to light.
- Money Laundering.
- A professional duty or right to disclose by the professional accountant / auditor when not prohibited by law, such as to comply with quality assurance reviews, to respond to an inquiry by an institute (e.g. an inquiry from ICPAR), to protect the professional interests of another ICPAR member in legal proceedings or to comply with technical standards and ethical requirements.

Having decided that there should be some disclosure, the auditor must consider:

- Whether the interests of any parties could be harmed by such disclosure and whether the auditor will incur legal liability because of the disclosure.
- Whether all relevant facts are known and substantiated.
- The type of communication that is expected and to whom it should be addressed.

Under ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements, if auditors become aware of a suspected or actual occurrence of non-compliance with law and regulation which give rise to a statutory right or duty to report by the auditor, they should consider reporting it to the proper authority.

ISA 250 – Reporting non-compliance to regulatory and enforcement authorities

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

In all cases of disclosure where there is a duty of confidentiality, you should seek legal advice.

Auditor Engagement and Liability

Conditions for Accepting the Audit Engagement

Before an audit engagement can be accepted, an auditor must consider a range of factors which will affect the decision on whether to carry out the audit.

These factors include:

- Ensuring that the potential client will agree to certain conditions such as allowing the auditor access to all the information that will be required for the audit and that the directors will produce the financial statements in accordance with the applicable financial reporting framework (IFRS in Rwanda).
- Asking the potential client for permission to contact the previous auditor. The new auditor will ask for information relevant to the decision whether to accept the appointment.
- Ensuring there are no threats to the auditor's independence and objectivity.
- Assessing management's integrity.
- Ensuring the audit firm has the competence (e.g., resources, skills, experience etc) to carry out the engagement.
- Assessing any risks at the potential client like poor internal control systems.
- Discussing the audit fee and ensuring this is sufficient to perform the required work.
- Whether the audit firm wants to be associated with the client (the client may have a poor reputation and the proposed relationship may have the potential to cause damage to the reputation of the audit firm).

Engagement Letter

At the start of each engagement the auditor sends the audited body an engagement letter, setting out the details of the proposed audit and the audited entity's responsibilities in relation to the audit process. The engagement letter is an essential element in ensuring the audited entity understands what will happen and how it is required to contribute to the audit. The engagement letter should reflect agreements and mutual understandings established between the auditor and the audited body during preliminary discussions.

The main purposes of an engagement letter are to:

- Minimise the risk of misunderstanding between the auditor and the client and reduce the expectation gap.
- Confirm formal acceptance of the engagement.
- Set out the terms and conditions of the engagement.

The letter is sent and formally agreed between the audit firm and the audited entity prior to the audit commencing. It will be reviewed each year although it is not required to sign a new engagement each year unless there are significant changes in the audit or changes in client management. Many audit firms do re-issue the engagement letter each year anyway as a method of reminding the client's management of the purpose of the audit.

While the exact content of the audit engagement letter will vary from audit to audit, ISA 210 (Terms of Audit Engagements) sets some requirements. It states that the auditor and the client should agree on the terms of the engagement. The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract and that the terms should be recorded in writing.

The main points to be included in the letter of engagement would include:

- Confirmation of the auditor's acceptance of the appointment.
- The auditor's responsibility to report to the shareholders.
- The directors of the company have a statutory duty to maintain the books of the company and are responsible for the preparation of the financial statements.
- The directors are responsible for the prevention and detection of fraud.
- The fact that because of the test nature and other inherent limitations of an audit, there is the unavoidable risk that some material misstatements may remain undiscovered.
- The scope of the audit including reference to appropriate legislation and standards.
- There should be unrestricted access to whatever books and records the auditor needs in the performance of his duties.

Other points which can be included are:

- Arrangements regarding the planning and performance of the audit.
- The expectation of receiving from management written confirmation regarding representations made in connection with the audit. (e.g. Management Representation Letter)
- Request for the client to confirm in writing the terms of the letter.
- The fee to be charged.

- The form of any reports or other communication of results of the engagement.

Example Engagement Letter

To the appropriate representative of management or those charged with governance of ABC Company.

You have requested that we audit the financial statements of ABC Company, which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and note to the financial statements, including a summary of significant accounting policies. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter.

The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with International Standards on Auditing (ISAs) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually, or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

We will conduct our audit in accordance with ISAs. Those Standards require that we comply with ethical requirements. As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting, evaluate the overall presentation, structure, and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.

Our audit will be conducted on the basis that management and, where appropriate, those charged with governance, acknowledge and understand that they have responsibility:

- For the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards;
- For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- To provide us with:
 - Access to all information of which [management] is aware that is relevant to the preparation of the financial statements;
 - Additional information that we may request from [management] for the purpose of the audit; and
 - Unrestricted access to persons in the entity from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from management and, where appropriate, those charged with governance, written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation from your staff during our audit. The form and content of our report may need to be amended in light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

XYZ

Auditors

***Acknowledged and agreed on behalf of ABC Company by
(signed)***

Name and Title

Date

Professional Liability

Auditors may have professional liability under statute law and in the tort of negligence.

Statute law

There are occasions when auditors have professional liability under statute law:

- In insolvency legislation, the auditor could be found to be an officer of the company and thus could be charged with a criminal offence in connection with the winding up of the company.
- An auditor could be found to be guilty of insider dealing, which is a criminal offence.
- Auditors could be found guilty of a criminal offence in respect of money laundering issues as to their failure to report any known suspicions to the proper authority.

Tort of negligence

Negligence is based on customary/common law. It seeks to provide compensation to a loss suffered by one due to another's wrongful neglect.

To succeed, an injured party must prove:

- A duty of care existed.
- The duty of care was breached.
- The actual breach caused the loss.

Who would take an action against an Auditor?

If an auditor gave an incorrect audit opinion the following parties might take an action:

- The company
- The shareholders
- Creditors (for example, banks, lenders)
- Potential Investors

The key difference between all the above-mentioned parties is the nature and duty of care owed to them by the auditor. For example, the relationship between the shareholders and the auditor is much closer than other interested third parties.

Audit Client

An auditor owes a duty of care to the company as it is the audit client. The company has a contract with the audit firm. Therefore, the duty of care is automatic under law. The company is all the shareholders acting as a body; it cannot be represented by one shareholder alone.

The standard of work of the auditor is generally defined by legislation. Several judgements exist which have gauged the level of care as specific legislation does not exist which states clearly how an auditor should discharge his duty of care.

Re Kingston cotton mills 1896 Court of Appeal, England

"It is the duty of the auditor to bring to bear on the work he has performed that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution, must depend on the particular circumstances of the case."

Thomas Gerrard & son Ltd 1967 Chancery Division, England

"...the real ground on which re Kingston cotton mills....is, I think, capable of being distinguished is that the standards of reasonable care and skill are, upon the expert evidence, more exacting today than those which prevailed in 1896."

Re Fomento(sterling area) Ltd v Selsdon fountain pen co Ltd 1958

"...they must come to it with an inquiring mind, not suspicious of dishonesty....but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none."

Auditors must be careful in forming an opinion and they must consider all relevant matters. If an opinion reached by an auditor is one that no reasonably competent auditor would be likely to reach, then the auditor would possibly be held for negligence.

Third Parties

The auditor can only owe a duty of care to parties other than the audit client, if one can be established. Third parties will include any individual shareholders, potential investors and the bank. In these cases, there is no contract with the audit firm. Therefore, there is no implied duty of care.

Case law seems to suggest that the courts have been reluctant to attribute a duty of care for third parties to the auditor.

Caparo industries plc v Dickman and others 1990 England House of Lords – Caparo relied on a set of accounts to purchase shares in a company. Subsequently, they alleged that the accounts were misleading. They argued the auditors owed a duty of care.

The House of Lords found that there was no duty of care. The audit complied with the company's legislation and there was no mention in that legislation to suggest that auditors should protect the interests of investors.

James McNaughton paper group Ltd v Hicks Anderson 1990

The position held that a restrictive approach was now adopted to any extension of the scope of the duty of care beyond the person directly intended by the auditor. In addition, all circumstances should now be considered in deciding on a duty of care.

However, in 1995, a high court judge made an award against BDO as their joint audit of a company in which ADT were investing was held to be a contractual relationship with ADT.

Problems however still arise after this case law. The reality is that third parties do rely on audited accounts. The perception is if you are required to file your accounts with for example the Office of Registrar General in Rwanda, then this information must be credible and independent. It seems unfair that auditors should bear full responsibility for something for which they do not have the primary responsibility.

In recent times, directors of companies are required by law not to make misleading statements to auditors. Banks and other major lenders appear to have a more special relationship than other third parties.

Loan facilities will often contain clauses requiring audited accounts and up to date financial information on a regular basis. This may be seen to document a relationship with the auditor that establishes a duty of care.

Bank of Scotland v Bannerman, Johnstone MacLay and other 2002

The bank provided an overdraft facility to the company, who it is claimed misstated its position due to a fraud. It was argued that the auditors acted negligently by not finding the fraud.

The judge found that the auditors had a duty of care. They knew that the bank needed audited accounts as part of the overdraft arrangement and could have issued a disclaimer to the bank. But they did not and this was an important factor in deciding that they did owe a duty of care.

Litigation Avoidance

One way of dealing with litigation is to try and avoid it! While this will not provide a 100% guarantee of avoidance, mitigating actions will reduce the risk of a successful action. For example, an audit firm should:

- Have clear client acceptance procedures, screen new clients, use an engagement letter.
- Perform all audit work in accordance with international standards and best practice.
- Have effective quality control and quality assurance procedures in place.
- Issue appropriate disclaimers. Auditors may attempt to limit their liability by issuing disclaimers, although this may not always be effective in law.

Auditing Standards and Legislation

The Audit Requirement – Companies Act 2021

The requirement for limited liability companies to appoint an auditor is set in law by the Companies Act 2021. You should be familiar with these articles as the foundation stone for private sector audit in Rwanda. The relevant articles in relation to audit are presented in the table below.

Article	Requirements
Article 131: Instruction to conduct audit	Every company appoints an external auditor to audit its annual accounts.
Article 132: Appointment of an auditor	<ul style="list-style-type: none">• Authorised by shareholders.• If no auditor is appointed, then one can be appointed by Registrar of Companies• The audit fee can be determined at a general meeting of shareholders or the Board of Directors.
Article 133: Qualifications of auditor	Must be registered with ICPAR Cannot be: <ul style="list-style-type: none">• Director or employee of the company• Partner of director or employee of the company
Article 134: Auditor's right of access to information	Access to all information and explanations required for the audit
Article 135: Auditor's report	Must comply with audit and assurance standards and include the items included above in "Auditor Duties" Section.
Article 136: Right to attend shareholders' general meeting	<ul style="list-style-type: none">• Directors ensure auditor received all information relating to shareholder general meetings.• Auditor may attend any general shareholders meeting and be heard.
Article 137: Removal of an auditor	Auditor may be removed by an ordinary resolution passed at a shareholders meeting.
Article 138: Auditor ceasing to hold office	Auditor ceases to hold office if: <ul style="list-style-type: none">• Removed from office.• Term of appointment expires.• Death of auditor.

Article	Requirements
Article 139: Deemed reappointment of auditor	If term expires and does not cease to hold office, assumed to be reappointed for one year.
Article 140: Removal, replacement or resignation of an auditor	<p>Auditor cannot be removed, unless</p> <ul style="list-style-type: none"> • They have received a ten-days' notice. • They have had a chance to make representations to shareholders either in writing or at a meeting (at the discretion of auditor). <p>Where auditor has given notice of unwillingness to continue, Directors must give opportunity for auditor to:</p> <ul style="list-style-type: none"> • Distribute reasons for unwillingness to continue. • Make representations at a shareholders meeting.

International Standard of Auditing (ISAs)

Audits of companies in Rwanda should be conducted in accordance with International Standard of Auditing (ISAs). International Standards on Auditing (ISAs) apply to the audit of historical financial information by an independent auditor. The requirements are mandatory. Related guidance is provided in the form of application and other explanatory material, including appendices.

ISAs are issued by the International Auditing and Assurance Standards Board (IAASB).

The reason for using ISAs is twofold:

- Harmonisation of auditing procedures, so that users of audit services are confident in audits being conducted around the world.
- Focus on audit quality, so that the expectations of users are met.

ISAs do not override national laws and regulations; however, the Regulation determining Requirements and Other Conditions for Accreditation of External Auditors for Regulated Institutions³ (Regulation 44 of 2022), Article 15, requires that all audits are carried out in accordance with ISAs.

Each ISA has a uniform style:

- Introduction – introductory material may include information regarding the purpose, scope and subject matter of the ISA, in addition to the responsibilities of the auditors and others in the context on which the ISA is set.
- Objective(s) – each ISA contains a clear statement of the objective(s) of the auditor in the audit area addressed by that ISA.
- Definitions – for greater understanding of the ISAs, applicable terms have been

³ <https://www.bnr.rw/laws-and-regulations/regulatory-digest-market-consultation/regulatory-digest/accreditation-of-external-auditors-for-regulated-institutions/>

defined in each ISA.

- Requirements – each objective is supported by clearly stated requirements. Requirements are always expressed by the phrase “the auditor shall.”
- Application and other explanatory material – this explains more precisely what a requirement means or is intended to cover, or includes examples of procedures that may be appropriate under given circumstances.

An auditor must consider the entire text of an ISA to understand and apply it.

All current ISAs – and the subject to which they relate are shown in the table below. Note that it is simply not possible for you to memorise all the content of all the ISAs. However, it is important that you have a good understanding of their structure and can find the relevant standards when required.

ISA Ref.	Title
ISA 200	<i>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing</i>
ISA 210	<i>Agreeing on the Terms of Audit Engagements</i>
ISA 220	<i>Quality Control for an Audit of Financial Statements</i>
ISA 230	<i>Audit Documentation</i>
ISA 240	<i>The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements</i>
ISA 250	<i>Consideration of Laws and Regulations in an Audit of Financial Statements</i>
ISA 260	<i>Communication with Those Charged with Governance</i>
ISA 265	<i>Communicating Deficiencies in Internal Control to Those Charged with Governance and Management</i>
ISA 300	<i>Planning an Audit of Financial Statements</i>
ISA 315	<i>Identifying and Assessing the Risks of Material Misstatement</i>
ISA 320	<i>Materiality in Planning and Performing an Audit</i>
ISA 330	<i>The Auditor's Responses to Assessed Risks</i>
ISA 402	<i>Audit Considerations Relating to an Entity Using a Service Organisation</i>
ISA 450	<i>Evaluation of Misstatements Identified during the Audit</i>
ISA 500	<i>Audit Evidence</i>
ISA 501	<i>Audit Evidence—Specific Considerations for Selected Items</i>

ISA Ref.	Title
ISA 505	<i>External Confirmations</i>
ISA 510	<i>Initial Audit Engagements—Opening Balances</i>
ISA 520	<i>Analytical Procedures</i>
ISA 530	<i>Audit Sampling</i>
ISA 540	<i>Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures</i>
ISA 550	<i>Related Parties</i>
ISA 560	<i>Subsequent Events</i>
ISA 570	<i>Going Concern</i>
ISA 580	<i>Written Representations</i>
ISA 600	<i>Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)</i>
ISA 610	<i>Using the Work of Internal Auditors</i>
ISA 620	<i>Using the Work of an Auditor’s Expert</i>
ISA 700	<i>Forming an Opinion and Reporting on Financial Statements</i>
ISA 701	<i>Communicating Key Audit Matters in the Independent Auditor’s Report</i>
ISA 705	<i>Modifications to the Opinion in the Independent Auditor’s Report</i>
ISA 706	<i>Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report</i>
ISA 710	<i>Comparative Information—Corresponding Figures and Comparative Financial Statements</i>
ISA 720	<i>The Auditor’s Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements</i>
ISA 800	<i>Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks</i>
ISA 805	<i>Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement</i>
ISA 810	<i>Engagements to Report on Summary Financial Statements</i>

Other International Standards

While ISAs are the most relevant standards for conducting audits in Rwanda, there are others of which you should be aware. These are presented in table below.

Standards	Description
International Standards of Supreme Audit Institutions (ISSAIs)	<p>Provide auditing guidance for Supreme Audit Institutions (e.g. OAG Rwanda) on how to conduct public sector audits.</p> <p>Financial audit standards are largely based on ISAs with some additional guidance relating to public sector audit.</p> <p>In addition, ISSAIs cover wider aspects of the work of Supreme Audit Institutions such as performance audit as well as institutional aspects unique to public sector audit offices.</p>
Generally Accepted Auditing Standards (GAAS)	<p>GAAS are a set of principles and requirements that provide the basis for how an auditor prepares for, performs, and reports the results of audits in the USA and some other countries.</p> <p>Both frameworks adopt similar principles, and the difference is mostly in their geographic adoption.</p> <p>The use of GAAS is fairly rare in Rwanda but may be applicable when a company is receiving public funds of the USA through, for example, a USAID programme.</p>
Sarbanes Oxley (SOX)	<p>Related to the Sarbanes-Oxley Act 2002 in the USA.</p> <p>Additional requirements on auditor in areas such as auditor independence and oversight for audits related to US companies only.</p> <p>These requirements are unlikely to be directly relevant in the Rwandan context. However, SOX does contain elements of good practice in relation to, for example, corporate governance which Rwandan companies may choose to adopt.</p>

Materiality

The auditor's report concludes on the truth and fairness of the financial statements subject to audit; it does not state that the financial statements are correct. Financial statements are rarely, if ever, entirely correct as they will always contain estimates and other items which are based on judgement. Financial Statements are seen to be acceptable if it is substantially correct or, in auditing terms, if it is not subject to any material error or misstatement which change the view of the true and fair nature of the information reported.

An audit can never give absolute assurance that the financial statements are completely free of error or misstatement. The audit provides only reasonable assurance of freedom from material misstatement. No audit can give unconditional assurance that financial statements are totally accurate because of the inherent limitations in the auditor's ability to detect material misstatements due to:

- The use of testing and sampling processes in the audit.
- The inherent limitations of any accounting and internal control system, for example, the possibility of collusion to circumvent established controls.
- The fact that most audit evidence is persuasive rather than conclusive.
- Auditing is not a mechanical process. The work undertaken by the auditor to form an opinion is permeated by professional judgement, regarding:
 - Gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures.
 - Drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

The concept of materiality is fundamental to the presentation of information in Financial Statements. However, in common with the true and fair concept, materiality is not easily defined and is based on the judgement of the auditor. Guidance as to how the auditor should consider materiality is provided by ISA 320 (Materiality in Planning and Performing an Audit).

ISA 320 defines Materiality as

“Misstatements, 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 Materiality

The first aspect to be considered in the assessment of materiality is the quantitative aspect i.e. the bigger the error in the Financial Statements, the more likely it will be to impact the decisions of users. Setting quantitative materiality is a two-step process. First, the auditor should establish an appropriate benchmark; typically, this will be an account balance presented in the Financial Statements. Second, the auditor should then use professional judgement to apply a percentage to the chosen benchmark. Some common benchmarks and percentage ranges are shown below.

- Revenue: 0.5% – 1%
- Profit before tax: 5% – 10%
- Total assets: 1% – 2%

Which benchmark is most appropriate to use will depend on the audited organisation. Factors to consider, for example are:

- Profit before tax is often used for profit-oriented entities, but if that is volatile, other benchmarks may be more appropriate (e.g. gross profit or total revenues).
- Total assets are likely to be a more appropriate benchmark for an asset-based company such as an investment company.
- Other examples of benchmarks include net assets and total expenses.

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgement. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be appropriate depending on individual audit circumstances.

Note that, as materiality is a matter of professional judgement, different audit firms may adopt different approaches to determining benchmark or “rule of thumb” guides to assessing materiality. It is also likely that any individual audit firm may vary the benchmark guides depending upon the perception of audit risk associated with each individual audit assignment. The higher the perceived level of audit risk, the lower the level of estimated materiality applied.

Example

During an audit of a property investment company, quantitative materiality is calculated as follows.

1. **Benchmark** – Total Assets given the significance of this balance in the financial statements
2. **Percentage** – The audit firm methodology stipulates a range of between 1 and 2%. During previous audits, significant errors were identified. As a result, the initial assessment of audit risk is high. Therefore, a lower threshold of 1% is used.

Total Assets = 1 million.

Quantitative materiality = 1% x 1 million = **10,000**

Qualitative Materiality

In addition to the numerical approach to materiality, there are also likely to be qualitative aspects to be considered when assessing the impact of an item on the users of the financial statements. These should also be built into the auditor's assessment of materiality. i.e., there are possible errors or omissions in the financial statements that would likely affect the users of the financial statements regardless of monetary value.

These qualitative factors include:

- Nature of the item involved. Many items in financial statements are by their nature subject to a high degree of subjectivity, such as depreciation rates applied to non-current assets. In respect of these items the auditor will have to accept a reasonable margin of error. By contrast, other items leave little scope for judgement, such as cash at bank. On these types of items, the auditor will typically take a tighter view on the question of materiality. It seems likely that auditors will typically expect this type of item to be correct. In addition, where there are any items that must be correct in the financial statements e.g. to comply with the financial reporting framework, then even if the difference is very small it will be material. (Material by nature)

- Impact of the item involved. This principle relates back to the definition of materiality – the impact of the item on the view presented by the financial statements to the user. The suggestion is that errors which may not be great in numerical terms may have a major impact on the picture presented by the financial statements.

For example – The draft financial statements of a company show a small pre-tax profit. The auditor discovers an inventory error which, if corrected would have the impact of changing the draft profit into a pre-tax loss. The error may not be material by value, but many auditors would see the impact of the item (turning a profit into a loss) as being material and would expect an adjustment to be made. (Material by context)

Materiality requires the exercise of professional judgement and consideration of the unique circumstances of the entity and the needs of users of the financial statements.

Performance Materiality

During the audit, it is unlikely that an individual transaction will be identified that has been materially misstated. It is more common for several smaller misstatements to have a cumulative effect that leads to a material misstatement in the financial statements. This may occur, for example, if several similar transactions have all been wrongly accounted for – the cumulative impact of several smaller misstatements is more likely to have a material impact upon whether the financial statements show a true and fair view. As a result, auditors reduce the materiality threshold further to lower audit risk to an acceptable level.

ISA 320 defines Performance Materiality as “

“The amount set by auditors at below overall materiality to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds overall materiality.”

Performance materiality is set at a lower level than overall materiality for the purposes of planning and performing audit work. Consequently, this approach is more likely to identify not only an individual transaction that has been materially misstated but also identify situations where multiple transactions have been misstated (none of which are material on an individual basis), but which cumulatively result in a material misstatement.

For example, if overall materiality has been set by the auditor at 500,000, performance materiality may be set at, say, 400,000. This means that audit work will be planned and performed to give a reasonable expectation that misstatements of 400,000 will be identified during the audit.

The level of “haircut” to calculate performance materiality is subject to the professional judgement of the auditor. Normally, performance materiality is likely to be between 60% and 90% of overall materiality.

Materiality in the Audit Process

Materiality should be considered by the auditor when:

- Determining the nature, timing and extent of audit procedures. For example, when determining relevant sample sizes for audit testing.
- Evaluating the effect of misstatements. For example, when drafting the audit opinion.

The auditor considers materiality both at the overall financial statement level and in relation to individual account balances, classes of transactions and levels of disclosure of items in the statements. Materiality may be influenced by considerations such as legal and regulatory requirements, and considerations relating to individual financial statement account balances and relationships. This process may result in different materiality levels, depending on the aspect of the financial statements being considered.

When planning the audit, the auditor should consider what would make the financial statements materially misstated. The auditor's assessment of materiality, related to specific account balances and classes of transactions, helps the auditor decide such questions as what items to examine sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to reduce audit risk to an acceptably low level.

Audit Risk

ISA 200 defines Audit Risk as “

“The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.”

At the planning stage of the audit the auditor determines the extent and nature of the audit work to be performed. The greater the degree of audit risk attached to an assignment, the more audit work will need to be built into the audit plan. This in turn is likely to affect the time spent on the audit and the level of experience of audit staff required; the audit fee will therefore also be affected.

Similarly, the auditor may take the view that some areas of an audit are riskier than others – perhaps bad debt provisions are seen to be a high-risk area, but cash at bank is a low-risk area. Similar considerations on timing and staffing will be built into the audit plan on an area-by-area basis.

Risk Based Audit Approach

ISA 315 (Identifying and Assessing the Risks of Material Misstatement) requires that the auditor adopts a risk-based approach to planning and performing the audit. It requires auditors to assess the overall level of audit risk relating to a specific audit, along with the audit risk attached to each element or component of the financial statements. Consequently, more audit time and resources will be applied to those parts of the audit assignment which are of higher risk. The result of this approach is that overall audit risk should be reduced to an acceptably low level.

Auditors will typically set an overall level of audit risk which they find acceptable in respect of the audit client concerned. Let us assume that this risk level is set at 5%. This means that the auditor is willing to accept a 5% chance that an inappropriate conclusion may be reached on the financial statements being audited.

If the auditor is willing to accept a 5% chance of getting it wrong, we can also say the auditor wants to be 95% confident of getting it right. This risk level (or confidence level) will be based on the evidence which the auditor has collected during the audit planning process. It will reflect the auditor's experience of the client and assessment of the internal controls system around financial transactions/balances.

Total audit risk is made up of three elements:

- inherent risk (or IR)
- control risk (or CR)
- detection risk (or DR)

This relationship can be expressed as the function:

$$\mathbf{AR = IR \times CR \times DR}$$

Using this relationship to determine the level of detection risk required to reduce audit risk to an acceptably low level assists the auditor in planning the audit approach.

Inherent Risk

In developing the overall audit plan, the auditor should assess the inherent risk of material misstatement in the financial statements. This should then be related to the material account balances and transaction types to determine the level of testing required.

ISA 200 defines Inherent Risk as

“Susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.”

To assess inherent risk, the auditor must use professional judgement to evaluate numerous factors, for example:

- At the financial statement level:
 - The quality, experience, knowledge and integrity of management.
 - Unusual pressures on management to misstate the financial statements, for example if objectives have not been achieved.
 - The complexity of the audited body's operations, for example, the number of locations and geographical spread of its facilities.
- For each material system or account balance:
 - The transaction types particularly susceptible to misstatement, for example, accounts that have, in the past, required adjustment or those that involve a high degree of estimation of values.
 - The complexity of underlying transactions.
 - The degree of judgement involved in determining account balances.
 - The susceptibility of assets to loss or misappropriation, for example, assets that are highly desirable and movable, such as cash.
 - The completion of unusual and complex transactions, particularly at or near the period end.
 - Transactions not subjected to routine processing that may evade normal

controls.

Not that the level of inherent risk is determined by the organisation being audited and the auditor can only measure the level of risk but cannot change it.

Control Risk

ISA 200 defines Control Risk as

“The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control.”

After obtaining an understanding of the accounting and internal control systems, the auditor should make a preliminary assessment of control risk for each material account balance and transaction type. This assessment is a key factor in determining the audit approach to be adopted.

The preliminary assessment of control risk is obtained by evaluating the effectiveness of an audited body’s accounting and internal control systems in preventing or detecting and correcting material misstatements. The estimated value of the risk should be initially set as High, unless and until the auditor:

- Can firmly internal controls relevant to the assertion that are likely to prevent, or detect and correct a material misstatement; and
- Performs tests of control and uses the result to support or change the initial assessment.

To support assessments of control risk, the auditor should fully document the evaluation of accounting and internal control systems in the audit working papers. The documentation should include narrative descriptions of processes, checklists, flow charts, reviews of procedural manuals, and should evidence and support:

- The auditor’s understanding of the accounting and internal control systems, and
- The auditor’s assessment of control risk.

If after evaluating the systems the auditor decides that the control risk is assessed as “High”, then the auditor cannot rely on the operation of internal control systems and must therefore rely on the Direct Substantive Testing (DST) approach to gathering audit evidence.

Management often reacts to inherent risk situations by designing accounting and internal control systems to prevent, or detect and correct misstatements, and therefore, in many cases, inherent risk and control risk may be highly interrelated. For example, international banks dealing in large and regular foreign transaction payments is inherently risky; however, the bank is likely to have identified that and put in place to mitigate this risk. In effect – IR would be high, CR low. The auditor should be aware of this relationship when assessing and documenting inherent and control risk.

Not that Control Risk is also controlled by the auditee and the auditor can only gather evidence to assess the level of this risk.

Detection Risk

ISA 200 defines Detection Risk as

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

There is an inverse relationship between detection risk and levels of inherent and control risk. When levels of inherent and control risks are high, acceptable detection risk needs to be low to reduce overall audit risk to an acceptably low level. But if inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level. The level of detection risk directly influences the extent of audit work required.

The auditor should therefore consider the assessed levels of inherent and control risks in determining the nature, timing and extent of testing required to reduce audit risk to an acceptable level. In this regard, the auditor must consider:

- The extent of audit procedures, in particular the need for larger sample sizes and the testing of a larger number of processes to reduce detection risk.
- The nature of audit procedures, for example, using tests directed towards independent parties outside the audited body rather than tests directed towards parties or documentation within the audited body, or using tests of details for a particular audit objective where a lower detection risk could require only analytical procedures; and
- The timing of audit procedures, for example performing them at period end rather than at an earlier date.

The level of detection risk has an inverse relationship with the volume of testing undertaken. The more testing is done, the greater the probability that any misstatements that exist will be detected. It should be noted that some detection risk will always be present; however, even if an auditor were to examine 100 percent of the account balance or class of transactions there is a risk that they miss something.

It must be noted that the assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform at least some substantive testing. Regardless of the assessed levels of inherent and control risks, the audit or must always undertake some testing on material account balances and transaction types.

The auditor's assessment of the components of audit risk may change during an audit. For example, information may come to the auditor's attention when performing substantive procedures that differs significantly from the information on which the auditor originally assessed inherent and control risks. In such cases, the auditor must modify the planned testing based on a revision of the assessed levels of inherent and control risks and the auditor should remain alert for such information emerging as the audit progresses.

Sampling and Non-Sampling Risk

The three components of audit risk (i.e. inherent, control and detection risk) are considered during the planning process and have already been discussed above. There is however a further dimension to detection risk that is directly relevant to the auditor's sampling strategy i.e. the distinction between sampling and non-sampling risk. When testing controls, the auditor may find no errors in a sample, for example, and conclude that control risk is low, when the rate of error in the population is, in fact, unacceptably high i.e. the sample may not be typical of the population as a whole (sampling risk). Or there may be errors in the sample that the auditor fails to recognise (non-sampling risk).

The auditor may use a variety of methods to reduce detection risk to an acceptable level. Depending on their nature, these methods will be subject to sampling and/or non-sampling risks. For example, the auditor may choose an inappropriate analytical procedure (non-sampling risk) or may find only minor misstatements in a test of details when, in fact, the sample untested contains material misstatements (sampling risk).

For both control and substantive tests, sampling risk can be reduced by increasing the sample size, while non-sampling risk can be reduced by proper engagement planning, supervision, and review. Another way to reduce non-sampling risk is to assign more experience staff to perform the work (less likely to make a mistake)

Response to Assessed Risks

Risk analysis is an important stage of the audit. In conducting a thorough assessment of risk auditors will be able to:

- Identify areas of the financial statements where misstatements are likely to occur early in the audit.
- Plan procedures that address the significant risk areas identified.
- Carry out an efficient, focussed and effective audit.
- Minimise the risk of issuing an inappropriate audit opinion to an acceptable level.

While the assessment of risk is important, the critical factor for the auditor is their response to identified risks. This is covered in ISA 330 (The Auditor's Responses to Assessed Risks). The key objective is to reduce audit risk, and this can be achieved by manipulating detection risk, as follows:

- Allocating complex or risky areas of the engagement to suitably experienced and competent staff.
- Placing more, or less, reliance on the results of systems and controls testing.
- Altering the volume of substantive procedures performed after the year end.
- Altering the volume of balances tested by changing sample sizes.
- Performing more, or fewer, substantive analytical procedures.
- Consulting external experts on technically complex or contentious matters changing the timing and frequency of review procedures, including using additional partners to review work.

Summary of Unit A and key learning outcomes

After completing Unit A, you should be able to demonstrate an understanding of the legal and professional standards required for an external auditor.

The key learning outcomes are presented in the table below.

Ref	Learning Outcome	
A1	Explain the legal and ethical duties of auditors, including the content of reports and the definition of proper records.	<ul style="list-style-type: none">• Understand the purpose of external audit.• Identify the benefits to key users of financial statements from external audit.• Identify the legal requirements of a statutory external audit.• Apply ethical principles set down in the IFAC and ICPAR ethics codes.• Have a general awareness of the main sections in an ISA compliant audit report
A2	Explain the liability of auditors under contract and negligence including liability to third parties.	<ul style="list-style-type: none">• Understand the potential for auditor liability to contractual parties.• Understand potential for auditor liability to other external third parties.
A3	Explain the relevant legislation and auditing standards.	<ul style="list-style-type: none">• Be aware of the key provisions relating to audit in the Companies Act 2021• Understand that audit should comply with international standards of auditing
A4	Define audit risk and how it applies to external audit.	Define audit risk and its constituent parts. Understand the tools available to an auditor to change audit risk
A5	Define materiality and explain its application in auditing.	<ul style="list-style-type: none">• Understand the concept of materiality (both quantitatively and qualitatively)• Understand the relationship between materiality and audit risk

Quiz Questions

1	Learning Outcome: A1
What is the primary objective of an external audit?	
A	To ensure compliance with internal policies and procedures
B	To provide assurance on the truth and fairness of financial statements
C	To improve operational efficiency within the organisation
D	To identify potential areas of cost reduction

1	Feedback
A	No. While the external auditor should report issues around compliance with internal policies and procedures (control deficiencies) to management and those charged with governance. This is not the primary objective.
B	Yes!
C	No. While the external auditor might make recommendations in this regard it is not the primary objective. Internal auditors are likely to have more of a role in this area.
D	No. Not a primary objective.

2	Learning Outcome: A1
Which of the following is a key characteristic of an external auditor?	
A	Employed by the organisation being audited
B	Provides consulting services to the audited company
C	Maintains independence from the audited entity
D	Reports directly to the management team

2	Feedback
A	No. External auditors should be independent
B	No. Providing consultancy services to an auditee poses independence concerns.
C	Yes!
D	No. External auditors should be independent

3	Learning Outcome: A1
In the context of external auditor ethics, what does the principle of “independence” refer to?	
A	Remaining impartial and unbiased in the audit process
B	Building strong relationships with management to facilitate future engagements
C	Accepting gifts or favours from the audited entity if they do not influence judgement
D	Aligning audit procedures with the interests of the shareholders

3	Feedback
A	Yes! Remaining impartial and unbiased are crucial to maintain auditor independence
B	No. Focussing on future engagements threatens independence.
C	No. It is important auditors are seen to be independent as well as independent in practice.
D	No. Audit procedures should be dictated by ISAs and auditors’ judgement.

4	Learning Outcome: A2
How can external auditors mitigate third-party liability risks?	
A	By prioritising the interests of the audited entity's management
B	By issuing vague and non-committal audit opinions
C	By adhering strictly to professional standards and ethical guidelines
D	By delegating audit responsibilities to internal auditors

4	Feedback
A	No. interests should be focussed on the needs of external users and the requirements of ISAs.
B	No. Clear opinions, in accordance with ISAs, reduce exposure for liability.
C	Yes! By sticking to ISAs auditors minimise potential for liability.
D	No. Internal audit is not independent of management.

