

AUDITING & ASSURANCE

ACF3600

Semester 2 - 2017

PREVIEW

Assertions

- Those charged with governance of an entity are responsible for ensuring that the financial report gives a true and fair view of the entity and its operations
- ASA 315 requires auditors to use assertions when:
 - assessing the *risk of material misstatement*; and
 - *designing the audit procedures*
- This means that auditors need to gather sufficient appropriate evidence about each assertion for:

1. Classes of transactions and events (P/L), and
2. Account balances at year-end (BS), or
3. Presentation and disclosure

Important for Final Exam!
Apply assertions to the case scenario questions

Classes of transactions and events

Assertions	Definition	Examples
Occurrence	Transactions and events that <i>have been recorded</i> have <i>occurred</i> and pertain to the entity	Sales recorded in the account represent goods that were shipped to customers during the period
Completeness	All transactions and events that <i>should</i> have been recorded <i>have been recorded</i>	All goods shipped to customers during the period are recorded in the accounts
Accuracy	Amounts and other data relating to recorded transactions and events have been recorded <i>appropriately</i>	Sales amount and other data are recorded properly
Cut-off	Transactions and events have been recorded in the <i>correct accounting period</i>	All sales transactions arising before the period end are recorded in the current period and those arising after the period are included in the next period
Classification	Transactions and events have been recorded in the <i>proper accounts</i>	Sales are recorded in the correct amount

Account balances at year-end

Assertions	Definition	Examples
Existence	Assets, liabilities and equity interests <i>exist</i> in the business	<ul style="list-style-type: none"> • Inventories included in the balance sheet <i>physically</i> exist • Inventories represent items held for sale in normal course of business
Rights & obligations	The <i>entity holds or controls the rights to assets, and liabilities</i> are the obligations of the entity (Assets & liabilities)	<ul style="list-style-type: none"> • The company has legal title or similar rights of ownership obligations to the inventories • Inventories exclude items billed to customers or owned by others
Completeness	All assets, liabilities and equity interests that should have been recorded have been recorded	<ul style="list-style-type: none"> • Inventory quantities as per the accounting records include all products, materials and supplies owned by the company that are on hand

		<ul style="list-style-type: none"> Inventory quantities include all products, materials and supplies owned by the company that are in transit or stored at outside locations
Valuation and allocation	Assets, liabilities and equity interests are included in the financial report at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded	<ul style="list-style-type: none"> Inventories are properly stated at cost (except when the allocation net realisable value is lower) Slow-moving, excess, defective and obsolete items included in inventories are properly identified and valued

Presentation and disclosure

- Relate to the disclosure themselves, not the underlying asset, liability, equity, revenue or expense items

Assertions	Definition	Examples
Occurrence, rights and obligations	Disclosed events, transactions and other matters have <i>occurred</i> and pertain to the entity	Disclosed payroll events have occurred and pertain to the entity
Completeness	All disclosures that <i>should have</i> been included in the financial report <i>have been</i> included	Accrued payroll liabilities are properly identified and classified in the financial statements
Classification and understandability	Financial information is <i>appropriately presented</i> and described, and disclosures are <i>clearly expressed</i>	Payroll information is appropriately presented and information disclosed is clearly expressed
Accuracy and valuation	Financial and other information are disclosed <i>fairly</i> and at <i>appropriate</i> amounts	Payroll information is disclosed accurately and at appropriate amount

Types of audit evidence

- Evidence is the information that an auditor uses when *arriving at their opinion on the truth and fairness of the client's financial report*

High-risk Account

Audit risk = f	Inherent risk	Control risk	Detection risk	Evidence
	High	High	Low	High

Substantive approach

Low-risk Account

Audit risk = f	Inherent risk	Control risk	Detection risk	Evidence
	Low	Low	High	Low

