

## ACCT3600 Accounting & Auditing in Practice

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# Week 1. The value of an audit, auditor ethics & independence

**Assurance engagements:** defined as an engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence. **5 elements** of an assurance engagement:

1. Three-party relationship (assurance practitioner, responsible party, intended users)
2. Underlying subject matter
3. Criteria
4. Sufficient appropriate evidence
5. A written assurance report

3 Types of assurance engagement:

1. Reasonable assurance engagement → for services on historical information, a *reasonable* assurance engagement is termed as an **audit**
2. Limited assurance engagement → a *limited* engagement is termed a **review**
3. Agreed-upon procedures → not deemed to be an assurance nature as the auditor only issues a report of factual findings, in which no conclusion is communicated and expresses no assurance. Can only undertake evidence-collection procedures agreed upon

**Audit** → the purpose of an audit and the auditor's opinion is to **enhance the degree of confidence of intended users of financial information** (ASA 200.3). The audit report expresses an opinion as to whether the financial report is prepared in accordance with an applicable financial framework. If free from material misstatement: **Unqualified Opinion**. Otherwise: Qualified Opinion. **Users should not assume** the auditor's opinion is an assurance of the entity's future viability. Auditors could be liable for negligence though.

Why have audits:

- Conflicts of interest - preparers and users
- Consequences
- Complexity of information
- Remoteness of owners: agency theory/ stewardship hypothesis

**Responsibility of auditors: Corporations Act 2001** → Report an opinion to the members of the company on the financial report presented by the directors at the annual general meeting.

Australian Securities and Investments Commission (ASIC) Act 2001 establishes Financial Reporting Council (FRC) which oversees operations of Auditing and Assurance Standards Board (**AUASB**). The Accounting Professional and Ethical Standards Board (**APESB**) issues

**APES110 Code of Ethics for Professional Accountants: auditors must act in the public interest. 5 principles:**

- **Integrity**
- **Objectivity**
- **Professional competence and due care**
- **Confidentiality**
- **Professional behaviour**

**Professional Scepticism:** the auditor shall plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial report to be materially misstated.

**Auditor Independence** → **perceived independence and actual independence.**

**5 threats to auditors independence:**

- **Self interest**
- **Self-review:** when an auditor evaluates a situation that is a consequence of a previous judgment by the auditor or the auditor's firm. E.g. auditor was recently the director, or the original preparer of records.
- **Advocacy:** when the auditor promotes a position or opinion to the point where subsequent objectivity may be compromised. (This occurs when the auditor is asked to promote or represent their client in some way. In this situation the auditor would have to be biased in favour of the client and therefore cannot be objective. This could happen if the client asked the auditor to promote their shares for a stock exchange listing or if the client asked the auditor to represent them in court.)
- **Familiarity:** auditors become too sympathetic to the interests of another party because of a close relationship, or acceptance of gifts.
- **Intimidation:** when an auditor's actions may be compromised by actual or perceived threats.

# Week 5. Testing Internal Controls. Use of Experts. Substantive testing examples.

**Internal control:** improve both the quality and efficiency of business operations and reporting the prime responsibility for implementing and monitoring internal controls of a client's management. Auditors are required to understand and evaluate the internal control at both the planning stage and the detailed evidence collection stage of the audit (ASA 315.12)

Categories:

- Information processing controls (week 7)
  - **General controls**
  - **Application controls**
- Other internal controls (week 5)
  - **Segregation of duties**
  - **Manual accounting controls**
  - **Physical controls**
  - **Performance reviews**

**Assessing control risk: control risk will be determined as high if**

- Control do not exist
- Controls that do exist will not provide reliable evidence, or
- It is more efficient or effective to gather the required evidence by undertaking substantive testing

**If control risk is high → will not undertake test of controls**, except where substantive procedures along do not provide sufficient evidence.

## **Test of controls**

**If control risk is less than high → must gather evidence through test of control** to see whether controls are actually working.

**Basic types of internal control activities**

- **Independent approval, review, checking or recalculation**
  - Authorisation of purchase or sales invoices
  - Recompilation of arithmetic on vouchers
  - Subsequent review of individual transactions
- **Matching of independently generated documents**
  - Matching of sales invoices and shipping documents
  - Matching of purchase invoices and receiving reports

- **Prenumbering** and sequence checking of key account
  - Pre-numbering shipping documents, sales invoices, cheques, vouchers...
- **Maintenance of independent control totals**
  - Recording of cash receipts total before banking
  - Use of batch controls: can help accountants avoid trans-posting
  - Use of control accounts

Test of control procedure 4 types: (must be performed at various times during the audit year)

- Make **inquiries** of appropriate client personnel
- **Inspect** documents, records and reports
- **Observe** control-related activities
- **Re-perform** client procedures

Sales cycle → revenue, receivables and receipts. Commonly characterised by a high volume of routine transactions.