5	Learning Outcome: A3
Which standard serves as a framework for conducting external audits in Rwanda?	
A	International Financial Reporting Standards (IFRS)
B	Generally Accepted Accounting Principles (GAAP)
C	International Standards on Auditing (ISA)
D	Sarbanes-Oxley Act (SOX)

5	Feedback
A	No. IFRS relate to the financial reporting framework under which the financial statements should be prepared by the auditee.
B	No. GAAP is the IFRS equivalent in the USA for financial reporting.
C	Yes. Audits are to be conducted in accordance with ISAs.
D	No. SOX is specific conditions attached to audits of companies in the USA.

6	Learning Outcome: A4
Which of the following best defines audit risk?	
A	The risk that the auditor may not detect a material misstatement in the financial statements
B	The risk that the audited entity will incur financial losses due to audit findings
C	The risk that the audited entity's management will not cooperate with the audit process
D	The risk that the auditor's independence will be compromised during the audit engagement

6	Feedback
A	Yes!
B	No. This is a business risk of the auditee.
C	No. This might prove a risk to the efficient completion of the audit but is not an audit risk under ISA definition.
D	No. This might prove a risk to the audit. However, not audit risk under ISA definition.

7	Learning Outcome: A4
How does inherent risk differ from control risk in the context of audit risk assessment?	
A	Inherent risk is the risk of material misstatement before considering internal controls, while control risk is the risk that internal controls fail to prevent or detect material misstatements.
B	Control risk is the risk of material misstatement before considering internal controls, while inherent risk is the risk that internal controls fail to prevent or detect material misstatements.
C	Control risk and inherent risk are always inversely related.
D	Inherent risk is influenced by the effectiveness of internal controls, while control risk is influenced by the nature of the audited entity's industry.

7	Feedback
A	Yes!
B	No – It is the other way round.
C	No. In well controlled businesses they might be. i.e. they put in controls to compensate for high inherent risk. However, this is not always the case.
D	No – it is the other way round.

8	Learning Outcome: A5
What is materiality in the context of auditing?	
A	The level of detail required to prepare financial statements
B	The significance of an omission or misstatement that would influence the decisions of users of the financial statements
C	The total assets of the audited entity
D	The number of transactions recorded in the financial statements

8	Feedback
A	No. The financial statements should be prepared including all relevant financial information.
B	Yes. This is the ISA definition. Focussing on influencing users and the decisions they take.
C	No. Total asset may influence the materiality level set however.
D	No. Number of transactions has no direct influence over materiality.

9	Learning Outcome: A5
How does the concept of materiality differ between quantitative and qualitative factors?	
A	Quantitative factors are numerical, while qualitative factors are subjective.
B	Quantitative factors are immaterial, while qualitative factors are material.

9	Learning Outcome: A5
C	Quantitative factors have a greater impact on financial statements than qualitative factors.
D	Quantitative factors are more important to users of the financial statements.

9	Feedback
A	Yes!
B	No. Quantitative factors can be material.
C	No. Sometimes qualitative errors or omissions have a more material impact regardless of value.
D	No. Often qualitative aspects are more important.

10	Learning Outcome: A5
Which statement best describes the relationship between materiality and audit risk?	
A	Materiality is the risk that the auditor may overlook important financial statement elements, whereas audit risk is the level of significance of an error or omission in the financial statements.
B	Materiality and audit risk are unrelated concepts in auditing.
C	A low level of materiality indicates higher audit risk.
D	Materiality determines the amount of audit risk present in the financial statements.

11	Feedback
A	No. It is the other way around.
B	No. They are related.
C	Yes! There is an inverse relationship between audit risk and materiality.
D	No. The amount of audit risk is determined by $IR \times CR \times DR$.

Quiz Answers

Question	Answer
1	B
2	C
3	A
4	C
5	C
6	A
7	A
8	B
9	A
10	C

Exercises

1. Identify five key users of the financial statements and explain why each might rely on the audit report.
2. Identify and explain the five key areas of auditor ethics as outlined in the IESBA and IPCAR codes.
3. Explain the related concepts of detection risk, sampling risk and non-sampling risk. Give examples of how the auditor can reduce these risks.

Exercise Solutions

1. Investors and Shareholders – Investors and shareholders rely on financial statements to make informed decisions about buying, holding, or selling securities. They depend on the audit report to provide assurance regarding the accuracy and fairness of the financial information presented. A clean audit report indicates that the financial statements have been examined by an independent auditor, increasing confidence in the reliability of the information disclosed.
 - Creditors and Lenders – Creditors and lenders use financial statements to assess the creditworthiness and financial health of an entity before extending credit or loans. The audit report serves as a form of assurance that the financial statements fairly represent the entity's financial position, performance, and cash flows. This assurance helps creditors evaluate the entity's ability to meet its financial obligations, manage debt, and generate sufficient cash flows for repayment.
 - Regulators and Government Agencies – Regulators and government agencies

rely on financial statements to ensure compliance with laws, regulations, and accounting standards. They use the audit report to verify the accuracy and completeness of financial reporting, especially in regulated industries such as banking, insurance, and publicly traded companies. The audit report provides assurance that the financial statements comply with applicable regulatory requirements and provide a true and fair view of the entity's financial position and performance.

- **Management and Board of Directors** – Management and the board of directors use financial statements to monitor the entity's financial performance, assess operational efficiency, and make strategic decisions. They rely on the audit report to validate the integrity of the financial information provided by management. An independent audit provides assurance that internal controls are effective, financial transactions are properly recorded, and risks are adequately disclosed, enhancing the reliability of financial information used for decision-making purposes.
- **Analysts and Financial Advisors** – Analysts and financial advisors analyse financial statements to evaluate the entity's performance, profitability, and growth prospects. They rely on the audit report to assess the quality and reliability of financial information disclosed in the statements. A clean audit report enhances the credibility of financial statements, leading to more accurate financial analysis and investment recommendations.

Other answers could include the public, employees and almost any other stakeholder.

Overall, the audit report plays a crucial role in providing assurance to various stakeholders that the financial statements are free from material misstatement and fairly present the entity's financial position, performance, and cash flows. This assurance enhances transparency, accountability, and trust in the financial reporting process, thereby facilitating better decision-making by users of financial statements.

2. **Integrity** – Integrity refers to the fundamental quality of honesty and truthfulness. Auditors are expected to be straightforward and honest in all professional and business relationships. They should not knowingly be associated with information that is false or misleading. Upholding integrity ensures the reliability and credibility of the audit process and enhances public trust in the accounting profession.

- **Objectivity** – Objectivity requires auditors to approach their work without bias, conflicts of interest, or undue influence from others. Auditors must maintain independence of mind and appearance, avoiding any personal or financial relationships that could impair their judgement or integrity. Objectivity ensures that audit opinions are based solely on evidence and professional judgement rather than personal or external influences.
- **Professional Competence and Due Care** – Auditors are expected to possess the necessary knowledge, skills, and expertise to perform their duties competently. They should continuously update their technical knowledge and skills to ensure they remain competent in their profession. Additionally, auditors must exercise due care in planning, conducting, and reporting on audit engagements. This includes adequately supervising staff, obtaining sufficient appropriate audit evidence, and critically evaluating audit findings.
- **Confidentiality** – Confidentiality requires auditors to maintain the confidentiality of client information acquired during the course of their work. Auditors must

not disclose any confidential information to third parties without proper authorisation, except when required by law or professional standards. Protecting client confidentiality fosters trust between auditors and clients and safeguards sensitive information from unauthorised disclosure.

- Professional Behaviour – Professional behaviour encompasses the conduct and demeanour expected of auditors in their interactions with clients, colleagues, and the public. Auditors should act with courtesy, respect, and professionalism in all professional and business relationships. They must avoid conduct that could discredit the profession, such as engaging in dishonesty, fraud, or any behaviour that undermines public confidence in the integrity of the audit process.
3. Detection Risk: the risk that the auditor fails to detect material misstatements in the financial statements. It is the risk that audit procedures will not uncover existing errors or frauds. Detection risk is inversely related to the assurance provided by audit procedures; as detection risk decreases, the level of assurance increases.
- o Example: An auditor performs substantive testing on a sample of accounts receivable balances to detect potential overstatements. If the auditor's procedures fail to identify a material misstatement in the sample, it results in detection risk. This risk could occur due to inadequate sample size, ineffective audit procedures, or misinterpretation of audit evidence.
 - o Ways to reduce detection risk:
 - Increase the extent of substantive testing by examining more transactions or account balances.
 - Perform additional audit procedures such as analytical procedures or substantive analytical review.
 - Use more experienced or specialised audit staff to conduct audit procedures.
 - Enhance the effectiveness of internal control testing to rely on controls to reduce detection risk.
 - Sampling Risk – the risk that the auditor reaches an incorrect conclusion because the sample selected for testing is not representative of the population. It arises from the inherent variability within the population and the reliance on a sample to draw conclusions about the entire population.
 - o Example: An auditor selects a sample of 50 invoices from a population of 1,000 invoices for testing. If the sample is not truly representative of the entire population, there is a risk that the auditor's conclusion based on the sample may be incorrect.
 - o Ways to reduce sampling risk:
 - Increase the sample size to enhance the representativeness of the sample.
 - Use statistical sampling techniques to ensure randomness and reduce bias in sample selection.
 - Employ professional judgement to select a sample that is likely to contain potential errors or deviations.
 - Perform additional substantive procedures or controls testing to supplement the results of sampling.

- Non-Sampling Risk – the risk that arises from factors other than sampling, such as human error, judgemental errors, or misinterpretation of audit evidence. It includes errors in planning, execution, or evaluation of audit procedures.
- o Example: An auditor misinterprets the results of analytical procedures due to insufficient understanding of the client’s industry or economic factors. This misinterpretation leads to an incorrect assessment of the risk of material misstatement in the financial statements.
- o Ways to reduce non-sampling risk:
 - Enhance auditor training and professional development to improve technical skills and judgement.
 - Implement robust quality control procedures to review audit work and ensure compliance with auditing standards.
 - Use experienced audit personnel with relevant industry knowledge and expertise.
 - Exercise professional scepticism and critical thinking throughout the audit process to identify and address potential sources of error.

Unit B: Organisation's external auditing procedures.

Learning outcomes

- B.1 Describe the organisation's systems and the external auditing procedures.
- B.2 Describe the features of accounting systems including purchases, sales, stock, expenses, statement of financial position (balance sheet) items and payroll.
- B.3 Identify principles of control and when they should be used including separation of functions, the need for authorisation, recording custody, vouching and verification.

Introduction to Unit B

Now you understand the legal and regulatory framework for the audit, Unit B will introduce key issue for consideration around the respective roles and responsibilities of the auditor and the auditee. In addition, we need to understand how the auditor should communicate with key auditee stakeholders at the various stages of the audit process.

It is also important that you understand the key elements of any accounting and internal control system and are aware of how we should consider these as an external auditor. While management is responsible for implementing accounting and internal control systems, we need to understand these to properly identify and assess audit risk.

Auditor and Auditee Relationship

Both the auditor and the auditee have crucial roles to play in the audit process. It is important that these respective roles are clear and that communication between both parties ensures that the process is completed efficiently and line with legislation/ standards.

Role of the Auditor

As we have already stated in the previous unit, the auditor is the independent person that gives their opinion on a set of financial statements. He does not provide absolute assurance. In other words, he does not say the "accounts are correct" due to limitations on the audit process.

However, this is often misunderstood by users of accounts who seem to wrongly accuse the auditor of shortcomings especially where there are infamous business failures or perceived wrongdoing. This is known as the "expectation gap".

The expectation gap exists because the role and duties of the auditor which are recommended to be laid out by the companies acts, codes of ethics and auditing standards might be quite different from the perceived role of the auditor by the public and even company directors themselves. For example, it is commonly believed that the auditor should find all errors whether unintentional or intentional such as fraud. Auditors should make every effort to close this expectation gap.

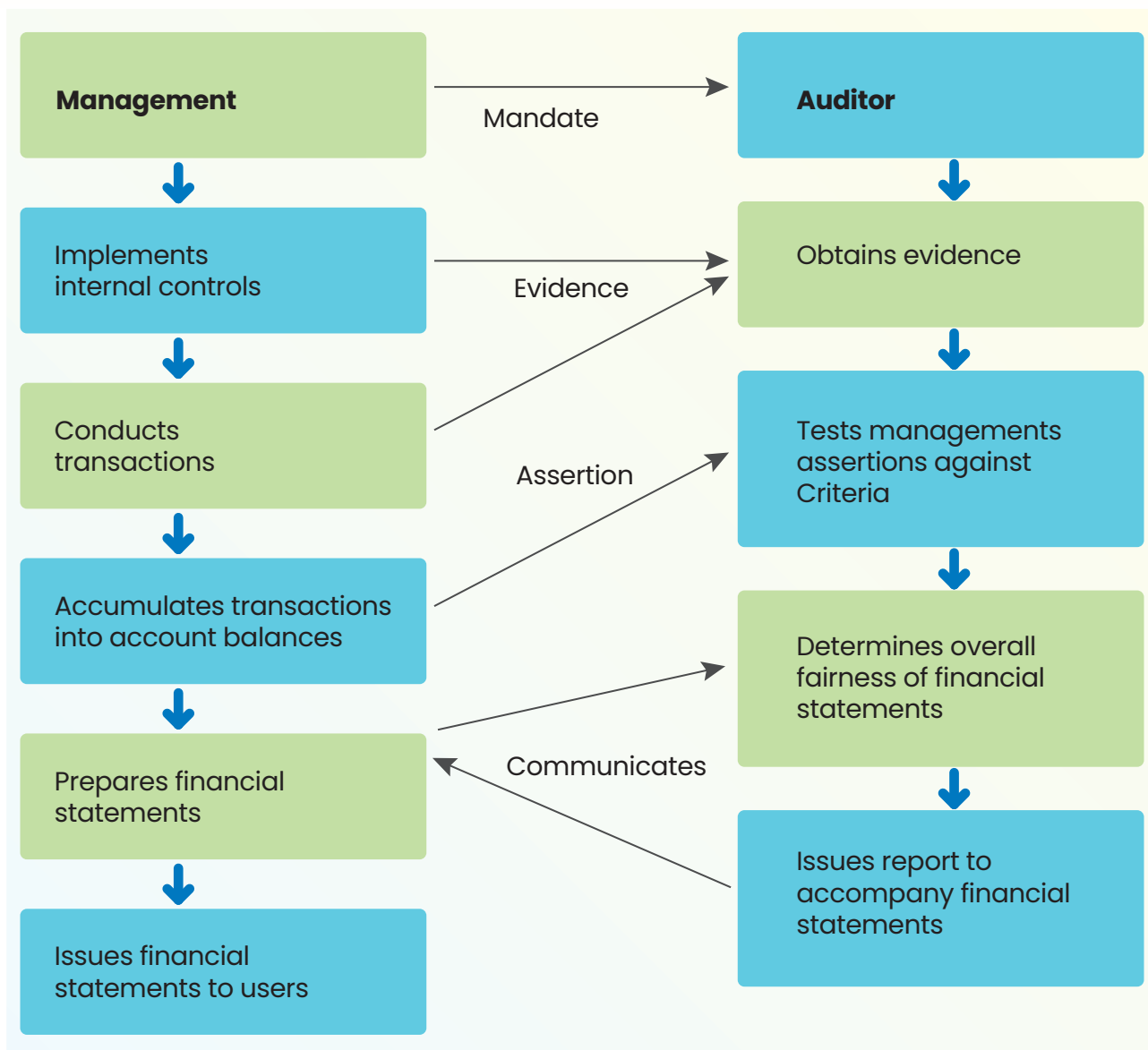
Relationships and Responsibilities

There are several stakeholders interested in financial statements from the shareholders to management, customers to suppliers, revenue authorities to bank managers, and even future investors. The audit report is prepared by the auditor for the shareholders on the actions of the management (directors). The auditor has no legal duty to report to management or anyone else in respect of the financial statements. However, in practice other parties do read the audit report and often rely on the assurance given by the auditors.

One of the principal areas of misunderstanding is around the split of responsibility between the auditor and management of the auditee. It is important that all stakeholders understand these respective responsibilities, particularly that:

- Management is responsible for the preparation and presentation of the accounts.
- Management is responsible for the prevention and detection of fraud within a company.
- Management is responsible for safeguarding the assets of a company.
- The auditor is responsible for expressing an opinion on a set of accounts prepared by management.

Key roles and responsibilities during the financial statement audit process are shown in the diagram below:



Appointment of Auditors

Under Article 132 of the Companies Act 2021, the appointment of auditors is authorised by an ordinary resolution of the shareholders of a company. The term lasts from the end of one Annual Meeting until the next Annual Meeting unless of course the auditor has resigned or has been removed during the year.

Where the company fails to appoint an auditor the Registrar General shall have the powers to direct the company appoint its auditor within thirty days.

Management

Under ISA 200, "management" (of the auditee) generally refers to the individuals responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework and the implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

The responsibilities of management in the context of an audit include:

- **Preparation of Financial Statements:** Management is responsible for preparing the entity's financial statements in accordance with the applicable financial reporting framework. This involves selecting appropriate accounting policies and making estimates that are reasonable in the circumstances.
- **Maintaining Internal Controls:** Management is responsible for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of financial statements. This includes establishing and maintaining policies and procedures to prevent and detect fraud and error.
- **Representation and Assertions:** Management is responsible for providing written representations to the auditor about various matters relevant to the audit, including the completeness and accuracy of information provided to the auditor. Typically, these representations will be documented in the Management Representation Letter discussed later in this module.
- **Communication with the Auditor:** Management is responsible for engaging in open and transparent communication with the auditor throughout the audit process, including providing explanations and additional information as requested by the auditor. This is enshrined in law – Companies Act 2021 Article 134.
- **Compliance with Laws and Regulations:** Management is responsible for ensuring that the entity's operations are conducted in compliance with applicable laws and regulations, including those relating to financial reporting and auditing. For example, complying with the Companies Act 2021.

The auditor's responsibility is to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether due to fraud or error. In doing so, the auditor evaluates the sufficiency and appropriateness of audit evidence obtained, which often involves interactions with management to understand the entity's operations, assess risks, and obtain explanations for significant transactions or events. However, the ultimate responsibility for the financial statements rests with management.

Those Charged with Governance

In addition to understanding the role of "management", ISAs also refer to "those charged with governance". The concept of "those charged with governance" is outlined in various International Standards on Auditing (ISAs), but it is primarily addressed in ISA 260.

The term "Those charged with governance" varies slightly depending on the organisational structure. Typically, it could include:

- **Board of Directors:** In corporations, the board of directors typically assumes the role of governance oversight. This includes executive and non-executive directors.
- **Board of Trustees:** Non-profit organisations often have a board of trustees responsible for governance oversight.
- **Partners or Owners:** In partnerships or proprietorships, the owners or partners may fulfil the role of governance oversight.
- **Governance Committees:** Some entities may establish specific committees tasked with governance responsibilities, such as audit committees (discussed below) or risk management committees.

The responsibilities of those charged with governance include:

- Overseeing the entity's financial reporting process, ensuring it is accurate, complete, and in compliance with relevant standards and regulations.
- Approving financial statements before they are issued to stakeholders.
- Monitoring the entity's internal control systems and risk management processes.
- Appointing and overseeing the external auditor, including approving the auditor's engagement and fees.
- Reviewing and approving significant accounting policies and financial reporting judgements.
- Addressing any conflicts of interest and ensuring compliance with laws and regulations.

ISAs require auditors to communicate with those charged with governance throughout the audit process, including obtaining an understanding of their roles and responsibilities, discussing audit findings and significant matters, and obtaining representations regarding the financial statements and related matters.

Effective communication with those charged with governance is essential for auditors to obtain the necessary information and support to perform their audit effectively. ISA 260 provides specific guidance on auditor communication with those charged with governance. Specifically, it includes:

- **Objectives of Communication:** The standard highlights the importance of effective communication between auditors and those charged with governance to ensure that audit matters are addressed appropriately and that the audit process remains efficient and effective.
- **Timing of Communication:** ISA 260 specifies that auditors should communicate with those charged with governance regarding significant matters arising during the audit, including audit planning, audit findings, and any significant issues identified during the audit process.
- **Content of Communication:** The standard outlines the types of matters that should be communicated to those charged with governance, such as the scope and timing of the audit, significant audit risks and findings, and any instances of non-compliance with laws and regulations identified during the audit.
- **Responsibilities in Case of Non-compliance:** ISA 260 requires auditors to communicate to those charged with governance any instances of non-compliance with laws and regulations identified during the audit that could have a material effect on the financial statements. So, for example, if the company is not properly calculating its tax liability, this should be reported if it is considered material.

Overall, ISA 260 emphasises the importance of open and transparent communication between auditors and those charged with governance to facilitate effective oversight of the audit process.

Audit Communication

Throughout the audit process, auditors communicate with various parties to ensure

effective planning, execution, and reporting of the audit. Key audit communications typically include:

- **Engagement Letter:** At the beginning of the audit process, auditors communicate with management or those charged with governance to establish the terms of the audit engagement. This includes the scope of the audit, responsibilities of both parties, and any other relevant terms and conditions. The engagement letter formalises the agreement between the auditor and the auditee.
- **Entry Meeting:** Towards the start of the audit process, the audit team should meet with the auditee and discuss the elements of the engagement letter. While they may have acknowledged the letter in writing, there may be some remaining misunderstandings that can be discussed and corrected at an early stage.
- **Audit Planning Meeting:** Auditors typically hold a meeting with management or those charged with governance to discuss the audit plan. This includes the timing of fieldwork, areas of focus, significant risks, and other relevant matters. The purpose of this meeting is to ensure alignment between the auditor and the auditee regarding the audit approach.
- **Interim Audit Findings:** During the audit fieldwork, auditors may communicate interim findings to management or relevant personnel. These findings may include preliminary observations on control deficiencies, potential errors, or areas of concern. Timely communication of interim findings allows management to take corrective action promptly.
- **Audit Progress Updates:** Auditors provide periodic updates on the progress of the audit to management or those charged with governance. This includes updates on fieldwork completion, any significant issues encountered, and any changes to the audit plan. Regular communication ensures transparency and allows for adjustments as necessary.
- **Management Representations:** Auditors obtain representations from management or those charged with governance regarding various matters related to the financial statements. These representations confirm management's responsibilities, the completeness of information provided to auditors, and other relevant matters. Management representations are typically documented in writing to provide evidence of management's acknowledgment of its responsibilities.
- **Exit Meeting:** Prior to issuing the audit report, the team should meet with the auditee to discuss all draft audit findings. This meeting gives the opportunity for the auditor to explain key findings and to address any potential misunderstandings relating to the audit before the audit reports is issued.
- **Final Audit Findings and Reports:** At the conclusion of the audit, auditors communicate their final findings and conclusions to management or those charged with governance. This includes the results of audit procedures, any identified issues or discrepancies, and the auditor's opinion on the financial statements. Auditors issue an audit report that summarises their findings and provides assurance on the truth and fairness of the financial statements.

Effective communication throughout the audit process is essential for building trust and ensuring the audit's success. It allows auditors to address concerns promptly, provide relevant insights, and facilitate a collaborative approach to achieving audit objectives.

Relationships with Audited Bodies

Auditors should make every effort to establish and maintain constructive working relationships with all audited bodies. An audit is not conducted to criticise or to score points, or solely to identify weaknesses or fraud. A more important audit aim is to bring about improvement and promote better financial and management practices in audited bodies. This requires the cooperation of audited bodies and auditors should take steps to obtain this by:

- Making early contact with senior staff in the audited body to arrange the audit.
- Providing the audited body with details of the proposed audit, including an outline of the scope of the audit, details of the branches, establishments and activities to be audited, details of the documents, records and files that will be required and the audit timetable.
- Arranging the nomination by management of a liaison officer from the audited body, who can provide a channel for regular and timely contact with the audited body for the duration of the audit.
- Maintaining contact throughout the audit to ensure responsible officers of the audited body are aware of progress and of the issues emerging from the audit as they arise.

Audit Committees

A particularly important element of “those charged with governance” for auditors is the audit committee. If in place, these committees tend to be the main point of contact for the auditor through the audit process.

Typically, an audit committee is a subcommittee within an organisation’s board of directors or governing body that is responsible for overseeing the financial reporting process, internal controls, and audit functions. Its primary purpose is to provide independent and objective oversight of the financial reporting process, ensuring accuracy, transparency, and compliance with relevant regulations and standards.

Key responsibilities of an audit committee might include:

- Financial Reporting Oversight: Reviewing and approving financial statements, ensuring they are accurate, complete, and in accordance with applicable accounting standards and regulations.
- Internal Control Evaluation: Assessing the effectiveness of the organisation’s internal controls and risk management processes to safeguard assets, ensure compliance with laws and regulations and maintain the integrity of financial reporting.
- External Audit Oversight: Selecting, appointing, and overseeing the external audit firm responsible for auditing the organisation’s financial statements. The committee monitors the auditor’s independence, performance, and objectivity.
- Risk Management: Evaluating and monitoring financial, operational, and compliance risks facing the organisation, and ensuring appropriate measures are in place to mitigate these risks.
- Compliance and Ethics Oversight: Reviewing the organisation’s compliance with relevant laws, regulations, and ethical standards, including whistleblower policies and codes of conduct.

- **Communication with Stakeholders:** Ensuring communication with shareholders, regulators, and other stakeholders regarding financial reporting matters, audit findings, and significant risks.
- **Board Governance:** Contributing to the overall governance of the organisation by advising the board on financial matters, internal controls, and audit-related issues.

Audit committees are typically composed of independent directors with financial expertise who are not involved in the day-to-day operations of the organisation. This independence helps ensure objectivity and impartiality in their oversight duties. Additionally, audit committees may have the authority to engage independent advisors or consultants as needed to assist in fulfilling their responsibilities.

The establishment of an audit committee is often seen as a best practice in corporate governance, particularly in publicly traded companies, where regulatory requirements may mandate its formation. Having a well-functioning audit committee enhances transparency, accountability, and trust among stakeholders in the organisation's financial reporting and governance processes.

Accounting System

An accounting system refers to the structured and organised process of recording, summarising, analysing, and reporting financial transactions and information within an organisation. It encompasses the methods, procedures, and software used to manage an entity's financial activities effectively.

Key components of an accounting system include:

- **Recording Transactions:** The system captures financial transactions, such as sales, purchases, receipts, and payments, in a systematic manner. This may involve the use of journals, ledgers, or electronic accounting software.
- **Classification and Categorisation:** Transactions are classified and categorised according to accounting principles and standards, such as International Financial Reporting Standards (IFRS). This ensures consistency and accuracy in financial reporting.
- **Summarisation and Posting:** Transaction data is summarised and posted to appropriate accounts in the general ledger, which serves as the central repository for financial information. This process includes transferring data from journals to ledger accounts.
- **Financial Reporting:** The accounting system generates various financial reports, including the balance sheet, income statement, and cash flow statement, to provide insights into the organisation's financial performance and position. These reports are used by management, investors, creditors, and other stakeholders to make informed decisions.

Overall, an accounting system plays a vital role in managing an organisation's finances, enabling timely and accurate recording, analysis, and reporting of financial transactions to support decision-making, accountability, and transparency.

To be able to assess audit risk during the audit planning process, they need an understanding of the accounting systems sufficient to identify and understand:

- Major types of transactions in the audited body's operations.

- How such transactions are initiated, authorised and approved, and carried into effect.
- Accounting documents created to support transactions, the amount and nature of supporting evidence, and the security and storage of documents.
- Audit trails including numbering and control systems and basic controls such as bank reconciliations and documentation, and controls over the accuracy of accounting records created.
- Significant accounting records, supporting documents and account balances in the financial statements.
- The accounting and financial reporting process, from the initiation of significant transactions and other events to their inclusion in financial statements and other financial reports.

Content of Financial Statements

It is important that you are clear as to exactly what the financial statements consist of under the IFRS framework.

- They comprise the following:
 - The primary statements
 - Statement of financial position.
 - Statement of profit or loss and other comprehensive income.
 - Statement of changes in equity.
 - Statement of cash flows.
 - The notes to the accounts, including a statement of significant accounting policies.

It is also traditional for the annual report document to include further reports (which are not part of the financial statements) such as:

- The directors' report.
- The chairman's report.
- The auditor's report (where the accounts have been audited).

The main principles underlying the preparation and presentation of company financial statements as set out in the Conceptual Framework are required by IAS 1 Presentation of Financial Statements.

The major points from this document are summarised below:

1. The elements of financial statements

- The starting point here is definitions of assets and liabilities. The other elements are then defined in terms of these.
 - Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.
 - Liabilities are obligations of an entity to transfer economic benefits as a result

of past transactions or events.

- o Owners' equity is arrived at by deducting liabilities from assets (capital = assets – liabilities).
- o Gains and losses are determined in terms of increases and decreases in owners' equity.

2. Recognition in financial statements

- Recognition essentially means the process of recording an item in the accounts. The principles here address when it is acceptable to recognise (record) an asset or liability and when should assets and liabilities be de-recognised (no longer recorded in financial statements). The main points to note are:
 - o Assets and liabilities should be recognised when there is evidence of their existence AND they can be reliably measured.
 - o They should be derecognised when the rights (assets) or obligations (liabilities) no longer exist.

Further details on the content and presentation of financial statements are considered as part of the Financial Accounting modules.

Important Elements – Statement of Financial Position

Important account balances and the key features of the associated accounting systems are summarised below.

Non-Current Assets

A non-current asset accounting system, also known as fixed asset accounting, is a structured process used by organisations to record, track, and manage non-current assets throughout their lifecycle. Non-current assets, also referred to as fixed assets or long-term assets, include tangible assets such as property, plant, and equipment (PP&E), as well as intangible assets like patents, trademarks, and goodwill.

Key elements of the accounting system might include:

- Acquisition: The system records the acquisition of non-current assets, including their cost and any associated expenses such as installation or delivery costs. This typically involves documenting purchase invoices, contracts, or other evidence of ownership.
- Capitalisation: Non-current assets with a useful life extending beyond one accounting period are capitalised, meaning their costs are recorded as assets on the balance sheet rather than expensed immediately on the income statement. Capitalisation thresholds and criteria are established to determine which expenditures qualify for capitalisation.
- Depreciation or Amortisation: Non-current assets are systematically depreciated (for tangible assets) or amortised (for intangible assets) over their estimated useful lives. Depreciation and amortisation expenses are recognised on the income statement to allocate the asset's cost over its useful life, reflecting the consumption of economic benefits provided by the asset.
- Impairment Testing: Non-current assets are periodically assessed for impairment, which occurs when the carrying amount of an asset exceeds its recoverable amount. Impairment testing involves comparing the asset's carrying amount to its

recoverable amount and recognising impairment losses if necessary.

- **Disposal:** The system tracks the disposal of non-current assets when they are sold, retired, or otherwise disposed of. Disposal transactions involve removing the asset from the balance sheet, recognising any gain or loss on disposal, and updating depreciation or amortisation schedules accordingly.
- **Revaluation:** Some organisations may choose to revalue certain non-current assets periodically to reflect changes in fair value. Revaluation involves updating the asset's carrying amount to its current fair value, with any resulting gains or losses recognised in the income statement.
- **Accounting Policies and Disclosures:** Non-current asset accounting systems establish accounting policies and procedures for the recognition, measurement, and disclosure of non-current assets in accordance with relevant accounting standards (such as IFRS). These policies ensure consistency and transparency in financial reporting.

Cash in Bank

A cash in bank accounting system is a structured process used by organisations to record, track, and manage their cash balances held in bank accounts. This system ensures accurate financial reporting and effective cash management.

Key elements of the accounting system might include:

- **Recording Cash Transactions:** All cash transactions, including deposits, withdrawals, transfers, and bank charges, are promptly recorded in the accounting records. This ensures that the organisation's cash balances are up-to-date and accurately reflected in the financial statements.
- **Cash Flow Management:** The cash in bank accounting system helps organisations monitor their cash flow position, including inflows and outflows of cash. Cash flow projections and forecasts may be prepared based on historical data and expected future transactions to ensure adequate liquidity to meet operational needs.
- **Bank Accounts Management:** Organisations may have multiple bank accounts for different purposes, such as operating accounts, payroll accounts, and savings accounts. The accounting system tracks each bank account separately and reconciles their balances to ensure accuracy.
- **Interest and Bank Charges:** Interest earned on bank deposits and fees charged by banks are recorded in the accounting system. Interest income is typically reported as revenue, while bank charges are treated as expenses.
- **Accounting Policies and Disclosures:** Cash accounting policies and procedures are established to ensure consistency and compliance with accounting standards (such as IFRS). Disclosure requirements related to cash balances and cash equivalents are followed in the financial statements.

Inventory

An inventory accounting system is a structured process used by organisations to record, track, and manage their inventory, which consists of goods held for sale, production, or use in the normal course of business.

Key elements of the accounting system might include:

- **Inventory Valuation Methods:** Organisations must decide on the method they will use to value their inventory. Common valuation methods include First-In, First-Out (FIFO), Last-In, First-Out (LIFO), and weighted average cost. Each method has its own implications for financial reporting and tax purposes.
- **Inventory Tracking:** The system captures data on the quantity, cost, and location of inventory items as they move through the organisation's supply chain, from acquisition to sale or usage. This may involve the use of barcode scanning, radio-frequency identification (RFID) technology, or manual tracking methods.
- **Purchasing and Receiving:** Procedures for purchasing inventory should include controls to ensure that inventory is acquired at the correct quantities, prices, and quality standards. Receiving processes should verify that the inventory received matches the quantities and specifications outlined in purchase orders.
- **Inventory Counts and Reconciliation:** Regular physical inventory counts are conducted to reconcile the quantities of inventory on hand with the amounts recorded in the accounting records. Discrepancies are investigated and adjusted as necessary to maintain accuracy.
- **Cost of Goods Sold (COGS) Calculation:** Inventory accounting systems track the cost of goods sold by recording the cost of inventory sold during a specific accounting period. This calculation is crucial for determining gross profit and accurately reporting financial results.
- **Financial Reporting:** Inventory accounting systems generate reports for financial statements, including the balance sheet (showing inventory assets) and income statement (reflecting COGS and gross profit). These reports must comply with relevant accounting standards, such as IFRS.

Liabilities

A liability accounting system is a structured process used by organisations to record, track, and manage their financial obligations or debts. Liabilities represent amounts owed to creditors, suppliers, employees, or other parties and are an essential component of the organisation's financial position.

Key elements of the accounting system might include:

- **Classification of Liabilities:** Liabilities are categorised based on their nature, timing, and terms of payment. Common categories of liabilities include accounts payable, accrued expenses, loans payable, bonds payable, deferred revenue, and provisions for contingencies.
- **Recording Transactions:** All transactions that result in the creation, modification, or settlement of liabilities are promptly recorded in the accounting records. This includes purchases on credit, accrual of expenses, borrowing of funds, repayment of loans, and other contractual obligations.
- **Measurement and Valuation:** Liabilities are initially recorded at their fair value or the amount of consideration received or payable, whichever is more reliably measurable. Subsequent measurement may involve amortisation of discounts or premiums, accrual of interest, and adjustments for changes in fair value or estimates.
- **Disclosure and Reporting:** Liabilities are disclosed in the financial statements,

including the balance sheet and accompanying notes, to provide stakeholders with information about the organisation's financial obligations. This includes details about the nature, timing, and terms of liabilities, as well as any significant risks or uncertainties.