Control approach

Important to understand when, and what, approach to use

Types of evidence	Examples
Sufficient appropriate audit evidence	<ul style="list-style-type: none"> • Auditor must gather sufficient & appropriate evidence <ul style="list-style-type: none"> - Sufficiency = <i>quantity</i> of evidence - Appropriateness = <i>quality</i> of evidence
External confirmations	<ul style="list-style-type: none"> • Auditor <i>requests third party to confirm</i> matter in confirmation letter <u>Example:</u> Banks confirm cash balances etc./lawyers confirm documents being held/creditors confirm amount owed/debtors confirm amount owed to client • Negative form: reply if information is incorrect (hard to interpret non-response) • Positive form: reply in all circumstance (cannot know how well other party checked their records)
Documentary evidence	<ul style="list-style-type: none"> • Invoices, suppliers' statements, bank statements, minutes of meetings, correspondence, legal agreements • Cannot be internally or externally generated
Representations	<ul style="list-style-type: none"> • <u>Legal representation letter</u> is sent by client to its lawyers (includes opinions on legal matters, details of disagreements with client) • <u>Management representation letter</u> contains acknowledgement of management's responsibilities, undertaking about legal compliance, confirmation of discussions
Verbal evidence	<ul style="list-style-type: none"> • Auditor <u>documents</u> discussions with client, management and staff • Used to gain <u>understanding of internal controls</u>; corroborate other evidence
Computational evidence	<ul style="list-style-type: none"> • Auditor checks mathematical accuracy • Re-adding entries • Verifying formulae
Physical evidence	<ul style="list-style-type: none"> • Gathered inspection of a client's <u>tangible</u> assets
Electronic evidence	<ul style="list-style-type: none"> • Includes data held on client's computer, emails to auditor, and scans and faxes

Persuasiveness of audit evidence

1. Internally generated evidence (least persuasive)

- Includes
 - Records of cheques sent
 - Copies of invoices and statements sent to customers
 - Purchase orders
 - Contracts, minutes of meeting
 - Journals, ledgers, trial balances, spreadsheets, worksheets, reconciliations
- Can be held in paper or electronic form
- Least persuasive because it is possible that client could manipulate or omit this type of evidence

2. Externally generated evidence held by the client

- Includes
 - Supplier invoices and statements, customer orders, bank statements, contracts
- Originals are more persuasive than photocopies
- More persuasive than internally generated evidence because it is produced by third parties, however still possible that client could omit or tamper with evidence

3. Externally generated evidence sent directly to the auditor

- Includes
 - Bank confirmations, debtors' confirmations, correspondence with client's lawyers, experts valuations
- Most reliable type of evidence because it is independent of client
- Client has no opportunity to alter evidence

Using the work of an expert

Auditor may engage expert to help in audit when auditor does not possess required skills and knowledge to assess item. Expert could be member of audit team, audit firm, client, or independent

Steps to consider:

1. Assessing the need to use an expert

- Significance and complexity of item being assessed

2. Determining the scope of the work to be carried out

- Auditor must set nature, timing and extent of work

3. Assessing the capability of the expert

- Expert's qualifications
- Membership of professional body
- Reputation in the field
- Experience

4. Assessing the objectivity of the expert

- To form an opinion
- Arrive at a conclusion without the influence of personal preferences
- More objective if they are not associated with the client

5. Assessing the expert's report

- Report should be understandable to non-expert
- Include process, assumptions, data used by expert
- Auditor must consider consistency with other information

6. Responsibility for the conclusion

- Auditor to assess the quality of the evidence provided by an expert and determine whether it is reliable and objective

Evidence gather procedures

Procedure	Example
<i>Inspection of records and documents</i>	For evidence of authorization and to check amounts
<i>Inspection of tangible assets</i>	To see if they exist, their condition and to trace to records
<i>Observation of client staff</i>	Test to see if they conduct stock take correctly
<i>Enquiry</i>	Useful for gaining understanding, or to corroborate other evidence; auditor will document conversation
<i>Recalculations</i>	To check mathematical accuracy
<i>Re-performance</i>	Follow the process used by client
<i>Analytical procedures</i>	Relationship between data

PREVIEW

Types of controls

- Controls have two main objectives:
 1. To prevent or detect misstatements in the financial report
 2. To support the automated parts of the business in the functioning of the controls in place

Prevent and detect controls:

Prevent controls

WCGW	ASSERTION	PREVENT CONTROL
Sales occur that are not recoverable	Occurrence Existence	The computer program will not allow a sale to be processed if a customer has exceeded its credit limit
Fictitious employees are paid	Occurrence	Amounts are not able to be paid to employees without first matching a valid tax file number to the employee master file
Sales are recorded at an incorrect value	Accuracy	Sales invoices are automatically priced using the information in the price master file
Transactions are classified and coded to incorrect accounts	Classification	The account coding on each purchase order is checked by the computer to a table of valid account numbers, and then various logic tests are performed by the computer

Detect controls

WCGW	ASSERTION	DETECT CONTROL
Cash is received but no recorded in the general ledger, payments are made but not recorded, cash receipts or cash payments are not real or not recorded on a timely basis	Completeness Occurrence Cut-off	Bank reconciliations and follow-up of unexpected outstanding items (e.g. unexpected or large deposits not yet cleared by the bank, cheques presented by the bank but not recorded in the general ledger)
Shipments not billed and recorded, and billings are not related to the actual shipments of product	Completeness Occurrence	The computer performs a daily comparison of the quantities shipped to quantities billed. If differences are detected, a report is generated for review and follow-up by the billing supervisor
Unrecorded billings and errors in classifying sales or cash receipts	Completeness Classification	Quarterly reviews of credit balances in accounts receivable to determine their causes
Among other things, errors in the number of units or unit prices being calculated or applied incorrectly	Accuracy	The sales manager reviews daily shipments, total sales, and sales per unit shipped

Manual and automated controls:

Manual controls

- Purely *manual* controls do not rely on IT for operation
e.g. locked cage for inventory
- Could rely on IT information from others
e.g. reconcile stock count to computer generated consignment stock statements

Automated controls

- *IT General Controls (ITGCs)*
 - Support functioning of automated controls
 - Provide basis for relying on electronic evidence in audit
- Types of ITGCs:
 - Program change controls
 - Logical access controls
 - Data back-up
- *Application controls* apply to processing of individual transactions, support segregation of duties
 - Edit checks, validations, calculations, interfaces, authorisations

IT dependent manual controls

- Has both manual and automated characteristics
- E.g. management reviews a monthly variance report (automated) and follows-up (manual) on significant variances
 - Auditor must consider both aspects – report generation and management follow-up
 - Consider controls over report generation – is report accurate and complete? If not, follow-up will not be effective

Techniques for *testing controls*

1. Enquiry
 - auditor questions employee performing control, management about review of control
2. Observation
 - Auditor observes actual control being performed (*employee might be more diligent when observed*)
3. Inspection of physical evidence
 - Trace from reconciliation to accounting records or other documents
 - Examine reconciling items to determine whether reconciliation detects error and action to deal with errors
4. Re-performance
 - Auditor re-performs control (e.g. prepares reconciliation)

Selecting and designing tests of controls

1. WHICH CONTROLS SHOULD BE SELECTED FOR TESTING?

- Select controls that will provide most efficient and effective audit evidence
 - Increase efficiency by only testing controls that are critical to audit opinion (*those that address the WCGWs most effectively with least amount of testing*)
 - More efficient to *test controls that address multiple WCGWs*

2. HOW MUCH TESTING DOES THE AUDITOR NEED TO DO?

Extent of testing based on statistical sampling or professional judgment. Consider:

- How often is control **performed**? *More often = more testing*
- Degree of **reliance on control**. *More = more testing*
- **Persuasive** of evidence from testing. *More = less testing*

Application controls – test using these methods:

Test operating effectiveness

- Test manual follow-up procedures that support the application control
e.g. investigate how client follows up on computer generated exception report for sales with no prices in master file

Test controls over program changes, and/or access to data files

- Test ITGCs
e.g. test controls to ensure that all changes to pricing master file are approved

Benchmarking

- Carry forward benefit of certain application controls testing into future audit periods
- Computer will continue to perform procedure in same way until application program is changes
- Verify that there are no changes to program, no need to repeat audit procedures. More likely when:
 - Specific program can be identified
 - Application is stable
 - Reliable record of program changes available

Timing of test of control

- Usually at interim date, especially if controls relied upon to reduce substantive procedures
- Preferable to test entity level controls and ITGCs early in audit because results impact other tests
- Update interim results and evaluation at year-end