Two levels of internal control: examples for cash (1,2) and suppliers invoice (3,4)

1. **Preventative control:** a staff member is responsible for preparing the bank reconciliation for the cash account on a daily, weekly, or monthly basis.
2. **Detective control:** an independent and senior staff is now responsible for reviewing the bank reconciliation to ensure the quality and completion of the process
3. **Preventative control:** staff member signs supplies invoice that goods were actually received
4. **Detective control:** separate staff only processes an accounts payable invoice from supplier where a delivery note is attached to supplies invoice or where a staff has **signed the invoice to evidence** the receipt of the goods or service.

Aspect	Definition	How tested
Existence	Whether prescribed internal control procedures actually exist. For example, if a clerk is supposed to verify the mathematical accuracy of an invoice, does he/she actually perform the verification?	Existence is normally identified when evaluating the design of the internal control policy and activities, using the audit procedures outlined in Chapter 7 under 'Assessing control risk'.
Effectiveness	Whether the control is operating effectively. That is, does the control prevent or detect the misstatements that it is designed to prevent or detect?	Effectiveness is usually evaluated as part of the tests of controls. Procedures include re-performing the control (e.g. checking the price, quantities and maths on invoices) and sighting documents to see that controls were complied with (e.g. checking that a voucher contains supporting documentation). If the control is programmed, such as checking authorisation codes, run unauthorised transactions through the program to make sure they are correctly identified and excluded.
Continuity	Whether the control operated throughout the period of intended reliance. For example, if the control was operational for only part of the year, then no reliance can be placed on the control for the period when it was not operating.	Continuity is usually evaluated as part of the tests of controls. This is usually achieved by ensuring that the sample of transactions to be tested is selected from throughout the year.

Note: The auditing standards refer to effectiveness and continuity as 'operating effectiveness'.

**Payroll examples:** identify the key assertion at risk and design a practical substantive test to validate this assertion

- 1. Tests for payroll payments to non-existent employees: occurrence** → select a sample of paid employees from a number of payroll reports, and validate with the existence of a complete HR file/ time sheets to evidence weekly work/ bank details in the HR file agree to the payroll disbursement report
- 2. Tests for fraudulent hours worked: occurrence** → from the weekly payroll register, select a sample of time sheets for employees and evidence of correct completion and/or review employee approved leave periods and ensure no normal weekly earning have been paid
- 3. Tests for incorrect pay rate applied: accuracy** → select a sample of paid time sheets and perform re-calculations OR agree the pay rates used to approved HR pay rates list OR agree gross, tax and net pay calculations and any employee approved deductions

## Week 6. Revision for MSE

- **Substantive procedures** are performed to obtain evidence about the validity and the propriety of the accounting treatment of transactions and balances or, conversely, of errors or irregularities therein.
- **Substantive Analytical procedures** involve undertaking analytical procedures to determine the amount of misstatement in an account balance. For example, total sales commission expense can normally be estimated from total sales revenue, rather than from the details of entries in the sales commissions account.
- **Test of balances:** Are tests applied directly to the details of balances in general ledger accounts. For example, the balances in the accounts receivable ledger are confirmed with individual customers
- **Test of transactions:** The auditor tests the processing of individual transactions by inspecting the relevant documents and accounting records. For example, a sample of shipping documents is traced to the sales journal to see whether shipments have been recorded as sales.

Key A/C	Internal Control	Test of Control	Substantive procedure	Assertion addressed
Sales	Policy of attaching shipping documents to sales invoices	Inspect a sample of sales invoices and check if for every invoice there is a corresponding shipping document attached.	Select a sample of sales from sales journal, for each transaction trace to shipping documents and cash receipts	Occurrence
Sales	Shipping documents and packing slips are pre-numbered and sequence accounted for	Test numerical sequence and review the evidence (e.g. staff initials) of accounting for numerical sequence of shipping documents	Select a sample of delivery notes or packing slips and check if the sales transactions are recorded	Completeness

<b>Key A/C</b>	<b>Internal Control</b>	<b>Test of Control</b>	<b>Substantive procedure</b>	<b>Assertion addressed</b>
<b>Inventory</b>	Policy of always keeping an internal security door locked to prevent theft of small & high value inventory items	Random checking if the security door is locked at all times	Select a sample of inventory items from the Inventory subledger in that location noting Qty, and perform a stocktake	<b>Existence</b>
<b>Wages expense</b>	All entries to the wages expense journal are initiated by a timesheet that is signed by the employee's supervisor	Check that for each entry in the journal there is a signed timesheet	Select a sample of transactions from wages expense and trace to supporting documents contained in the HR file and relevant timesheets	<b>Occurrence</b>

### **Substantive Analytical Procedures requirements**

- **Determine the suitability** of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details 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**
- **Determine the amount of any difference**