Important Elements – Statement of Profit and Loss and Other Comprehensive Income

Important account balances and the key features of the associated accounting systems are summarised below.

Sales

A sales accounting system is a structured process used by organisations to record, track, and manage their sales transactions. It encompasses various activities related to sales, including invoicing customers, recording revenue, managing accounts receivable, and ensuring compliance with accounting standards and regulations.

Key elements of the accounting system might include:

- **Order Processing:** The system starts with the processing of sales orders received from customers. This involves verifying customer information, product details, pricing, and terms of sale.
- **Invoicing:** Invoices are generated and sent to customers for goods sold or services rendered. Invoices typically include details such as the quantity, description, price, and total amount due. Depending on the terms of sale, invoices may be issued at the time of sale or upon shipment of goods or completion of services.
- **Revenue Recognition:** Revenue from sales is recognised in accordance with accounting standards such as IFRS. Revenue recognition criteria, including the transfer of risks and rewards of ownership, are applied to determine when revenue should be recognised.
- **Accounts Receivable:** Accounts receivable represent amounts owed by customers for goods or services sold on credit. The sales accounting system tracks accounts receivable balances, aging schedules, collections, and allowances for doubtful accounts. (Accounts Receivable balance is presented at year end in the SOFP)
- **Cash Receipts:** Cash receipts from customer payments are recorded and applied to outstanding accounts receivable. Cash receipts may be received via various payment methods, including cash, cheques, electronic funds transfers, credit cards, or online payment platforms.
- **Sales Returns and Allowances:** The system records and tracks sales returns, allowances, and discounts granted to customers. These adjustments are reflected in the accounting records to ensure accurate reporting of net sales revenue.

Expenses (Including Purchases)

An expense accounting system is a structured process used by organisations to record, track, and manage their expenditures incurred in the normal course of business operations. It encompasses various activities related to acquiring goods and services from suppliers, processing purchase orders, managing accounts payable, and ensuring compliance with accounting standards and regulations.

Key elements of the accounting system might include:

- **Purchase Requisition:** The system begins with the submission of purchase requisitions by authorised personnel who identify the need for goods or services. Purchase requisitions specify details such as the description of items, quantity, specifications, delivery requirements, and budgetary approvals.
- **Purchase Order (PO) Processing:** Purchase orders are generated based on approved purchase requisitions. POs are sent to suppliers to formalize the purchase agreement, confirm pricing and terms, and authorise the delivery of goods or services. POs typically include details such as the item description, quantity, price, delivery date, and terms of payment.
- **Receipt of Goods or Services:** Upon receipt of goods or services, the receiving department verifies the quantity, quality, and condition of the items received against the information specified in the purchase order. Any discrepancies or damages are documented and communicated to the purchasing department for resolution.
- **Invoice Processing:** Invoices received from suppliers are matched against corresponding purchase orders and receiving reports to ensure accuracy and completeness. Invoices are verified for correct pricing, quantities, discounts, and terms of payment before processing for payment.
- **Accounts Payable:** The purchases accounting system maintains records of accounts payable, representing amounts owed to suppliers for goods or services received but not yet paid. Accounts payable balances are monitored, aged, and managed to ensure timely payment and optimise cash flow.
- **Payment Processing:** Approved invoices are processed for payment according to the agreed-upon terms with suppliers. Payment methods may include cheques, electronic funds transfers, wire transfers, or other electronic payment platforms. Payment terms, such as payment due dates and discounts for advance payment, are adhered to.
- **Accrual Accounting:** Purchases are recorded on an accrual basis, meaning they are recognised when incurred, regardless of when cash is paid or received. This ensures that expenses are matched with the revenues they generate in the appropriate accounting period, in accordance with accounting standards.

Payroll

A payroll accounting system is a structured process used by organisations to manage and record employee compensation, deductions, and related payroll expenses. It ensures accurate calculation and timely disbursement of wages or salaries to employees while complying with relevant laws, regulations, and internal policies.

Key elements of the accounting system might include:

- **Employee Information Management:** The system maintains accurate records of employee information, including personal details, employment status, tax withholding allowances, salary or wage rates, benefits, and deductions.
- **Timekeeping and Attendance Tracking:** Timekeeping systems or time clocks are used to track employee hours worked, overtime, vacation, sick leave, and other absences. This data is used to calculate employee compensation accurately.
- **Payroll Processing:** Payroll processing involves calculating gross wages or salaries for each employee based on hours worked, rates of pay, and other factors such as overtime, commissions, bonuses, and allowances. Deductions for taxes, benefits,

retirement contributions, and other withholdings are also calculated.

- **Tax Withholding and Reporting:** The system calculates and withholds applicable federal, state, and local taxes from employee wages, including income tax, Social Security tax, Medicare tax, and unemployment tax. It generates tax forms such as W-2s for employees and reports payroll taxes to tax authorities as required by law.
- **Benefit Administration:** Payroll systems may administer employee benefits such as health insurance, retirement plans, flexible spending accounts, and other voluntary deductions. Deductions for benefits are calculated and withheld from employee payments, and contributions are remitted to benefit providers.
- **Direct Deposit and Payment Distribution:** Payroll systems facilitate electronic fund transfers for direct deposit of employee wages into their bank accounts. They also generate paper payments or electronic pay stubs for employees who do not use direct deposit.

Internal Controls

ISA 315 (Identifying and Assessing the Risks of Material Misstatement) requires that auditors must understand an entity's internal controls. It identifies five components of a system of internal control consistent with the COSO Framework.

Internal control generally refers to any action designed to reduce or mitigate risks that may prevent an organisation meeting its objectives. It refers to the policies, procedures, and practices implemented by an organisation to safeguard its assets, ensure accuracy and reliability in financial reporting, and promote compliance with laws, regulations, and internal policies.

Key elements of internal control include:

- **Control Environment:** The tone set by management and the organisation's culture regarding the importance of internal control and ethical behaviour. A strong control environment fosters a culture of accountability, integrity, and compliance throughout the organisation.
- **Risk Assessment:** The process of identifying, analysing, and evaluating risks that could impact the achievement of organisational objectives. Risk assessment helps determine the nature and extent of controls needed to mitigate identified risks effectively.
- **Control Activities:** The specific policies, procedures, and practices implemented to address identified risks and achieve control objectives. Control activities may include segregation of duties, authorisation procedures, physical controls, reconciliations, and reviews of operations.
- **Information and Communication:** The timely and accurate communication of relevant information throughout the organisation to support effective decision-making and control activities. This includes clear communication of roles, responsibilities, policies, and procedures to employees. ISA 315 requires the auditor to understand how the entity communicates significant matters that support the preparation of the financial statements and related reporting responsibilities in the information system and other components of the system of internal control. This includes:
 - Between people within the entity, including how financial reporting roles and

responsibilities are communicated.

- o Between management and those charged with governance.
- o With external parties, such as those with regulatory authorities.
- **Monitoring Activities:** Ongoing monitoring of internal control processes and activities to assess their effectiveness, identify deficiencies or weaknesses, and take corrective action as needed. Monitoring activities may include management reviews, internal audits, self-assessments, and feedback mechanisms.

Internal control systems are designed to provide reasonable assurance, not absolute assurance, regarding the achievement of organisational objectives. They are tailored to the specific risks and circumstances of each organisation and may evolve over time in response to changes in the business environment, technology, regulations, or other factors.

Effective internal control systems help organisations achieve their goals, protect their assets, maintain integrity in financial reporting, and comply with legal and regulatory requirements. They also contribute to the efficient and effective operation of the organisation and enhance confidence among stakeholders, including investors, creditors, regulators, and the public.

Benefits of Internal Control

The main benefits to an organisation of effective internal control systems include:

- Assurance that all transactions are completely and accurately processed.
- Confidence that only authorised transactions take place.
- Assurance that adequate documentation supporting transactions is created and retained.
- Assurance that the company's assets and liabilities are correctly stated, in order for them to make informed decisions on the operation of the business.
- Minimisation of the risk of fraud and misappropriation of assets.

If a sound system of internal control exists, the auditor will be able to rely on those controls and reduce the audit testing accordingly whilst still being able to provide an audit opinion on the financial statements.

Control Activity Categories

Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that relate to the following:

Authorisation and approvals – an authorisation affirms that a transaction is valid and typically takes the form of an approval by a higher level of management or of verification and a determination if the transaction is valid. An example of an authorisation and approval control is a supervisor approving an expense report after reviewing whether the expenses seem reasonable and within policy. An example of an automated approval is when an invoice unit cost is automatically compared with the related purchase order unit cost within a pre- established tolerance level. Invoices within the tolerance level are automatically approved for payment. Those invoices outside the tolerance level are flagged for additional investigation.

Reconciliations – controls that compare two or more data elements. If differences are identified, action is taken to bring the data into agreement. Reconciliations generally address the completeness or accuracy of processing transactions. The most common reconciliation is the bank reconciliation; the organisation checks the cash balance as per the accounting system to the balance as per the bank statement. Any differences are investigated and corrections made as required.

Verifications – controls that compare two or more items with each other or compare an item with a policy and will likely involve a follow-up action when the two items do not match or the item is not consistent with policy. Verifications generally address the completeness, accuracy or validity of processing transactions.

Physical or logical controls – controls that encompass the physical security of assets such as secured facilities over access to assets and records, banking cash immediately, authorisation for access to computer programs and data files, electronic tagging of inventory and portable non-current assets.

Segregation of duties – assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be able to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

Possible application:

- Consider a purchasing system in a manufacturing company:
 - Order actioned by Purchasing Manager.
 - Finance Manager approved purchase order.
 - Storekeeper checks goods received.
 - Finance Director authorises final payment.

Internal Audit

Internal audit is a common monitoring control in an organisation. Internal Audit is an independent unit within an organisation charged with audit activities on behalf of the management of the organisation. They act as an independent check on performance and can be very effective in helping management to fulfil its monitoring role.

To be most effective, internal audits must remain independent and not become part of operational controls. The internal audit unit should not be performing checks (such as ex-ante or ex-post controls of expense vouchers) on an on-going basis. It should carry out risk-based audits as independent reviews, to ensure that management and staff have been carrying out their duties properly.

The external auditor should inquire with the auditee which type of internal audits are undertaken. If acceptable, this would mean that the external auditor could apply a more efficient approach by making use of the work and results of the internal audit.

If the entity has an internal audit function, the auditor shall obtain an understanding of the following to determine whether the internal audit function is likely to be relevant to the audit:

- The nature of the internal audit function's responsibilities.
- How the internal audit function fits in the entity's organisational structure.

- The activities performed, or to be performed, by the internal audit function.

Summary of Unit B and key learning outcomes

After completing Unit B, you should be able to demonstrate an understanding of the organisation's external auditing procedures.

The key learning outcomes are presented in the table below.

Ref	Learning Outcome	
B1	Describe the organisation's systems and the external auditing procedures. Describe the features of accounting systems including purchases, sales, stock, expenses, statement of financial position (balance sheet) items and payroll.	Understand the respective roles of the auditor, management and those charged with governance. Outline the key elements of auditor/ auditee communication through the audit process. Explain the typical role of audit committees
B2	Describe the features of accounting systems including purchases, sales, stock, expenses, statement of financial position (balance sheet) items and payroll.	Describe the main elements of any accounting system and main contents of financial statements prepared under IFRS. Explain the accounting systems around the main elements of the Statement of Financial Position and the Statement of Profit, Loss and other Comprehensive Income.
B3	Identify principles of control and when they should be used including separation of functions, the need for authorisation, recording custody, vouching and verification.	Explain the main elements of internal control. Understand the main categories of control activities.

Quiz Questions

1	Learning Outcome: BI
Which of the following statements best describes the timing of communication between auditors and those charged with governance?	
A	Communication should occur throughout the audit process, including planning, fieldwork, and reporting stages.
B	Communication should only occur at the conclusion of the audit engagement.
C	Communication should only occur if significant issues arise during the audit.
D	Communication should be limited to written reports

1	Feedback
A	Yes! Communication should occur at all stages of the audit.
B	No – all stages.
C	No – Communication should take place at all stages and even if no significant issues arise.
D	No – Verbal communication is also important e.g. to attend audit committee meetings.

2	Learning Outcome: BI
What is the primary responsibility of management in relation to the audit process?	
A	Conducting the audit procedures and verifying financial transactions.
B	Reviewing and approving the audit engagement letter.
C	Approving the appointment of the auditor
D	Overseeing the audit engagement, providing access to records and personnel, and ensuring cooperation with auditors

2	Feedback
A	No – this is the work for the auditor!

B	No – they might sign off acknowledgement of the engagement letter but not primary responsibility.
C	No – This should be done by shareholders.
D	Yes! To facilitate the audit process and provide access to all information.

3	Learning Outcome: B2
What is the auditor's primary objective when evaluating the organisation's accounting system?	
A	To identify opportunities for cost reduction and process improvement.
B	To ensure compliance with tax laws and regulations.
C	To provide assurance on the accuracy and reliability of financial reporting.
D	To manage financial risks and prevent fraud.

3	Feedback
A	No. This is the responsibility of management – although the auditor can report such matters if they come across them.
B	No. This is the responsibility of management – although the auditor can report such matters if they come across them.
C	Yes – as required by ISAs.
D	No. This is the responsibility of management – although the auditor can report such matters if they come across them.

4	Learning Outcome: B4
How does segregation of duties help prevent and detect fraud?	
A	By consolidating all responsibilities within a single department.
B	By minimising oversight and control over financial transactions.
C	By ensuring that no single individual has control over all aspects of a transaction.
D	By allowing employees to perform tasks without proper authorisation.

4	Feedback
A	No. This would be a risk.
B	No. It institutes more control.
C	Yes! By ensuring multiple officers have a role in a single transaction it reduces the risk of error/fraud.
D	No. Authorisation is another key element of control activities.

5	Learning Outcome: B5
How is the scope of internal audit typically determined?	
A	By regulatory authorities and accounting standards.
B	By management and the board of directors.
C	By external auditors and industry peers.
D	By government agencies and tax authorities.

5	Feedback
A	No.
B	Yes! Internal auditors are employed by the organisation and are subject to the direction of senior management/board of directors.
C	No.
D	No.

Quiz Answers

Question	Answer
1	A
2	D
3	C
4	C
5	B

Exercises

1. Explain the key features of a payroll accounting system.
2. Identify and explain the five key elements of an internal control system under ISA 315/ COSO Framework
3. Give an example of how segregation of duties could be executed in an inventory system

Exercise Solutions

1. Employee Information Management: Maintaining accurate records of employee details such as names, addresses, tax withholding allowances, and salary rates.
 - Timekeeping and Attendance Tracking: Recording employee work hours, overtime, vacation, and sick leave to calculate wages accurately.
 - Payroll Processing: Calculating gross wages based on hours worked and applicable rates, and deducting taxes, benefits, and other withholdings.
 - Tax Withholding and Reporting: Withholding and remitting federal, state, and local taxes from employee wages, and preparing and filing tax forms as required by law.
 - Benefits Administration: Managing employee benefits such as health insurance, retirement plans, and other deductions from payroll.
 - Payment Distribution: Distributing employee wages through direct deposit or issuing paper cheques or pay stubs.
 - Payroll Reconciliation: Reconciling payroll transactions with timekeeping records, employee information, and general ledger accounts.
 - Compliance and Reporting: Ensuring compliance with tax laws, labour regulations, and reporting requirements, and generating payroll reports for internal and external stakeholders.
2. Control Environment: This is the overall attitude and awareness about the importance of control within the organisation, set by top management. It is about creating a culture where everyone understands the value of following rules, being ethical, and taking responsibility.

- **Risk Assessment:** This involves identifying and understanding potential risks that could affect the organisation's ability to achieve its goals. By knowing what risks exist, management can plan how to deal with them effectively.
 - **Control Activities:** These are the specific actions and procedures put in place to address the identified risks. They include things like having clear rules and procedures, making sure different tasks are separated to prevent errors or fraud, and regularly checking that everything is working as it should.
 - **Information and Communication:** This is about making sure that everyone has the information they need to do their jobs effectively and that communication is clear and open across the organisation. It is important for decision-making, problem-solving, and keeping everyone informed about what is happening.
 - **Monitoring Activities:** This involves regularly checking to make sure that the controls in place are working as intended. It is like doing regular health check-ups on the organisation's systems and processes to catch any problems early and fix them before they become bigger issues.
3. **Inventory Receiving:** One employee is responsible for receiving inventory shipments and inspecting them for accuracy and quality. This employee verifies that the items received match the corresponding purchase orders and packing slips, checks for any damages or discrepancies, and records the receipt of inventory in the system.
- **Inventory Storage:** Another employee is responsible for storing the received inventory in the appropriate location within the warehouse or storeroom. This employee ensures that items are organised, labelled correctly, and stored securely to prevent loss, damage, or theft.
 - **Inventory Issuance:** A separate employee is responsible for issuing inventory to other departments or locations as needed. This employee receives requests for inventory from authorised personnel, retrieves the items from storage, and records the issuance in the system to maintain accurate inventory records.
 - **Inventory Reconciliation:** A different employee is responsible for reconciling the physical inventory counts with the inventory records in the system on a regular basis. This employee conducts periodic physical inventory counts, compares the results to the recorded inventory balances, investigates any discrepancies, and adjusts as necessary to ensure accuracy.

Unit C: Audit Techniques and Planning Methods.

Learning outcomes

- C.1 Describe the different verification techniques that can be used and explain what type of item could be audited by this method. Methods to include physical examination, reperformance, third party confirmation, vouching, documentary evidence and identification of unusual items.
- C.2 Identify different sampling techniques used in auditing and describe where these could be used including confidence levels, selection techniques including random numbers, interval sampling and stratified sampling.
- C.3 Explain tests of control and substantive procedures and their links to the audit objective.
- C.4 Explain the auditing techniques that should be used in an IT environment.
- C.5 Explain how management feedback, that includes systems weaknesses, clerical/accounting mistakes, disagreement regarding accounting policies or treatment, can be used when planning an audit.

Introduction to Unit C

This Unit we consider key steps in gathering audit evidence to inform our audit report. First, we start by considering what we mean by “Audit Evidence” and the different possible sources of evidence through the audit process. Given that we cannot possibly review all transactions and documents at the auditee we also think about how we go about testing a sample of these to allow us to make an informed conclusion over the entire population. Remember, the objective is only to give reasonable assurance not total assurance that the financial statements are free from material misstatement.

We also consider assertions, or specific characteristics, around the key financial statement disclosures and how we can link these to the audit work performed. We have a menu of options to test these assertions and we will examine these in more detail. Any audit involved a mix of controls testing, test of details and analytical procedures; we will explain each of these in detail.

Given that IT plays an ever-increasing role in our lives and in business activities we will consider how we approach control around IT systems during an audit. Risks around IT systems, specifically related to the financial statements have the potential to play a significant role in focusing audit work and detailed examples of such controls will be considered.

Finally, we will think about what happens if we come across information from management that might imply a risk of material misstatement to one, or more, financial statement balance or disclosure.

Audit Evidence

ISA 500 states the evidentiary requirements for an audit.

ISA 500 – Audit Evidence

“The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.”

- Sufficiency of Audit Evidence: Relates to the quantity of the audit evidence.
 - Sufficiency refers to the quantity or amount of audit evidence that needs to be obtained by the auditor. The auditor must gather enough evidence to provide a reasonable basis for their conclusions on the financial statements.
 - The sufficiency of audit evidence is influenced by factors such as the nature and complexity of the entity’s operations, the assessed risks of material misstatement, and the reliability of available evidence.
 - The auditor needs to exercise professional judgement to determine the appropriate extent of audit procedures necessary to obtain sufficient evidence in the circumstances of the audit.
- Appropriateness of Audit Evidence: Relates to the relevance and reliability of the audit evidence.
 - Appropriateness refers to the relevance and reliability of the audit evidence obtained. The evidence must be both relevant and reliable to support the conclusions reached by the auditor.
 - Relevant evidence is pertinent to the financial statement assertions being tested. It provides information about the accuracy, completeness, and validity of the financial statements.
 - Reliable evidence is trustworthy and can be depended upon to support the auditor’s conclusions. The reliability of evidence can be influenced by its source, nature, and circumstances under which it was obtained.
 - The auditor needs to consider the quality of available evidence and perform appropriate audit procedures to obtain evidence that is both relevant and reliable.

Sources of Audit Evidence

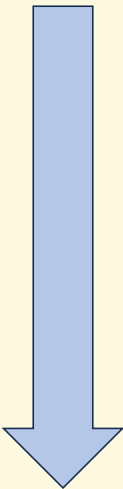
The reliability of audit evidence is influenced by its source: internal or external, and by its nature: visual, documentary, electronic or oral. The extent to which the auditor can rely on evidence depends on the circumstances in which it is collected. However, there are some guiding principles for the auditor:

- Audit evidence from external sources can be more reliable than evidence from less independent internal sources. For example, the confirmation of a debt or loan by the debtor or lender can be more reliable than an internal record.
- Audit evidence generated internally is more reliable when the related accounting

and internal control systems are effective. For example, a payment voucher is more reliable as evidence of a payment if it has been approved by an appropriate delegate.

- Audit evidence obtained directly by the auditor is more reliable than that obtained (or produced) by the audited body. Auditors should take some action to confirm, from other sources or records, confirmation of assertions provided by the audited body.
- Audit evidence in the form of documents and written representations is more reliable than oral representations. Where possible, the auditor should seek to obtain written confirmation of all material oral statements made by management and/or directors.

The various sources of evidence and their reliability is shown in the diagram below.

Evidence		Examples
	Most reliable	
Externally generated documents sent directly to the auditor		Bank confirmations Receivables and payables confirmations
Externally generated documents held by the client		Suppliers invoice Bank statement
Internally generated documents that are externally circulated		Receipted shipping document
Internally generated documents that are not circulated		Purchase requisitions
	Least Reliable	

The auditor should consider the relationship between the cost of obtaining audit evidence and the usefulness of the information obtained. However, difficulty or expense involved in obtaining evidence does not provide a valid basis for omitting a necessary procedure.

When in doubt concerning a material financial statement assertion, the auditor must attempt to obtain sufficient evidence to remove such doubt. If unable to obtain such evidence, however, the auditor will need to consider a modified audit opinion. See ISA 500 Audit Evidence for more guidance.

Evidence Gathering Techniques

To gather sufficient appropriate audit evidence the auditor will carry out audit work and complete specified audit programs focussed on the risks identified during audit planning. In designing the audit program, the most time and cost-effective approach should be

adopted given the objectives and scope of the audit. It should aim to collect sufficient and appropriate evidence that enables the auditor to attain well-founded audit findings about the program or activity under review and to make appropriate recommendations. Decisions will have to be made at each stage of the audit regarding the need for specific testing, data collection and analysis. In general terms, audit evidence is obtained through the performance of and use of variety of techniques as shown in the table below.

Technique	Description
Observation	Observation involves looking at a process or procedures being performed. For example, this may include looking at how payments are processed or how an end-of-year stock count is carried out.
Inspection	Inspection might involve examining books, records and other case files or physical assets. Inspection may include examining the books and records to determine how funds have been accounted for (e.g. classification, accuracy). Inspection may also involve examination of assets, such as vehicles or buildings to check their existence.
Inquiry	<p>This is a request to elicit specific information. A great deal of audit work is based on inquiries/interviews, and different kinds of interviews are carried out at different stages of the audit. The entire spectrum of inquiries is used, from fact-finding conversations and discussions, through unstructured interviews (that is, with “open-ended” questions) to structured interviews that follow a list of closed questions.</p> <p>The results of the interviews must be compiled and documented in a way that facilitates analysis and reliability of information. For all interviews, meeting minutes should be prepared and retained on the audit file.</p>

Technique	Description
Walk through	<p>Walkthrough is the act of tracing the identified significant controls in a transaction through organisational records and procedures – a practical approach to learning how a process works and determining whether or not the policies have been communicated and implemented. The auditor's primary objective when performing a walkthrough is to develop an understanding of the transactions flow – that is, how transactions are initiated, processed, authorised, recorded, and reported. It is a technique for validating the understanding of the system/process and verifying the accuracy of the flowcharts, narratives and other documentations. When performing a walkthrough, the auditor may find that some processes having control significance were inadvertently omitted in the flowcharts or narrative notes. For example, tracing a transaction through the expense system from initiation (e.g. purchase order) through to payment and tracing another transaction from payment back to initiation.</p> <p>Walk-through tests are normally conducted during audit planning to confirm understanding of controls and processes. They can be contrasted with controls tests (discussed later in this module) which are used to test whether controls systems are actually operating as intended.</p>
Analytical Review	<p>Analytical review procedures are an important tool in the audit process and they are employed during:</p> <p>Audit Planning</p> <ul style="list-style-type: none"> • Understanding of the “unit/process” under audit – as there is the need to deepen the understanding of the relevant unit and issues surrounding it. • Risk assessment – to direct attention to higher risk areas in determining the nature, timing and extent of audit procedures. <p>Audit Execution</p> <ul style="list-style-type: none"> • Substantive testing – to obtain audit evidence of accuracy or to identify potential errors/misstatements as a substitute for tests of details. <p>Audit Completion</p> <ul style="list-style-type: none"> • Overall conclusion – to assist in assessing the propriety of audit conclusions reached in evaluating the overall opinion/report. <p>Note that analytical procedures must be used as part of audit planning (ISA 315) and at audit completion (ISA 520). While the auditor may find it useful to perform analytical procedures as part of audit execution this is not an ISA requirement.</p>

Technique	Description
Computer Assisted Audit Techniques and Tools (CAATs)	<p>CAATs are computer tools and techniques in performing various auditing procedures and improving the effectiveness and efficiency of obtaining and evaluating audit evidence. It provides effective tests of controls and substantive procedures where a wide range of techniques and tools are used to automate the test procedures for evaluating controls, obtaining evidence and data analysis.</p> <ul style="list-style-type: none"> • CAATs used to validate programs/systems (functionality of the programmable controls) Program review involves a detailed examination of program coding. It generally involves a fair degree of programming skill and a thorough knowledge of program specification; and, • CAATs can be used to analyse data files. The results of data analysis can indirectly help the auditor to reach conclusions regarding the quality of programs. However, these CAATs do not directly test the validity of programs.
External Confirmation	<p>External Confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party) in paper form, or by electronic or by other medium. External confirmation procedures are relevant when addressing assertions associated with certain account balances and their elements however it may not be restricted to account balances only e.g. the auditor may request confirmation about the terms of a contract or transactions which an entity has with third parties. The most common type of external confirmation usually comes from banks to confirm number of accounts held and account balances (cash at bank) at a particular time – normally at year-end.</p>
Re-performance	<p>Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control system. For example, reperforming a bank reconciliation using source documents i.e. general ledger and bank statements.</p>
Recalculation	<p>Recalculation consists of checking the mathematical accuracy of documents or records and may be performed manually or electronically. For example, checking the additions and mathematical accuracy of a bank reconciliation.</p>

Sampling

Obviously, an auditor does not have time to test all financial transactions of the organisation before giving an audit opinion. As previously, mentioned, the auditor should perform enough work to lower audit risk to an acceptable level. For this reason, we use audit sampling to base conclusions over large populations based on the results of testing some of them.

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

Audit sampling is used to provide evidence and provide a reasonable basis to draw conclusions about a population from which a sample is selected. The auditor should design and select an audit sample, perform audit procedures, and evaluate sample results to obtain sufficient appropriate audit evidence to achieve the audit's objectives.

Sampling is not inevitable for all audit areas but is normally appropriate for areas in which there are a large number of similar transactions and where it is not cost effective to test them all. Examples where sampling is NOT appropriate:

- The auditor is performing inquiry or observation procedures.
- Populations are too small for valid conclusions to be drawn and it is quicker to test all transactions rather than spend time constructing a sample. For example, four large quarterly payments.
- All the individual transactions in a particular area are material.

Sampling Terminology

Audit sampling is the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

Audit population is the full set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Confidence level is the level of assurance that auditors have in the results obtained from the sample, and the degree of confidence they have in extrapolating those results to the entire population. It is a measure of the reliability of the conclusions drawn from the sample.

Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

- In the case of a test of controls, that controls are more effective than they are. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- In the case of a test of controls, that controls are less effective than they are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Non-sampling risk is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Anomaly is a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

A sampling unit is the individual items constituting a population. Sampling units might be physical items e.g. checks listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances or monetary units.

Statistical sampling – An approach to sampling that has the following characteristics:

- Random selection of the sample items; and
- The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have the two characteristics above is considered non-statistical sampling.

Stratification is the process of dividing a population into subpopulations, each of which is a group of sampling units which have similar characteristics (often monetary value).

Tolerable misstatement is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. Tolerable misstatement is the application of performance materiality to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

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

Sampling Steps

Whether the sampling method is statistical or non-statistical, and regardless of the sampling technique applied, the auditor can follow the key steps below in the audit sampling process:

Step 1 – Design the audit sample. The auditors should consider the objectives of the audit procedures and the attributes of the population from which the sample will be drawn. They should

- Determine test objectives.
- Define error conditions.
- Define the population from which the sample will be drawn.
- Determine the sampling method and the selection technique.
- Define sampling units, i.e. individual items that the population comprises.

Step 2 – Determine sample size. Sample size is affected by the level of sampling risk the auditor is willing to accept. The lower the acceptable risk to the auditor, the greater the sample size will be. The sample size can be determined by the application of a statistically based formula or through the exercise of professional judgement. Among the factors influencing sample size are the following:

- Confidence level or reliability factor. The greater the auditor's required degree of

reliability or confidence that the results of the sample are in fact indicative of the actual incidence of error in the population, the larger the sample size needs to be.

- Extent to which the risk of material misstatement is reduced by the operating effectiveness of controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of risk of material misstatement will be and the larger the sample size needs to be.
- Assessment of the risk of material misstatement. The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be.
- Tolerable deviation rate, i.e. a rate set by the auditor of deviation from prescribed internal control procedures. The auditor seeks to obtain an appropriate level of assurance that the set rate of deviation is not exceeded by the actual rate of deviation in the population; the lower the deviation rates the auditor is willing to accept, the larger the sample size needs to be. (Tolerable rate of deviation as defined by ISA 530.5j is a rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population)
- Expected population deviation rate. The higher the rate of deviation the auditor expects, the larger the sample size needs to be, so the auditor can be able to make a reasonable estimate of the actual rate of deviation.
- Tolerable error. The smaller the error the auditor is willing to accept, the larger the sample size needs to be. (Tolerable error or misstatement as defined by ISA 530.5i is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population).

Select the sample. Select the sample in the expectation that all sampling units in the population have an equal chance of selection. Some methods of sample selection are shown below.

- Random Sampling: Random sampling involves selecting items from the population in such a way that each item has an equal chance of being selected. This method ensures that every item in the population has a chance of being included in the sample, and it helps minimise bias in the selection process. Random sampling is often used when the population is homogeneous, and auditors want to achieve a representative sample.
- Systematic (or Fixed Interval) Sampling: Systematic sampling involves selecting items from the population at regular intervals. The auditor first determines the sample size and then selects every n th item from the population, where " n " is calculated as the population size divided by the sample size. Systematic sampling is efficient and easy to implement, especially when the population is large and well-organised. However, it may introduce bias if there is a systematic pattern in the population.
- Stratified Sampling: Stratified sampling involves dividing the population into subgroups or strata based on certain characteristics (e.g., dollar value, geographical location, type of transaction) and then selecting samples from each stratum. This method allows auditors to ensure adequate representation of different segments of the population and can improve the precision of the sample estimates. Stratified sampling is particularly useful when there are significant variations within the population, and auditors want to focus their testing efforts on specific subgroups.

- **Haphazard (or Targeted) Sampling:** Haphazard sampling, also known as judgemental or purposive sampling, involves selecting items from the population based on the auditor's judgement and discretion. Unlike random or systematic sampling, there is no predetermined method for selecting items, and auditors may choose items based on their knowledge of the client, perceived risks, or specific audit objectives. While haphazard sampling can be quick and flexible, it may be subject to bias and may not provide a representative sample if not carefully planned and executed.
- **Cluster (or Block) Sampling:** Cluster sampling involves dividing the population into clusters or groups and then selecting entire clusters as the sample units. Auditors then perform testing on all items within the selected clusters. Cluster sampling is useful when the population is naturally grouped, and it can help reduce the time and cost associated with sample selection and testing. However, it may introduce additional variability if the clusters are not homogeneous – For example, if you test only transactions in certain months (clusters) there is a risk that there is something different about the other months that means they are not homogenous.

Perform the audit procedures. The auditor should perform audit procedures appropriate to the test objective on each item selected, as follows:

- For tests of controls, the auditor selects the sample units and examines them to determine whether they contain deviations from the controls relevant to an audit. Some auditors find it practical to select a single set of samples for more than one test objective and to select several extra sampling units for possible replacement. If the auditor is unable to apply the planned audit procedures because the selected item is unavailable, and no alternative procedure can be done to test whether the control was applied as prescribed, the item should be considered a deviation from the control for purposes of evaluating the sample. In a case where many deviations are found in testing the first part of the sample, the auditor may reassess the level of control risk and consider whether it is necessary to continue the test to support the reassessed level of control risk.
- For tests of details, in instances where the auditor was not able to apply the planned audit procedures to selected sampling units because supporting documentation was missing, how the unexamined items are treated would depend on their effect on the evaluation of the sample. It is not necessary to examine those unexamined items if the auditor's evaluation of sample results would not be altered by considering them to be misstated.

Evaluate the sample results. After testing the samples and summarising the observed errors, the auditor shall evaluate the results to reach an overall conclusion, as follows:

- Consider the nature and causes of errors. The direct effect of identified errors on the financial statements should be considered by the auditor in the evaluation of the results. It may be possible that errors have a common feature or trend. In such case, the auditor may decide to identify all the items in the population that possess the common feature and extend audit procedures in that stratum. It is also possible that such errors may be intentional and may indicate the possibility of fraud.
- Calculate and project the sample error. (Covered later in the module under "Error Extrapolation")
- Reach an overall conclusion. The auditor should evaluate the sample results to determine whether the preliminary assessment of the relevant characteristics of the

population is confirmed or needs to be revised, and what the effect of the sample result is on both the test objective and other areas of audit.

- Consider the need to decide whether the identified errors warrant more sampling and additional testing.

Document the sampling procedures. The auditor should document the sampling plan and procedures in the form of working papers.

Audit Assertions

Assertions are statements that the auditors use to focus their audit. Audit components have different risks that are material to the audit. Consequently, when looking at a specific financial statement component, the auditor must be able to identify whether one assertion is more important than the other. For example, testing the existence of assets is more important than testing completeness. In turn completeness of revenue collected is normally more important than evaluating whether a transaction has occurred for the recorded revenue. This may vary on each audit considering the specific risks that may be relevant. The auditor uses assertions in assessing risks by considering the different types of potential misstatements that may occur, and thereby designing audit procedures that are responsive to the assessed risks.

According to ISA 315, assertions fall into the following categories:

- Assertions about classes of transaction and events for the period under audit – 5 Assertions (Occurrence, Completeness, Accuracy, Cut-off and Classification).
- Assertions about account balances at the period – 4 Assertions (Existence, Rights and Obligations, Completeness; and Valuation and Allocation).
- Assertions about presentation and disclosure – 4 Assertions (Occurrence, Completeness, Classification and Understandability and Accuracy and Valuation).

These assertions are presented in the table below.

Assertions about classes of transactions and events for the period		
No.	Assertion	Description
1	Occurrence	Transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
2	Completeness	All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
3	Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.

4	Cut-off	Transactions and events have been recorded in the correct accounting period.
5	Classification	Transactions and events have been recorded in the proper accounts.

Assertions about account balances, and related disclosures, at the period end

No.	Assertion	Description
1	Existence	Assets, liabilities, and equity interest exist.
2	Rights and obligations	The entity holds or controls the right of assets and liabilities are obligation of the entity.
3	Completeness	All assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
4	Valuation and allocation	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Assertions About Presentation and Disclosure

No.	Assertion	Description
1	Occurrence and rights and obligations	Transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
2	Completeness	All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
3	Classification and understandability	Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
4	Accuracy and valuation	Transactions and events have been recorded in the correct accounting period.

Audit Procedures

The purpose of designing audit procedures is to gather sufficient appropriate audit evidence. Upon identifying and assessing the risks of material misstatement, an auditor is expected to respond appropriately to those risks by designing appropriate “further audit procedures” as defined in ISA 330. In a risk-based approach to auditing, audit procedures that are not linked to assessed risks will not serve the purpose as they will be a “waste” of audit time. Audit effort should always be focussed on the risk of material misstatement identified during audit planning.

The auditor should design and perform further audit programs whose nature, timing and extent are responsive to the assessed risks of material misstatement at the assertion (see above for guidance on audit assertions) level. In designing further audit programs, the auditor considers the following:

- The significance of the risk.
- The likelihood that a material misstatement will occur.
- The characteristics of the class of transactions, account balance, or disclosure involved.
- The nature of the specific controls used by the entity and whether they are manual or automated.
- Whether the auditor expects to obtain audit evidence to determine if the entity’s controls are effective in preventing, or detecting and correcting, material misstatements. The nature of the audit procedures is of most importance in responding to the assessed risks.
- The auditor’s assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit programs. The higher the auditor’s assessment of risk the more persuasive audit evidence needs to be obtained.

Step 1:

Identify the risk that will cause material misstatement at the assertion level

The identified risk that will cause material misstatements in the financial statement should relate to the assertion being affected because of risk, which will also provide clarity in terms of designing the audit procedures.

**Step 2:**

Identify the assertion to be tested

Audit procedures are designed and performed to test financial statement assertions based on assessed risks of material misstatements. Therefore, the second step in designing the audit procedure is to identify the assertion

**Step 3:**

Identify the risk that will cause material misstatement at the assertion level

The next step is to design the appropriate audit procedure to test the assertion and detect material misstatement in the financial statements because of the risk identified in Step 1. The audit procedures can take the form of tests of controls or substantive tests.

Test of Controls

Test of controls are audit procedures designed to evaluate the operating effectiveness of controls in preventing or detecting and correcting material misstatements at the assertion level. The auditor should perform tests of controls to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit. Tests of controls are performed when:

- There is an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level. This would be the case when significant risks have been identified for the assertion.
- The auditor expects that controls are operating effectively. This means that the auditor deems that controls are suitably designed for a specific assertion confirmed to be operational by performing a walkthrough. Note – if the auditor deems that controls are not suitably designed then no reliance can be placed on controls and there is no point in testing them. This approach will then involve more substantive audit procedures as outlined in the sections below.

The auditor should perform more tests of controls to be able to place greater reliance on the effectiveness of a control. For high reliance on controls, more transactions should be tested. In designing and performing tests of controls, the auditor should keep in mind that inquiry alone is not sufficient to obtain audit evidence about the operating effectiveness of the controls. The auditor needs to identify:

- How the controls were applied at relevant times during the period under audit.
- The consistency with which they were applied.
- By whom or by what means they were applied.

Evaluating the Effectiveness of Internal Controls

To evaluate the effective operation of (suitably designed) controls the auditor should test a sample of control items and reach a conclusion based on the results of testing. An example of audit evidence around controls applied during processing travel claims is shown in the table below.

Control Objective	Suggested Evidence Gathering Techniques
Do staff understand the system which they operate?	<p>Enquire whether the clerk knows the procedures and understands them</p> <p>Observe how the clerk carries out the procedures.</p> <p>Inspect regulations and circulars to determine if they are up to date.</p> <p>Inspect the list of authorised signatories to confirm that it is up to date.</p> <p>Re-performance: comparison between the documents and what the auditor has been told.</p>

Control Objective	Suggested Evidence Gathering Techniques
Test for Completeness – are all travel claims entered in the cashbook?	<p>Enquire whether the clerk knows the procedures and understands them.</p> <p>Observe how the clerk carries out the entries.</p> <p>Inspect the cash book to form an overview about traveling claim entries.</p> <p>Re-performance: comparison of the traveling claims documents with the cashbook to substantiate that the entire sample are entered.</p>
Tests for Occurrence (or fact) – are the recorded travel claims real, i.e. not fictitious?	<p>Enquire whether the clerk knows the procedures and understands them.</p> <p>Enquire to gain an understanding of the last time the clerk rejected a claim as evidence that the clerk is checking and rejecting 'odd' claims.</p> <p>Observe how the clerk carries out the entries.</p> <p>Inspect a sample of travel claims to confirm that the correct claim form has been used; evidence that the clerk has rejected unofficial claims.</p> <p>Inspect a sample of travel claims to confirm that journeys are likely to be real, bearing in mind the claimant's job, NB this is evidence that the auditor believes the journeys appear to be real.</p>
Tests for Accuracy – are all claims measured (calculated) in accordance with the appropriate circular?	<p>Enquire whether the clerk knows the procedures and understands them.</p> <p>Enquire to gain an understanding of the last time the clerk rejected a claim; evidence that the clerk is checking and rejecting claims.</p> <p>Observe how the clerk carries out the entries.</p> <p>Inspect a sample of travel claims to confirm the entry of the clerk's signature indicating that calculations have been checked.</p> <p>Re-performance: comparison of the traveling and subsistence rates in the sample of traveling claim documents with up-to-date circulars to substantiate that the up-to-date rates have been claimed (and no more).</p>
Classification – have the claims been correctly coded in the accounts	<p>Enquire whether the clerk knows the procedures and understands them.</p> <p>Observe how the clerk codes the claims.</p> <p>Inspect of a sample of travel claims to confirm that they have been correctly coded.</p>

Substantive Testing

Substantive procedures are performed to detect material misstatements at the assertion level. Substantive procedures comprise:

- Tests of details of classes of transactions, account balances, and disclosures.
- Substantive analytical procedures.

The auditor plans and performs substantive procedures to be responsive to the related assessment of the risk of material misstatement. Irrespective of the assessed risk of material misstatement or whether controls have been tested or not, the auditor should design and perform substantive procedures for each material class of transactions, account balance and disclosure. This requirement reflects the fact that the auditor's assessment of risk is judgemental and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations to internal control including management override.

The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. This would typically be done to confirm bank balances, loans, debtors and creditors. Since external confirmations are an exceptionally reliable source of evidence auditors should consider obtaining confirmation as much as possible and practical. The auditor's substantive procedures should include the following audit procedures related to the financial statement closing process:

- Agreeing the financial statements to the underlying accounting records; and
- Examining material journal entries and other adjustments made to the financial statements.

Test of Details

Tests of details are substantive procedures that are performed to detect material misstatements at the assertion level for individual financial statement items (classes of transactions, account balances or disclosures); i.e. to obtain audit evidence as to whether a financial statement item is free from material misstatement.

Both tests of controls and substantive audit procedures deal with detecting material misstatements at the assertion level. The difference is that the test of controls deals with evaluating the operating effectiveness of internal controls that are supposed to prevent and detect material misstatements at the assertion level, while the substantive procedure is a detailed test that needs to be designed and performed on classes of transactions, account balances or disclosures, irrespective of whether internal controls exist or not.

Test of details include the testing of details of components, classes of transactions, account balances or disclosures—e.g. reconciling general ledger expense account totals to purchase journal; reconciling (a sample of) quantities on purchase invoices to goods received. They are planned as part of the overall mix of procedures to obtain sufficient appropriate audit evidence based on the reliance on internal controls.

The following four steps are performed in respect of the audit sample to complete the tests of details and to conclude on the population for sampling (discussed separately hereunder):

Step 1. Determine the sample size.

Step 2. Select the sample items.

Step 3. Perform the planned procedures on the selected items.

Step 4. Evaluate the sample results and conclude.

In summary, test of details includes tracing a sample of figures to relevant supporting documents to determine that the audit assertions in relation to the overall population are valid.

Analytical Procedures

Analytical procedures are used to evaluate financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also include any investigation relating to identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

ISA 520 – Analytical Procedures

“When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with ISA 330 the auditor shall:

- *Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions.*
- *Evaluate the reliability of data from which the auditor’s expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation.*
- *Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.*
- *Determine the amount of any difference of recorded amounts from expected values that is acceptable without further...”.*

The auditor should design and perform analytical procedures:

- As risk assessment procedures to obtain an understanding of the entity during strategic planning. (Audit Planning)
- As a form of substantive testing to obtain relevant and reliable audit evidence. (Audit Execution). Note that while analytical procedures are required by ISAs during audit planning and audit completion there is no such requirement for them to be used during audit execution.
- To assist the auditor near to the end of the audit to confirm the auditors understanding of the auditee when forming an overall conclusion on the financial statements. (Audit Completion)

There are relationships between individual items of the financial statements. For example, there is a direct relationship between sales and purchases. See some examples of possible analytical procedures in the table below.

Type of Analytical Procedure	Example
Ratio Analysis: Comparing financial ratios (e.g., current ratio, debt-to-equity ratio) with industry benchmarks or prior period data to assess financial performance and liquidity.	A manufacturing company's auditor conducts ratio analysis by comparing the company's current ratio (current assets divided by current liabilities) with industry benchmarks and prior year data. Suppose the current ratio is 2.5, which is higher than the industry average of 2.0 and the prior year's ratio of 2.2. This analysis suggests that the company has a strong liquidity position compared to its industry peers and its own historical performance.
Trend Analysis: Examining changes in financial data over time to identify significant fluctuations or patterns that may indicate underlying risks or changes in business operations.	An auditor performing trend analysis for a retail chain examines the trend in sales revenue over the past five years. They observe a consistent upward trend in revenue until the most recent year, where there is a sudden decline. Further investigation reveals that the decline is due to a decrease in consumer spending and increased competition. This trend analysis alerts the auditor to potential risks affecting the company's financial performance.
Comparative Analysis: Comparing current financial data with prior period data or budgets to evaluate performance and identify variances that may require further investigation.	An auditor compares the budgeted expenses for a construction company's building project with the actual expenses incurred. They find that actual expenses exceed the budgeted amounts for certain cost categories, such as materials and labour. This comparative analysis highlights areas where costs have exceeded expectations, prompting the auditor to investigate potential reasons for the variances, such as inefficiencies or changes in project scope.
Reasonableness Testing: Assessing the reasonableness of financial data by comparing it with expectations based on industry norms, economic factors, or internal benchmarks.	An auditor performs reasonableness testing on the payroll expenses of a software company by comparing them to industry benchmarks and the company's historical payroll data. Suppose the company's payroll expenses have increased by 20% compared to the prior year, while industry salary surveys indicate an average increase of 10%. The auditor investigates the reasons for the higher-than-expected increase, such as new hires, salary adjustments, or overtime payments, to ensure the expenses are reasonable and accurately stated.

The following steps should be followed when performing substantive analytical procedures:

- Step 1:** Determine the suitability of the substantive analytical procedure. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.
- Step 2:** Identify the information requirements and determine whether the information is reliable. Reliability should be considered by looking at the source, comparability, nature, relevance and the controls over the preparation, review and maintenance of information.
- Step 3:** Develop an expectation (if applicable) for example an amount based on the audit assertion. This could be the number staff, multiplied by average salary.
- Step 4:** Identify a threshold or a tolerable limit. This will be determined by the auditor's tolerance for error. This will be closely linked to materiality i.e. what size of difference is an auditor willing to accept.
- Step 5:** Compare what should have happened against what did happen.
- Step 6:** Identify variances where they exceed the pre-determined threshold or are inconsistent with the expectation.
- Step 7:** Obtain explanations for material differences from the management of the audited entity through enquiries. If management cannot offer explanations the auditors may need to investigate further the underlying reasons for the lack of information and determine who is responsible
- Step 8:** Perform additional audit procedures as necessary in the circumstances. If no reliance can be placed on substantive analytical procedures more test of details should be performed.

The IT Environment

We live in an increasingly computerised world and IT systems form the backbone of many systems related to maintaining and reporting financial information; as such it is critical that they are examined as part of the audit. ISA 315 (Identifying and Assessing the Risk of Material Misstatement) requires that the auditor considers risks around IT systems relevant to the preparation of the financial statements (e.g. the financial information system) and in relation to specific risks around IT systems used to implement control activities (e.g. stock management system).

It should be noted that while some work in relation to IT systems (risks and controls) can be conducted by every auditor, in-depth testing of sophisticated IT systems will normally require additional expertise provided by an IT auditor who has the skills and experience to conduct a detailed IT audit of key systems.

Auditors need to be aware of the main types of internal controls over computer-based systems. These controls can be divided into three main types:

- General controls.
- Application controls.
- Access controls.

General Controls

General controls refer to all aspects surrounding the IT environment and has an indirect effect on the IT environment and the financial statements. They form the basis of application and access controls and should therefore be assessed before the auditor performs tests on the application controls. Before a general control review is embarked upon, the auditors should gain an understanding of the auditee's application systems to:

- Identify major application systems involved in processing financial information or information relating to service delivery transactions. If there are different modules available, auditors should also understand which modules are implemented from the system (General Ledger, payroll, accounts receivable etc.).
- Understand how different financial and non-financial systems interlink or feed information into the system which generates information for the financial statements e.g. there are many inter-related financial and non-financial controls related to a payroll system.

Key areas of focus when considering general IT controls are shown below.

IT Governance

An IT steering committee is a key component in IT governance since it provides the strategic alignment required to fulfil the organisations' goals and objectives. Senior management usually establishes the committee to oversee the information systems function and activities. It is a mechanism that ensures the IT section is in harmony with the corporate mission and goals. The auditor could ask the following questions in relation to auditee IT governance:

- Is the IT strategy and the organisation's strategy of the auditee aligned?
- What level of IT investment has the auditee made and is it aligned with the IT strategy?
- Have major IT investments or projects been properly approved?
- Has the introduction of IT systems impacted positively or negatively on auditee performance?
- Are any IT activities outsourced due to lack of auditee capacity?
- Is the auditee transitioning or already moved to greater use of information systems?
- What level of end user support has been provided to support the transition?
- Review minutes of management meeting and IT steering committee related to IT activities.

IT Strategic Plan

Usually, the IT steering committee will determine the future direction of IT in the organisation and agree it with executive management. This is achieved through formalising the decisions of the IT steering committee and executive management in an IT strategy document. A review of the auditees IT strategy could indicate risk areas for the auditor e.g. the IT strategy may state that the organisation will replace its financial management system in 2 years' time which will impact on the work of the auditor. The main purpose for an IT strategic plan is to ensure that IT operations are aligned with those of the organisation.

IT Security Management

The auditee should have a written IT security policy document which is available to all employees responsible for information security. There should be clearly defined responsibilities for the protection of individual assets and for carrying out specific security processes. This should be supplemented, where necessary, with more detailed guidance for specific sites, systems or services which should clearly define responsibilities for individual assets (both physical and information) and security processes, e.g. business continuity planning. This will also contain information on retention storage handling and disposal of records and information.

IT security management is critical as unauthorised or malicious software could enter an auditees information system and corrupt the data in those systems thus impacting the quality of information produced by those systems. When performing the audit, the auditor will determine what steps management have taken to ensure the security of its IT data. This may include:

- Limitation on file sizes that can be downloaded from the internet.
- Internet or website access control by staff.
- Periodic reviews of computers hard drives to detect unauthorised software.

The basis of protection against viruses established on good security awareness and appropriate system access controls. The auditee should establish a formal policy requiring compliance with software licenses and prohibiting the use of unauthorised software, this includes using anti-virus software (including firewall) developed by a reputable supplier. The auditor should also review the structure of the IT department to determine whether there is sufficient segregation of duties. Small organisations may have combined IT functions; however, the following functions should not be combined:

- Program and database administrator.
- System administrator and database administrator.
- Security administrator and database administrator.
- Network administrator and database administrator.

There should be a mechanism which allows the timely reporting of security incidents through appropriate management channels.

IT Change Management

Change controls are part of the change management process and focus on what a staff member should do when requesting system changes. There should be a formally documented policy describing the process to be followed and standardised Change Request form(s) completed by staff when requesting system changes.

IT Policies and Procedures

IT policies state the principle that requires, guides or restricts action. Auditors should assess if IT policies are:

- Clearly stated in writing and organised in handbooks, manuals, and other publications and are properly approved.
- Clearly communicated to all officials and appropriate employees of the organisation.

- Provide a degree of assurance that organisation resources and assets are adequately safeguarded.
- Reviewed periodically and revised when circumstances change.

Procedures are methods employed to carry out activities in conformity with prescribed policies. Auditors should assess if IT procedures:

- Reduce the possibility of fraud and error as they should be so coordinated that one employee's work should be checked by another independent employee performing separate prescribed duties.
- Are as simple and as inexpensive as possible.
- Do not overlap, duplicate or conflict.
- Are reviewed periodically to ensure they are still applicable.
- Are freely available to all staff for reference.

IT Education and Training

The auditor should assess if IT system and application end users have received appropriate training in IT policies and procedures, including security requirements and other controls, as well as training in the correct use of IT systems that they interact with prior to gaining access to IT services.

IT Business Continuity and Disaster Recovery Planning

When a disaster occurs, the organisation should have a plan in place to assist and guide personnel with the timely recovery of data needed for restoring key functions first. The business continuity planning process can be divided into the following phases:

- Business impact analysis – Identify the various events which could have an impact on the continuity of services either in a financial, human resources or reputation aspect.
- Criticality of information resources such as networks, IT infrastructure, applications, data, etc, must be established and approved by management. Normal classifications include:
- Critical systems – these functions cannot be performed unless they are replaced by identical capabilities. Critical applications cannot be replaced by manual methods. Tolerance to interruptions is extremely low and the cost of recovery will be extremely high.
- Vital systems – These functions can be performed manually for a brief period and there is a higher tolerance to interruption than with critical systems. Cost for recovery is lower, provided these functions are restored within a certain time.
- Sensitive – These functions can be performed manually at a tolerable cost and for an extended period.
- Non-critical – these functions can be performed manually for an extended period with little or no cost to the organisation.

Note that disaster recovery planning will vary depending on the size and nature of the business; a ridiculously small business would not be expected to have planned as much as a much larger, more complex, organisation.

IT Business Recovery Plans

The selection of a recovery strategy will depend upon the criticality of the business processes, the cost and time to recover the business processes and security issues. The most appropriate strategy an organisation can select is where the cost for an acceptable recovery time is reasonable compared to the likelihood of occurrence as determined in the business impact analysis. When a disaster impairs the primary site, the organisation must have offsite facilities available which can be used as backup alternatives including:

- Duplicate processing facilities – these facilities are dedicated recovery sites that can back up critical applications.
- Warm sites – these sites are partially configured with network connections and certain peripheral equipment. Warm sites are less costly than the hot sites and can be ready within a few hours.
- Cold sites – these sites only provide the basic environment, and all other equipment should be brought in by the organisation.
- Reciprocal agreements – with branches in the organisation or other organisations – In these agreements, organisations promise to provide computer time to each other when an emergency occurs.

Once the overall recovery approach is determined, the organisation should have a detailed recovery plan which has been implemented, tested and is updated regularly.

Application Controls

These relate to specific tasks performed by the system and are categorised as:

- Input controls relate to the rejection, correction and resubmission of data where it is deemed to be initially incorrect. For example, mechanisms to detect and prevent the entry of duplicate payroll transactions or employee records.
- Processing controls are in place to ensure that no unauthorised transactions can be processed. For example, automated reconciliation of payroll data at different stages of the monthly payroll process.
- Output controls are implemented to ensure the accuracy of processing and the access of output to authorised individuals only. For example, the payroll system automatically calculates checksums or hash values for payroll reports before they are finalised.

Access Controls

Access controls impose the selective restriction of access to a place or resource. Access controls can be categorised as logical, physical and environmental access controls.

Logical access controls

These controls ensure that only those persons with bona fide purpose and authorisation have access to computer databases and other systems. These controls are more important in large databases and when access to external systems is available. Some examples include:

- Passwords and ID Numbers – This is an effective access control when properly enforced. Passwords should be held securely and should be sufficiently strong,

made up of a combination of letters, numbers and other symbols and more than 8 characters long.

- File Attributes – These control access to and the use of files e.g. some individuals have read only access, archive and some fields are hidden from other users.
- System access logs – Record all attempts to use the system, the date, time, codes used, mode of access, data involved, and mode of intervention are all recorded. This provides an audit trail that can be reviewed later.
- Automatic log-off – Removes the possibility of viewing sensitive data at inactive data terminal.

Physical access controls

Physical access controls are designed to protect the organisation from unauthorised access. This includes not only the access to the computer room but also access to the premises as well as computers and hand-held devices. Typical physical controls include, doors, walls, physical deterrents to entry etc. The auditor should assess if the auditee has sufficient physical controls in place to prevent and detect:

- Access to restricted areas or terminals.
- Accidental or intentional damage by staff.
- Theft of computers or their individual components.
- Bypass of logical access controls.
- Copying or viewing of sensitive or confidential information.

Environmental controls

Environmental exposures are primarily relating to natural occurrences such as earthquakes and storms or fires. The result of these natural occurrences can lead to many types of problems for example power surges that have a negative effect on the information infrastructure. There are a number of controls an organisation can implement to reduce the risks for environmental exposures which include:

- Water detectors.
- Handheld fire extinguishers.
- Manual fire alarms.
- Smoke detectors.
- Fire suppression systems.
- Fireproof walls, floors, ceilings surrounding the computer room.
- Electrical surge protectors.
- Uninterruptible power supply/generators.
- Emergency power-off switch.

The auditor should assess whether the auditee has sufficient environmental controls in place to mitigate against environmental risks.

Management Feedback

During the audit process, the audit team will have regular communications with various levels of management on various issues. This communication is vital to obtain information and audit evidence and can be used by the auditor in a number of ways especially when it includes information about systems weaknesses, clerical/accounting mistakes, and disagreements regarding accounting policies or treatments. For example, this feedback can be used in the following areas:

- **Identifying Risk Areas:** Management feedback helps auditors identify potential risk areas. For example, if management reports weaknesses in the internal control system, it alerts auditors to areas where there may be a higher risk of errors or fraud. This information guides auditors in allocating their resources effectively to address these risks during the audit.
- **Tailoring Audit Procedures:** Understanding the specific weaknesses and mistakes reported by management allows auditors to tailor their audit procedures accordingly. They can focus more attention on areas where errors are more likely to occur, ensuring a thorough examination of those areas.
- **Testing Controls:** Feedback about systems weaknesses can prompt auditors to perform additional testing of internal controls to ensure they are operating effectively. This may involve testing the design and operating effectiveness of controls to mitigate identified risks.
- **Adjusting Materiality Thresholds:** Clerical or accounting mistakes reported by management can influence the determination of materiality thresholds for the audit. Materiality thresholds are used to assess the significance of errors or discrepancies in financial statements. If management reports significant mistakes in certain accounts or transactions, auditors may adjust their materiality thresholds accordingly to ensure that they focus on items that could potentially impact the financial statements.
- **Evaluating Accounting Policies:** Disagreements regarding accounting policies or treatments may indicate areas of subjectivity or complexity in financial reporting. Auditors can use this information to carefully evaluate the appropriateness of accounting policies and treatments applied by the organisation especially focussed on the areas of disagreement identified. They should exercise professional judgement and conduct additional scrutiny in these areas to ensure compliance with accounting standards and regulations. Disagreement with management would constitute a matter that should be communicated to those charged with governance and material disagreements would impact the final audit report issued.
- **Enhancing Communication with Management:** Engaging in discussions about management feedback fosters open communication between auditors and management and should be encouraged to help deliver an effective and efficient audit. This dialogue allows auditors to gain a deeper understanding of the organisation's operations, challenges, and areas of focus. It also provides an opportunity to address any concerns or discrepancies in a collaborative manner.

Some specific examples of management feedback and possible audit responses are presented in the table below.

Management Feedback	Possible Audit Response
Management reports that the organisation's inventory system lacks sufficient controls to prevent errors in inventory counts and valuation.	<ul style="list-style-type: none"> • Focus on testing controls related to inventory management. • Review procedures for receiving, storing, and recording inventory, and perform substantive testing to verify the accuracy of inventory counts and valuation. • May assess the adequacy of controls over inventory movements and adjustments to mitigate the risk of misstatements.
Management identifies frequent errors in revenue recognition due to misinterpretation of accounting standards by junior accounting staff.	<ul style="list-style-type: none"> • Increase the extent of their testing of revenue transactions. • Review a larger sample of revenue contracts, conduct detailed assessments of revenue recognition criteria, and scrutinise the adequacy of controls over the revenue recognition process.
Management and auditors disagree on the treatment of a complex financial instrument, resulting in differing interpretations of accounting standards	<ul style="list-style-type: none"> • Conduct thorough research and analysis to evaluate the appropriateness of the accounting treatment for the financial instrument in question. • Review relevant accounting standards, consult with technical experts or industry specialists, and consider precedents or interpretations from regulatory bodies or accounting authorities. • Aim to reach a consensus with management on the appropriate accounting treatment to ensure compliance with IFRS.
Management identifies manual data entry errors in the general ledger reconciliation process, resulting in delays and inaccuracies in financial reporting	<ul style="list-style-type: none"> • Focusing on testing controls over the general ledger reconciliation process. • Assess the effectiveness of automated controls or data validation procedures implemented by management to detect and prevent data entry errors.
Management expresses concerns about the effectiveness of internal controls over financial reporting and requests input from auditors on potential improvements.	<ul style="list-style-type: none"> • Engage in open and collaborative discussions with management to address identified control weaknesses or deficiencies. • Provide recommendations for strengthening internal controls, enhancing documentation and monitoring procedures, and implementing best practices to mitigate risks and improve the reliability of financial reporting going forward.

Management Representation Letter

As required by ISA 580, you should ask management of the auditee for a written representation on every audit engagement.

ISA 580 – Written Representations

“The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned”.

The written representation is used as audit evidence for management’s understanding of their role and responsibilities for the financial statements and implementing internal controls. The representation letter also includes assurance that management has provided the auditor with all relevant information and documentation and that they consider any uncorrected misstatements as not material.

Management representation letters are likely to include:

- **Confirmation of Responsibility:** Management confirms its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable accounting standard.
- **Completeness of Information:** Management confirms that all relevant information and records, including financial records, have been provided to the auditors.
- **Accuracy of Information:** Management asserts that the financial statements are accurate and complete in all material respects and that they do not contain any material misstatements, whether due to fraud or error.
- **Internal Controls:** Management confirms that it has established and maintained adequate internal control systems to ensure the reliability of financial reporting and the safeguarding of assets.
- **Disclosure of Significant Matters:** Management discloses any significant matters, including known fraud or suspected fraud involving management or employees with significant roles in internal control, to the auditors.
- **Compliance with Laws and Regulations:** Management confirms compliance with relevant laws and regulations, including tax laws, accounting standards, and regulatory requirements.
- **Communication of Known Misstatements:** Management discloses any known misstatements identified during the audit process and the corrective actions taken or planned to address them.

There is a template representation letter to use, but you may add other aspects as necessary. The draft management representation letter should be sent to the auditee for management to sign and send back to you before you can issue the auditor’s report. The fact that we want a representation letter should be communicated and agreed in the engagement letter at the beginning of the audit so that management are aware of auditor expectations and any potential issues can be addressed at the earliest possible stage.

If management makes amendments to the representation letter or refuses to sign it, you have to consider whether you can rely on other information obtained from management and also consider issuing a modified opinion. Any refusal to sign such a letter is a significant “red flag” and should be treated as a serious matter.

ISA 580 – Written Representations

“If management does not provide one or more of the requested written representations, the auditor shall:

(a) Discuss the matter with management;

(b) Reevaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

(c) Take appropriate actions, including determining the possible effect on the opinion in the auditor’s report in accordance with ISA 705”

Further detail on Management Representations is provided in ISA 580.

Summary of Unit C and key learning outcomes

After completing Unit C, you should be able to demonstrate an understanding of a range of auditing techniques and know which to use when planning audits on different aspects of the system.

1. Describe the different verification techniques that can be used and explain what type of item could be audited by this method. Methods to include physical examination, reperformance, third party confirmation, vouching, documentary evidence and identification of unusual items.
2. Identify different sampling techniques used in auditing and describe where these could be used including confidence levels, selection techniques including random numbers, interval sampling and stratified sampling.
3. Explain tests of control and substantive procedures and their links to the audit objective.
4. Explain the auditing techniques that should be used in an IT environment.
5. Explain how management feedback, that includes systems weaknesses, clerical/ accounting mistakes, disagreement regarding accounting policies or treatment, can be used when planning an audit.

Ref	Learning Outcome	
C1	Describe the different verification techniques that can be used and explain what type of item could be audited by this method. Methods to include physical examination, reperformance, third party confirmation, vouching, documentary evidence and identification of unusual items.	<ul style="list-style-type: none"> • Understand the concept of audit evidence. • Identify and explain the main forms of audit evidence that an auditor can obtain to support audit conclusions. • Understand the difference in reliability of these different forms of evidence.
C2	Identify different sampling techniques used in auditing and describe where these could be used including confidence levels, selection techniques including random numbers, interval sampling and stratified sampling.	<ul style="list-style-type: none"> • Understand the reasons for audit sampling • Explain the process for audit sampling. • Identify and distinguish the different methods for selecting audit samples.
C3	Explain tests of control and substantive procedures and their links to the audit objective.	<ul style="list-style-type: none"> • Identify the different audit assertions relating to different financial statement balances. • Understand the main forms of audit testing: controls testing, analytical procedures and test of details.
C4	Explain the auditing techniques that should be used in an IT environment.	<ul style="list-style-type: none"> • Understand auditor responsibilities in relation to IT controls.
C5	Explain how management feedback, that includes systems weaknesses, clerical/ accounting mistakes, disagreement regarding accounting policies or treatment, can be used when planning an audit.	<ul style="list-style-type: none"> • Explain how management feedback over potential issues with financial statement disclosures will impact the audit approach.

Quiz Questions

1	Learning Outcome: C1
Which of the following is a characteristic of sufficient appropriate audit evidence?	
A	It is relevant and reliable.
B	It provides absolute assurance regarding the accuracy of financial statements.
C	It is subjective and based solely on the auditor's judgement.
D	It is limited to information provided by management.

1	Feedback
A	Yes! Audit evidence should be sufficient and appropriate (i.e. relevant and reliable)
B	No. No amount of audit evidence can give absolute assurance
C	No. Auditors judgement is used to assess the evidence, but it is not a characteristic of sufficient appropriate audit evidence.
D	No. External sources also provide (more reliable!) audit evidence.

2	Learning Outcome: C2
When would stratified sampling be most appropriate in audit sampling?	
A	When the population is small and homogeneous.
B	When the population is large and heterogeneous.
C	When the auditor wants to select items based on personal judgement.
D	When the auditor wants to select items randomly from the entire population.

2	Feedback
A	No. Stratification is used to split heterogenous populations i.e. transactions with different characteristics.
B	Yes!
C	No. Judgemental or Systematic sampling is based on auditor judgement.
D	No. stratification splits the population into different parts.

3	Learning Outcome: C3
Audit assertions related to whether transactions are recorded in the correct accounting period pertain to the assertion of:	
A	Occurrence
B	Completeness
C	Accuracy
D	Cutoff

3	Feedback
A	No. Occurrence relates to whether the transaction actually took place.
B	No. Completeness relates to transactions taken place which have not been recorded.
C	No. Accuracy relates to the transaction being recorded at the correct value.
D	Yes! Cutoff relates to the transaction being recorded in the correct accounting period.

4	Learning Outcome: C3
In conducting substantive testing, auditors primarily focus on:	

A	Evaluating internal control effectiveness
B	Confirming the accuracy of financial statement assertions
C	Assessing inherent risk in the financial statements
D	Reviewing the consistency of accounting policies

4	Feedback
A	No. This would be controls testing.
B	Yes! Substantive testing is focussed on testing the financial statement balances.
C	No. Inherent risk is assessed as part of audit planning <i>before</i> substantive testing is performed.
D	No. Substantive testing does not check consistency of accounting policies.

5	Learning Outcome: C4
Which of the following is an example of an access control rather than a general IT control?	
A	Password complexity requirements.
B	Backup and recovery procedures.
C	User access management.
D	Data encryption standards

5	Feedback
A	Yes! This is an example of access control
B	No. General IT Control

C	No. General IT Control
D	No. General IT Control

6	Learning Outcome: C5
Which of the following statements regarding the management representation letter is true?	
A	It is optional and may be omitted if management refuses to sign.
B	It is a substitute for obtaining external confirmations from third parties.
C	It is a formal written statement provided by management to the auditor.
D	It is primarily used to communicate audit findings to stakeholders.

6	Feedback
A	No. If management refuse to sign – there are consequences for the audit and possibly the final audit report.
B	No. External confirmations are a separate example of audit evidence.
C	Yes!
D	No. Audit findings are communicated at the conclusion of the audit in the form of the “management letter”.

Quiz Answers

Question	Answer
1	A
2	B
3	D
4	B
5	A
6	C

Exercises

1. Give examples where an auditor might request external confirmations to obtain audit evidence.
2. Suggest possible audit procedures to test risks around completeness of sales revenue in the financial statements.
3. Outline some of the advantages and disadvantages of statistical and non-statistical sampling techniques.

Exercise Solutions

1. Bank Confirmations: Auditors send confirmation requests to the entity's banks to verify the accuracy of cash balances and outstanding loans or other liabilities. Banks are asked to confirm the account balances and other relevant details directly to the auditors.
 - Accounts Receivable Confirmations: Auditors send confirmation requests to the entity's customers to verify the accuracy and completeness of accounts receivable balances. Customers are asked to confirm the amount owed to the entity as of a specific date.
 - Accounts Payable Confirmations: Auditors may send confirmation requests to the entity's suppliers or vendors to verify the accuracy and completeness of accounts payable balances. Suppliers are asked to confirm the amounts owed to them by the entity as of a specific date.
 - Investment Confirmations: Auditors may send confirmation requests to brokers, custodians, or other financial institutions to verify the ownership and valuation of investments held by the entity. External parties are asked to confirm the details of investment holdings directly to the auditors.
 - Loan Confirmations: Auditors send confirmation requests to lenders or financial institutions to verify the existence and terms of loans or other financing arrangements entered into by the entity. External parties are asked to confirm loan balances, interest rates, and other relevant details.

- Legal Confirmations: Auditors may send confirmation requests to the entity's lawyer to verify the status of pending litigation, claims, or contingent liabilities. The lawyer is asked to confirm the details of legal matters directly to the auditors.
 - Insurance Confirmations: Auditors may send confirmation requests to insurance companies to verify the coverage and terms of insurance policies held by the entity. Insurance providers are asked to confirm policy details directly to the auditors.
2. Completeness of sales relates to the risk that sales that actually took place have not been recorded. To test the completeness of sales, auditors can employ various audit procedures aimed at obtaining sufficient and appropriate audit evidence. Here are some possible audit tests that can be used:
- Examine Sales Invoices and Shipping Documents - Review a sample of sales invoices and corresponding shipping documents to ensure that all recorded sales transactions have been properly documented and shipped to customers. Any missing or unrecorded shipments may indicate incomplete sales recognition.
 - Review Sales Journal and General Ledger: - Compare the sales recorded in the sales journal to those posted in the general ledger. Ensure that all sales transactions recorded in the sales journal have been accurately posted to the general ledger accounts. Any discrepancies may indicate omitted sales.
 - Confirmations from Customers: - Send confirmatory requests to a sample of customers requesting confirmation of sales transactions. Obtain direct confirmation from customers regarding the completeness and accuracy of recorded sales. Non-responses or discrepancies may indicate unrecorded sales.
 - Analytical Procedures: - Perform analytical procedures such as trend analysis and ratio analysis to identify unusual fluctuations or patterns in sales revenue over time. Significant deviations from expected trends may indicate potential unrecorded sales or omitted transactions.
 - Reconciliation of Sales to Cash Receipts: - Reconcile sales revenue recorded in the accounting records to cash receipts deposited in the bank. Ensure that all cash receipts relating to sales transactions have been properly recorded and accounted for in the sales revenue accounts.
 - Tracing from Shipping Records to Sales Records: - Select a sample of shipping records and trace them back to corresponding sales invoices and sales journal entries. Ensure that all shipments have been properly recorded as sales transactions in the accounting records.
 - Review of Sales Contracts and Agreements: Review sales contracts, agreements, and other supporting documentation for evidence of sales transactions. Ensure that all contractual obligations have been properly recognised as sales revenue in accordance with accounting standards.
 - Inspect Inventory Records and Goods Returns: Review inventory records and goods returns documentation to identify any instances where sales transactions may have been reversed or cancelled after initial recognition. Ensure that such reversals are appropriately accounted for and disclosed.

- **Testing of Sales Returns and Allowances:** Test the accuracy and completeness of sales returns and allowances by reviewing documentation supporting returns, credits, and adjustments to sales revenue. Ensure that all returns and allowances are properly authorised, recorded, and disclosed.

3. Statistical Sampling:

Advantages:

- **Objective Selection:** Statistical sampling uses mathematical techniques to randomly select samples from the population. This ensures that each item in the population has a known probability of being selected, providing an unbiased representation of the entire population.
- **Quantifiable Results:** Statistical sampling allows auditors to quantify the risk associated with sampling error and calculate confidence intervals around sample estimates. This provides a measure of the reliability and precision of the sample results.
- **Efficiency:** Statistical sampling often requires smaller sample sizes compared to non-statistical sampling methods to achieve the same level of confidence. This can result in time and cost savings for the audit engagement.
- **Regulatory Acceptance:** Statistical sampling is widely accepted by regulatory bodies and standards-setting organisations, providing a recognised framework for audit sampling.

Disadvantages:

- **Complexity:** Statistical sampling techniques may be more complex and require specialised knowledge and skills to implement effectively. Auditors need to understand statistical concepts and calculations to design and interpret sample results accurately.
- **Resource Intensive:** Implementing statistical sampling may require specialised software, tools, and resources, which can increase the cost and complexity of the audit engagement.
- **Assumptions and Limitations:** Statistical sampling relies on certain assumptions about the population distribution and characteristics. Deviations from these assumptions or limitations in data quality may affect the validity of sample results.
- **Overreliance on Sample Results:** Auditors may become overly reliant on statistical sample results without considering qualitative factors or judgement. This could lead to overlooking anomalies or exceptions that may require further investigation.

Non-Statistical Sampling:

Advantages:

- **Simplicity:** Non-statistical sampling methods are often simpler and easier to understand and apply compared to statistical techniques. They may involve straightforward selection methods such as haphazard or judgemental sampling.
- **Flexibility:** Non-statistical sampling allows auditors to tailor sample selection methods based on their judgement, experience, and knowledge of the client's business and risks. This flexibility can be particularly useful in situations where statistical methods are not feasible or practical.
- **Practicality:** Non-statistical sampling may be more practical and cost-effective for small populations or when limited resources are available. It can be applied quickly and efficiently without the need for specialised tools or software.
- **Qualitative Considerations:** Non-statistical sampling allows auditors to consider qualitative factors and judgement when selecting samples and interpreting results. This can be beneficial for identifying unusual transactions or patterns that may warrant further investigation.

Disadvantages:

1. **Subjectivity:** Non-statistical sampling methods rely on auditor judgement and discretion, which may introduce bias or subjectivity into the sample selection process. This could potentially lead to non-representative samples or overlooking important risks.
2. **Lack of Objectivity:** Non-statistical sampling does not provide a quantitative measure of sampling risk or confidence intervals around sample estimates. Auditors may have less confidence in the reliability and precision of sample results compared to statistical sampling.
3. **Limited Regulatory Acceptance:** Non-statistical sampling may be less accepted by regulatory bodies and standards-setting organisations compared to statistical techniques. Auditors may face challenges in justifying the use of non-statistical sampling methods in certain audit engagements.
4. **Risk of Inefficiency:** Non-statistical sampling may require larger sample sizes compared to statistical methods to achieve the same level of confidence. This could result in increased audit effort and resource utilisation, particularly for larger populations or high-risk areas.

Unit D: Audit Planning and Risk Assessment.

Learning outcomes

- D.1 Identify the accounting systems under review and accurately record them on appropriate working papers.
- D.2 Correctly identify the control framework.
- D.3 Accurately assess risks associated with the accounting system and its controls.
- D.4 Correctly record significant weaknesses in control.
- D.5 Identify account balances to be verified and the associated risks.
- D.6 Select an appropriate sample for testing.
- D.7 Select or devise appropriate tests in accordance with the auditing principles and agree them with the engagement partner.
- D.8 Provide clear information and recommendations for the proposed audit plan, and submit it to the appropriate person for consideration.

Introduction to Unit D

This Unit covers key elements of the planning process. Firstly, you should be able to identify the different accounting and internal control systems and be aware of how these systems can be documented.

Once an auditor understands the key systems, they must then be able to identify and document control weaknesses and consider risks around each significant financial statement balance based on audit planning. The audit work will be based on risks identified and the unit considers typical risks and possible audit tests in relation these risks. Throughout the audit planning process, the auditor must identify risks in relation to the financial statements as a whole and at the balance/assertion level, consider possible controls and be able to produce a program of audit testing which addresses risks identified.

Finally, we consider what to include in the documented audit plan. This plan will then be used to drive the audit work during the execution stage.

Documenting the Accounting and Control System

The need to understand the accounting and internal control system in relation to the financial statements was introduced in Unit B and it is required by ISA 300. As we build an understanding of these systems we must document them in the audit file.

There are various methods of recording the system including:

- Narrative notes.
- Organisation charts.
- Flowcharts.

Narrative Notes

This is a simple and apparently convenient way of describing systems. Having ascertained the system, the auditor draws up a narrative description of it for the audit files. An example might be:

“Sales invoices are prepared byThey are checked byand then passed to for recording in the customer’s account in the receivables ledger etc.”

However, while this method records all the detailed understanding of the system it suffers from several disadvantages.

- It is long-winded; and takes considerable time to prepare.
- Notes may be difficult to interpret and review.
- It is time consuming to incorporate system changes into the notes and omissions may occur.
- It may be difficult to see if part of the system has been missed out altogether.
- Deficiencies in the controls in the system may not be immediately apparent.

This method is suitable for small simple systems where relatively few transactions are involved. It is more often used in conjunction with other methods rather than being used in isolation.

Organisational Chart

The organisation chart provides a convenient way of describing the relationships between individuals in an organisation. However, it does not specify the precise duties of the individuals concerned and it only describes the formal relationships between them. In practice, informal relationships may have important implications for the auditor. An example of an organisation chart is set out below.



The information contained in an organisational chart will allow the auditor to:

- Very easily understand the structure of an organisation.
- Identify key personnel and provide some information on their roles and responsibilities.
- Understand reporting lines and how these relate to the internal control system.
- Identify potential risks. For example, where individuals hold conflicting roles.

However, the information gained from the organisation chart will only provide limited information and usually will be supplemented by more detailed information contained in narrative or flowchart form. They have some limitations including:

- They do not show informal structures or relationships that exist within an organisation.
- They provide a snapshot; often organisations structures change, and these changes may not be reflected in the chart.
- They can be hard to develop and understand for large complex organisations.
- They do not contain the level of detail required to fully understand relationships, roles and responsibilities and internal control responsibilities.

Flowcharts

Flowcharts are widely used for recording accounting systems in audit files. A flowchart is a diagrammatical representation of an accounting system. A good flowchart will be supplemented with narrative, which helps with the understanding of the system.

Flowcharts have the following advantages:

- As the information is presented in a standard form, they are relatively easy to follow and to review.
- They portray the flow of documents through the system and enable the auditor to relate those movements with procedures and checks carried out as part of that system.
- They show the movement of documents in such a way that, when properly prepared, the sources and destinations of all documents will be clear.

- They help to ensure that the system is recorded in its entirety, as every flow must have a start and end.
- They help to highlight deficiencies in the accounting and control systems of the business.
- They reduce the need for extensive narrative

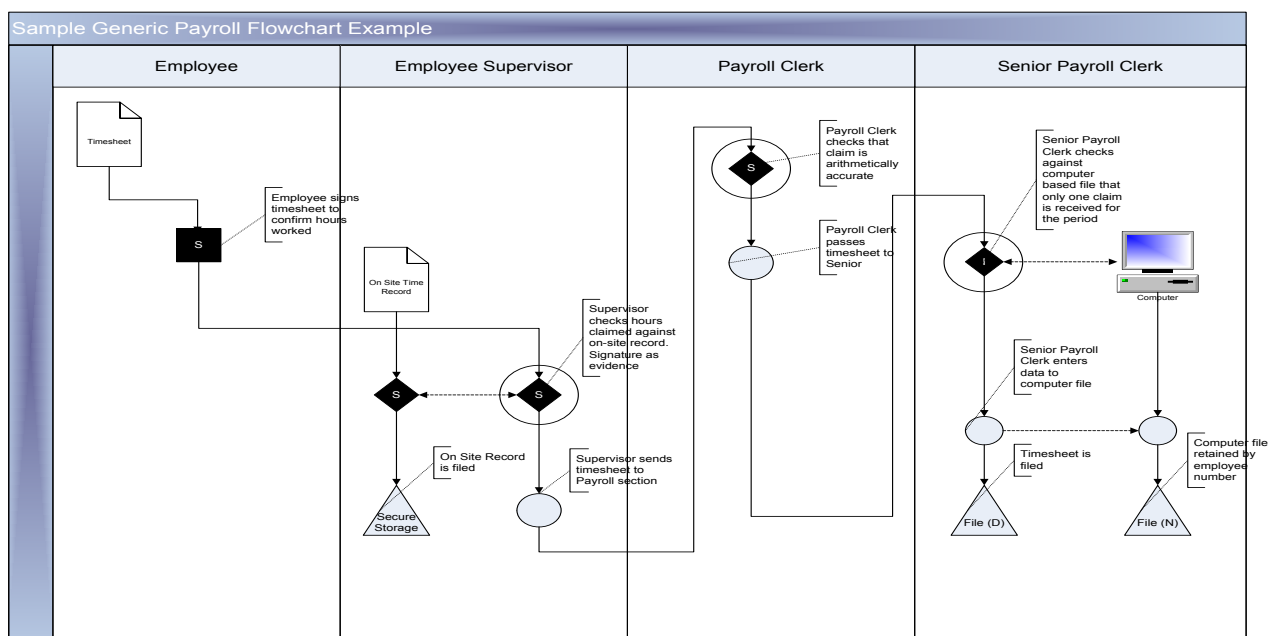
Standard symbols are used to represent documents, operations and checks carried out. Flow lines are used to join up the symbols and represent the movement of documents. Dotted lines are used to represent the flow of information between documents.

However, flowcharts have the following disadvantages:

- If standard conventions and notation have not been adopted in their preparation, they may not be easily understood.
- They are not suitable for dealing with non-standard or unusual transactions. These will usually require detailed narrative notes.
- They may be complex and difficult to follow depending upon the size and structure of an organisation.
- They may be difficult to amend or update where there are major or regular changes to systems.

Manual systems flowcharts – as opposed to computer systems flowcharts – deal with the clerical (manual) procedures of accounting systems. They chart the flow of documents and checks and operations carried out in the section of the system being described.

See a simple example flowchart for a generic payroll system below.



Control Framework

It is the responsibility of an entity to establish internal controls to prevent and detect material misstatements in the financial statements. The auditor's responsibility is to ascertain whether those controls were effectively designed and are being well implemented.

However, not all internal controls designed and implemented by management may be relevant to an audit. ISA 315 requires an auditor to obtain an understanding of internal controls that are relevant to an audit. In adopting the risk-based approach to auditing, auditors are expected to identify those controls relevant to risks identified by the auditor.

ISA 315 requires that when identifying internal controls, the auditor considers and establishes an understanding of all five components of internal controls. These consist of the control environment; the entity's risk assessment process; the information system including the related business processes, relevant to financial reporting, and communication; control activities; and monitoring of controls.

Further information on internal controls is provide in Unit B.

Control Environment

The control environment includes governance and management functions; attitudes, awareness and actions of those charged with governance and management towards the entity's internal control; and the importance of internal control within the entity.

The control environment sets the tone of an organisation, influencing the control consciousness of its staff and management. As such, it determines the effectiveness of other components of internal controls: internal control activities may not function unless a culture of honesty, integrity and ethical behaviour exists in an organisation. Deficiencies in the control environment undermine the effectiveness of controls that are put in place, particularly in relation to fraud. Therefore, in assessing the risks of material misstatement due to error or fraud, evaluating the control environment is very important.

Risk Assessment

In understanding the entity and its environment, the auditor should obtain an understanding of entity's risk assessment process. That process is a component of internal control that is aimed at managing the risks faced by the entity in its business operations and that assists the auditor in identifying the risks of material misstatements. Note the difference between the organisations business risk (i.e. risks faced by the organisation) and the auditors audit risk (i.e. the risk that the auditor issues an inappropriate audit report).

The extent of audit procedures to be performed in this regard depends on the entity's environment and whether a risk assessment process exists. If there is such a process, the auditor should gain an understanding of it and document the results. The auditor's responsibility is not to understand just the entity's risk assessment process but also how management has responded to the assessed risks (management's action).

If a risk assessment process does not exist, the auditor shall also evaluate the impact on the preparation and presentation of the financial statements. Depending on the circumstances and the size of the entity, the absence of a risk assessment process may represent a significant deficiency in internal controls.

Information System Related to the Financial Statements

Auditors should obtain an understanding of the information system, including the business processes relevant to financial reporting.

Pertinent information must be identified, captured, and communicated in a form and time frame that enable people to carry out their responsibilities. Information systems

produce reports containing operational, financial, and compliance-related information that make it possible to run and control the organisation's operations. They deal not only with internally generated data, but also information about external events, activities, and conditions necessary to informed business decision making and external reporting. Effective communication also must occur in a broader sense, flowing down, across, and up the organisation.

All personnel must receive a clear message from senior management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties.

Control Activities

Control activities are the policies and procedures that help to ensure that the organisation's activities are carried out as required and the financial statements are free from material misstatements.

It is the responsibility of management to institute control activities that will prevent and detect errors, omissions and fraud in preparing and presenting the financial statements. The auditor's responsibility is to see whether the controls are designed and implemented and operate effectively in preparing and presenting financial statements that are free from material misstatements.

In public sector entities, the relevant control activities in the preparation of financial statements are by and large defined in rules, regulations and standard operating procedures. Effective enforcement of and adherence to these rules and regulations will prevent material misstatements in the financial statements depending on the attitude (ethics and integrity) of management and those charged with governance. The auditor needs to obtain an understanding of those rules and regulations and other controls that are relevant to audit and risk identification.

Monitoring Controls

Internal control systems need to be monitored – a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring occurs during operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties.

The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the board.

The internal audit function plays a vital role in monitoring the implementation of internal controls within an entity. It is a management tool, and its effectiveness depends on how independently it is situated within the entity's structure, to whom it reports, and what action on the internal auditor's report is taken by management and those charged with governance. An effective internal audit function may reduce the level of work to be done by the external auditors. However, not all work by internal audit will be relevant to an audit of financial statements.

Where an entity has an internal audit function, the auditor is required to obtain an understanding of that function, its responsibilities, its organisational status and the activities it performs. The work done by internal audit may also impact the nature and extent of audit procedures if an entity has an internal audit function whose work can be used, after a positive evaluation of the IA function as required by ISA 610. The auditor can, in this regard, confirm whether the entity has an internal audit function and in which areas and to what extent the internal auditors' work can be used.

Identifying Risks or Material Misstatement

ISA 315 requires the auditor to identify and assess the risk of material misstatement at the financial statements level and the assertion level for particular classes of transactions, account balances or disclosures to provide a basis for designing and performing further audit procedures.

After obtaining a complete understanding of the entity and its environment the next step is to identify the processes involved in the entity, which will include routine and non-routine processes undergone by classes of transactions, account balances and disclosures presented in the financial statements to identify risk of material misstatement. While documenting the understanding of this process, the auditor needs to identify risks at every stage of the process. In other words, the auditor should be able to identify "what could go wrong" at every stage of the process. See below for an example of a risk in relation to expenses.

Payment process	Risk	What could go wrong
Processing final payment for purchase of computer equipment	Inflated rate in the final invoice (over and above quoted rate)	Overstatement of expenditure. (Accuracy assertion)

The auditor is expected to apply professional judgement while identifying the risks of material misstatement in the financial statements. The risks identified by the auditor should be documented in the risk register working paper and linked to every stage of the process documented by the auditor.

Upon identifying risks of material misstatement at the assertion level, the auditor needs to identify significant classes of transactions, account balances and disclosures and their relevant assertions, which are affected by those risks. (A significant class of transactions, account balance and disclosure are those where there is one or more relevant assertions).

Linking Risks and Controls

To mitigate the risks of material misstatements in the preparation and presentation of financial statements, management and, where relevant, those charged with governance are expected to put internal controls in place. Based on obtaining an understanding of the entity process through process flow or narrative write-up and linking the risks to every stage of the process, the auditor needs to identify those controls that are intended to mitigate the risks identified at an assertion level. These control activities may be recorded in an internal control log linked to risks identified.

See below for an example in relation to our payment processing example mentioned above.

Risk	Control activity
Inflated rate in the final invoice (over and above quoted rate)	An independent check should be performed of payment amount against original purchase order.

It is important for the auditor to understand the link between risk assessment and audit assertions. The auditor identifies the risks that could cause material misstatement in the financial statements. Management of an entity makes various assertions while preparing the financial statements, which are referred as financial statements assertions. Therefore, the auditor should ensure that the identified risk is relevant to the assertion(s). After identifying the risk, the auditor must assess “what could go wrong” at the assertion level as a result of that risk. This will be further explained in section below on “Key Financial Statement Balances, Associated Risks and Possible Audit Tests”.

Audit Assertions have been explained in Unit C. Further examples related to “what could go wrong?” linked to the audit assertions are shown in the table below.

Transactions and Events

For a transaction such as the purchase of office equipment, the management is asserting in the financial statements that:

Occurrence The purchase really did take place.

Completeness All purchase transactions are included in the financial statements.

Accuracy The quantities and prices are correctly stated.

Cut-off The transaction was dealt with in the correct accounting period.

Classification It really is a purchase of equipment, not a payroll cost or a motor vehicle and it has been accounted for accordingly.

Account balances at the year end

For account balances at the year end, the assertions are slightly different, because the things about which the assertions are made are different:

Existence

- Are all these motor vehicles, office equipment, land and buildings, inventories real? Do they exist?
- Are these trade receivables real? Have we sold them something for which they owe us money?
- Was something effectively bought from these trade payables and therefore do we really owe them some money?

Rights and Obligations

- Do we own the factory? The car? The computer?
- The trade receivables may exist, but have we factored them or otherwise transferred our rights to them?

Accuracy, Valuation and Allocation

- Has depreciation been calculated correctly on the non-current assets?
- Are the trade debtors going to pay us?
- Is the inventory damaged, slow moving or obsolete?

Documenting Control Weaknesses

When control weaknesses are identified they should be documented and will feed into the management letter at the conclusion of the audit. To ensure an efficient audit process, the auditor should document the audit finding in the same format as the management letter to be issued; this allows for an easy transfer later on.

Typically, the auditor should document:

- **Describe the Control Weakness:** Clearly describe the control weakness, including its nature, scope, and impact on the organisation's operations and financial reporting. Use descriptive language to ensure that the weakness is well-understood by readers.
- **Identify the Root Cause:** Analyse the underlying factors contributing to the control weakness. Identify the root cause, such as inadequate segregation of duties, ineffective oversight, or deficiencies in system configurations. The "five whys" approach is included in Unit F under the Management Letter Section.
- **Provide Context:** Provide context for the control weakness by explaining the relevant control objectives, processes, and risks associated with the audited area. This helps readers understand the significance of the weakness within the broader control environment.
- **Quantify the Impact:** Assess the potential impact of the control weakness on the organisation's operations, financial reporting, and compliance with regulatory requirements. Quantify the impact, if possible, using relevant metrics or qualitative assessments.
- **Link to Supporting Evidence:** Include supporting evidence to substantiate the existence of the control weakness. This may include audit findings, testing results, documentation reviews, interviews with personnel, and other relevant audit evidence.
- **Assign a Severity Rating:** Assign a severity rating to the control weakness based on its significance and potential impact. Use a standardised rating scale, such as low, moderate, or high, to categorise the severity of the weakness.
- **Recommend Corrective Actions:** Recommend specific actions to allow the organisation to address the control weakness and mitigate associated risks. Provide actionable recommendations that are practical, feasible, and tailored to the organisation's circumstances.

Further detailed guidance on documenting instances of control weaknesses is provided in Unit F under the Management Letter section.

Sampling – Test of Controls

Determining samples for tests of controls (e.g., how many monthly bank reconciliations to test) follows the same process as outlined in Unit C.

The following factors affect the number of selections for testing controls:

- The lower the level of reliance placed on the controls tested, the lower the number of selections required.
- Where a risk factor has been identified for a specific transaction type, the number of selections will increase.

As with many things to do with audit, the auditor should apply professional judgement.

Control testing will only be performed when the auditor is confident that controls for the audit component are adequate. The lower the level of reliance to be placed on the controls tested, the lower the number of selections required for control testing. Low reliance on controls will require more assurance to be obtained through substantive procedures. Typical sample sizes for tests of control are shown in the table below.

Type of Control	Moderate Reliance	High Reliance
Detailed controls Controls performed randomly – mostly more than once a day e.g. authorisation of payment vouchers	30 selections	50 selections
Daily controls Performed once a day e.g. banking, counting cash received etc.	10 selections	20 selections
Monthly controls Controls performed monthly, e.g. bank reconciliations, approval of salary payments	2 selections	5 selections

Key Financial Statement Balances, Associated Risks and Possible Audit Tests

As part of the audit planning process, the auditor must be able to plan test of controls or substantive audit procedures to address audit risks identified.

Each audit is different, and an auditor must be able to adapt to the circumstances identified during the audit planning process. However, you should be aware of typical risks and possible audit tests in relation to these risks. Examples in relation to each of the key financial statement balances are presented in the sections below.

Non-Current Assets

Risk	Possible Audit Tests
<p>Valuation and Impairment:</p> <ul style="list-style-type: none"> The risk that non-current assets are not properly valued on the balance sheet, leading to overstatement or understatement of their carrying amounts. The risk that impairment losses are not recognised or are inadequately measured, resulting in misstatement of asset values. 	<ul style="list-style-type: none"> Test the accuracy of non-current asset valuations by comparing carrying amounts to independent appraisals or market values. Assess the reasonableness of depreciation/ amortisation expense by recalculating it based on the expected useful lives and residual values of assets. Review management's impairment assessments for non-current assets and assess their compliance with relevant accounting standards.
<p>Existence and Ownership:</p> <ul style="list-style-type: none"> The risk that non-current assets recorded on the balance sheet do not exist or are not owned by the entity, leading to overstatement of assets. The risk of unrecorded assets or off-balance sheet arrangements that should be disclosed, but are omitted from the financial statements. 	<ul style="list-style-type: none"> Physically inspect a sample of non-current assets to verify their existence and condition. Confirm ownership of non-current assets by reviewing title deeds, lease agreements, or other legal documents. Perform inquiries with management and third parties to verify the ownership and location of non-current assets.
<p>Completeness:</p> <ul style="list-style-type: none"> The risk that all non-current assets owned or controlled by the entity are not included in the financial statements, leading to understatement of assets. The risk of unrecorded acquisitions or disposals of non-current assets during the reporting period. 	<ul style="list-style-type: none"> Trace additions and disposals of non-current assets to supporting documentation, such as purchase orders, invoices, and sales agreements. Review capital expenditure budgets and compare them to actual expenditures to ensure completeness of non-current asset additions. Analyse depreciation expense trends and investigate any significant fluctuations or anomalies.

Risk	Possible Audit Tests
<p>Capitalisation Policies:</p> <ul style="list-style-type: none"> • The risk that expenditures that should be expensed are capitalised as non-current assets, leading to overstatement of assets and understatement of expenses. • The risk that costs associated with non-current assets under construction or development are improperly capitalised before they meet the criteria for capitalisation. 	<ul style="list-style-type: none"> • Review the capitalisation policy for non-current assets and assess its compliance with accounting standards and industry practices. • Test the capitalisation criteria applied to non-current asset additions to ensure that only qualifying expenditures are capitalised. • Analyse the composition of capitalised costs and assess their reasonableness and appropriateness based on the nature of the assets and the entity's operations.
<p>Related Party Transactions:</p> <ul style="list-style-type: none"> • The risk that non-current assets are transferred to or from related parties at non-arm's length terms, leading to misstatement of asset values or undisclosed related party transactions. • The risk of undisclosed related party leases, disposals, or impairments that could impact the financial statements. 	<ul style="list-style-type: none"> • Obtain a list of related parties from management and review related party disclosures in the financial statements. • Assess the adequacy of related party disclosures, including the nature of relationships, transactions, and outstanding balances with related parties. • Investigate any undisclosed related party transactions involving non-current assets identified during the review.
<p>Lease Accounting:</p> <ul style="list-style-type: none"> • The risk that lease agreements are not properly accounted for and disclosed in accordance with lease accounting standards, leading to misstatement of lease assets and liabilities. • The risk that lease classifications and lease terms are incorrectly determined, resulting in misclassification of leases as operating or finance leases. 	<ul style="list-style-type: none"> • Obtain a schedule of lease agreements and review them to understand the terms and conditions of each lease. • Verify that all lease agreements have been properly identified and included in the lease schedule. • Confirm that lease agreements are in writing and contain essential lease terms, such as lease term, payment terms, renewal options, and purchase options.

Risk	Possible Audit Tests
Government Grants and Subsidies: <ul style="list-style-type: none"> The risk that government grants or subsidies related to non-current assets are not properly accounted for and disclosed in accordance with accounting standards, leading to misstatement of asset values or income. The risk that compliance requirements associated with government grants or subsidies are not met, resulting in repayment obligations or adverse consequences. 	<ul style="list-style-type: none"> Obtain copies of government grant agreements and review them to understand the terms and conditions, including eligibility criteria, performance obligations, and reporting requirements. Confirm that all relevant government grants and subsidies have been identified and properly documented. Evaluate management's accounting treatment for government grants and subsidies related to non-current assets.

Cash in Bank

Risk	Possible Audit Tests
Misappropriation of Cash: <ul style="list-style-type: none"> There's a risk that employees or management may misappropriate cash for personal gain or fraudulent activities. 	<ul style="list-style-type: none"> Assess the effectiveness of internal controls over cash handling. Conduct surprise cash counts. Review authorisation procedures for cash disbursements and receipts.
Fraudulent Financial Reporting: <ul style="list-style-type: none"> Management might engage in fraudulent financial reporting by manipulating cash balances or transactions to misstate financial results. 	<ul style="list-style-type: none"> Assess the integrity and ethics of management. Review internal controls over cash transactions. Perform substantive tests on cash balances and transactions.

Risk	Possible Audit Tests
<p>Foreign Exchange Translation</p> <ul style="list-style-type: none"> There is a risk that incorrect foreign exchange rates are used for translating cash balances held in foreign currencies into the entity's reporting currency, resulting in misstatement of cash balances in the financial statements. 	<ul style="list-style-type: none"> Assess the entity's process for determining foreign exchange rates used for translating cash balances, including the source of exchange rates (e.g., central bank rates, market rates, company policies). Evaluate the reliability and accuracy of exchange rate data sources and the methodology used for currency translation. Perform substantive testing by recalculating translated cash balances using appropriate exchange rates obtained from reliable sources (e.g., central banks, financial institutions). Review management's documentation and rationale for selecting exchange rates, including any deviations from standard exchange rate sources. Test controls over the determination and application of exchange rates, including approval procedures and monitoring of exchange rate fluctuations.
<p>Non-Disclosure of Bank Accounts</p> <ul style="list-style-type: none"> The risk that the entity has undisclosed bank accounts not included in the accounting records or financial statements, leading to incomplete and inaccurate financial reporting. 	<ul style="list-style-type: none"> Assess the entity's process for identifying and disclosing bank accounts in the accounting records and financial statements. Evaluate the effectiveness of internal controls over bank account management, including procedures for opening, closing, and monitoring bank accounts. Perform inquiries with management and review relevant documentation (e.g., bank statements, correspondence with financial institutions) to identify all bank accounts held by the entity. Conduct bank confirmations or direct communication with financial institutions to verify the completeness and accuracy of disclosed bank accounts.

Inventory

Risk	Possible Audit Tests
Existence and Completeness: <ul style="list-style-type: none"> There's a risk that inventory recorded in the accounting records does not physically exist or that all existing inventory is not recorded. 	<ul style="list-style-type: none"> Auditors should perform physical inventory counts. Test count procedures. Inspect inventory locations. Reconcile physical counts to inventory records.
Valuation: <ul style="list-style-type: none"> Inventory may be incorrectly valued, either overvalued or undervalued, leading to misstatement of assets and net income. 	<ul style="list-style-type: none"> Auditors should assess the appropriateness of inventory valuation methods. Test the accuracy of cost allocations. Evaluate the reasonableness of overhead allocations.
Ownership: <ul style="list-style-type: none"> There's a risk that inventory recorded in the accounting records does not belong to the entity or that the entity's ownership rights are not adequately documented. 	<ul style="list-style-type: none"> Auditors should review purchase agreements Obtain confirmations from suppliers. Assess the adequacy of documentation supporting ownership rights.
Obsolete or Slow-Moving Inventory: <ul style="list-style-type: none"> There's a risk that inventory items are obsolete or slow-moving, leading to overstatement of asset values. 	<ul style="list-style-type: none"> Assess the adequacy of inventory write-downs. Evaluate the classification of inventory items. Review management's assessment of inventory obsolescence.

Liabilities

Risk	Possible Audit Tests
Understatement of Liabilities: <ul style="list-style-type: none"> There's a risk that liabilities are understated, leading to an understatement of the entity's obligations in the financial statements. 	<ul style="list-style-type: none"> Auditors should carefully scrutinise liabilities, particularly those subject to estimation (such as provisions and contingent liabilities). Ensuring completeness and accuracy through substantive testing and review of relevant documentation. External confirmation on creditors.

Risk	Possible Audit Tests
Overstatement of Liabilities: <ul style="list-style-type: none"> There's a risk that liabilities are overstated, either intentionally or inadvertently, leading to an overstatement of the entity's obligations in the financial statements. 	<ul style="list-style-type: none"> Assess the reliability of management's estimates and assumptions. Review the appropriateness of accounting policies applied. Perform substantive testing to verify the accuracy of reported liabilities.
Misclassification of Liabilities: <ul style="list-style-type: none"> There's a risk that liabilities are misclassified or improperly presented in the financial statements, leading to confusion or misinterpretation by users. 	<ul style="list-style-type: none"> Evaluate the classification and presentation of liabilities in accordance with applicable accounting standards. Ensuring consistency with the entity's operations, financing arrangements, and industry practices.
Complexity of Lease Obligations: <ul style="list-style-type: none"> Lease obligations under IFRS 16 can be complex, requiring careful assessment of lease terms, discount rates, and lease classification. 	<ul style="list-style-type: none"> Auditors should assess the completeness and accuracy of lease disclosures. Review lease agreements and related documentation. Perform substantive testing to verify the accuracy of lease liability measurements and disclosures including checking lease valuation calculations.

Sales

Risk	Possible Audit Tests
Overstated Sales Revenue: The risk that sales revenue is overstated due to the inclusion of fictitious sales, premature recognition of revenue, or improper revenue recognition criteria. This could occur if sales are recorded before goods or services are actually delivered, or if sales are recorded for goods that have not been shipped.	<ul style="list-style-type: none"> Select a sample of sales transactions and trace them to supporting documentation, such as sales orders, shipping documents, and customer invoices. Confirm selected sales transactions directly with customers to verify the authenticity of the transactions. Analyse sales patterns and trends to identify unusual or unexpected fluctuations in sales volume or revenue.

Risk	Possible Audit Tests
<p>Understated Sales Returns and Allowances: The risk that sales returns and allowances are not properly recorded or disclosed, leading to an understatement of sales revenue. Auditors need to ensure that sales returns, allowances, and discounts are accurately accounted for and accurately reflected in the financial statements.</p>	<ul style="list-style-type: none"> • Review sales contracts and agreements to determine the specific criteria for revenue recognition, such as delivery terms and acceptance clauses. • Verify that revenue is recognised only when all revenue recognition criteria are met, including the transfer of control of goods or services to the customer. • Perform substantive testing of revenue transactions to ensure that revenue is recognised in the appropriate accounting period.
<p>Misstatement of Sales Discounts and Discounts Given: The risk that sales discounts and discounts given to customers are not properly recorded or applied, resulting in misstatement of sales revenue. Auditors need to verify the accuracy and completeness of discounts recorded, ensuring they are properly authorised and supported by appropriate documentation.</p>	<ul style="list-style-type: none"> • Select a sample of sales returns and allowances and verify that they are properly authorised and supported by appropriate documentation, such as return authorisation forms and credit memos. • Test the completeness of sales returns and allowances by reviewing subsequent cash receipts and customer account reconciliations. • Evaluate the adequacy of the allowance for sales returns and allowances by comparing historical return rates to current period activity.
<p>Failure to Recognise Revenue on Consignment Sales: The risk that revenue from consignment sales is not properly recognised or disclosed. Auditors need to evaluate whether consignment sales are accounted for in accordance with applicable accounting standards, ensuring that revenue is recognised when control of the goods transfers to the customer.</p>	<ul style="list-style-type: none"> • Obtain a listing of consignment sales transactions and verify that revenue is recognised in accordance with applicable accounting standards. • Confirm consignment arrangements with the consignor to ensure that revenue recognition is appropriate based on the transfer of control criteria. • Test the completeness of consignment sales by reconciling consignment inventory balances to sales records and consignment agreements.

Risk	Possible Audit Tests
<p>Cut-off Errors: The risk that sales transactions are recorded in the wrong accounting period, leading to misstatement of sales revenue. Auditors need to perform cut-off procedures to ensure that sales transactions are recorded in the correct period, especially at year-end.</p>	<ul style="list-style-type: none"> • Perform cut-off testing by selecting a sample of sales transactions near the end of the reporting period and tracing them to shipping documents and sales invoices. • Review sales orders and shipping documents to verify that sales transactions are recorded in the correct accounting period. • Analyse the sequence of sales transactions to identify any gaps or overlaps in transaction dates.
<p>Lack of Segregation of Duties: The risk that there is inadequate segregation of duties in the sales process, leading to increased opportunities for fraud or errors. Auditors need to assess the effectiveness of internal controls over sales transactions, including segregation of duties between sales, billing, and collection functions.</p>	<ul style="list-style-type: none"> • Evaluate the effectiveness of segregation of duties by reviewing organisational charts, job descriptions, and access controls. • Test the operating effectiveness of segregation of duties by tracing sales transactions through the sales process and documenting the segregation of duties observed. • Perform walkthroughs of the sales process to identify any weaknesses or breakdowns in segregation of duties.
<p>Fraudulent Sales Schemes: The risk that sales are recorded as a result of fraudulent schemes, such as fictitious sales, channel stuffing, or improper revenue recognition practices. Auditors need to be vigilant for indicators of fraud and perform procedures to detect and deter fraudulent activities.</p>	<ul style="list-style-type: none"> • Perform data analytics to identify unusual or suspicious patterns in sales transactions, such as round-dollar amounts, sequential invoice numbers, or excessive discounts. • Conduct interviews with management and personnel to inquire about sales practices, policies, and controls, focusing on areas of potential fraud risk. • Review internal controls and procedures related to sales transactions to identify opportunities for fraudulent activities and recommend enhancements to mitigate fraud risk.

Expenses

Risk	Possible Audit Tests
<p>Misclassification of Expenses: The risk that expenses are recorded in incorrect accounts, leading to misstatement of financial statements. This could occur due to errors or intentional misclassification to conceal certain transactions.</p>	<ul style="list-style-type: none"> • Select a sample of expense transactions and verify the accuracy of account coding by tracing them back to supporting documentation, such as invoices, purchase orders, and expense reports. • Review the general ledger and trial balance for unusual or unexpected account balances that may indicate misclassification of expenses. • Analyse expense trends and ratios to identify any anomalies or fluctuations that may suggest misclassification.
<p>Overstated Expenses: The risk that expenses are overstated, either intentionally or unintentionally, resulting in higher reported expenses than the actual amount incurred. This could occur due to improper recording of expenses, inclusion of non-business-related expenses, or duplication of expenses.</p>	<ul style="list-style-type: none"> • Perform substantive testing of expense transactions by selecting a sample and verifying the accuracy and validity of the expenses recorded. • Analyse expense accounts for unusual patterns or trends, such as sudden increases in expenses or inconsistencies with historical data. • Review supporting documentation for high-value or unusual transactions to ensure that expenses are properly supported and authorised.
<p>Understated Liabilities: The risk that expenses are understated, leading to the understatement of liabilities on the balance sheet. This could occur if certain expenses are not recorded or recognised in the appropriate accounting period, leading to an inaccurate representation of the entity's financial position.</p>	<ul style="list-style-type: none"> • Review accounts payable balances and aged payables reports to identify any unrecorded liabilities or accrued expenses. • Test the completeness of expense recognition by analysing expense cutoff procedures and ensuring that expenses are recorded in the appropriate accounting period. • Perform inquiries with management and review board minutes or other relevant documentation for discussions of significant liabilities or contingent obligations.

Risk	Possible Audit Tests
<p>Fraudulent Expenses: The risk that expenses are recorded as a result of fraudulent activities, such as fictitious vendors, inflated invoices, or unauthorised expenditures. Auditors need to be vigilant for indicators of fraud and perform procedures to detect and deter fraudulent activities.</p>	<ul style="list-style-type: none"> • Conduct data analytics to identify unusual or suspicious patterns in expense transactions, such as round-dollar amounts, duplicate invoices, or payments to unfamiliar vendors. • Perform background checks on key vendors and suppliers to verify their legitimacy and existence. • Review expense approval processes and verify the authorisation of high-value or unusual transactions with appropriate documentation and approvals.
<p>Inadequate Expense Authorisation and Approval: The risk that expenses are incurred without proper authorisation or approval, leading to unauthorised or unnecessary expenditures. Auditors need to evaluate the effectiveness of internal controls over expense authorisation and ensure that expenses are incurred in accordance with established policies and procedures.</p>	<ul style="list-style-type: none"> • Evaluate the effectiveness of internal controls over expense authorisation and approval, including segregation of duties and review procedures. • Select a sample of expense transactions and verify the authorisation and approval of expenditures by reviewing supporting documentation and approval signatures. • Test the operating effectiveness of expense approval processes by performing walkthroughs and observing the flow of transactions through the approval hierarchy.
<p>Expense Cutoff Errors: The risk that expenses are recorded in the wrong accounting period, leading to misstatement of financial statements. Auditors need to perform cutoff testing to ensure that expenses are recorded in the appropriate period, especially at year-end.</p>	<ul style="list-style-type: none"> • Perform cutoff testing by selecting a sample of expense transactions near the end of the reporting period and verifying the accuracy of the recording date. • Review shipping documents, receiving reports, and other relevant documentation to ensure that expenses are recorded in the appropriate period. • Analyse the sequence of expense transactions to identify any gaps or overlaps in transaction dates that may indicate cutoff errors.

Risk	Possible Audit Tests
<p>Inadequate Documentation and Support: The risk that expenses lack adequate supporting documentation or are not properly substantiated, leading to questions about their validity and appropriateness. Auditors need to review expense documentation, such as invoices, receipts, contracts, and approvals, to ensure completeness and accuracy.</p>	<ul style="list-style-type: none"> • Review expense documentation, such as invoices, receipts, contracts, and approvals, to ensure completeness and accuracy. • Verify the authenticity and legitimacy of expense documentation by contacting vendors and suppliers directly. • Assess the adequacy of documentation retention policies and procedures to ensure that supporting documentation is retained for the required period.
<p>Expense Recognition Timing: The risk that expenses are recognised in the wrong accounting period, leading to misstatement of financial statements. Auditors need to evaluate the timing of expense recognition to ensure that expenses are recorded in the period in which they are incurred, following the matching principle.</p>	<ul style="list-style-type: none"> • Test the accuracy of expense recognition timing by selecting a sample of transactions and verifying that expenses are recorded in the period in which they are incurred. • Review accruals and prepayments to ensure that expenses are appropriately recognised in the correct accounting period. • Evaluate the reasonableness of cutoff adjustments and accruals made at year-end to ensure compliance with accounting principles and policies.
<p>Vendor and Contract Compliance: The risk that expenses related to vendors or contracts are not in compliance with contractual agreements or regulatory requirements. Auditors need to review vendor contracts, purchase orders, and invoices to ensure that expenses are in accordance with agreed-upon terms and conditions.</p>	<ul style="list-style-type: none"> • Review vendor contracts, purchase orders, and invoices to ensure compliance with contractual agreements and regulatory requirements. • Perform substantive testing of vendor transactions to verify the accuracy and completeness of expenses recorded. • Conduct inquiries with management and perform analytical procedures to identify any discrepancies or inconsistencies in vendor and contract compliance.

Risk	Possible Audit Tests
Foreign Exchange Exposure: The risk that expenses denominated in foreign currencies are subject to foreign exchange rate fluctuations, leading to potential misstatement of financial statements. Auditors need to assess the impact of foreign currency transactions on expenses and ensure appropriate accounting treatment and disclosure.	<ul style="list-style-type: none"> Review foreign currency transactions and assess the impact of foreign exchange rate fluctuations on expenses. Evaluate the appropriateness of foreign currency translation methods and exchange rate assumptions used in recording expenses. Verify the accuracy and completeness of foreign currency disclosures in the financial statements to ensure compliance with accounting standards and regulatory requirements.

Payroll

Risk	Possible Audit Tests
Overstated Payroll Expenses: The risk that payroll expenses are overstated due to errors, misclassification, or fraudulent activities. This could include improper recording of payroll costs, inclusion of non-payroll-related expenses, or inflated payroll accruals.	<ul style="list-style-type: none"> Select a sample of payroll transactions and verify the accuracy of amounts recorded by comparing them to supporting documentation such as timesheets, employee contracts, and payroll registers. Review payroll expense accounts for unusual fluctuations or trends compared to prior periods and industry benchmarks. Conduct analytical procedures to identify any unexpected changes in payroll expenses relative to revenue or employee headcount.
Unauthorised or Fictitious Employees: The risk that payments are made to unauthorised or fictitious employees, resulting in improper or fraudulent disbursements. This could occur due to inadequate controls over employee hiring, onboarding, and termination processes.	<ul style="list-style-type: none"> Select a sample of payroll transactions and verify the accuracy of amounts recorded by comparing them to supporting documentation such as timesheets, employee contracts, and payroll registers. Review payroll expense accounts for unusual fluctuations or trends compared to prior periods and industry benchmarks. Conduct analytical procedures to identify any unexpected changes in payroll expenses relative to revenue or employee headcount.

Risk	Possible Audit Tests
<p>Overtime and Wage Compliance: The risk that payroll expenses related to overtime, bonuses, and other wage-related payments are not properly authorised, calculated, or recorded in compliance with contractual agreements, labour laws, and company policies.</p>	<ul style="list-style-type: none"> • Select a sample of payroll transactions involving overtime and bonuses and verify the accuracy of calculations and approvals. • Review employment contracts, collective bargaining agreements, and relevant labour laws to ensure compliance with wage and hour requirements. • Test the accuracy of payroll accruals by comparing them to actual payments made and reconciling any differences.
<p>Segregation of Duties: The risk that there is inadequate segregation of duties within the payroll process, leading to increased opportunities for errors or fraud. This could include lack of segregation between payroll processing, approval, and reconciliation functions.</p>	<ul style="list-style-type: none"> • Evaluate the segregation of duties within the payroll process and identify any weaknesses or deficiencies. • Review payroll processing procedures to ensure that critical tasks, such as payroll processing, approval, and reconciliation, are adequately segregated. • Test the effectiveness of segregation of duties by performing walkthroughs and observing the flow of transactions through the payroll process.
<p>Payroll Tax Compliance: The risk that payroll taxes, including income tax withholding, Social Security, Medicare, and unemployment taxes, are not accurately calculated, withheld, reported, or remitted in compliance with tax laws and regulations.</p>	<ul style="list-style-type: none"> • Verify the accuracy of payroll tax calculations by comparing them to applicable tax rates and regulations. • Review payroll tax filings for completeness, accuracy, and timeliness. • Confirm the remittance of payroll taxes by reconciling payroll tax liabilities reported on the balance sheet to tax payments made to tax authorities.

Risk	Possible Audit Tests
<p>Benefits and Deductions Accuracy: The risk that employee benefits, deductions, and garnishments are not accurately calculated, authorised, or recorded. This could include errors in benefits administration, incorrect deductions, or unauthorised changes to employee compensation.</p>	<ul style="list-style-type: none"> • Select a sample of payroll transactions involving benefits and deductions and verify the accuracy of calculations and authorisations. • Review employee benefit plans, policies, and enrolment records to ensure that benefits are administered in accordance with plan provisions and regulatory requirements. • Test the accuracy of deduction calculations by recalculating selected deductions and comparing them to payroll records.
<p>Payroll Cutoff Errors: The risk that payroll transactions are recorded in the wrong accounting period, leading to misstatement of financial statements. This could occur due to delays in processing payroll, improper cutoff procedures, or inclusion of subsequent period transactions in the current period.</p>	<ul style="list-style-type: none"> • Perform cutoff testing by selecting a sample of payroll transactions near the end of the reporting period and verifying the accuracy of the recording date. • Review payroll registers and timekeeping records for transactions that may have been recorded in the wrong accounting period. • Analyse the sequence of payroll transactions to identify any gaps or overlaps in transaction dates that may indicate cutoff errors.
<p>Manual Processing and Controls: The risk that manual payroll processing procedures are prone to errors, omissions, or manipulation. This could include reliance on manual calculations, spreadsheets, or paper-based records without adequate controls or oversight.</p>	<ul style="list-style-type: none"> • Evaluate the effectiveness of manual payroll processing controls by assessing the design and operating effectiveness of key controls, such as manual reconciliations and approvals. • Test the accuracy of manual calculations by independently recalculating selected payroll transactions and comparing the results to payroll records. • Review payroll processing policies and procedures to identify opportunities for automation and enhancement of internal controls.

Risk	Possible Audit Tests
Employee Reimbursements and Expenses: The risk that employee reimbursements and expenses are not properly authorised, documented, or recorded. This could include fraudulent expense claims, inadequate documentation, or lack of adherence to company policies and procedures.	<ul style="list-style-type: none"> • Select a sample of employee expense reports and verify the accuracy and appropriateness of expenses claimed. • Review expense reimbursement policies and procedures to ensure compliance with company policies and applicable regulations. • Test the completeness of expense documentation by verifying that expenses are supported by receipts, invoices, and other relevant documentation.
Internal and External Fraud: The risk that payroll processes are vulnerable to internal or external fraud schemes, such as ghost employees, payroll padding, or identity theft. This could occur due to weak internal controls, collusion among employees, or exploitation of system vulnerabilities.	<ul style="list-style-type: none"> • Conduct data analytics to identify patterns or anomalies indicative of potential fraud, such as duplicate payments, irregular transaction amounts, or unusual employee identifiers. • Perform background checks on key employees involved in payroll processing and review access controls to sensitive payroll systems and data. • Implement fraud detection procedures, such as surprise audits or forensic data analysis, to detect and deter fraudulent activities.

Audit Plan

The overall audit plan (or strategy) should set the scope, timing and direction of the audit. Key decisions and significant matters are documented in the plan which will inform and guide all members of the audit team about aspects of the audit.

The objectives of the audit plan are:

- To document the audit task, and to describe the scope and coverage of the audit, its objectives, intended outcomes and the products that will result from the audit.
- To ensure that sufficient, reliable and relevant evidence is gathered to support the audit opinion.
- To ensure the most efficient audit approach and the most effective deployment of resources.
- To identify potential problem areas to allow for ASSL management approval and progress monitoring.
- To ensure all audit team members understand what is required and thus avoid misdirected effort.

Audit Plan – Typical Contents

The exact structure and content of an audit plan will vary from audit firm to audit firm. However, they will generally contain the following information:

- **Engagement Objectives and Scope:** Clearly define the objectives of the audit engagement, including the financial statement assertions to be tested and the scope of the audit work. This section outlines the primary focus areas and key deliverables of the audit.
- **Understanding of the Entity and Its Environment:** Provide an overview of the audited entity's industry, operations, and regulatory environment. Describe the entity's business model, significant accounting policies, and key financial reporting risks. This section also includes considerations related to internal controls and governance structures.
- **Risk Assessment:** Discuss the risk assessment process, including the identification and evaluation of inherent and control risks associated with the audited entity's operations and financial reporting.
- **Materiality and Audit Planning:** Determine materiality levels for the financial statements as a whole and for individual account balances or disclosures. Discuss how materiality thresholds are applied in audit planning, including the allocation of audit resources and the selection of audit procedures.
- **Audit Approach and Procedures:** Outline the overall audit approach, including the use of substantive testing, tests of controls, and analytical procedures. Describe the specific audit procedures to be performed in response to assessed risks, including sampling methods, data analytics, and other audit techniques.
- **Timing and Phasing of Audit Work:** Establish a timeline for the completion of audit procedures, including interim and year-end testing phases. Discuss the timing of audit fieldwork, management inquiries, and reporting deadlines. Allocate resources and coordinate audit activities to ensure timely completion of the engagement.
- **Coordination with Other Auditors and Experts:** If applicable, describe the coordination efforts with component auditors, specialists, or external experts involved in the audit engagement. Discuss communication protocols, data sharing arrangements, and coordination of audit findings.
- **Communication and Reporting:** Outline the communication protocols for reporting audit findings to management, the audit committee, and other stakeholders. Discuss the format and content of the audit report, including any required supplementary information or disclosures.
- **Documentation and Quality Control:** Establish documentation standards and quality control procedures for audit documentation, including workpapers, memos, and other supporting materials. Discuss review processes, documentation retention policies, and compliance with professional standards.
- **Contingency Planning and Risk Management:** Identify potential risks and uncertainties that could impact the audit engagement, such as resource constraints, unexpected events, or changes in circumstances. Develop contingency plans and risk mitigation strategies to address these risks proactively.
- **Ethical and Independence Considerations:** Discuss compliance with ethical requirements and independence standards applicable to the audit engagement.

Address any potential threats to independence and integrity and describe safeguards implemented to mitigate these threats.

- **Approval and Authorisation:** Obtain approval and authorisation from appropriate parties, such as engagement partners, to proceed with the audit engagement. Document any formal approvals and sign-offs required for audit planning prior to commencing audit execution work.

Changes to the Plan

The audit plan should be documented, updated and changed as necessary during the audit. Planning an audit is a continual and iterative process. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the audit procedures, the auditor may need to modify the plan (for one or more components), and thereby the resulting planned nature, timing and extent of further audit procedures. All changes made should be documented.

The auditor should plan the nature, timing and extent of direction and supervision of the audit team members and the review of their work. The nature, timing and extent of the direction and supervision of the audit team members and the review of their work vary depending on many factors, including the size and complexity of the entity, the area of audit, the risks of material misstatement, and the capabilities and competence of personnel performing the audit work.

Audit Team Planning Meeting

The members of the engagement team should discuss the overall objectives of the audit and the susceptibility of the entity's financial statements to material misstatements. The objective of this discussion is for members of the engagement team to gain a better understanding of the potential for material misstatements of the financial statements, resulting from fraud or error in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures. Auditors with prior experience on the audit should share any significant aspects of these experiences.

The discussion among the engagement team members emphasises the need to maintain professional scepticism throughout the engagement, to be alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred, and to be rigorous in following up on such indications. The person responsible for the audit and other key engagement team members should participate in the discussion and determine which matters are to be communicated to engagement team members not involved in the discussion.

The extent of the discussion is influenced by the roles, experience and information needs of the engagement team members. Professional judgement is used to determine which members of the engagement team are included in the discussion, how and when it occurs, and the extent of the discussion. The key members of the engagement team are ordinarily involved in the discussion including the person responsible for the audit; however, it is not necessary for all team members to have a comprehensive knowledge of all aspects of the audit.

In a multi-location audit, for example, there may be multiple discussions that involve the key members of the engagement team in each significant location. Another factor to consider

in planning the discussions is whether to include experts assigned to the engagement team. For example, the auditor may determine the need for a professional technology (IT) specialist, or any other skills needed on the engagement team and therefore would include that individual in the discussion. Discussions around potential risks relating to fraud may include consideration of the susceptibility of the entity's procurement process to fraud carried out through related parties.

This team planning meeting should be documented and a copy of the minutes retained on the audit file.

Summary of Unit D and key learning outcomes

After completing Unit D, you should be able to help participate in audit planning by accurately identifying areas to be verified and any associated risks.

- Identify the accounting systems under review and accurately record them on appropriate working papers.
- Correctly identify the control framework.
- Accurately assess risks associated with the accounting system and its controls.
- Correctly record significant weaknesses in control.
- Identify account balances to be verified and the associated risks.
- Select an appropriate sample for testing.
- Select or devise appropriate tests in accordance with the auditing principles and agree them with the engagement partner.
- Provide clear information and recommendations for the proposed audit plan and submit it to the appropriate person for consideration.

Ref	Learning Outcome	
D1	Identify the accounting systems under review and accurately record them on appropriate working papers.	<ul style="list-style-type: none"> • Understand the requirement for the auditor to document the accounting system. • Be aware of some different methods for recording auditor understanding of the accounting system.
D2	Correctly identify the control framework.	<ul style="list-style-type: none"> • Understand the requirement for the auditor to understand key elements of the internal control system. • Be aware of some different methods for recording auditor understanding of the control system.
D3	Accurately assess risks associated with the accounting system and its controls.	<ul style="list-style-type: none"> • Able to identify audit risks from audit planning work. • Able to link risks identified to possible control activities.

Ref	Learning Outcome	
D4	Correctly record significant weaknesses in control.	<ul style="list-style-type: none"> Understand the key elements required to fully record control weaknesses identified.
D5	Identify account balances to be verified and the associated risks.	<ul style="list-style-type: none"> Be aware of typical risks in relation to key financial statement balances
D6	Select an appropriate sample for testing.	<ul style="list-style-type: none"> Understand the process for selecting a sample for controls testing
D7	Select or devise appropriate tests in accordance with the auditing principles and agree them with the engagement partner.	<ul style="list-style-type: none"> Be able to identify audit risks and identify possible audit procedures in response to these risks.
D8	Provide clear information and recommendations for the proposed audit plan, and submit it to the appropriate person for consideration.	<ul style="list-style-type: none"> Understand the reason for preparing an audit plan Identify and explain typical contents of an audit plan Be aware of the need for an audit team planning meeting at the end of the audit planning phase.

Quiz Questions

1	Learning Outcome: D1
How does flowcharting aid auditors in identifying control weaknesses?	
A	By capturing lots of detail
B	By simplifying complex processes
C	By providing a visual representation of processes and controls
D	By providing better audit evidence

1	Feedback
A	No. Flowcharts present less detail than narrative systems documentation.
B	No. The process might still be complex.
C	Yes! It is easier to see gaps or issues with the process/controls given the visual nature of flowcharting
D	No. Not a form of audit evidence. Just documents the evidence gathered.

2	Learning Outcome: D2
Which internal control dimension refers to the organisation's ethics and integrity?	
A	Control Environment
B	Risk Assessment
C	Control Activities
D	Monitoring Activities

2	Feedback
A	Yes! Tone at the top includes ethical considerations.
B	No. Concerned with setting objectives and managing risks in reaching those objectives.
C	No. Control activities are the individual controls put in place.
D	No. Monitoring controls are the controls in place to monitor the rest of the internal control framework.

3	Learning Outcome: D3
What control activity ensures that terminated employees are promptly removed from the payroll system?	
A	Regular reconciliation of payroll accounts
B	Management review and approval of payroll changes
C	Automated termination procedures in the payroll system
D	Segregation of duties between payroll processing and payroll distribution

3	Feedback
A	No. Reconciliation of accounts would not pick up payment to an employee who has left.
B	No. By definition the change might not be processed.
C	Yes!
D	No. Processing and distribution controls would not pick up if an employee has left the organisation.

4	Learning Outcome: D4
How does documenting control weaknesses benefit auditors during subsequent audits?	

A	It allows auditors to claim greater fees from clients
B	It provides a historical record of control weaknesses for trend analysis
C	It reduces the need for substantive audit procedures in future audits.
D	It allows the auditor to report these issues in the audit opinion.

4	Feedback
A	No. This is not related directly to fee rates.
B	Yes! Issues identified in prior year audits can be used to consider risks in subsequent years.
C	No. If anything a history of control weakness might indicate greater risk and lead to <i>more</i> substantive testing.
D	No. Control weakness are not directly included in the audit opinion. They would be taken to the management letter.

5	Learning Outcome: D5
What audit procedure is most appropriate for testing the cutoff of expenses?	
A	Testing expense items to check whether they were posted to the correct account code
B	Reviewing expense accounts for large, unusual transactions at year-end.
C	Observing physical inventory counts of supplies and materials
D	Inspecting purchase orders and contracts for approval signatures

5	Feedback
A	No. This would test for classification
B	Yes! The normal audit tests to address cutoff risks relate to testing samples before and after year end.
C	No. This would relate to assertions around inventory.
D	No. Purchase order authorisation controls would not impact cutoff risks.

6	Learning Outcome: D6
What is the primary drawback of using judgemental sampling for tests of control?	
A	It may lead to biased results if the sample is not representative
B	It requires a larger sample size compared to other methods
C	It is time-consuming and resource-intensive.
D	It does not allow for sample stratification

6	Feedback
A	Yes! There may be something about the way the sample was selected by the auditor which means the sample is not representative.
B	No. In fact, judgemental sampling often requires smaller sample sizes compared to other sampling methods because it relies on the auditor's judgement to select items that are deemed most relevant or risky
C	No. It is usually quicker to perform judgemental sampling.
D	No. Often judgemental sampling is used for a part of the population and random sampling applied to the rest.

7	Learning Outcome: D7
How does the auditor typically verify the ownership of non-current assets?	
A	Reviewing board meeting minutes for authorisation of asset acquisitions
B	Inspecting physical asset tags and serial numbers
C	Confirming asset valuations with independent appraisers
D	Testing the accuracy of asset impairment calculations

7	Feedback
A	No. While reviewing board meeting minutes can provide evidence of authorisation for asset acquisitions, it primarily verifies the approval process rather than ownership. This option is not directly related to verifying ownership.
B	Yes! Inspecting physical asset tags and serial numbers is a common audit procedure to verify ownership of non-current assets. By physically examining asset tags and serial numbers, auditors can match them to the records in the asset register to confirm ownership
C	No. This is focused on valuation of assets.
D	No. This is also focused on valuation.

8	Learning Outcome: D8
When should the audit plan be finalised?	
A	After the completion of fieldwork
B	At the start of the audit
C	After the issuance of the audit report
D	Before the start of audit fieldwork

8	Feedback
A	No. Audit plan guides the fieldwork.
B	No. Audit planning steps must be performed to inform the audit plan.
C	No. The plan should influence the work that feeds into the audit report.
D	Yes! The plan guides the audit fieldwork.

Quiz Answers

Question	Answer
1	C
2	A
3	C
4	B
5	B
6	A
7	B
8	D

Exercises

1. Identify and explain the five different components of an internal control system to be reviewed during the audit planning stage.
2. What audit tests could an auditor perform to test completeness of liabilities?
3. What are some of the benefits of having a written audit plan?

Exercise Solutions

1. **Control Environment:** The control environment sets the tone at the top of an organisation and influences the control consciousness of its employees. It encompasses factors such as management's integrity and ethical values, the commitment to competence, the organisational structure, the assignment of authority and responsibility, and the oversight provided by the board of directors and management. A strong control environment fosters a culture of accountability, integrity, and ethical behaviour throughout the organisation.
2. **Risk Assessment:** Risk assessment involves identifying, analysing, and prioritising risks that could prevent the organisation from achieving its objectives. It encompasses both internal and external factors that may impact the organisation's ability to execute its strategies and achieve its goals. Effective risk assessment enables management to anticipate potential risks, assess their potential impact, and develop appropriate responses to mitigate or manage them.
3. **Control Activities:** Control activities are the policies, procedures, and practices established by management to achieve specific objectives and mitigate risks. They include a wide range of activities such as approvals, authorisations, verifications, reconciliations, segregation of duties, physical controls, and information processing controls. Control activities are designed to prevent or detect errors, fraud, and noncompliance with policies and regulations.

4. **Information and Communication:** Information and communication involve the timely and accurate communication of relevant information throughout the organisation. It includes the systems, processes, and technologies used to capture, record, process, and report information, as well as the channels through which information flows within the organisation. Effective information and communication ensure that employees have access to the information they need to perform their responsibilities and make informed decisions.
5. **Monitoring Activities:** Monitoring activities involve ongoing assessment of the effectiveness of internal controls by management and other stakeholders. It includes regular reviews, evaluations, and audits of control activities to ensure that they are operating as intended and addressing identified risks. Monitoring activities also involve responding to deficiencies or weaknesses in internal controls and implementing corrective actions to address them
2. **Accounts Payable Ledger Review:** Examine the accounts payable ledger to identify all recorded liabilities. Ensure that all invoices, bills, and other documentation supporting payables are accurately recorded and classified.
- **Vendor Confirmations:** Send confirmation requests to a sample of vendors to verify the completeness of accounts payable. Request vendors to confirm the balances owed to them as of a specific date and inquire about any outstanding invoices not yet recorded by the company.
 - **Invoice Matching:** Match a sample of recorded accounts payable invoices to receiving reports, purchase orders, and other supporting documentation. Ensure that all invoices received from vendors are properly matched and recorded in the accounts payable ledger.
 - **Accrual Testing:** Review expenses and other accruals recorded at the end of the reporting period to ensure completeness. Test a sample of accrued expenses to verify that all expenses incurred but not yet invoiced or paid are properly accrued and recorded.
 - **Vendor Statement Reconciliation:** Reconcile vendor statements to the accounts payable ledger to identify any discrepancies or missing invoices. Investigate any differences between vendor statements and the accounts payable records to ensure completeness.
 - **Analytical Procedures:** Perform analytical procedures, such as trend analysis and ratio analysis, to identify any significant fluctuations or anomalies in liabilities balances compared to prior periods or industry benchmarks. Investigate any deviations from expectations to determine their cause and ensure completeness.
 - **Legal Letter Inquiry:** Send inquiry letters to the company's legal counsel to inquire about any pending or threatened legal claims or liabilities that may not be recorded in the financial statements. Obtain confirmation from legal counsel regarding the completeness of disclosed and undisclosed liabilities.
 - **Review Contractual Agreements:** Review contracts, lease agreements, loan agreements, and other legal documents to identify any potential liabilities not yet recorded in the financial statements. Ensure that all contractual obligations are appropriately disclosed and accounted for.

- Bank Reconciliation: Reconcile the company's bank accounts to the general ledger to ensure that all outstanding cheques and other liabilities are properly recorded. Investigate any reconciling items to verify their accuracy and completeness.
3. Clarity and Direction: A written audit plan provides a clear roadmap outlining the audit objectives, scope, approach, and procedures to be followed. This clarity helps auditors understand their roles and responsibilities, ensuring that the audit is conducted efficiently and effectively.
- Alignment with Objectives: It ensures that the audit objectives are aligned with the organisation's goals and risks. By documenting specific objectives, auditors can tailor their procedures to address key risks and areas of concern identified during the planning process.
 - Communication: A written audit plan facilitates communication between auditors, management, and other stakeholders involved in the audit process. It serves as a formal document that can be shared with relevant parties to ensure everyone is on the same page regarding the audit scope, timelines, and expectations.
 - Documentation of Planning Process: It provides a documented record of the planning process, including considerations such as risk assessment, materiality determination, and resource allocation. This documentation serves as evidence of the thoroughness and professionalism of the audit planning activities.
 - Resource Allocation: A written audit plan helps allocate resources effectively by identifying the necessary personnel, tools, and budget required to execute the audit. It enables auditors to plan and schedule their activities in advance, optimising resource utilisation and minimising disruptions to the organisation's operations.
 - Risk Management: By documenting the audit approach and procedures, a written audit plan helps manage audit risks effectively. It ensures that auditors are focused on high-risk areas and have strategies in place to address potential issues that may arise during the audit process.
 - Quality Control: A written audit plan serves as a tool for quality control by providing a framework for review and oversight. It allows supervisors and management to assess the adequacy and completeness of the audit plan before its implementation, minimising the risk of errors or omissions.
 - Continuity and Consistency: It promotes continuity and consistency in the audit process, especially in cases where multiple auditors are involved or when audits are conducted periodically. A written audit plan serves as a reference point for future audits, ensuring consistency in approach and methodology over time.

Unit E: Practical Audit Execution.

Learning outcomes

- E.1 Conduct tests correctly, properly record test results and draw valid conclusions from them as specified in the audit plan.
- E.2 Establish the existence, completeness, ownership, valuation and description of assets and liabilities and gather appropriate evidence to support these findings.
- E.3 Identify all matters of an unusual nature and refer them promptly to the engagement partner.
- E.4 Identify and record material and significant errors, deficiencies or other variations from standard and report them to the engagement partner.

Introduction to Unit E

Now the audit has been planned, the auditor will now conduct audit procedures to gather sufficient appropriate audit evidence to support the conclusions in the audit report.

Audit tests will be a combination of:

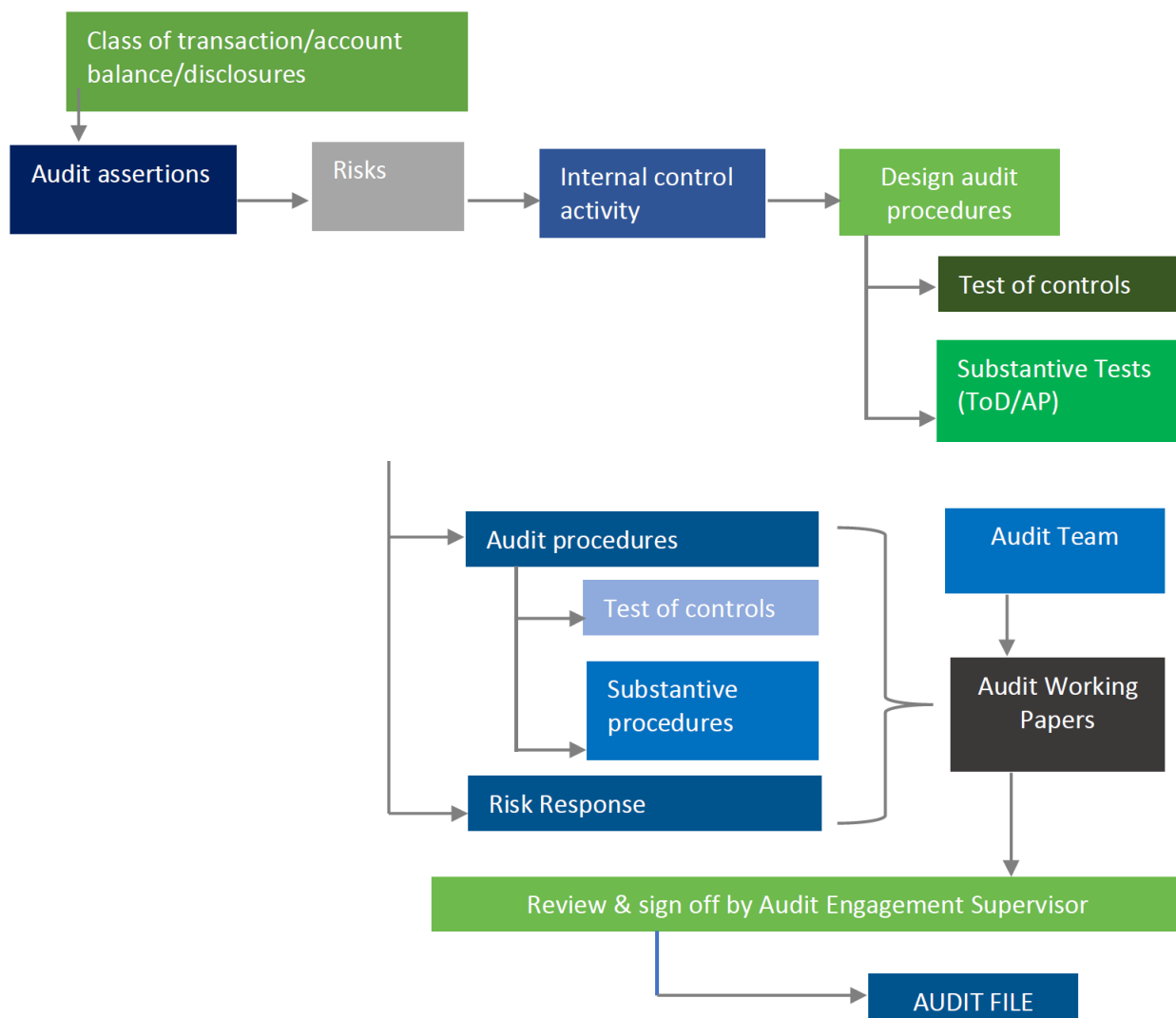
- Testing the system of internal controls to ensure that it is working as planned. (Controls Testing)
- Performing some analysis to gain comfort that disclosures presented in the financial statements are correct (Analytical Procedures)
- Testing a sample of transactions or balances to ensure they are presented fairly in the financial statements (Test of Details)

To be used as audit evidence, the results of this testing must be recorded in the audit file and properly reviewed. Any issues identified should be reviewed and the consequences for the audit report considered.

Audit Programs

The purpose of designing audit procedures is to gather sufficient appropriate audit evidence. Risk assessment procedures are considered audit procedures under ISA 315. Upon identifying and assessing the risks of material misstatement, an auditor is expected to respond appropriately to those risks by performing appropriate “further audit procedures”.

This process is summarised in the diagram below.



In a risk-based approach to auditing, audit procedures not linked to assessed risks will not serve the purpose. The risks identified and assessed at both the financial statement and the assertion levels drive the audit programs to be performed.

As mentioned already, these procedures will be a mix of controls testing, test of details and analytical review. The exact combination of these tests will vary and should be driven by the risk assessment process outlined in previous sections.

- **Test of controls:** An audit procedure designed to evaluate the operating effectiveness of controls in preventing or detecting and correcting material misstatements at the assertion level. These tests are necessary when the auditor's risk assessment includes an expectation of the operating effectiveness of controls, requiring the testing of those controls to support the risk assessment; and where substantive procedures alone do not provide sufficient appropriate audit evidence, requiring tests of controls to obtain audit evidence about their operating effectiveness. For example, testing a sample of payment invoices to check that they have been reviewed to verify proper classification.

- **Substantive Testing:**

1. Test of Details: testing classes of transactions, account balances or disclosures—e.g. reconcile general ledger expense account totals to purchase journal; reconcile (a sample of) quantities on purchase invoices to goods received.
2. Analytical Procedures: Performing analysis of the balance or class of transaction in total. e.g. calculating the average inventory holding period and comparing to the prior year (ratio analysis); calculating the percentage increase in revenue and comparing to forecast and to prior year (trend analysis); performing a calculation to test the reasonableness of interest received as, for instance, the average bank balance against average interest rate for the year (proof in total).
3. In summary, test of details includes tracing figures to relevant supporting documents to determine the validity of transactions, proper classification, and completeness. Substantive analytical procedures consist of comparing financial information in the financial statements with other reliable information or with the auditor's expectation, to determine if reported information is accurate.

The table below shows the link between assertion, risk and audit procedure to be performed.

Financial Statement Assertion	Accuracy
Account balance	Closing balance (Cash & Bank)
Risk	Incorrect closing balance of cash
Substantive audit procedure	Obtain an independent bank confirmation letter from the bank and compare the balance provided by the bank with that of closing balance reflected in the Cash Book and the financial statements to ensure that the balance agrees.

There are a number of considerations when designing audit procedures. These would include:

Ensure clarity of audit procedure: Audit procedures should be designed in such a way that even a new or junior auditor and a reviewing auditor in an audit team will be able to understand what is to be done. Procedures should not be stated in vague terms such as "Check invoices". This does not specify what is to be checked in the invoices. For example, if the test is designed to check accuracy and classification, the procedure would be "test a sample of invoices to check they have been recorded at the correct amount and in the correct account code in the financial ledger system."

Mention the reason for performing the audit procedure

There should be a purpose for designing and performing the audit procedure and the reason is usually linked to an assessment/confirmation of the financial statement assertion that is being reported in the auditee's financial statements. See above for example.

What is the assertion that is being tested? Audit procedures are supposed to test the

assertions made in the financial statements. In other words, the reason for performing the audit procedure as indicated above is to test the assertion. However, it is important for an auditor to understand which assertion will be tested before designing the audit procedure.

Commonly used terminologies in designing audit procedures: The terminologies relating to audit such as agree, cast, trace may be used while designing an audit procedure so that it is very specific.

The word cast would mean totalling up a list—for example, cast the payments reflected in the financial statements. The words agree or trace would mean matching/reconciling information from two documents/records—for example, agree the invoice to payment listing.

Documenting Audit Procedures

The auditor performs audit procedures to gather audit evidence, which would form the basis of the auditor's conclusion. The auditor is required to gather sufficient and appropriate audit evidence. While the sufficiency is related to quantity of audit evidence, the appropriateness relates to the quality in terms of relevance and reliability.

After performing the audit procedures, the auditor needs to record the conclusions arrived at and should also indicate therein whether the purpose of the audit procedures has been met. The act of documenting the conclusions also ensures that the auditor has performed the audit procedures designed at the planning stage, and the documentation serves as audit evidence in other words, properly documented, the conclusion is evidence that the audit procedures have been performed.

All audit tests should be fully documented and linked to audit evidence. The exact format and structure of audit working papers will vary from firm to firm but would normally include:

- **Objective:** Each audit test result should begin with a clear statement of the audit objective or purpose of the test. This helps provide context for understanding why the test was performed and what specific assertion or risk it aimed to address.
- **Description of Test Procedure:** Detail the specific audit procedure or test performed, including the audit steps followed, the sampling method used (if applicable), and any relevant instructions or guidelines followed during the test.
- **Sample Selection:** If the test involved sampling, document how the sample was selected, including the sampling method used (e.g., random, systematic, judgemental) and the rationale for selecting the sample size.
- **Test Results:** Record the results of the audit test, including any findings, exceptions, deviations, or discrepancies identified during the test. Ensure that the results are clearly documented, accurately described, and supported by sufficient evidence.
- **Supporting Documentation:** Attach relevant supporting documentation to the working paper to corroborate the test results. This may include copies of invoices, contracts, bank statements, reconciliations, correspondence, or other relevant documents reviewed during the test. Note that there is no need to attach all supporting documents. Instead, this would only be needed if there are problems with the items in question.
- **Quantitative Analysis:** If applicable, provide quantitative analysis or calculations related to the test results. This may include numerical summaries, calculations of

error rates, statistical analysis, or other quantitative measures used to assess the significance of the findings. See guidance on error extrapolation at the end of the Unit.

- **Qualitative Analysis:** Provide qualitative analysis or explanations of the test results, including the significance of any exceptions or deviations identified, their potential impact on financial statement assertions, and any contributing factors or root causes identified during the audit.
- **Conclusion:** Summarise the overall conclusion or assessment based on the test results. This should include an evaluation of whether the audit objective was achieved, any implications for the audit opinion or report, and any follow-up actions or recommendations required.
- **Reviewer Comments:** If the working paper undergoes review by a supervisor or reviewer, document any comments, feedback, or additional instructions provided by the reviewer regarding the test results.
- **Signature and Initials:** Date and initial the working paper to indicate when the test was performed, reviewed, or updated. Reviewers then review the file and do the same. This helps establish a clear audit trail and ensures accountability for the information recorded in the working paper.

Specific Audit Tests

Examples of specific Audit Tests in relation to key financial statement balances directly related to audit assertions are shown below.

Non-Current Assets

Test	Ex	R & O	Comp	V & A
Examine a sample of title deeds, land registry certificates and/or conveyancing documentation from solicitors. Pay particular attention to any "encumbrances" i.e. mortgages or other securities held over assets	X	X		X
Review a sample of entries in the non-current asset register and trace back to source documentation to ensure properly stated at cost				X
Review a sample of calculations of depreciation and ensure accurate and in line with company policy				X
Physically inspect a sample of assets selected from the asset register	X			
Trace a sample of physical assets and trace to the asset register			X	

Test	Ex	R & O	Comp	V & A
Reconcile the non-current asset register to the general ledger	X		X	X

Cash in Bank

Test	Ex	R & O	Comp	V & A
Direct confirmation from the bank or other financial institution, of the account balance. This gives the auditor written external evidence from a very reliable source.	X	X	X	X
Examine the year and bank reconciliations and test a sample of reconciling items.	X		X	X

Audit of Bank Reconciliation

The auditor needs to inspect the reconciliation between the cash book figure (which appears in the financial statements) and the bank statement figure (which has been directly confirmed by the bank). Given that most financial transactions are processed through the bank, assurance over the bank balance is of particular importance to an auditor as it links to almost all other balances in the financial statements. Given the nature of double entry bookkeeping, checking the cash balance gives some assurance over other financial statement balances.

The reconciliation should establish that:

- Any differences between the bank and the client's records can be specifically identified.
- The differences are differences of timing which should clear in the period after the reporting date.
- Previous differences have all been cleared by making the relevant accounting adjustments.
- Any differences other than timing differences (e.g. errors or omissions by the bank or the client) are advised to the bank or adjusted in the client's accounting records.

Reconciliations usually start with the balance per the cash book and reconcile this to the balance per the bank statement.

Reconciling items are usually due to timing delays. 'Unpresented cheques' are those which have been sent to suppliers but not yet banked. 'Outstanding lodgements' are cheques received by the company and paid into the bank, but not yet credited by the bank i.e. there is usually a delay of two to three days for the cheques to be cleared.

All unpresented cheques and outstanding lodgements should be inspected to ensure that they do 'clear' shortly after the period end by reviewing bank statements just after the period end. Any old items should be considered carefully. If a cheque has not been presented to the bank after 6 months, it may be that the supplier has lost it or has gone

out of business. In any case the cheque will be 'out of date' and the bank will not honour it even if it is presented. The auditor should consider the need for the payable to be reinstated and a new cheque issued, or the need for the cheque to be written back as income. Differences, even small differences must be investigated as they may represent large errors in both directions that net each other off.

All of the adjusting items need to be checked to their source. As these are cash book errors and the cash book forms part of the double entry system, there is likely to be a double entry effect of these adjustments which the auditor should establish has been correctly dealt with.

Reconciliations are normally performed monthly (although they can happen more frequently when the organisation is dealing with large amounts of transactions) and should show evidence of review i.e. who reviewed it and on what date. The auditor should also ensure that they check that they are casted correctly (i.e. arithmetical accuracy).

Cash

The amount of audit verification work that the auditor will carry out on cash (liquid) balances will be very much dependent on their materiality. If, for example, the only cash balance held in a large company is a small petty cash float where controls are strong, the auditor may carry out no substantive work at all.

However, in situations where cash balances are more material (for example when auditing a bank) standard audit procedures might include:

- Attendance at a cash count at the reporting date or performing a surprise cash count in the presence of the client. If the auditor counts the cash, it should be done in the presence of two or more officers of the company and obtain a signed receipt when the cash is handed back to the client.
- If cash is held at more than one location, all cash at all locations should be counted simultaneously.
- The auditor should agree the cash balance with the figure in the accounting records and check the validity of any reconciling items.

Inventory

Test	Ex	R & O	Comp	V & A
Attend the client's physical inventory count to observe the counting process. Verify that the counting procedures are performed accurately and compare the physical count to the inventory records to identify any discrepancies.	X	X	X	
Review shipping and receiving documents around the year-end to identify inventory transactions occurring before and after the end of the reporting period. Verify that these transactions are recorded in the appropriate period.	X		X	

Test	Ex	R & O	Comp	V & A
Select a sample of inventory items and recalculate their valuation using the appropriate costing method (e.g., FIFO, LIFO, weighted average). Compare the recalculated values to the values recorded in the inventory records to ensure accuracy.				X
Send confirmation requests to selected suppliers or customers to confirm the existence of inventory held by the client on consignment or in transit. Compare the confirmation responses to the inventory records to verify existence.	X	X		
Classify inventory items by age (e.g., current, obsolete, slow-moving) and analyse the composition of inventory by age category. Review the adequacy of inventory reserves based on the age and condition of inventory items.				X
Evaluate the client's inventory costing methods (e.g., FIFO, LIFO, weighted average) and assess their consistency and appropriateness. Consider factors such as industry practices, inventory turnover, and tax implications when reviewing inventory costing methods.				X

Inventory Count

ISA 501 Audit Evidence (Additional Considerations for Selected Items) requires the auditor to attend the client's inventory count if inventory is material to the financial statements and if the auditor is to rely on the inventory count as a source of evidence as to the physical quantities of inventory on hand.

The auditor will usually attend the client's inventory count, the purpose of attending being to assess the effectiveness of the client's inventory counting procedures. Attendance at inventory counts is primarily a test of controls, not a substantive procedure. It is not the auditor's responsibility to count inventory, but the client's. The auditor will perform test counts, but these tiny samples are not intended to be representative of the populations they are drawn from.

Liabilities

Test	Ex	R & O	Comp	V & A
Obtain a schedule of the trade payables with appropriate age analysis and check this with the control account and the payables ledger.	X		X	X

Test	Ex	R & O	Comp	V & A
Scan the payables listing. Debit and credit balances should be separated, debit balances being included in receivables.				X
Consider the need to request external confirmation from suppliers. Because evidence from an external source should exist in the case of payables – in the form of supplier statements – direct confirmation is usually not required. However, if controls are weak or supplier statements are unavailable or considered to be unreliable, external confirmation of a sample of payables balances or specific suppliers may be appropriate.	X	X	X	X
Test a sample of payment invoices near year end and check that appropriate payable is recorded at the correct amount.		X	X	X
Trace a sample of items from the payables listing to supporting documentation e.g. invoices	X		X	X

Unusual Items

Throughout the audit process the auditor may come across unusual items. Identifying matters of an unusual nature during an audit requires auditors to exercise professional judgement, scepticism and requires an understanding of the client's business and industry to be able to properly identify these.

Typically, the auditor will identify unusual items in a number of ways.

- **Understanding of the Entity and its Environment:** Auditors develop an understanding of the client's business, industry, regulatory environment, and internal control system. This understanding helps auditors identify matters that deviate from the norm or are inconsistent with expectations.
- **Professional Scepticism:** Auditors maintain a sceptical mindset throughout the audit process, questioning the validity and reliability of evidence obtained and remaining alert to potential red flags or inconsistencies that may indicate matters of an unusual nature.
- **Risk Assessment Procedures:** Auditors conduct risk assessment procedures to identify and assess the risks of material misstatement due to fraud or error. Identifying high-risk areas or significant risks may lead auditors to focus on matters of an unusual nature within those areas.
- **Comparison with Prior Periods:** Auditors compare current financial data with data

from prior periods to identify significant fluctuations or anomalies. Any unexpected changes in financial performance, ratios, or trends may indicate matters of an unusual nature that require further investigation.

- **Benchmarking Against Industry Standards:** Auditors benchmark the client's financial performance against industry peers or benchmarks to identify outliers or deviations from industry norms. Significant deviations may signal matters of an unusual nature that warrant additional scrutiny.
- **Analytical Procedures:** Auditors perform analytical procedures to assess the reasonableness of financial data and identify unusual trends or relationships. Common analytical procedures include ratio analysis, trend analysis, and variance analysis.
- **Inquiry and Discussion:** Auditors interview management, key personnel, and those charged with governance to gather information about the business, industry, and any significant events or transactions. Discussions with management may reveal matters of an unusual nature that require further investigation.
- **Review of Board Minutes and Other Documentation:** Auditors review board minutes, meeting agendas, contracts, correspondence, and other relevant documentation to identify matters discussed or events occurring during the audit period. Unusual or significant matters disclosed in such documents may require additional audit procedures.
- **Consultation with Experts:** Auditors may consult with industry specialists, technical experts, or other professionals to obtain insights into complex or unusual matters encountered during the audit.

When an auditor comes across an unusual item, they should consider whether it has the possibility of having a material impact on the financial statements. Normally, further enquiries should be made to provide further audit evidence in relation to the matter and if necessary, the potential impact on the audit report should be considered.

Recording Errors

When an auditor identifies an error during audit testing it is important they know what to do to ensure that the impact of that error has on the final audit report.

Normally an auditor will follow the main steps when an error is identified.

- **Identify the Error:** The auditor should clearly identify the nature and scope of the error. This includes understanding the source of the error, its impact on the financial statements, and any underlying causes.
- **Document the Error:** Record detailed information about the error in the audit working papers. Include relevant details such as the date the error was discovered, the specific accounts or transactions affected, the amount of the error, and any supporting documentation.
- **Assess Materiality:** Evaluate the materiality of the error to determine its significance in relation to the financial statements as a whole. Consider quantitative factors (e.g., monetary amount, percentage of total assets) and qualitative factors (e.g., nature of the error, potential impact on users of the financial statements) when assessing

materiality.

- **Evaluate the Cause:** Investigate the root cause of the error to understand why it occurred. Determine whether the error resulted from a breakdown in internal controls, an accounting misstatement, a calculation error, or other factors. This will enable the auditor to make a constructive recommendation to address the issue.
- **Consider the Implications:** Assess the implications of the error on the audit opinion and the audit report. Determine whether the error is isolated or indicative of broader issues that may affect the auditor's conclusions on the financial statements.
- **Discuss with Management:** Communicate the error to management promptly and discuss the findings with them. Provide management with an opportunity to explain the error, its cause, and any corrective actions taken or planned to address it.
- **Document Management's Response:** Record management's response to the error in the audit working papers. Document any remedial actions taken by management to correct the error and prevent its recurrence in the future.
- **Adjust Audit Procedures:** Modify audit procedures as necessary to address the implications of the error and ensure the completeness and accuracy of the audit work performed. Consider performing additional procedures to corroborate the reliability of the financial information affected by the error.
- **Maintain Documentation:** Maintain thorough documentation of the error, including the audit procedures performed, the conclusions reached, and any subsequent actions taken. Ensure that the audit working papers provide a clear audit trail of the error and the auditor's response to it.
- **Review:** All audit work should be reviewed by more senior members of the audit team. When an error is identified, the engagement partner should review the issue and the work supporting it so that the possible implications of the audit report can be fully considered.

Error Extrapolation

As the auditor uses samples to form a conclusion over whole populations, errors identified during sample testing need to be extrapolated to provide an estimate of the total error. It is this total estimated error that will be considered against materiality for consideration for inclusion in the audit report.

The auditor should examine closely the errors detected in testing and:

- Understand why the errors occurred and whether there is any pattern to them. This is vital. For example, did all the errors occur in the same regional office? Are invoices received from the same supplier? Payments made by the same officer? Most importantly, do they appear to be genuine, random, anomalous errors, or is there a pattern that suggests a possible fraud or underlying system failure that needs to be rectified?
- Decide whether it is necessary to undertake more testing to see if the errors detected are repeated in the larger sample, and whether that testing should be general or focused on a specific area or person. Decisions on the extent to which sample sizes should be increased in response to errors detected will be influenced by the auditor's

knowledge of the audited body and specifically his assessment of the likelihood that an increased sample might yield results significantly different from those provided by the sample already examined.

- Record in working papers all instances of error detected and the results of reviews to ascertain causes. The auditor should consider the scope for recommendations for improved control or other action to correct and avoid recurrences. The errors detected, the reasons they occurred, and the auditor's recommendations should be reported as necessary in the audit reports, memoranda and management letter.

If it seems likely to the auditor that his findings might require a qualification to the audit opinion, he will need to consider:

- Whether the error can be corrected by the organisation; and
- Whether a further sample of transactions should be tested in the same area to establish the extent of the errors more precisely. To do this the auditor must evaluate any errors found against the total value of the sample tested.

Anomalous errors should be excluded when projecting sample errors to the population although the effect of any such error, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous errors. If stratified sampling has been used, the error must be projected for each stratum separately. Projected errors plus anomalous errors for each stratum are then combined when considering the overall effect of errors on the financial statements.

For errors detected when testing controls, no explicit projection of errors is necessary, since the sample error rate is also the projected rate of error for the population.

Example

If the auditor has tested a number of transactions of one type, for example payroll, with a total sample value of 1,000,000,000 FRW and has found a number of errors totalling 40,000,000 FRW, the most likely error on that transaction type, in this case payroll, is 4%. ($40,000,000/1,000,000,000$)

The total payroll balance is 5,000,000,000 FRW. Applying the error rate of 4% gives an estimated error of 200,000,000 FRW.

This total estimated error would then be considered against materiality. If it is material then it would lead to a modification of the audit opinion.

Evaluate Misstatements

As required by ISA 450, the auditor should assess the effect of identified misstatements on the audit and the effect of aggregated uncorrected misstatements in forming an opinion on the financial statements as a whole. At this point auditors should:

Compare (Anomalous Error + Projected Errors) vs. tolerable errors.

Consider whether the nature and occurrence of the misstatement indicates that the initial risk of material misstatement identified on a financial statement level is still appropriate.

Re-calculate final materiality and determine if it will differ from planning materiality. If yes, the impact of any changes to materiality and risk on the audit approach need to be considered and documented.

Aggregate audit findings (errors) and evaluate whether the accumulated misstatements approach the materiality limit. The auditor should consider the size and nature of the misstatements, taking quantitative and qualitative materiality factors into account. The effect of uncorrected misstatements related to prior periods should also be assessed.

Consider whether sufficient and adequate audit evidence was collected during the audit or whether the audit procedures should be extended to identify the extent of certain problems.

The following definitions apply to the different types of audit issues identified:

- Control deficiency (control weakness) is a condition in which the design or operation of a control does not allow management or employees to timely prevent or detect material misstatements. Such instances should be noted in the system description and reported in the management letter.
- Control deviation is the entity's failure to follow or implement a significant control procedure for a transaction. Control deviations will generally be noted via tests of controls and will impact on the audit approach. i.e. more substantive testing. In addition, the deviation would be reported in the management letter.
- Misstatement (error in financial statements). The total estimated error should be calculated as shown above and recorded in the working paper. Misstatements should then be aggregated and consideration given as to whether these misstatements are material. If they are then the audit opinion should be modified.

A conclusion that the financial statements are free of material misstatements, on the basis of sufficient appropriate audit evidence, means the auditor is satisfied that the risk of material misstatements in the financial statements is considered to be at an acceptably low level. When facing this risk, the auditor should consider:

- The surrounding circumstances and qualitative aspects of significant audit findings including their effect on presentation and disclosure in the financial statements.
- Whether there were audit findings in the prior year and if so, their nature and effect on the current year's financial statements are assessed.
- The financial statements are prepared in accordance with acceptable accounting policies consistently applied, or, if changed, the changes are presented appropriately.
- Appropriate information is disclosed, classified and described in accordance with acceptable accounting policies and, if applicable, legal requirements.
- Information in the financial statements is consistent with the auditor's knowledge of the auditee's operations.

The auditors work needs to be considered in the light of the audit evidence obtained and the accumulated knowledge of the auditee. This includes assessing if:

- The auditor has obtained, and corroborated, explanations for significant and unusual or unexpected matters or relationships in the financial statements.

- The current year's financial statements appear to be reasonable in comparison with the prior year.
- Financial statements are likely to make sense from the point of view of a reasonable person.

Auditors should document all misstatements and whether they have been corrected. Identified control deviations and control deficiencies. The impact and materiality of uncorrected misstatements and control deficiencies should also be assessed and provide the basis for audit conclusions to be drawn.

Summary of Unit E and key learning outcomes

- E. After completing Unit D, you should be able to undertake an audit under supervision
1. Conduct tests correctly, properly record test results and draw valid conclusions from them as specified in the audit plan.
 2. Establish the existence, completeness, ownership, valuation and description of assets and liabilities and gather appropriate evidence to support these findings.
 3. Identify all matters of an unusual nature and refer them promptly to the engagement partner.
 4. Identify and record material and significant errors, deficiencies or other variations from standard and report them to the engagement partner.

Ref	Learning Outcome	
E1	Conduct tests correctly, properly record test results and draw valid conclusions from them as specified in the audit plan	<ul style="list-style-type: none"> • Understand how audit programs guide the work to be performed during audit execution • Be able to record audit testing in working papers using standard headings
E2	Establish the existence, completeness, ownership, valuation and description of assets and liabilities and gather appropriate evidence to support these findings	<ul style="list-style-type: none"> • Understand typical audit tests in relation to key assets and liabilities and be able to link these to relevant audit assertions
E3	Identify all matters of an unusual nature and refer them promptly to the engagement partner	<ul style="list-style-type: none"> • Understand how the auditor can identify unusual items • Understand how unusual items impact on the audit process

E4	Identify and record material and significant errors, deficiencies or other variations from standard and report them to the engagement partner	<ul style="list-style-type: none"> • Be able to record errors identified during audit testing • Understand how to extrapolate an estimated error based on results of sample testing • Be aware of how misstatements identified should be considered in developing the audit report
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Quiz Questions

1	Learning Outcome: E1
Which of the following is a consideration when determining the extent of audit procedures in an audit program?	
A	The auditor's risk assessment
B	The size of the audit fee budget
C	The client's industry sector
D	The auditor's independence requirements

1	Feedback
A	Yes! The risk assessment should drive the work to be performed.
B	No. The size of the audit fee should not influence the audit program.
C	No. While indirectly the industry will impact upon risks – there is no direct relationship.
D	No. The auditor should be independent at all times.

2	Learning Outcome: E1
Which section of the audit working paper may include numerical summaries, error rates, or statistical analysis related to the test results?	
A	Conclusion
B	Quantitative Analysis
C	Description of Test Procedure
D	Reviewer Comments

2	Feedback
A	No. Conclusion provides the final impact on the audit. i.e. after the analysis has been performed to calculate the total estimated error.
B	Yes! Analysis to be performed to estimate the total error.
C	No. This is the description of what work was done.
D	No. The reviewer may comment on all aspects of the working paper

3	Learning Outcome: E2
Which of the following tests would address the risk of expense completeness	
A	Test a sample of invoices and check to the accounting system
B	Review payments made in the accounting system and check that they have been recorded at the correct value by testing to invoice.
C	Test a sample of payments from the accounting system and agree to supporting documentations such as invoices
D	Test a sample of expenses from the accounting system and trace to bank payment

3	Feedback
A	Yes! Completeness relates to the risk that expenses are omitted from the financial statements. By tracing from paper records this addresses completeness.
B	No. This tests accuracy.
C	No. Opposite of A above. Tests occurrence.
D	No. Tests occurrence.

4	Learning Outcome: E2
Which of the following best describes the auditor's role during a stock count?	
A	To assist the client's employees in counting inventory items
B	To verify the accuracy of the inventory records after the count
C	To observe the count process and obtain audit evidence
D	To determine the selling price of inventory items for valuation purposes

4	Feedback
A	No. The implementation of controls (e.g. stock count) rests with management
B	No. Normally auditor attendance is a controls test.
C	Yes! To observe the controls.
D	No. Controls test.

5	Learning Outcome: E3
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What should an auditor do if they identify unusual items that may indicate potential risks of material misstatement in the financial statements?

A	Proceed with the audit as planned and address the unusual items in the management letter
B	Modify planned audit procedures to obtain further audit evidence regarding the unusual items
C	Report the unusual items directly to regulatory authorities
D	Ignore the unusual items if they are immaterial to the financial statements

5	Feedback
A	No. The unusual item could represent a risk and might impact upon the audit report.
B	Yes! Further audit work should be performed to more fully assess the unusual item.
C	No. The matter should be dealt with as part of the audit process – at least initially.
D	No. Without further work there is not sufficient audit evidence to confirm whether the matter is material or not.

6	Learning Outcome: E4
What is the primary objective of error extrapolation in auditing?	
A	To identify errors in the financial statements
B	To estimate the total monetary value of errors based on a sample
C	To assess the effectiveness of internal controls
D	To calculate the audit risk for the engagement

6	Feedback
A	No. The error has already been identified. Extrapolation is used to estimate the total size of the error.
B	Yes! Based on the sample extrapolation gives the total estimated error.
C	No. Normally sample testing of controls is not extrapolated. They are either working or they are not.
D	No. Extrapolation is not used in calculating audit risk.

Quiz Answers

Question	Answer
1	A
2	B
3	A
4	C
5	B
6	B

Exercises

1. Suggest possible audit tests to gain assurance over accuracy of payroll costs.
2. Explain the main steps in auditing a bank reconciliation.

Exercise Solutions

1. Reconciliation of Payroll Register to General Ledger: Auditors reconcile the payroll register, which details employee wages and deductions, to the general ledger to ensure that all payroll transactions are accurately recorded in the financial statements.
 - Review of Employee Master File: Auditors review the employee master file to verify that all employees listed are active and that their pay rates, tax withholdings, and other relevant information are accurately maintained.
 - Test of Controls over Payroll Processing: Auditors assess the effectiveness of controls in place over payroll processing, such as segregation of duties, authorisation procedures, and review processes, to prevent errors or fraudulent activities.
 - Testing of Payroll Calculations: Auditors select a sample of payroll calculations, including gross pay, taxes, deductions, and net pay, and recalculate them independently to verify accuracy.
 - Comparison of Payroll to Budget or Forecast: Auditors compare actual payroll expenses to budgeted or forecasted amounts to assess reasonableness and identify any significant variances that may require further investigation.
 - Review of Payroll Tax Filings and Payments: Auditors review payroll tax filings and verify that payroll taxes withheld from employees are accurately reported and remitted to the appropriate tax authorities.
 - Analytical Review of Payroll Expenses: Auditors perform analytical procedures on payroll expenses, comparing current period expenses to prior periods and industry benchmarks to identify any anomalies or areas of potential concern.

2. Review of Bank Reconciliation Procedures: Auditors start by understanding the organisation's procedures for preparing bank reconciliations. They review the company's documented policies and procedures to ensure they are adequate and properly followed.
- Examination of Bank Statements and External Confirmation: Auditors obtain copies of bank statements directly from the bank and compare them to the company's records.
 - Comparison of Bank Balances: Auditors compare the ending balance on the bank statement to the ending balance in the company's general ledger. They ensure that these balances agree and investigate any differences.
 - Confirmation of Bank Balances: Auditors may confirm the bank balances directly with the bank to verify the accuracy of the balances reported in the bank statements.
 - Tracing Outstanding Cheques and Deposits: Auditors trace outstanding cheques and deposits recorded in the company's records to the subsequent bank statements to ensure they are appropriately cleared and reconciled.
 - Review of Reconciliation Process: Auditors review the bank reconciliation process to ensure that it is performed regularly and by appropriate personnel. They also verify that reconciliations are properly reviewed and approved by management.
 - Investigation of Unusual Items: Auditors investigate any unusual items identified during the reconciliation process, such as large outstanding cheques or deposits, to determine their nature and propriety.
 - Testing of Controls over Bank Reconciliations: Auditors test the effectiveness of controls over the bank reconciliation process, such as segregation of duties and review procedures, to ensure that errors and discrepancies are promptly identified and corrected.

Unit F: Audit Reporting and Documentation.

Learning outcomes

- F.1 Prepare and submit clear and concise draft reports illustrating constructive and practicable recommendations in line with organisational procedures.
- F.2 Discuss preliminary conclusions and recommendations with the engagement partner and gain approval from the engagement partner.
- F.3 Follow confidentiality and security procedures at all times.

Introduction to Unit F

At the end of the audit process, the auditor will prepare the audit report. The primary audit report is the audit opinion; this is the report which gives stakeholders information regarding the information contained within the financial statements on which they can then make good decisions. However, in addition auditors produce a “management letter”. This is the report used to present audit findings, with constructive recommendations for improvement, to management and those charged with governance.

This Unit takes you through the process in preparing these two key reports with some guidance as to how these reports should be structured to comply with ISAs and presented in such a way as to be of maximum use to users.

Finally, we will consider quality controls around the audit report and re-emphasise the importance of confidentiality and security during the audit process.

Audit Reporting

The purpose of the audit reporting phase is:

- To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained.
- To express that opinion through a written report.
- To provide the auditee with information on audit issues identified and constructive recommendations for improvement.

Normally an auditor will issue two distinct audit reports. Firstly, the audit opinion (guided by ISA 700) will give stakeholders information on the truth and fairness of the financial statements. This is prepared by the auditor and is inserted into the financial statements published so that readers can appreciate conclusions reached in relation to financial statement disclosures. Secondly, the auditor will issue another report, normally referred to as the management letter (guided by ISA 260 and 265), providing information to management and those charged with governance on key audit issues identified. This will

also include constructive recommendations for improvement so that the organisation can improve their systems going forward.

The process is normally something like that presented in the table below.

Step	Description	Output
Step 1	Gather and document all misstatements and internal control weaknesses identified during the audit.	Management Letter
Step 2	Preparation of draft management letter and review by Audit Manager/Engagement partner	
Step 3	Draft management letter and send to auditee.	
Step 4	Auditee comment on draft management letter.	
Step 5	Exit meeting with auditee to discuss audit findings	
Step 6	Final management letter with auditee comments	
Step 7	Issue the final management letter to auditee.	
Step 8	Form an audit opinion on the financial statements of the auditee.	Audit Opinion
Step 9	Prepare the draft audit report and review by Audit Manager/Engagement Partner	
Step 10	Final review by Engagement Partner (and signature)	
Step 11	Issue the final audit report with opinion to the auditee.	

The main differences between audit opinions and management letters are shown below.

Factor	Audit Opinion	Management Letter
Objective	To communicate whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework	To report identified weakness in the internal control system
Audience	Public – attached to financial statements.	Not public. Communicated to senior management and board of auditee.
Recommendations	No recommendations	Includes recommendations for improvement

Factor	Audit Opinion	Management Letter
Length	Generally, 2–3 pages	Usually much larger (e.g. 20+ pages)
Format	Detailed prescribed format in ISA 700–706	General guidance in ISA 265
Features	One of four main opinions	Normally – background, scope, executive summary, detailed findings
Issues	Material issues in relation to financial statements	Significant control deficiencies reported. Less significant issues also normally included.

Before considering each of these audit reports in turn, let us consider some general principles in drafting any report – even those with nothing to do with audit! While the exact nature of different reports will vary, some common key concepts apply to help ensure that a report conveys information in a clear, concise and structured manner. These key concepts should always be considered when drafting any report.

- **Purpose:** The reason for writing the report. It could be to present findings of a research study, give an account of an event or to explain a problem. Knowing the purpose of your report is crucial in determining its structure, the information to include (and exclude) and the tone to use.
- **Audience:** Identify who will read your report. The intended audience will significantly influence the language, level of detail, and the structure of your report. A report for a technical audience will be quite different from one for a non-technical audience.
- **Research:** Almost all reports will require some level of research. The research can come in various forms such as literature review, interviews, surveys or experiments. All the facts, data, and information that you include in your report should be accurate, relevant and up to date.
- **Structure:** A report typically has a specific structure. This often includes a title page, table of contents, executive summary, introduction, methods, findings/results, discussion, conclusion and recommendations. However, the exact structure can vary depending on the type of report and the guidelines provided.
- **Clarity and Conciseness:** A report should be clear and concise. Avoid jargon and complex language, unless it is absolutely necessary, and the audience will understand it. Each section should convey a specific point or idea. Keep your sentences short and clear and use bullet points and headings where possible to break up the text and make it easier to read.
- **Objectivity:** Reports should be objective and unbiased. When presenting your findings or analysis, stick to the facts and avoid letting your personal opinions or beliefs influence the content.
- **Language and Tone:** The language and tone of a report are usually formal. However,

depending on your audience and the purpose of your report, a less formal tone might be more appropriate.

- **Revising and Editing:** This is a crucial step in report writing. Ensure there are no grammatical errors, the information flows logically, all necessary information has been included and the report meets the guidelines provided.
- **Presentation:** The presentation of your report should be neat and professional. Use charts, graphs, and tables where appropriate to represent information visually.

Management Letters

The overall objective of the audit management letter is to communicate key audit findings to senior management and those charged with governance and to make constructive recommendations for improvement.

In modern auditing, all auditors should be looking to “add value” by providing auditees with constructive, practical and realistic recommendations to improve their operations. Overall, the audit management letter is a tool for constructive dialogue between auditors and management, with the goal of contributing to the overall effectiveness, efficiency, and integrity of the audited organisation’s operations.

Management Letter Structure

The exact format of management letters varies from audit firm to audit firm. However, they mostly follow a structure something like that shown below.

Introduction

The Introduction section of an audit management letter provides essential context for the audit and sets the stage for the detailed findings and recommendations that follow.

Background

Start with a brief background that outlines the purpose of the audit management letter. Mention that the letter is a summary of the audit process, findings and recommendations.

Example: “This audit management letter serves as a comprehensive summary of our recent audit activities and aims to communicate key findings and recommendations for your consideration.”

Also include some basic information about the auditee such as geographical location, staff size and key organisational objectives.

Scope

Clearly define the scope of the audit. Specify the areas, processes, or departments that were subject to examination during the audit and the financial year(s) subject to audit.

Example: “The audit focused on the audit of the financial statements for the year ended 31st December 20X1”.

Objectives

State the primary objectives of the audit. Normally, this will be to provide an audit opinion on the financial statements.

Example: "To express an opinion on whether the financial statements present fairly, in all material respects, the financial position and the results of its operations for the year ended 31st December 20X1".

Audit Approach

Briefly describe the methodology used during the audit. Highlight any specific audit standards or frameworks followed (likely ISAs) and also provide a high-level summary of audit work performed e.g. discussions with key staff, sample testing of transactions, analytical procedures.

Example: "Our audit was conducted in accordance with International Standards Auditing (ISAs) utilising a risk-based approach to identify key areas of focus and allocate resources effectively. During the audit we met with key management and staff, sample tested transactions and performed analysis of financial reports".

Appreciation

Say thank you. Even when cooperation has not been perfect make the effort to focus on the positive aspects of the collaborative relationship.

Example: "Throughout the audit, we maintained an open line of communication with key personnel and collaborated closely with [relevant departments or teams] to ensure a thorough understanding of processes and procedures."

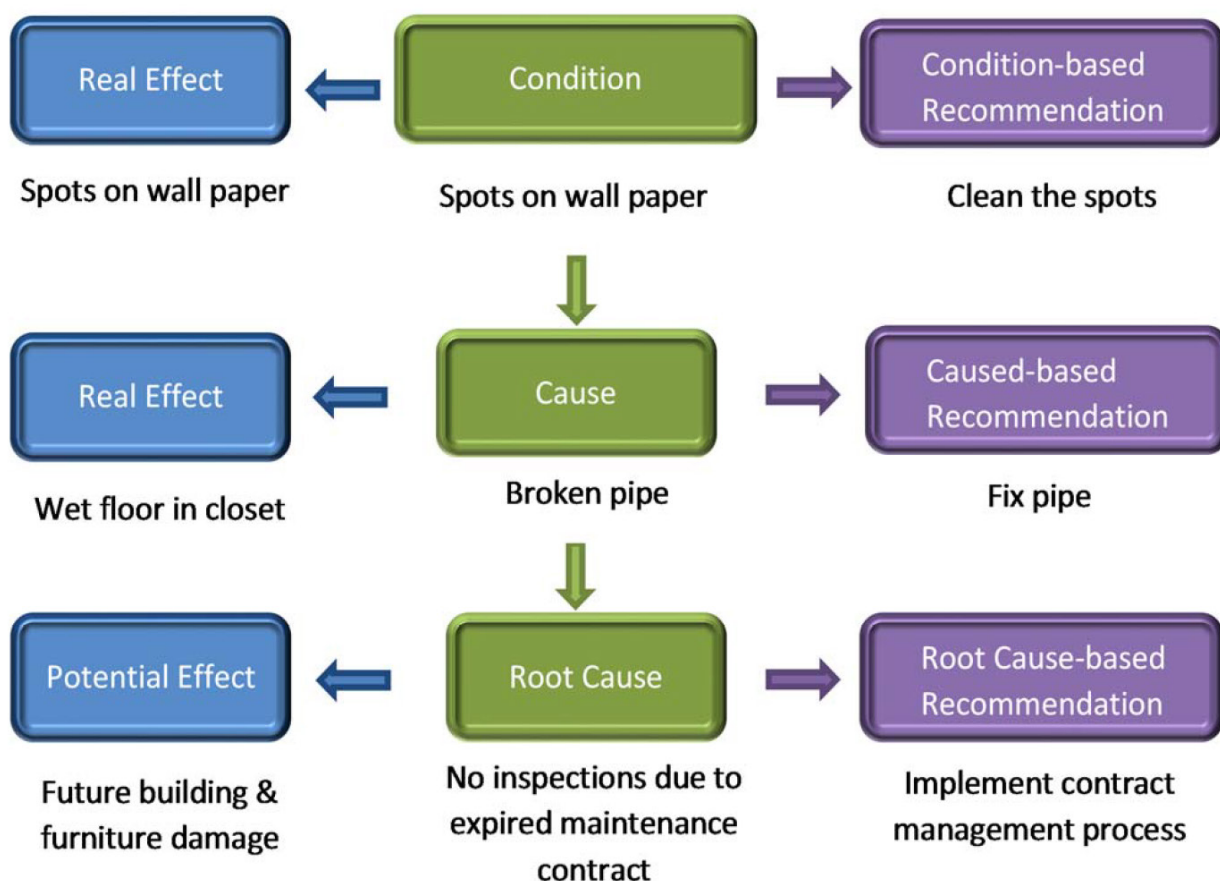
Detailed Findings

There is no "correct" way to present audit findings in the management letter. One way to help structure your thinking is to consider the "Five Cs". This is a concept used in internal audit (IIA Standard 2410) but nonetheless can be largely transferred to thinking about our, external audit, management letters.

The Five Cs stand for:

- Criterion (or criteria): What standards or controls are in place (or should be)?
- Condition: This is your observation – what have you found to be the reality? It usually doesn't match the criterion or criteria.
- Cause: What is the root cause?
- Consequence: What is/are the risk/s (or implication/s)?
- Corrective action: What are your recommendations for senior management and those charged with governance (or management may already have plans in place to take corrective action)?

In presenting your detailed findings you should address all five of these; the first two (and third if you can – see below) should be addressed as part of the "finding" or observation. The consequence (or benefit) should be reported under "implication" and of course the corrective action should be documented under "recommendation". Addressing all five C's fully will help you to present more meaningful and easily understandable audit findings.



The cause is the underlying reason for the difference between the criteria and condition (why the difference exists). It answers the questions “what allows the condition to exist?” and “why did the condition occur?” It is essential that auditors work with auditee management to try and identify the root cause of the gap. This will not always be possible but at least some discussion should be held particularly during the audit exit meeting.

Merely fixing the issue does not address what caused the issue to exist and does not improve the overall governance, risk, and control environment. Finding and appropriately addressing the root cause will improve systems into the future.

Possibly the hardest of the Cs to address is “Cause” and how this relates to “effect”. To do this, we should consider using some form of root cause analysis (there are many of these available on the internet and only one example is shown below).

The “Five Whys” is a simple but powerful problem-solving technique used in root cause analysis to identify the underlying causes of a problem. It involves asking “why” repeatedly until the root cause of the problem is uncovered. The number “five” in the Five Whys is not a strict rule; it can be more or fewer depending on the situation. The goal is to reach a point where the answers lead to a clear and actionable root cause.

- Identify the Problem - Clearly define the problem or issue that needs to be addressed.
- Ask “Why” for the First Time - Ask why the problem occurred and identify the immediate cause.
 - Example: Why did the machine stop working? (The first answer might be a specific reason, such as a sensor failure.)

- Ask “Why” Again – Take the answer from the first question and ask why it occurred.
 - Example: Why did the sensor fail? (The second answer might be a lack of maintenance.)
- Repeat the Process – Continue asking “why” for each answer, drilling down to deeper levels of causation.
 - Example: Why was maintenance neglected? (The third answer might be a lack of a regular maintenance schedule.)
- Continue Until Root Cause is Identified – Repeat the process until you reach a point where the answer identifies a fundamental or systemic issue that, when addressed, will prevent the problem from recurring.
 - Example: Why wasn’t there a regular maintenance schedule? (The fifth answer might be a lack of a standardised maintenance procedure.)

The key is to go beyond addressing symptoms and get to the “heart of the matter” by identifying the root cause. By systematically asking “why” you can uncover hidden factors that contributed to the problem and implement corrective actions that address the underlying issues. In some cases, more or fewer than five “whys” may be needed to fully understand the complexity of a problem.

While time constraints during the audit process may prevent us applying detailed root cause analysis to each audit issue found, some consideration should be given to applying it to make more impactful audit recommendations.

Finding

Under the finding heading the audit observation should be clearly documented. It is likely to include the following elements.

- Clearly State the Finding – Begin each audit finding with a clear and concise statement. State the specific issue or observation identified during the audit.
 - Example: “During the audit, it was observed that [specific issue or deficiency].”
- Provide Context – Offer background information to help the reader understand the context of the finding. Include relevant details such as processes, transactions, or controls involved.
 - Example: “In the course of reviewing the [process/area], it was noted that [further details about the context of the finding].”
- Reference Criteria or Standards – Reference the criteria or standards used to assess the finding. This could include internal policies or legal requirements.
 - Example: “This finding is in contravention of IFRS, which requires [description of the expected compliance].”
- Quantify and Qualify the Impact – If possible, articulate the estimated impact of the finding on the organisation. If applicable, provide quantitative data or qualitative assessments of the severity of the issue.
 - Example: “It is estimated that this has cost approximately Rwf XXX billion based on sample testing conducted.” (based on audit testing and extrapolation if necessary)

- **Mention Supporting Evidence** – Provide supporting evidence or documentation that validates the finding. This could be in the form of audit test results, samples, or other relevant documentation.
 - Example: “A list of unsigned payment vouchers is included in Appendix 1.”
- **Identify Responsible Parties** – Clearly specify the individuals or departments responsible for the finding. This helps in assigning accountability and streamlining corrective actions.
 - Example: “The responsibility for addressing this finding lies with [specific department/individual], who is accountable for ensuring payment vouchers are signed.”

Implication

Discuss the potential risks associated with each finding and its impact on the organisation. For example, “Failure to implement payment controls as required by the payment policy may mean that payments are inappropriately actioned.”

Priority

Findings should be prioritised (High/Medium/Low) based on their severity and potential impact on the auditee. This helps management focus on addressing the most critical issues first, helps those charged with governance focus on the most critical issues and will help you write the executive summary later.

Recommendation

The recommendations made should be able to be easily used by management to improve systems going forward. You should consider the following elements when preparing your audit recommendations.

- **Be Clear and Specific** – Clearly state the recommended action in a concise and specific manner. Avoid vague language and ensure that the recommendation is easily understood.
 - Example: “It is recommended that [specific action] be implemented to address the identified deficiency.”
- **Link Recommendations to Findings** – Ensure that each recommendation directly corresponds to a specific audit finding. This helps in creating a clear connection between the issue identified and the proposed solution.
 - Example: “To rectify the lack of controls in [specific process], it is recommended that [detailed action] be established to mitigate the associated risks.”
- **Include Actionable Steps** – Break down the recommendation into actionable steps. Provide a roadmap or plan for implementation, detailing the sequence of actions to be taken.
 - Example: “To implement [recommended action], the following steps are suggested: [step 1], [step 2], [step 3].”
- **Specify Responsible Parties and Timelines** – If possible, clearly identify the individuals or departments responsible for implementing each recommendation. Include

realistic timelines for completion.

- o Example: "The [specific department or individual] is responsible for implementing the recommended changes by [specific date]."

Agreed Management Action

To include detailed management response included agreed management action with agreed date and manager responsible. Auditor comment should also be added here if appropriate after any verification work. Ideally, the final management letter will contain a detailed action plan that management can implement to correct audit issues identified.

Example – Detailed Audit Finding

Ref	Review Finding	Risk	Priority	Recommendation	NES Management Response
Reconciliation of IT Asset Register					
3.13	There is currently no reconciliation performed between the IT asset register held on the Employment Service System and the fixed asset inventories physically verified and recorded as part of the annual NES financial reporting process.	<p>NES IT Assets may be misappropriated.</p> <p>The asset balance in the balance sheet of NES may be misstated.</p>	High	A reconciliation should be performed on an annual basis between the IT asset register held on the Employment Service System and the asset registers (local and headquarters) used as part of the annual financial reporting process. For this to happen, all local offices will need to provide detailed inventories of assets held at year end including the IT asset registration numbers to NES Headquarters. All discrepancies in this reconciliation process should be fully investigated and appropriate action taken.	<p>Agreed Action: Yes</p> <p>Responsible Officer: IT sector & Budget Sector</p> <p>Implementation Date:</p>

Executive Summary

The Executive Summary is probably the most important part of any report; it is the bit that senior management are most likely to read and digest. This means that it is important

that we get it right.

While everyone has their own writing style, it is likely that the Executive Summary is the last thing to be prepared once the other elements of the report have been drafted, refined and finalised. The purpose of the executive summary is to condense that content into no more than two or three pages. Suggested content and what should be included is shown in the sections below.

Outline of the Audit

Start the executive summary with a concise introduction that outlines the purpose of the audit and the scope of the examination.

Example: "This executive summary provides a brief overview of the findings and recommendations resulting from the recent audit conducted on [specific area or process]. The audit aimed to assess compliance with [relevant laws or regulations] and identify opportunities for improvement."

Summary of Findings

Provide a synopsis of the information contained in the detailed findings sections of the report usually split by sub-heading. This will likely include:

- Highlight Key Findings – Summarise the most significant (i.e. focus on the "high" priority issues) audit findings in a few sentences. Focus on the findings that have the most substantial impact on the organisation.
 - Example: "The audit revealed several key findings, including [brief description of major findings]. These observations highlight areas where improvements are needed to enhance internal controls and mitigate associated risks."
- Provide a Snapshot of Recommendations – Briefly outline the main recommendations proposed to address the identified findings. Emphasise the positive impact that the implementation of these recommendations can have on the organisation.
 - Example: "To address the identified deficiencies, we recommend the implementation of targeted measures, such as [specific recommendations]. These actions are designed to strengthen internal controls and improve overall operational efficiency."
- Quantify and Qualify Impact – Summarise the overall impact of the audit findings and recommendations. If possible, quantify the potential benefits or risks associated with the identified issues.
 - Example: "The findings have been assessed for their impact on organisational objectives, with a focus on [specific goals]. Addressing these findings is crucial to mitigating risks and ensuring continued compliance with [relevant criteria]."
- Highlight Positive Aspects and Achievements – Acknowledge and highlight any positive aspects or commendable practices identified during the audit. This helps balance the tone of the summary and provides context for improvement areas.
 - Example: "While the audit identified areas for improvement, it's important to note the commendable practices observed in [specific areas]. These positive aspects demonstrate the organisation's commitment to [relevant goals or standards]."

- Address Timelines and Accountability - Mention any specific timelines for implementing recommendations and clarify accountability. Provide an overview of the proposed action plan to address the findings.
 - o Example: "The implementation of the recommended measures is advised within [specified timeline]. Accountability for these actions rests with [responsible departments or individuals], ensuring a timely and coordinated response."

Management Letter – Common Mistakes

Some common mistakes made in relation to management letters and possible ways to address these are shown in the table below.

Factor	Mistake	Solution
Lack of Clarity	Using complex language or unclear terms that make it difficult for the reader to understand the findings and recommendations.	Use clear and concise language, avoiding unnecessary jargon. Ensure that the message is easily understandable to a diverse audience.
Overemphasis on Negatives	Focusing excessively on weaknesses and deficiencies without highlighting positive aspects or areas of strength.	Maintain a balanced approach by acknowledging strengths and best practices alongside areas for improvement. This provides a more constructive and motivating tone.
Insufficient Evidence	Presenting findings without sufficient supporting evidence or documentation.	Include relevant evidence, such as test results, data, or documentation, to substantiate each finding.
Lack of Prioritisation	Failing to prioritise recommendations based on their urgency and potential impact.	Clearly indicate the priority levels of recommendations to guide management in addressing issues in order of importance.
Vague Recommendations	P r o v i d i n g recommendations that are too general or lacking specific actions.	Offer clear and actionable recommendations, specifying the steps management should take to address each finding. This helps in implementing solutions effectively.
Inadequate Root Cause Analysis	Identifying issues without a thorough analysis of their root causes.	Dig deeper to understand the underlying causes of identified issues. This ensures that recommendations address the root of the problem rather than just surface-level symptoms.

Factor	Mistake	Solution
Failure to Consider Management's Perspective	Overlooking or dismissing management's perspective on certain issues.	Encourage collaboration by considering and incorporating management's viewpoint. This fosters a more cooperative and effective resolution process.
Omission of Follow-Up Plan	Neglecting to outline a clear follow-up plan for monitoring the implementation of recommendations.	Clearly articulate expectations for follow-up, including timelines and methods for tracking progress. This ensures accountability and helps measure the impact of the recommendations.
Inconsistent Formatting	Inconsistencies in formatting, such as different fonts, styles or organisation throughout the management letter.	Maintain a consistent and professional format to enhance readability and convey a polished image.
Neglecting a Professional Tone	Adopting a tone that is overly critical or confrontational.	Maintain a professional and respectful tone throughout the letter. Focus on collaboration and improvement rather than assigning blame.

Follow Up

Auditors should always follow-up on material observations they have raised to ensure the issues that have been identified have been resolved by the audited entity. The auditor will typically perform this follow-up as part of the audit process of the subsequent year audit since unresolved prior year issues may represent risks of material misstatement of the financial statements of the subsequent year. The results of this follow up work are typically included in the management letter to report progress (or lack thereof!) to those charged with governance.

Audit Opinions

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework (e.g. IFRS). When forming that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall consider:

- The auditor's conclusion, in accordance with ISA 330, whether sufficient appropriate audit evidence has been obtained.
- The auditor's conclusion, in accordance with ISA 450, whether uncorrected misstatements are material, individually or in aggregate.

- The auditor's evaluation of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.
- The consistent application of those accounting practices by the auditee.
- If the accounting estimates made by management are reasonable.
- If the information presented in the financial statements is relevant, reliable, comparable, and understandable.
- If the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.
- If the terminology used in the financial statements, including the title of each financial statement, is appropriate.

In addition to detailed guidance on application, numerous examples of audit opinions are provided in ISA 700 to ISA 706. An example of typical audit opinion contents is provided in Unit 1 with an example of an unqualified opinion.

The Opinion

An auditor's opinion may be:

- Unmodified which is an unqualified or "clean" opinion;
 - Unmodified with Material Uncertainties regarding Going Concern or Emphasis of Matter(s) or Other Matter(s).
- Modified which can be:
 - Qualified.
 - Adverse.
 - Disclaimer opinions.

Unmodified Opinion

An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable FRF.

Auditors should draw users' attention to a matter or matters presented or disclosed in or outside the financial statements that are important for users' understanding of the financial statements or the auditor's report. These matters should be included in a "material uncertainties regarding going concern" or an "emphasis of matter(s)" or "other matter(s)" paragraph(s).

The auditor may select to issue an unmodified opinion with a "material uncertainties regarding going concern" or an "emphasis of matter" paragraph or with "other matter" paragraph. In this circumstance, the report will have to include a paragraph on the matter.

Under ISA 570, a Material Uncertainty Related to Going Concern section should be added to the audit report when there is a material uncertainty over the auditees ability to continue as a going concern and this has adequately been disclosed in the financial statements. This section should draw attention to the note in the financial statements which explains the material uncertainty, explain that a material uncertainty exists which

may cast significant doubt on the entity's ability to continue as a going concern, and that the audit opinion has not been modified in relation to this matter. Further detail on auditing going concern will be covered on the Strategic level course on Advanced Audit and Assurance.

An Emphasis of Matter paragraph refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

Examples of when an Emphasis of Matter paragraph is used:

- An uncertainty relating to the future outcome of exceptional litigation.
- Early application (in advance of its effective date) of a new accounting standard that has a pervasive effect on the financial statements.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.
- The need to properly disclose items in the financial statements:
 - Fraud, abuse or losses.
 - Significant internal control weaknesses.
 - Questionable business practices.
 - Prior period restatements.

Other Matter paragraphs include findings relating to matters relevant to the users of the report listed above (under the Emphasis of Matters paragraphs) but not presented or disclosed in the financial statements. Other matter paragraphs normally include control weaknesses or non-compliance with laws and regulations as applicable.

Modified Audit Opinions

The auditor should modify the opinion in the auditor's report when the auditor:

- Concludes that, based on the audit evidence obtained, the financial statements are not free from material misstatement.
- Is unable to obtain sufficient appropriate audit evidence.
- Determines that the auditee did not comply with responsibilities prescribed by the financial reporting framework to:
 - Achieve fair presentation of financial information.
 - Fulfil all requirements of the financial reporting framework.

Pervasive is a term used to describe the effects on the financial statements of misstatements or possible effects, if any, which are undetected due to an inability to obtain sufficient and appropriate audit evidence. Pervasiveness of the finding will determine the kind of modified audit opinion which will be issued. Pervasive effects on the financial statements are those that, in the auditor's judgement:

- Are not confined to specific elements, accounts or items of the financial statements.
- Represent or could represent a substantial proportion of the financial statements.
- Are fundamental to users' understanding of the financial statements.

The auditor should select the most appropriate modified opinion from the three options described below.

Option 1 – Qualified Opinion

A qualified audit opinion should be expressed when the auditor having obtained sufficient appropriate audit evidence concludes that there are material misstatements in the financial statements or if the auditor cannot obtain adequate evidence on aspects of the audit. Qualified opinion is issued when the misstatement or limitation on scope is not as material and pervasive as to require an adverse opinion or a disclaimer of opinion. It is expressed as being 'except for' the effects of the matter to which the qualification relates.

Option 2 – Adverse Opinion

An adverse opinion should be expressed when the effect of a misstatement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

Option 3 – Disclaimer Opinion

A disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient and appropriate audit evidence and accordingly is unable to express an opinion on the financial statements. A disclaimer opinion may also be issued considering the potential cumulative effect of uncertainties even when all audit evidence is received.

The decision on which type of modified opinion is appropriate depends upon:

- The nature of the audit finding (quantitative materiality).
- The extent of misstatement of the financial statements (quantitative materiality).
- The pervasiveness or the possible effects of the matter on the financial statements.

The issues informing which modified opinion should be given is summarised in the table below.

Nature of Matter Giving Rise to the Modification	Auditor's Judgement about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but not Pervasive	Material and Pervasive
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Exit Meeting

The auditor should hold formal discussions with the head of the audited entity and/or concerned officials on the audit findings and considerations noted during the audit.

This meeting is significant in the manner that additional information, explanations, documentary evidence are expected to be obtained from the management to make appropriate judgement on the audit findings. Such meeting can help the auditor in reconfirming or modifying the audit conclusions and enabling the auditor in making suitable modification in audit conclusions based on the management response.

Audit findings can be resolved after obtaining convincing replies, evidence or explanations from the management in the meeting. During the audit, the auditor at various stages will have communicated the audit findings and request for additional evidence to those responsible for resolving those findings. The outcome of the final meeting with the management and discussion minutes should be documented in the audit working files. Issues discussed should be written in the exit meeting minute to ensure that the auditee do not refute the issue later (e.g. When certain documents and information's are not available auditees later claim that those were made available for auditor's verification).

Quality Control Over the Audit Report

ISA 220 states that the Engagement Partner should take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirement, and for the auditor's report that is issued to be appropriate in the circumstances.

The audit engagement can be directed by informing members of the team of:

- Their responsibilities such as maintaining an objective state of mind, an appropriate level of professional scepticism and performing the work in accordance with due care.
- The nature of the entity's business.
- Risk related issues.
- Problems that may arise.
- The detailed approach to the performance of the engagement.

Engagement Partner responsibilities include:

- Tracking the progress of the engagement.
- Considering the capabilities and competence of members of the team, whether they have sufficient time, that they understand their instructions, and whether the work has been carried in accordance with the planned approach.
- Addressing significant issues as they arise, considering their significance and modifying the planned approach appropriately.
- Identifying matters for consultation by more experienced engagement team members during the engagement. Not just partner doing this, but all members of staff at different levels.

Review responsibilities are determined on the basis that the more experienced members of the audit engagement, review work performed by less experienced persons. The reviewers consider whether:

- The work has been performed in accordance with professional standards.
- Significant matters have been raised for further consultation.

- Appropriate consultations have taken place and the consultations have been documented and implemented.
- There is a need to revise the nature, timing and extent of the work performed.
- The work performed supports the conclusions reached and is appropriately documented.
- The evidence obtained is sufficient and appropriate to support the auditor's report.
- The objectives of the audit engagement procedures have been achieved.

Before the audit report is issued, the Engagement Partner, through review of the audit documentation and discussion with the engagement team, should be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the audit report to be issued.

Confidentiality and Security

As mentioned in Unit 1, ISA 200 identified the general requirement that auditors to maintain confidentiality during all audit engagements unless there is a legal or professional requirement or right to disclose. The confidentiality requirement applies to all information obtained by the auditor during the audit engagement, regardless of its form or medium. This includes information obtained from the client's records, discussions with management and staff, observations, and any other sources relevant to the audit.

Exceptions to this requirement include:

- Disclosure required by law, such as responding to a court summons or regulatory inquiry.
- Disclosure to a third party with proper authorisation from the client, such as when engaging specialists or obtaining legal advice.
- Disclosure in the public interest, such as reporting suspected fraud or illegal acts to appropriate authorities.

It is also vital that the auditor ensures that there are adequate security measures in place which maintain client confidentiality. In the absence of appropriate security measures, confidentiality will inevitably be at risk. Typical examples of such measures include:

- All audit files should be securely protected at all times – they will inevitably contain confidential information. They should never be left unattended at the client's premises or in an unsecured place. Care should be taken over information contained on portable storage devices such as memory sticks.
- Information stored on computers should also be subject to appropriate security measures to prevent unauthorised access, loss or corruption of data such as use of passwords, firewalls etc.

Summary of Unit F and key learning outcomes

After completing Unit F, you should be able to prepare draft reports for approval.

Ref	Learning Outcome	
F1	Prepare and submit clear and concise draft reports illustrating constructive and practicable recommendations in line with organisational procedures.	<p>Understand the main types of audit opinion and what circumstances each should be used.</p> <p>Understand the objectives of a management letter and key elements to be included.</p>
F2	Discuss preliminary conclusions and recommendations with the Engagement Partner and gain approval from the Engagement Partner.	Understand quality control processes throughout the audit with particular regard to the final audit report.
F3	Follow confidentiality and security procedures at all times.	Understand ISA requirements for confidentiality and suggest practical measures for ensuring confidentiality and security.

Quiz Questions

1	Learning Outcome: F1
Which of the following best describes an adverse audit opinion?	
A	The financial statements are presented fairly, except for a specific issue of material misstatement.
B	The auditor is unable to form an opinion on the financial statements due to significant limitations in scope
C	The financial statements present fairly, in all material respects, the financial position of the company.
D	The financial statements require additional disclosure to be presented fairly.

1	Feedback
A	No. This would be a qualified opinion.
B	No. This would be a disclaimer opinion.
C	No. This would be an unqualified opinion.
D	Yes! The financial statements are not true and fair.

2	Learning Outcome: F1
What is the primary purpose of an audit management letter?	
A	To provide a summary of the audit findings to shareholders.
B	To communicate significant audit findings and recommendations to management.
C	To request additional information from the audited organisation
D	To report on the financial performance of the audited organisation

2	Feedback
A	No. The management letter is not normally distributed to shareholders.
B	Yes!
C	No.
D	No. This is not the role of the auditor.

A). B). C. D)

3	Learning Outcome: F1
What is the primary purpose of an audit opinion?	
A	To communicate significant audit findings to management.
B	To provide recommendations for improving internal controls.
C	To express an independent auditor's conclusion on the fairness of financial statements.
D	To stipulate the terms of the audit.

3	Feedback
A	No. This is the management letter.
B	No. This is also the management letter.
C	Yes!
D	No. This would be the letter of engagement.

4	Learning Outcome: F2
Who is responsible for implementing quality control procedures over audit reporting within an audit firm?	

A	Audit clients
B	Audit team members
C	Audit engagement partners and firm leadership
D	Regulatory authorities.

4	Feedback
A	No. The auditee has no role in quality control of the audit. Independence!
B	No. Team members have a role to play but are not responsible for firm wide procedures.
C	Yes!
D	No. Regulatory authorities might set requirements – but implementation is down to the audit firm themselves.

5	Learning Outcome: F3
Who is responsible for ensuring the security of audit working papers?	
A	Only the audit engagement supervisor
B	Only the audit team members
C	Both the audit engagement supervisor and audit team members
D	Only the audit client.

5	Feedback
A	No. Both supervisor and all other team members.
B	No. Both supervisor and all other team members.
C	Yes!
D	No. The audit client has no role over audit working papers.

Quiz Answers

Question	Answer
1	D
2	B
3	C
4	C
5	C

Exercises

1. What are the key components of an audit report, and how do they contribute to the overall audit opinion?
2. How can the auditor ensure that the recommendations in the management letter are practical and feasible for implementation by the organisation?

Exercise Solutions

1. The key components of an audit report typically include:

- **Title:** The title usually includes the word “Independent” to highlight the auditor’s independence from the entity being audited. It often starts with “Independent Auditor’s Report.”
- **Addressee:** The report is usually addressed to the shareholders, board of directors, or other appropriate parties.
- **Introductory Paragraph:** This section identifies the financial statements that were audited, including the balance sheet, income statement, statement of changes in equity, statement of cash flows, and accompanying notes.
- **Management’s Responsibility:** The audit report typically includes a section outlining management’s responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
- **Auditor’s Responsibility:** This section describes the auditor’s responsibility to express an opinion on the financial statements based on their audit. It also explains the scope of the audit and the procedures performed.
- **Basis for Opinion:** The auditor provides a brief overview of the audit methodology and standards used, including any specific audit procedures performed. This

section helps stakeholders understand the basis for the auditor's opinion.

- **Opinion:** The auditor's opinion is the culmination of the audit process. It states whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in accordance with the applicable financial reporting framework.
 - **Emphasis of Matter Paragraph (if applicable):** This section highlights specific matters that the auditor considers relevant to users' understanding of the financial statements, such as significant accounting policies, uncertainties, or events subsequent to the reporting period.
 - **Other Matter Paragraph (if applicable):** Here, the auditor may include information that is relevant to users' understanding of the audit, such as reporting on compliance with regulatory requirements or reporting on supplementary information.
 - **Auditor's Signature and Date:** The audit report is signed by the auditor or audit firm, indicating their acceptance of responsibility for the audit opinion. It also includes the date of the report.
2. **Understanding Organisational Context:** Auditors familiarise themselves with the organisation's industry, operations, processes, and culture to gain insights into its unique characteristics and challenges. This understanding helps them tailor recommendations that are relevant and appropriate for the organisation's specific circumstances.
- **Consideration of Resources:** Auditors take into account the organisation's available resources, including financial, human, and technological resources, when formulating recommendations. They assess whether the organisation has the necessary resources to implement the recommendations effectively and consider alternative approaches if resource constraints exist.
 - **Engagement with Management:** Auditors actively engage with management throughout the audit process to gather input, validate findings, and discuss potential recommendations. By collaborating with management, auditors gain a deeper understanding of the organisation's capabilities and constraints, which informs the development of practical recommendations.
 - **Benchmarking and Best Practices:** Auditors may benchmark the organisation's practices against industry standards, regulatory requirements, and best practices to identify areas for improvement. They incorporate relevant benchmarks and best practices into their recommendations to ensure their practicality and feasibility.
 - **Consultation with Subject Matter Experts:** Auditors may consult with subject matter experts, both internally within the audit firm and externally, to validate findings and obtain insights into potential solutions. Subject matter experts provide technical expertise and practical guidance to help ensure the relevance and feasibility of recommendations.

- **Testing for Practicality:** Auditors assess the practicality of recommendations by considering factors such as their alignment with the organisation's strategic objectives, their ability to address root causes of issues, and their potential to deliver tangible benefits. They may conduct scenario analysis or pilot tests to evaluate the feasibility and potential impact of recommendations before finalising them.
- **Clear Communication:** Auditors communicate recommendations clearly and concisely in the management letter, providing sufficient context and rationale to facilitate understanding by management. They articulate the expected benefits of implementing the recommendations and outline the steps required for implementation to enhance their practicality. For example, during the exit meeting.

References and Further Reading

International Standards of Auditing – <https://www.iaasb.org/publications/2022-handbook-international-quality-management-auditing-review-other-assurance-and-related-services>

International Standards of Supreme Audit Institutions (Financial Audit) <https://www.issai.org/professional-pronouncements/?n=2000-2899>

2023 handbook of the international code of ethics for professional accountants – <https://www.ethicsboard.org/publications/2023-handbook-international-code-ethics-professional-accountants>

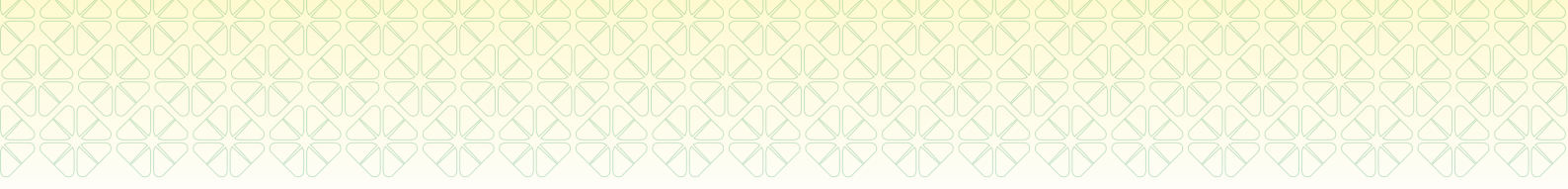
Institute of Certified Public Accountants of Rwanda (ICPAR) Code of Ethics – https://www.icparwanda.com/download_dir/14.pdf

Accreditation of External Auditors for Regulated Institutions – <https://www.bnr.rw/laws-and-regulations/regulatory-digest-market-consultation/regulatory-digest/accreditation-of-external-auditors-for-regulated-institutions/>

Rwanda Companies Act – <https://rdb.rw/notary/COMPANY-ACT-2021.pdf>

Institute of Internal Auditors – The Audit Committee – <https://www.theiia.org/globalassets/documents/about-us/about-internal-audit/the-audit-committee-internal-audit-oversight.pdf>







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